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# Understanding Unrelated Business Income and Alternative Investments

NCACPA Not-for-Profit Accounting  
Conference – May 22, 2024

# Presenter



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*16 years of experience*

# Agenda



**What is Unrelated Business Income?**



**Conceptual Framework of UBI**



**Example Walk-Through**



**Alternative Investments**



## What is Unrelated Business Income?

**“I have a church that is incorporated and they plan to sell part of their property this year. Are there any tax consequences they should be aware of?”**

- + “My understanding is that if any nonprofit, including churches, sells property there is no tax paid if the proceeds are used in activities related to the exempt purpose of the organization.”
- + “See Code Section 514(b)(1) – disposition of debt-financed property.”
- + “As long as they are exempt from the income tax under a 501c3 ruling or under a group ruling for their denomination, they are not subject to capital gains on the property. If the property was purchased for sale later (like an inventory purchase) and not related to the charitable purpose of the church, it is possible they would have to consider unrelated business income tax. If the property was used by the church for the charitable purpose but is just now being sold, UBIT would probably not apply



# What is Unrelated Business Income? – Continued

## **C.F. Mueller Co. v. Commissioner, 190F2d 120 (1951)**

- + C.F. Mueller Co was engaged in the manufacturing and selling of pasta and other foodstuffs
- + Wholly-owned subsidiary of the New York University School of Law (properly tax-exempt)
- + IRS examination for 1947 tax year, assessed deficiency
- + Mueller sued in Tax Court, which held for the Service; appealed to Circuit court, which reversed and held for the taxpayer; SCOTUS denied certiorari
- + Congress had already passed what we now know as Sec. 512



# UBI – Conceptual Framework

**Income from a trade or business**

**Regularly carried on**

**Unrelated to exempt purpose**



## UBI – Conceptual Framework – Continued

### Trade or business

- + An activity carried on for the production of income
- + Passive income (interest, dividends, rents) are generally excluded
- + Fundraising is not typically considered a trade or business

## UBI – Conceptual Framework – Continued

### Regularly carried on

- + Frequency and continuity
- + Pursued in a manner similar to comparable commercial activities



## UBI – Conceptual Framework – Continued

### Unrelated to exempt purpose

- + Does the activity contribute importantly to the purpose for which the organization is exempt?
- + Commonly applied to magazine publishing, merchandise sales, music festivals, etc.
- + How unrelated is “unrelated”?
- + Beware exploited exempt activities



## UBI – Conceptual Framework – Continued

### Fragmentation rule

- + Activities of an exempt organization are examined individually to determine whether or not they are UBI
- + An activity does NOT lose its identity as a trade or business if it is carried on within a larger aggregate of similar activities that may or may be related to the exempt purpose
- + Most common fragmentation is advertising within a periodical



# UBI – Conceptual Framework – Continued

## Regularly carried on – NCAA v. Commissioner (1990)

- + NCAA sold “Official Souvenir Programs” for the Final Four Round of the NCAA Tournament, which contained advertisements
- + IRS Examined the 1981 and 1982 tax years and assessed a deficiency
- + Appealed to Circuit Court, which held for the taxpayer.

NCAA argued that the Final Four Programs were akin to *Sports Illustrated*, in which light the activity was not regularly carried on

IRS argued that the Programs were more like Super Bowl or World Series programs, in which case the Final Four programs are regularly carried on



## UBI – Conceptual Framework – Continued

### Debt-financed income

- + Income which is debt-financed is taxable as UBI
- + Presence of debt forces the “trade or business” part of the 3-part test to a “yes,” even if the income is passive
- + Income is taxable to the extent of indebtedness
- + Example: \$5 million building, \$2 million mortgage, \$20,000 rental income = \$8,000 gross taxable UBI



## UBI – Conceptual Framework – Continued

### Separate trades or businesses

- + Tax Cuts and Jobs Act of 2017
- + Separate trade or business activities must be segregated and reported separately
- + Net losses from one activity cannot offset net income from another activity
- + Use first two digits of NAICS codes to determine which activities are separate



# UBI – Conceptual Framework – Continued

## Allocation of expenses

- + All the typical rules for normal non-exempt taxpayers apply, including deduction for ordinary and necessary expenses
- + Indirect expenses may be allocated using a “reasonable” basis for allocation
- + Unadjusted gross-to-gross is generally not reasonable.

## Exploited exempt activities

- + Deduction (to the extent of income) for excess of related-function expenses over related-function income



## Example – Advertising Income

- + Monthly newsletter with unrelated advertising
- + 3 pages, front and back (6(a) sides), total 1(b) side per issue of ads
- + Cost of adss is \$225(c) per 1/8 page
- + 209(d) subscribers at \$15(e) per year

- + Publication costs (f)
  - Printing – \$3,700
  - Postage – \$1,650
  - Design – \$2,365
- + Ad commissions \$750(g)
- + Salary

|            | Pub(h) | Ad(i) | Salary(j) |
|------------|--------|-------|-----------|
| • Prudence | 15%    | 2%    | \$10,000  |
| • Martha   | 35%    | 7%    | \$24,500  |
| • Sadie    | 5%     | 1%    | \$18,000  |
| • Julia    | 15%    | 0%    | \$16,750  |



