Unrelated Business Taxable Income

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Topics

- History and Overview
- Unrelated Business Income Tax
- UBTI and UDFI Details
- Why Now?

History and Overview

In the Beginning…

- In 1947, a benefactor created a charitable corp:
  - Charitable corp purchases Mueller Company, a pasta manufacturer, using a loan
    - Business income to go to NYU Law School
  - IRS challenged charitable corp’s exempt status
    - And based on pre-UBTI laws, Mueller won
  - Unrelated Business Taxable Income was passed into law **in 1950**

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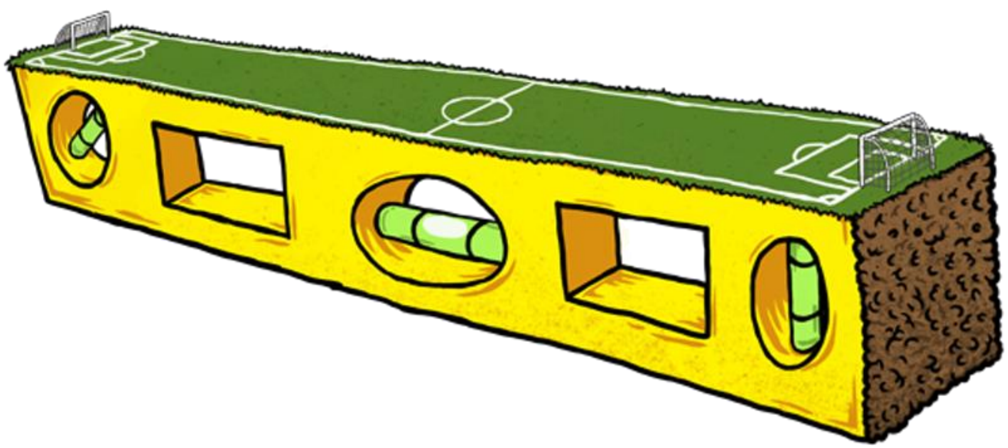
A Great Idea

- **My Dream:**
  - Use my Roth rollover account to purchase a gas station
  - Since profits will be “tax-free,” I can sell gas at a lower cost than competitors
  - Consumers will flock to my station to purchase lower-cost gas. (People will drive miles out of their way to save 5¢ per gallon on gas)
  - I make a lot of “tax-free” money (and drive my competitors out of business). Yippie for me!

Overview

- Generally income earned by a retirement plan is exempt from federal and state income tax
  - But some situations are considered "unfair competition" for tax-exempt organizations
  - The **Unrelated Business Taxable Income (UBTI)** rules were created to level this playing field



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Insights from the IRS

- “The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”
  - Treas. Reg. §1.513-1(b)

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What Is UBTI?

- UBTI is the gross income derived by an organization from any
  - **Unrelated**
  - **Trade or business** that is
  - **Regularly carried on** by the organization
  - Less expenses and certain adjustments
- UBTI includes **Unrelated Debt Financed Income** (UDFI)

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What Is UDFI

- Generally, debt-financing will generate UBTI
  - Example: Plan buys stock on margin
    - Borrows 50 percent of purchase price
    - **50 percent of income from stock is UDFI/UBTI**
- Real estate purchase exception

What Is **Not** UBTI

- Generally not UBTI (non-leveraged)
  - Interest income
  - Dividends
  - Annuities
  - Mutual fund distributions
  - Rents, from real property
  - Royalties
  - Investment income
  - Investment gains (other than stock/inventory)

Unrelated Business Income Tax (UBIT)

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I Have UBTI. So What?

