HAS UNRELATED BUSINESS TAXABLE INCOME BEEN PROPERLY CAPTURED?

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As long as the rules remain complex, the Service will continue to challenge and the taxpayers will continue to protest.

Unrelated business taxable income (UBTI) can be simply described as income from those activities conducted by an organization that are both commercial and not in furtherance of the organization's exempt purpose. At first glance, this simple definition would make it quite easy to determine when an organization has UBTI. The law, of course, is not so simple. Indeed, the UBTI rules are among the most complex rules in the Code relating to exempt organizations. Anyone advising exempt organizations must be familiar with these rules to help clients navigate the system.

There is a particular policy behind the rules on UBTI. When a nonprofit participates in commercial activity, it may be competing at an unfair advantage with for-profit entities because, as a nonprofit, it generally does not have to pay tax on its income. UBTI levels the playing field by taxing a nonprofit on commercial activity that is earned in a manner unrelated to its exempt purpose. If a nonprofit has a substantial amount of unrelated business activity, it will have a larger problem than UBTI. In that case, the nonprofit will risk revocation of exemption. On the other hand, nonprofits pay no income tax on their commercial activity that is related to its exempt purpose. Exhibit 1 on page 28 summarizes the instances in which UBTI arises.

What is UBTI?

Section 512(a)(1) defines UBTI simply as "the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less deductions allowed ... which are directly connected with the trade or business." Although the definition sounds straightforward, the details of determining what is UBTI are anything but simple. There are three components in the definition that have to be evaluated in determining whether the organization has UBTI—whether the activity constitutes (1) a trade or business (2) that is regularly carried on, and (3) that is unrelated to the organization' exempt purpose. If any one of the three elements is missing, the organization does not have UBTI.[1]

Trade or business. The term "trade or business" generally includes any activity conducted for the production of income from selling goods or performing services. Characterization as a trade or business depends, in part, on the level of active

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participation and the appearance of "business operations" by the organization generating the revenue. Reg. 1.513-1(b) supports this contention by stating that "for purposes of [Code] section 513 the term 'trade or business' has the same meaning it has in section 162 , and generally includes any activity carried on for the production of income...."

For example, according to Reg. 1.513-1(b), the "regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes...." Also, "soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization."

Characterization as a trade or business depends, in part, on the level of active participation and the appearance of 'business operations.'

However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of the trade or business is excluded from that classification merely because it does not result in profit.

An activity must be conducted with intent to profit in order to constitute a trade or business. An activity does not lose its identity as a trade or business merely because it is conducted within a larger group of similar activities that may or may not be related to the exempt purposes of the organization. For example, in *Professional Insurance Agents of Michigan,*[2] (*PIA*), the Sixth Circuit affirmed the Tax Court's ruling that administrative and promotional fees, and an experience rating reserve refund, constituted income from unrelated trade or business to a Section 501(c)(6) business league. This conclusion was founded, in part, on the court's analysis that the presence or absence of a profit motive was the determinative factor in the "trade or business" inquiry under Section 513(c).

EXHIBIT 1
Organizations' Activities and UBTI.

	Insubstantial	*Substantial*
Related	OK	OK
Unrelated	UBTI	Revocation

The language of the statute states that any activity which is carried on for the production of income is to be deemed a trade or business. The phrase "carried on for the production of income" limits the type of activities covered. That phrase requires us to examine the exempt organization's underlying reasons for engaging in the questioned activity. If it has as its motive the production of income, the activity constitutes a trade or business under section 513(c), so the language of the Code prescribes the application of the motive test. The regulations under section 513 strengthen this interpretation of the statute by incorporating the section 162 meaning of the term trade or business.[3]

Focusing on its role in selecting insurance carriers and negotiating fees with them, and its role in promoting and administering the insurance products, the Sixth Circuit found that the record supported the Tax Court's finding that a profit motive was reflected in the appellant's activities.

