



# Unrelated Business Income and Other IRS Recent Developments

Brian Todd, CPA, Partner

Mike Engle, CPA, Partner



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# Agenda

- Recent Developments
  - College and University Compliance Report
  - Camp Tax Proposal
  - Advisory Committee on Tax Exempt and Government Entities (ACT) Report on Unrelated Business Income Tax Compliance
- Unrelated Business Income
  - Common activities
  - Deductions and credits
- IRS Examination Activity



# RECENT DEVELOPMENTS



# IRS College & University Compliance Report

- Final report issued in 2013
- Sent questionnaires to around 400 tax-exempt colleges and universities
- Questionnaire topics
  - Demographic information
  - Exempt activities
  - Unrelated business income (UBI)
  - Endowment funds
  - Executive compensation
  - Endowment funds
- 34 audits conducted as a result



# IRS College & University Compliance Report

- Exams were designed to focus on executive compensation and UBI
- Exams found widespread noncompliance relating to reporting UBI
- Focused on characterization of income, methods for allocating expenses, recurring losses, and application of modifications and exceptions



# IRS College & University Compliance Report

- Results
  - Increases to unrelated business taxable income for 90% of organizations examined totaling about \$90 million
  - Disallowance of more than \$179 million in losses and NOLs
- Primary reasons for adjustments
  - Misclassification as trade or business: lack of profit motive
  - Misallocation of expenses
  - Errors in computation
  - Misclassification of related activities





# IRS College & University Compliance Report

- Lack of profit motive
  - Most common reason for disallowance
  - IRS disallowed losses in 70% of the examinations
  - Total amounted to more than \$150 million
- Review of UBI reporting
  - IRS also looked at whether advice was sought on UBI-related matters



# Camp Tax Proposal

- Released on February 26 by Ways and Means Committee Chairman Dave Camp
- 1,000 pages long
- Five topics of interest for tax-exempt organizations





# Camp Tax Proposal

- Charitable Contributions
  - Establishes 2% floor on individual tax returns
  - Election to treat charitable contributions made after the close of the tax year but before due date of the return as made in the tax year
  - Limits charitable contribution of appreciated property to the taxpayer's basis
- Unrelated Business Income
  - Compute UBIT separately for each line of business (losses from one activity can not offset income from another activity)
  - Modifies exclusion for qualified sponsorship payments
  - Name and logo royalties treated as unrelated
  - Exclusion of research income limited to publicly available research



# Camp Tax Proposal

- Excise Tax on Excess Tax-Exempt Organization Executive Compensation
  - Excise tax on employers equal to 25% of remuneration in excess of \$1 million paid to a covered employee
  - Applies to excess parachute payments (even if payment does not exceed \$1 million)
  - Covered employee is one of the five highest compensated employees of the organization (includes former employees) for the current or any preceding tax year
- Tax Exempt Bonds
  - Repeals exclusion from gross income interest paid on:
    - Private activity bonds
    - Advance refunding bonds



# Camp Tax Proposal

- Elimination of Rebuttable Presumption of Reasonableness
  - Entity level excise tax of 10% on any excess benefit transaction where minimum levels of due diligence were not followed:
    - Approval by an independent body
    - Reliance on appropriate comparability data
    - Concurrent documentation of the basis for approval
    - Above steps no longer give rise to a presumption of reasonableness
  - Safe harbor for organization managers who rely on professional advice eliminated



# ACT Report

- Analysis and Recommendations Regarding Unrelated Business Income Tax Compliance of Colleges and Universities
- Released June 11, 2014
- Committee selected this due to IRS' intention to increase its focus on UBIT reporting



# ACT Report Key Contents

- Overview of Unrelated Business Income Tax (UBIT)
- Application of UBIT rules to college and universities
- Key UBIT issues to be resolved
- Reporting and 990-T redesign
- Recommendations
- Proposed Revenue Ruling addressing UBIT
- Draft Redesigned Form 990T



# ACT Report Recommendations

- Regulations should be enacted so that profits from a substantial commercial activity will not preclude exemption under IRC Sect 501(c)(3) as long as an organization's income and its financial resources are used commensurate in scope with its charitable program



# ACT Report Recommendations

- Formal guidance should be provided to the field regarding proper methods for allocating indirect costs where facilities and/or personnel are used to carry on exempt activities and to conduct unrelated trade or business.





# ACT Report Recommendations

- A comprehensive revenue ruling should be published addressing some of the following areas
  - The ruling should provide categories of activities that will be considered related and unrelated
  - Guidance on preparatory time spent on activities
  - Scenarios of situations involving the activities frequently reported on the college and university questionnaire, such as facility rentals and dual use properties



# ACT Report Recommendations

- A new Form 990-T based upon the proposed format enumerated in this report should be adopted
- Continue to leverage use of electronic database and web based resources to include communication, education, and training



# UNRELATED BUSINESS INCOME



# Common Activities

- Advertising
- Corporate sponsorships
- Participation in partnerships
- Personal property rentals and services
- Alternative investments



# Advertising

- General rule is that advertising is considered an unrelated trade of business if it is regularly carried on
- When is it not unrelated?
  - Not regularly carried on
  - Substantially related to the exempt purpose of the organization (for example, advertising in a student run newspaper when the advertising and other activities provide educational training)
  - Conducted substantially by volunteers
- Examples of issues encountered



# Corporate Sponsorships

- Qualified sponsorship payments (QSP)
  - A payment by an entity engaged in a trade or business to an exempt organization without an arrangement or expectation that it will receive any substantial return benefit
  - Excluded from UBI
- Substantial return benefit
  - Advertising
  - Exclusive provider arrangement
  - Providing services, facilities, or other privileges to the payor or persons designated by the payor
  - Granting the payor or persons designated by the payor an exclusive or nonexclusive right to use an intangible asset, such as a trademark, patent, logo, or designation of the exempt organization.