## Example - Advertising Income - Continued

Gross Advertising Income

$c \times b \times 12$

**21,600**  $p$

Direct Ad Costs

$g$

750

Direct Ad Salaries

$i \times j$

2,095

Direct Ad Allocation

$f \times k$

1,286  $m$

Total Direct Ad Expenses

**4,131**  $r$

Total pages

$a \times 12$

72

Total ad pages

$b \times 12$

12

Ad ratio

16.67%  $k$

Circulation Income

$d \times e$

**3,135**  $s$

Publication Costs (less Ad)

$f - m$

6,429

Publication Salaries

$h \times j$

13,488

Readership Costs

**19,917**  $n$





## Example – Advertising Income – Continued

|  |       |        |
|--|-------|--------|
| Net Advertising Income                   | p - r | 17,469 |
| LESS: Excess Readership Costs            | n - s | 16,782 |
| LESS: State Tax                          |       | 800    |
| LESS: Tax Prep Fees                      |       | 500    |
| Taxable Income before Specific Deduction |       | (613)  |
| Specific Deduction                       |       | 1,000  |
| Taxable Income                           |       | (613)  |



## A Cautionary Tale About Workpapers...

990 T 2010

Membership 111506

Meetings 1562011

Comm. ① 551270 P. total 18.44 %

Legisl 764684

2989471

Admin. 4346923 x 18.44 = 801573<sup>②</sup>

① 551270

② 801573

1352843

# Alternative Investments

## What are alternative investments?

- + Investments which are not publicly-traded stocks, bonds, mutual funds, or cash
- + Cross reference Form 990, Part X, Line 12
- + See also investments categorized in the audited financial statements fair value hierarchy as Level 3 (no observable inputs)

## Why do we care?

- + Income from partnership retains its character as it passes through to the partner
- + Attributes such as trade or business and debt-financing
- + Income from S-Corporations is per se UBI



# Alternative Investments

| Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items |                                      |    |  |
|---|--------------------------------------|----|--|
| 1   | Ordinary business income (loss)      | 15 | Credits                                      |
|   | -6,626                               |    |  |
| 2   | Net rental real estate income (loss) |    |  |
| 3   | Other net rental income (loss)       | 16 | Foreign transactions                         |
| 4   | Guaranteed payments                  |    |  |
| 5   | Interest income                      |    |  |
|   | 936                                  |    |  |
| 6a  | Ordinary dividends                   |    |  |
| 6b  | Qualified dividends                  |    |  |
| 7   | Royalties                            |    |  |
| 8   | Net short-term capital gain (loss)   |    |  |
|   | -5,329                               |    |  |
| 9a  | Net long-term capital gain (loss)    | 17 | Alternative minimum tax (AMT) items          |
|   | -144,319                             |    |  |
| 9b  | Collectibles (28%) gain (loss)       |    |  |
| 9c  | Unrecaptured section 1250 gain       |    |  |
| 10  | Net section 1231 gain (loss)         | 18 | Tax-exempt income and nondeductible expenses |
|   | 94,867                               |    |  |
| 11  | Other income (loss)                  | C  | 10   |
|   |                                      |    |  |
|   |                                      |    |  |
| 12  | Section 179 deduction                | 19 | Distributions                                |
|   |                                      | A  | 161,101                                      |
| 13  | Other deductions                     |    |  |
| * H   | 931                                  | 20 | Other information                            |
| * K   | 50,714                               | A  | 936  |
|   |                                      | B  | 50,714                                       |
| 14  | Self-employment earnings (loss)      |    |  |
|   |                                      |    |  |

\*See attached statement for additional information.

## NOTICE TO TAX EXEMPT PARTNERS ONLY

### UNRELATED BUSINESS TAXABLE INCOME DISCLOSURE

THE ATTACHED SCHEDULE K-1 INCLUDES TRADE OR BUSINESS INCOME OR (LOSS) AS WELL AS INCOME OR DEDUCTIONS RELATED TO DEBT-FINANCED PROPERTY. PLEASE USE THE FOLLOWING TABLE TO DETERMINE THE AMOUNT OF EACH SCHEDULE K-1 LINE ITEM THAT IS CONSIDERED "UNRELATED" INCOME OR EXPENSE FOR YOUR TAX EXEMPT ORGANIZATION:

### SCHEDULE K-1 LINE NUMBER

LINE 1 - ORDINARY INCOME (LOSS) FROM TRADE OR BUSINESS ACTIVITIES

LINE 5 - INTEREST INCOME

LINE 10 - NET SECTION 1231 GAIN (LOSS)

LINE 13(H) - INTEREST EXPENSE ON INVESTMENT DEBTS

LINE 13(K) - DEDUCTIONS RELATED TO PORTFOLIO INCOME

### UNRELATED PERCENTAGE OF SCHEDULE K-1 AMOUNT

100.00%

17.59%

3.62%

53.56%

1.40%



## Alternative Investments – Continued

### Other considerations

- + Separate trade or business – regulations provide a 2% *de minimis* test and a 20% control test to allow aggregation of partnership investments into a single trade or business
- + Foreign activity – additional reporting may be required for partner's share of transfers to foreign corporations (Form 926) foreign partnerships (Form 8865) ownership of certain foreign corporations (Form 5471) and others
- + State reporting – partnerships may operate in multiple states, creating a potential filing obligation and/or tax liability



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Questions?

# Contact Information



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