- TI stands for **Taxable Income**
  - UBTI is **taxable to the Trust**
- The Unrelated Business Income Tax (UBIT) – the tax due – is calculated and reported on IRS Form 990-T
- **Only need to file if unrelated business gross income is > $1,000** – *de minimis exception*

Form **990-T** Department of the Treasury Internal Revenue Service	**Exempt Organization Business Income Tax Return** **(and proxy tax under section 6033(e))** For calendar year 2014 or other tax year beginning ______, 2014, and ending ______, 20 ____. ▶ **Information about Form 990-T and its instructions is available at *www.irs.gov/form990t*.** ▶ **Do not enter SSN numbers on this form as it may be made public if your organization is a 501(c)(3).**	OMB No. 1545-0687 **2014** **Open to Public Inspection for 501(c)(3) Organizations Only**

UBIT Based on Net Income

- Deduction to UBTI allowed for
  - Expenses and depreciation
  - Charitable contributions
  - Directly connected to the unrelated trade or business
    - Not connected to excluded income
  - Same as §162 (business expenses)

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The Tax Man Cometh…

- UBIT is calculated at **Trust** rates:

Over—	But not over—	Tax is:	Of the amount over—
$0.00	$2,500	**15%**	$0.00
2,500	5,800	**$375 + 25%**	2,500
5,800	8,900	**1,200 + 28%**	5,800
8,900	12,150	**2,068 + 33%**	8,900
12,150	- - - - -	**3,140.50 + 39.6%**	12,150

- 990-T due by 15th day of fourth month after PYE

Paying the Piper

- File IRS Form 990-T
  - Due 3½ months after PYE (April 15th)
  - Can be extended with Form 8868
    - First three months, automatic
    - Additional three months possible, **not**-automatic
- Quarterly estimated tax payments – due by Trustee if total tax is at least $500
- Penalties:
  - Failure to file = five percent of unpaid tax per month (25 percent max)
  - Late payment of tax = one-half percent of unpaid tax per month (25 percent max)

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Details

Important Definitions

- UBTI is the gross income derived by an organization from any
  - **Unrelated**
  - **Trade or business** that is
  - **Regularly carried on** by the organization
  - Less expenses and certain adjustments
    - IRC §512(a)

Trade or Business

- Broadly construed
- Any activity carried on for the production of income and that otherwise possesses the characteristics required to constitute a trade or business within the meaning of Section 162 is a trade or business
  - Treas. Reg. §1.513-1(b)

Not Substantially Related

- An unrelated Trade or Business is a trade or business not substantially related to the purpose or function of the exempt entity
- Strictly construed
  - That is, most businesses are deemed unrelated
- **In the case of a Trust (such as a retirement plan), any trade or business is considered unrelated.**
  - IRC §513(b)

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Related Trade or Business

- Examples of a <u>related</u> trade or business:
  - A charity providing training for the disabled; operates a thrift store where disabled clients work and gain experience
  - A university with a hospitality degree program; operates a hotel on-campus to provide practical experience for students
- There are **no** related trades or businesses for retirement plans…

Regularly Carried On

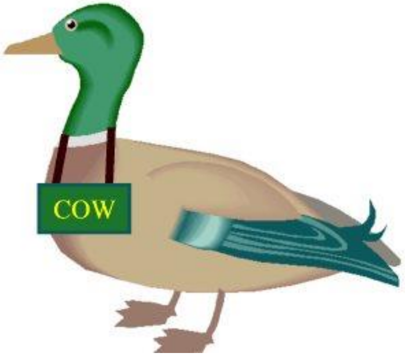
- Consideration is given to the **frequency and continuity** of the activity being conducted
  - If comparable to commercial business, then would be considered regularly carried on
    - Operation of a business three weeks a year (i.e., at state fair) not considered regularly carried on
    - Operation of a business one day a week (i.e., commercial parking Saturday nights) all year would be regularly carried on

Debt-Financed Property

- **Debt-Financed Property** is any property held to produce income that has "acquisition indebtedness"
- **Acquisition Indebtedness** is debt incurred in (or related to) acquiring or improving the debt financed property
- **UBTI** = the same percentage of gross income as the debt/value ratio