Similar conclusions were reached by the circuit courts in *Carolina Farm & Power Equipment Dealers Ass'n,*[4] (*Carolinas Farm*) and *Louisiana Credit Union League,*[5] (*LCUL*). In *LCUL,* the court expressly adopted the "profit motive" standard before ruling that the record supported the district court's finding of a profit motive. As in *PIA,* the court focused on the business league's selection of carriers and its endorsement, promotion, and administration of the insurance policies. In *Carolinas Farm,* the Fourth Circuit reversed the district court's judgment in favor of a Section 501(c)(6) organization. It held that a finding of a profit motive was sufficient to satisfy the "trade or business" requirement of Section 513(c) and that the only inference to be drawn from the record was that a profit motive was present. The Fourth Circuit supported this conclusion by relying on the consistent profitability of the insurance program, the high proportion of insurance income to total income, and the absence of a causal connection between the insurance activity and accomplishment of the organization's exempt purposes.

The *Carolinas Farm* case addressed a very subtle distinction between activities motivated by income production and those that merely produce income. As previously noted, "trade or business" contemplates any activity that is car-

[1] In a recent ruling, Ltr. Rul. 201544025, the IRS covered the three components of UBTI in detail. Even though the ruling is expressly intended for the applicant, it gives substantial insight into the Service's position on all three components of UBTI. The ruling is clear, concise, and provides some common examples of the type of issues faced by many exempt organizations.

[2] 726 F.2d 1097, 53 AFTR2d 84-634 (CA-6, 1984).

[3] *Id.* at 53 AFTR2d 84-638.

[4] 699 F.2d 167, 51 AFTR2d 83-546 (CA-4, 1983).

[5] 693 F.2d 525, 51 AFTR2d 83-451 (CA-5, 1982).

[6] 135 TC 276 (2010), *aff'd* 284 F3d 284, 109 AFTR2d 2012-1264 (CA-4, 2012).

[7] Reg. 1.513-1(c)(1).

ried on for the production of income from the sale of goods or the performance of services. The language in the Code limits the activities to those "carried on for the production of income." There is a fine distinction to be made between those activities that are carried on for the production of income and those which generate income as a result of an activity but ultimately have another motive. In *Carolinas Farm,* while generating income, a trade association's expressed purpose of participating in the insurance program was to provide an opportunity for its members to obtain group health insurance. The modest return received by the association was certainly not enough to support a profit motive on the part of the association.

The one point that is clear from the aforementioned cases is that the analysis rests on the facts and circumstances of each situation. In some cases this is an opportunity for planning. In other cases a serious analysis has to be made to determine if the operation of a trade or business is going to adversely affect the organization's exempt status.

In analyzing on audit whether a taxpayer operates an activity with a profit motive, the IRS typically considers the nine non-exclusive factors contained in Reg. 1.183-2(b):

- The manner in which the taxpayer carried on the activity.
- The expertise of the taxpayer or the taxpayer's advisers.
- The time and effort expended by the taxpayer in carrying on the activity.
- The expectation that the assets used in the activity may appreciate in value.
- The success of the taxpayer in carrying on other similar or dissimilar activities.
- The taxpayer's history of income or loss with respect to the activity.
- The amount of occasional profits, if any, which are earned.
- The financial status of the taxpayer.
- Elements of personal pleasure or recreation.

In another, more recent case, *Ocean Pines Association Inc.,*[6] a homeowners association exempt under Section 501(c)(4) operated parking lots and a beach club approximate eight miles from the community. Use of the parking and beach club were restricted to members of the association and their guests. The association failed to report the parking lot income as UBTI, causing a notice of deficiency for failure to report taxable income. The court held that the operation of the parking lots and the beach club were not substantially related to the promotion of community welfare since the facilities were not open to the public. An additional argument was made that income from the parking operation constituted rental income under Section 512(b)(3), but this argument failed because the association hired an attendant to operate the parking lot facility. This will be discussed further in the section on modifications, below.

