Unrelated Business Income: Common Traps

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Debt-Financed Income

Income from Controlled Entities

Royalties

Questions
Unrelated Debt-Financed Income

• Any property held to produce income to which there is an acquisition indebtedness at any time during the taxable year \([\$514(b)(1)]\)
  – Property held to produce income
    • Dividends, rents, royalties, interest, gains, etc.
  – Property with acquisition indebtedness:
    • At any time during the tax year
    • During the 12 month period ending with the date of disposition
  – Direct tracing rules apply
Exceptions to debt financed property:

- Property that is substantially used (85% or more) to further the exempt purpose of the organization
- Property to the extent the income is already taxed as UBI
- Property to the extent its income is derived from research activities excluded from UBI
- Property to the extent it is used in a trade or business to which the volunteer, convenience, or donated property exception applies
- Property acquired for future exempt organization use (e.g. neighborhood land)
Unrelated Debt Financed Income (cont.)

- Acquisition indebtedness [§514(c)]
  - Indebtedness is not defined in the IRC or Regulations – look to the substance of the transaction
  - Indebtedness incurred in connection with acquisition of property (no matter how acquired), whether incurred before, at the time of or after acquisition
    - Uses “but for” concept
    - Exceptions for gifted property
    - Liens similar to mortgages are treated as acquisition indebtedness
Unrelated Debt Financed Income (cont.)

- Exceptions to treatment as acquisition indebtedness provided for
  - Certain donated property acquired by gift, bequest or devise which is subject to debt
    - 10 year period following the date of acquisition (testamentary) or date of gift (inter vivos)
  - Debt incurred in performing exempt purpose
    - Indebtedness incurred to acquire investment assets is not considered exempt function, with limited exceptions
  - Charitable gift annuities
    - Obligation to pay the annuity does not constitute acquisition indebtedness if certain requirements are met
Unrelated Debt Financed Income (cont.)

• Educational institution exception
  – IRC Sec. 514(c)(9): certain debt incurred by an educational institution, qualified plan or multiple-parent title holding company to acquire or improve real property is not treated as “acquisition indebtedness”. This includes:
    • Educational organizations described in IRC Sec. 170(b)(1)(A)(ii)
    • Affiliated support organizations described in IRC Sec. 509(a)(3) of educational organizations
      – State University Foundations: IRC Sec. 170(b)(1)(A)(iv) may qualify if described in IRC Sec. 509(a)(3)?
      – SMLLC of an affiliated support organization also eligible for the exception
Unrelated Debt Financed Income (cont.)

- Amount included in UBI is proportionate to the debt associated with the property
  - Taxable amount = Gross Receipts x Average Acquisition Indebtedness / Average Adjusted Basis
    - Average Acquisition Indebtedness is the average amount of principal indebtedness on the property during the portion of the year the property is held
    - Average Adjusted Basis is the average of the adjusted basis of the debt-finances property on the first day of the year and the last day of the year
- In the case of the sale of property, you look to the highest balance on the debt in the 12 months preceding the asset sale.
Special Rules

- Changes in the use of the property
  - Exempt use to nonexempt use and vice versa
  - Look at outstanding principal as of the day of the change in use

- Continued indebtedness
  - Debt-financed income taint continues if proceeds from the sale of assets purchased with indebtedness are used to purchase other income producing assets

- Interorganizational indebtedness may not be “acquisition indebtedness”: See Rev Rul 77-72
  - Matter of accounting between 2 organizations
  - Use of existing resources, rather than borrowed funds, to advance funds to subsidiary
Unrelated Debt Financed Income (cont.)

- Special Rules (cont.)
  - Securities lending [§514(c)(8) and §512(a)(5)]
    - Exception does not apply when securities are pledged as collateral for a loan (see Kern County Elec. Pension Fund v. Comr)
    - Short sales do not generate debt-financed income (see Rev Ruls 95-8 and 78-88)
    - Purchase of securities on margin is generally debt-financed income (see Henry E. Bartels and Nancy Horton Bartels Trust v. US)
Unrelated Debt Financed Income (cont.)

• Special Rules (cont.)
  – Short term financing
    • Exceptions for pension funds using short-term borrowings to meet benefit payout requirements (see PLRs 200320027; 200235042; 200010061; 9644063; 9637053; 8721104; 8721107)
    • But see Regs 1.514(a)-1(a)(3) – fraction of a month shall be treated as a full month
  – Pledges and guarantees
    • If assets are pledged post acquisition and not using debt, then likely not acquisition indebtedness (see Rev Rul 70-132; PLRs 8008171, 8807082)
  – Installment sales
    • Use debt/basis percentage from the year of the sale
Unrelated Debt Financed Income (cont.)

- Property held by partnerships
  - Exempt organization partner must take into account its distributive share of partnership’s income and deductions
  - Debt held by the partnership to acquire income producing assets as well as debt incurred in order to purchase the partnership investment will likely generate debt-financed income unless an exclusion applies

- Blocker Corporations are sometimes used to avoid debt-financed income
  - However, need to also consider debt incurred to purchase stock of blocker corporation
Income from Controlled Entities
Income From Controlled Organizations

• Interest, annuities, rents, or royalties received from a controlled organization constitutes unrelated business income [IRC Sec. 512(b)(13)]

• Dividends received from controlled entities are not subject to 512(b)(13)

• Control threshold is “more than 50%”
  – Stock: vote or value
  – Partnership: profits or capital interest
  – Any other entity: beneficial entity
  – Apply attribution rules of IRC Sec. 318
Income From Controlled Orgs (cont.)