Liens Similar to Mortgage

- Liens similar to mortgages are treated as mortgages
  - Deeds of trust
  - Conditional sales contracts
  - Chattel mortgages
  - Security interests under the Uniform Commercial Code
  - Pledges
  - Agreements to hold title in escrow
  - Liens for taxes or assessments



Debt-Financed Property – General Rules

- Property considered debt-financed if acquisition indebtedness existed at any time during tax year or the 12 months preceding the sale of the property
- A special **exception** to the debt-financed income rule applies to a plan
  - Acquisition indebtedness generally does not include debt incurred by a plan in acquiring or improving any real estate

Exceptions to the Exception

- Plan real estate debt **is** acquisition indebtedness, **resulting in UBTI**, in the following circumstances:
  - The amount for acquisition or improvement is not fixed as of the date of the acquisition or completion of the improvement
  - The amount of any indebtedness is dependent upon revenue, income or profits derived from the real property
  - The property is leased back to the seller
  - The plan acquires the property from or leases the property to a disqualified person
  - A disqualified person provides the financing
  - The real property is held by a partnership
    - No UBTI if **all** partners are plans
    - Income is not UBTI if the allocations of partnership items to the partners meet certain criteria (no shifting of losses to taxable partner)
  - IRC §514(c)(9)

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Security Loan Agreements

- Securities loan agreements are not acquisition indebtedness
  - Nor is borrowing stock for short sale
  - "Margin" to purchase securities IS

UFDI Reasoning

- Concerns about a business being sold to tax-exempt plan with little or no down payment
  - Purchase price to be paid out of profits
  - Plan liquidates business and leases assets back to seller who continues to operate the business
  - Seller pays portion of profits as rent to plan
  - Plan returns rents to seller as payments for purchase
  - Plan's primary contribution was its tax exemption (rather than assets)

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Debt-Financed Property – Example 1

- Plan purchases investment for $500,000
  - – Cash = $200,000
  - – Loan = $300,000

$$\frac{\text{Average Acquisition Indebtedness}}{\text{Average Adjusted Basis from Property}} \quad \text{X} \quad \text{Gross Income} = \text{UDFI}$$

- If debt and basis remain unchanged, 60 percent of income generated by the property will be UFDI

Debt-Financed Property – Example 2

- Plan invests in a partnership with two other equal (non-qualified) partners
  - Plan invests \$3M (\$1M cash, \$2M borrowed)
  - Other partners invest \$6M total
- Partnership purchases building for \$24M
  - \$9M cash, \$15M borrowed
- For Plan, acquisition indebtedness = \$7M
  - \$2M of direct debt + \$5M (1/3) of partnership debt
- Plan's debt/basis percentage is 87.5 percent (\$7M/\$8M)
- 87.5 percent of partnership income is subject to UBTI
  - Would NOT be UBTI if <u>all</u> partners were plans

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Taxable Income

Deductions Allowed

- May deduct expenses directly connected with the unrelated business/debt financed property in calculating the unrelated taxable income
  - Can't channel all expenses into taxable activity
- General rules on deductible expenses apply to UBTI calculation
  - $1,000 standard deduction

Taxable Income/Loss

- Example:
  - $20,000 in rent (50% debt-financed property)
    - Expenses:
      - $5,000 – Property taxes
      - $5,000 – Interest on acquisition indebtedness
      - $15,000 – Salary to building manager
  - UBTI = 20,000 (x 50%) - $25,000 (x 50%) = -$2,500
    - Loss can be carried back/over to other tax years