In one other example that is extremely relevant today to many charitable organizations, the Service addressed the issue of merchandise sales on an organization's Web site in Ltr. Rul. 200722028. The organization was exempt under Section 501(c)(3) and created to promote education and public awareness of breast cancer prevention and research. The organization offered merchandise for purchase on its Web site year round and in its semi-annual newsletter. All of the merchandise offered contained markings specific to the organization such as logos and name recognition. All of the items fell into a grouping of apparel, jewelry, pins, home office supplies, and special gifts. In this case, the Service found that the promotion of breast cancer awareness was the exempt purpose of the organization and that the sales of merchandise with the organizations logo, name, and colors was substantially related to promoting such awareness. In this example there are two important issues to remember. First, this was a private ruling, and so is relevant only to the organization that requested it. Second, all of the merchandise being sold furthered public awareness of the organization's mission. This is often seen as a factor in the context of museum shops. If the museum gift shop is selling note cards containing art from previous, present, or future exhibits, those sales would be exempt. If it exploits its exempt status by selling unrelated merchandise, that merchandise would be treated as generating UBTI.

Regularly carried on. The second of the three requirements for inclusion of income in UBTI is that it must come from an activity that is regularly carried on.[7] Of the three elements, "regularly carried on" is the hardest to tie down because it is a concept rather than a specific definition. The general principal has to be evaluated in light of the frequency and continuity with which the organization pursues the activity that produces the income, along with the manner in which the activity is pursued. This analysis has to has to take into account the organization's exempt purpose and the manner in which it carries on its daily activities. This analysis

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is in furtherance of the general policy attempt to put the organization's unrelated business on an even par with its commercial counterparts.

The concept of being "regularly carried on" can be counterintuitive in some cases. It is measured within the framework of a year and not over a period of years. For example, the operation of a sandwich stand by a hospital auxiliary for a two-week period at a state fair is not regularly carried on.[8] Would the outcome change if the sandwich stand was operated during the same two-week period every year over a period of ten years? No, the answer would be the same. However, if the auxiliary moved from fair to fair across the region in two-week intervals, then the activity would be considered regularly carried on because of the frequency of the activity.

There is a very subtle distinction between activities motivated by income production and those that merely produce income.

In many cases, a small change in the facts—or even the emphasis attached to them—can make a major difference in the outcome. For example, one of the best known cases on the issue of whether an activity is regularly carried on involved the NCAA.[9] The issue in this case was whether the sale of advertising was deemed to be a regularly carried on activity. The Tax Court found that it was, saying that the soliciting of advertising for the programs at the NCAA's Final Four tournament was a year-round business that was regularly carried on. The Tenth Circuit reversed, however, looking to the fact that the NCAA's advertising solicitation was not limited to the Final Four program. Rather, multiple publications were involved. The NCAA sold advertising in other publications and solicited advertising from the same advertisers for a the Final Four program. Thus, said the appeals court, solicitation for the Final Four program was intermittently, not regularly, carried on. It was therefore like the sandwich stand, and the income it generated was not UBTI.

For charitable organizations selling real estate, whether or not the sale was a "casual" one or one made as part of a regularly carried on trade or business can have a substantial impact. In TAM 8734005, for example, a Section 501(c)(3) organization located on 60 acres of land decided to sell off part of the land because it was not being used for the organization's exempt purpose (an orphanage). The organization had held the property for over 80 years. It attempted to have the property rezoned to allow for commercial development but was not successful. It unsuccessfully tried to sell the entire parcel to one buyer. It then hired an engineer to subdivide the property into 36 lots including the roads and improvements necessary to make the property salable. The organization was also required to include curbs, gutters, sidewalks, drainage, and water systems. The lots were purchased in five blocks by five different parties.

The Service noted that when the organization was unable to sell the parcels in one block, it subdivided the land and made as few improvements as possible. The organization hired a real estate developer to market the property rather than attempting to sell the property itself. Because of difficult market conditions, it took over five years to sell off the parcels. Although there was a significant amount of effort on the organization's part, that effort did not convert the sales into anything other than "incidental."