• Exception
  – Not UBI if a non-exempt subsidiary’s activity would be exempt if conducted directly by an exempt parent [Reg. §1.512(b)-1(l)(3)]

• Allows for the proper matching of income and deductions within controlled entity group

• Deductions directly related to income are also allowed

• Apply transfer pricing requirements of IRC Section 482
  – Value transactions at fair market value
Income From Controlled Orgs (cont.)

- FMV exception for certain payments [§512(b)(13)(E)]
  - UBI only applies to amount that exceeds FMV
  - Binding contract 08-17-06
  - Received after 2005 and before December 31, 2013
    - Extended as part of the American Taxpayer Relief Act of 2012
A §501(c)(3) educational organization (EO) licenses the right to use its name and logo to a taxable subsidiary (TS) that produces a television show. TS pays EO $100,000 annually in royalties. TS had taxable income for the year of $900,000.

- $100,000 royalty is UBI
- Apply IRC 512(b)(13) first, then apply IRC 514: Regs. 1.512(b)-1(l)(5)(ii)
Income From Controlled Orgs (cont.)

- A §501(c)(3) educational organization (EO) has a taxable subsidiary in the publishing business.
- It publishes the EOs magazine (an activity that would not be UBI to the EO).
- The subsidiary pays a royalty for the use of the EO’s name and logo.
- The portion of the royalty allocable to the magazine would not be UBI.
Royalties
ROYALTIES

• Royalties and all deductions directly connected with royalty income are excluded from UBI under §512(b)(2).

• In general, a royalty is the payment for the use of a right regardless of whether the property represented by the right is used.

• For tax-exempt organizations, it is generally income from the right to use an intangible asset, e.g. organization’s logo, name, trademark, mailing list, etc.
Revenue Ruling 69-430

• Exempt organization (EO) owns the rights to publish a book, the publication of which does not contribute to EO’s exempt purpose
  – Situation 1: to commercialize the book, EO arranged for the printing, distribution, and retail sale of the book, including publicity and advertising. Income is UBI
  – Situation 2: EO transferred the publication rights with respect to the book to a commercial publisher in return for royalties. Income is excluded from UBI
Revenue Ruling 81-178

• To be a royalty, a payment must relate to the use of a valuable intellectual property right.
  – i.e. trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property

• Royalties do not include payments for personal services
  – For income from the performance of services to be exempt from UBIT, the services must be “substantially related” to the organization’s exempt purposes
MAILING LISTS AND AFFINITY CARDS

• Affinity Card Program
  – A tax exempt organization receives a portion of the revenues derived by a credit card issuer from marketing its credit card to the organization's members
  – The organization licenses its membership or mailing lists to the issuer under an agreement that usually includes using the name and logo of the organization on any issued credit cards
Focus is on active versus passive nature of the revenue generated

Several pro-taxpayer decisions
  - The income is royalty income, which is excluded from unrelated business taxable income, and is not considered payment for services

Historically IRS has argued that if significant services are provided by the exempt organization, the passive royalty treatment is tainted.
OREGON STATE ALUMNI ASSOCIATION AND ALUMNI ASSOCIATION OF THE UNIVERSITY OF OREGON V. COMM. (193 F.3d 1098 1999)

• The court determined that the organization’s involvement in the credit card program and solicitation was de minimis and the payment was deemed to be a passive royalty received in exchange for the use of an intangible property right

• Ninth Circuit rejected the IRS’s “all or nothing” approach that any service would taint all of the resulting income
ARKANSAS STATE POLICE ASSOCIATION, INC. V. COMM. (T.C. Memo 2001-38)

- Association entered into an agreement to have an outside publisher produce a magazine 3 times a year
- The publisher solicited all advertising and was primarily responsible for editorial content
- The Association’s Vice President for Public Relations spent 15-20 hours per year on the magazine
- The Association was paid a royalty consisting of a flat fee plus a percentage of the advertising revenue
- The Court of Appeals for the 8th Circuit concluded that the revenue was UBI (282 F.3d 556 2002)
QUESTIONS
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Jeff holds a B.S. in Accounting from Indiana University and an M.S. in Taxation from Drexel University. Jeff is the Chair of the AICPA Exempt Organizations Tax Technical Resource Panel and serves on the AICPA Non-Profit Organizations Conference Steering Committee. He is also an emeritus member of the IRS Employee Plans TE/GE Council for the Great Lakes Region and is a board member and treasurer at Dress for Success Indianapolis.
Kristina Rasmussen is a Senior Manager in the Minneapolis office of Deloitte Tax LLP. She is currently supporting Deloitte’s Washington National Tax Practice as a specialist in tax matters related to tax-exempt organizations. She has over fourteen years of experience working with not-for-profit clients including public charities, private foundations, higher education institutions, health care organizations, other tax-exempt organizations, and public sector organizations as well as related taxable entities. Kristina has assisted a diverse group of clients working on a variety of issues related to the not-for-profit industry including unrelated business income issues, tax-exempt status qualifications, IRS Coordinated Examination Program (CEP) audit issues, and tax risk assessments. Kristina received her Bachelor of Arts degree in Accounting and Master of Business Administration degree from the University of St. Thomas in St. Paul, MN. She is an associate member of the AICPA Exempt Organizations Tax Technical Resource Panel.
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