Details…

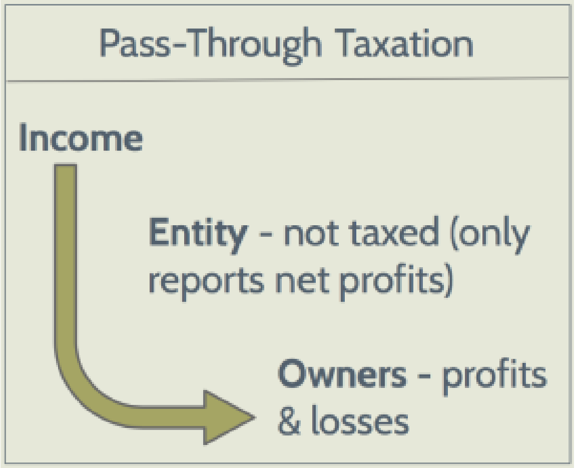
- The rules in this area are complex
- Example: UBTI generally applies to timber sales
  - Participant purchases real estate for $200,000 (no debt)
  - Participant has timber harvested from land
  - Net proceeds = UBTI. **Maybe…**
  - However, if timber is classified as "capital," then sales may become investment income (not subject to UBTI) instead of income from "trade or business"

Beware of Pass-Through Entities

- Pass-through entities may include:
  - Partnerships
  - MLPs
  - LLCs
  - Hedge Funds (if partnership or LLC)
  - S-Corps
  - Common Trust Funds
  - **NOT** REITs (generally)

Pass-Through Entities

- Proportionate share of income and expenses is passed through to the plan
- Must be recognized and reported by the recipient plan as UBTI



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UBTI Example - MLP

- Participant with self-directed account purchases an interest in a Master Limited Partnership (MLP)
- MLPs are pass-through entities
  - The plan is treated as if it had earned its share of the MLP's business income
- Plan will have to file 990-T and pay tax, if UBTI > $1,000
- *Also applies to traditional partnership interests*

IRS Examples

- The IRS has identified the following as examples of unrelated business income for a retirement plan:
  - Sales of lots (by plan sponsors in the business of developing/improving real estate)
  - Vending machine sales
  - Sales commissions or service fees
  - Fruit orchards and citrus groves
  - Lease of <u>personal</u> property (cars, boats, fishing or skiing equipment, signs, vending machines…)

$1,000 Threshold

- The $1,000 threshold for filing Form 990-T is a plan-level threshold
- Example:
  - **Participant A** purchases an interest in a MLP that generates $400 of net UBTI
  - **Participant B** purchases debt-financed rental property resulting in $500 of net UBTI
  - **Participant C** purchases a partnership interest that results in $250 of net UBTI
  - **Total UBTI = $1,150**; Plan must file 990-T

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Limitations on Investments

- Plans may limit participant-direction to investments that do not incur UBTI
  - Fiduciary may reject investments that result in UBTI
  - Minimizes compliance risks and/or administrative costs incurred by plan

Why Now?
Form 5500-SUP

2015 Form 5500/5500-SF/5500-SUP

Form **5500-SUP**

Department of the Treasury
Internal Revenue Service

Annual Return of Employee Benefit Plan Supplemental Information

This form is required to be filed under section 6058(a) of the Internal Revenue Code.
▶ **Complete all entries in accordance with the instructions to Form 5500-SUP.**

OMB No. 1545-1610

2015

This Form is Open to Public Inspection.

8 Did the plan trust incur unrelated business taxable income?
Check box. ☐ **Yes** ☐ **No** ☐ **N/A** If "Yes," enter amount

DO NOT FILE

- Required for 2015 plan years
- Either:
  - Paper file Form 5500-SUP, or
  - Answer optional questions on Form 5500/5500-SF
- Question 8: **Does the plan have UBTI?**
  - If so, **how much?**
  - N/A – Huh?

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New UBTI Question

- UBTI is not new; the 5500 question is
- Fair to assume that this is an area of interest to the IRS
  - IRS might suspect significant underreporting of UBTI and non-payment of tax liabilities
  - Question draws attention to the requirement
  - Could be a courteous way to instigate compliance
  - Remember: 5500/-SF/-SUPP *filed under penalty of perjury*…

Tax Time

- A "yes" answer to the UBTI question on the 5500/-SF/-SUP will cause the IRS to expect to receive the related Form 990-T and taxes

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Objectives for the TPA

Know what to look for

Know what to do

Know what to say

Questions?

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