# Corporate Sponsorships

- Substantial return benefit does not include
  - Recipient's use or acknowledgment of the sponsor's name, logo, or product lines
  - Mentioning the sponsor's location(s), telephone numbers, internet address, slogans, and value-neutral descriptions of the sponsor's goods or services in acknowledging the sponsor's support
  - Displaying the sponsor's products
- Exclusive provider arrangement will not qualify for QSP treatment but may be excluded under general UBIT rules if services are not provided in connection with the arrangement
- Trade agreements can be difficult to analyze
- Examples of issues encountered





# Participation in Partnerships

- May generate UBIT if the partnership activity is unrelated with respect to the organization or if it owns debt financed property
- Control is a factor the IRS commonly focuses, therefore a careful review of governing documents is crucial
- Joint venture policy?
- Many 990 questions related to joint ventures
- Examples of issues encountered



# Personal Property Rentals and Services

- Rent is excluded from UBIT, except when
  - Property is debt financed
  - Income is from a controlled corporation
  - Rent is calculated as a percentage of tenant's income
  - The payment includes compensation for services rendered to the lessee
  - More than 50% of the rent is attributable to personal property leased with the real property



# Personal Property Rentals and Services

- Rent can be based on a percentage of gross rather than net income of the tenant
- Lessor generally may provide utilities and janitorial services without tainting the rent income
  - Separately stating charges for services may be helpful
- For a mixed lease (i.e., one that includes both real and personal property), all of the rental income is excluded from UBI if the portion attributable to personal property is incidental to the total payments
  - *Incidental* means 10% or less of the total rents received or accrued under the lease
- Examples of issues encountered



# Alternative Investments

- Make certain you understand all compliance requirements and costs when investing
- If structured as a partnership, Schedule K-1 will be received
- UBIT
- State income tax reporting
- Foreign disclosures
- Examples of issues encountered



# Computation of Unrelated Business Taxable Income

- Commonly overlooked deductions
  - Charitable contributions
    - Report consistent with Schedule I, Part I
    - Obtain donor acknowledgment letter
  - State income taxes
- Tax rate
  - Generally taxed at regular corporation rates unless a trust
  - Consider controlled group rules

# Computation of Unrelated Business Taxable Income

- Credits available to offset income tax
  - Foreign tax credit
  - Qualified electric vehicle credit
  - Gasoline and special fuels credit for federal tax paid
  - Small employer health insurance premiums tax credit
  - Minimum tax credit

# Tips For Tracking and Monitoring

- Internal point person
- Training
- Mock IRS exam
- Outside advisors
- Checklists
- Monitor new revenue sources





# IRS EXAMINATION ACTIVITY



# Observed IRS Examination Triggers

- Organization reported lobbying activity as political activity on Schedule C
- Organization reported intercompany loans as loans to officers, directors, etc... on balance sheet with no corresponding Schedule L
- Organization reported salary and employee information inconsistent with payroll filings



# Observed IRS Examination Triggers

- Foreign activity
- Unrelated business income losses
- Form 1099 and W-2 provided to same employees



# What is the IRS looking at?

- Depends – single issue exam or full exam?
- Foreign activity
- Monitoring of grants to other charities
- Unrelated business income (or loss)
- Employment tax filings (1099 v. W-2)
- Minister housing allowances
- Business dealings with “disqualified persons”



# Example 1

- Exam likely triggered by UBI losses
- Exam was initiated with several phone calls before any correspondence was received
- Exam supposed to be focused on UBI and compensation
- Initial IRS estimate was to spend 1 week on-site per month for at least 9 months, total exam time expected to be around 18 months
- Currently on month 10 and still in the field



# Example 1

- Start with IT specialist to map lines of general ledger to Form 990 and 990-T
- Obtain all payroll data, benefit documents, employment contracts, executive contracts, etc...
- Review accounts payable data, W-9s, 1099s
- Review Governing instruments, board minutes, etc...
- Initial interviews and conferences with parties involved in the examination
- Obtain data from website



# Example 1

- Looking at specific areas of UBI
- Review overall activity and history of profits or losses
- Sample methodology used to determine unrelated v. exempt revenue
- Review expense allocation methodologies
- Conduct interviews with department heads and managers
- Looking very closely at worker classification issues





# Example 2

- Payroll tax examination
- Exam was already approaching a year when BKD assistance requested
- Agent again gathered significant amount of data from website



# Example 2

- Issues written up by agent:
  - Settlement to former CFO
  - Loan forgiveness programs
  - Reclassification to employee from independent contractor for several individuals
  - H-1B Visa issues
  - Inconsistent treatment among groups of employees
- Expanding exam to all open years



# Resources

- 2014 ACT Report - [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt13.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf)
- “Camp” Tax Proposal - [http://waysandmeans.house.gov/uploadedfiles/ways\\_and\\_means\\_section\\_by\\_section\\_summary\\_final\\_022614.pdf](http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf)
- IRS Compliance Questionnaire for Colleges and Universities - [http://www.irs.gov/pub/irs-tege/sample\\_cucp\\_questionnaire.pdf](http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf)



# Resources

- IRS College and Universities Compliance Project - [http://www.irs.gov/pub/irs-tege/cucp\\_interimrpt\\_052010.pdf](http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf)
- IRS Publication 598
- Thoughtware at [www.bkd.com](http://www.bkd.com)





Brian D Todd | Partner | 417-865-8701 | [btodd@bkd.com](mailto:btodd@bkd.com)  
Mike J Engle | Partner | 816-221-6300 | [mengle@bkd.com](mailto:mengle@bkd.com)



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