In Ltr. Rul. 8950072, a charitable foundation wanted to sell its largest asset—a parcel of unimproved real property comprising some 260 acres that it was renting out for $100,000 a year. The foundation presented the Service with three possible scenarios for such a sale. The first option was to sell the land "as is." The second option included some preliminary development and site work, such as obtaining permits and approvals and selling the property in large blocks to a few developers. Neither of these options would have generated UBTI. The third option involved the foundation's assumption of all the risks of developing and marketing the property from start to finish.

While the first two options produced no UBTI, The Service ruled that the third option would constitute an unrelated trade or business that the foundation was regularly carrying on. (The Service did say, though, that the foundation's exemption would not be threatened.)

Substantially related. The third criterion in determining UBTI is whether the trade or business activity is substantially related to the organization's exempt purpose. A trade or business is

[8] Reg. 1.513-1(c).

[9] *NCAA*, 92 TC 456 (1989), *rev'd* 914 F.2d 1417 (1989), 66 AFTR2d 90-5602 (CA-10).

[10] Reg. 1.513-1(d)(2).

[11] Ltr. Rul. 200225044.

[12] 1968-2 CB 250.

treated as related to an organization's exempt purposes only if it has a causal relationship to the organization's ability to achieve those exempt purposes (other than by the production of income). In addition, the relationship must be substantial. Specifically, in order to be substantially related to the purposes for which exemption is granted, the production or distribution of the goods or the performance of the services producing the income must contribute importantly to the accomplishment of the exempt purposes.[10] Whether activities contribute importantly to an organization's exempt purposes depends on the facts and circumstances of each case.

For example, there is no question that a medical clinic operated in conjunction with a drug treatment facility is a trade or business, and the fact that it is open 24/7 means it is regularly carried on. Using the third criterion, the organization would need to establish a direct relationship between the clinic and the drug treatment facility in order to avoid the potential of UBTI from the clinic's operation.

Again, being substantially related does not include being financially necessary. Determination of the relationship depends on how the money is earned and not on how the money is used. Even though the funds earned are used to further an organization's exempt purpose, if the funds are earned in an unrelated activity the result would be unrelated income.

Whether an activity is related can also depend on the size and extent of the activity. In determining whether an activity contributes importantly to accomplishing an exempt purpose, its size and extent must be considered in relationship to the nature and extent of the exempt function of the organization. For example, if a training facility were to open a restaurant to train its clients in food management, careful consideration would have to be given to the size and extent of the operations. Training programs that have been determined to be related to the mission of the organization, and thus not generating UBTI, exhibited a combination of the following characteristics:

- Clients are the primary employees, except for individuals providing the training.
- All the work performed is done by the clients and their supervisors.
- The program is transitional for the purpose of gaining job skills.
- The program clients can work in the program's employment only for a limited period of time.
- All net profits are applied to the organization and its mission.
- The clients will earn new occupational skills.[11]

It is also important to remember that an organization can exploit its exempt status when carrying on an activity on a grander scale than is necessary to accomplish its exempt purpose. For example, it is not uncommon for an animal shelter to house a veterinary practice within its operations. If that practice is strictly to accommodate the animals in the shelter and those previously adopted, then, at least from an accounting point of view, the activity would not be treated as an unrelated activity. On the other hand, if the local community could take advantage of reduced rates by bring their pets into the facility, regardless of relationship or need, the shelter would clearly be exploiting its exempt purpose. It is possible, however, with proper books and records, to account for the related and unrelated activities separately.

Being substantially related does not include being financially necessary.

Ltr. Rul. 8107006 addressed the issue whether the sale of certain items by a charitable organization resulted in taxable income under Section 511—specifically, whether the sale of the merchandise contributed importantly to the organization's mission. In the ruling, sales of stationery, clothing, and accessories by a conservation organization were treated as related activities because the products containing the logo of the organization, or other environmental reference, stimulate interest in wildlife preservation. The key factor was "the life-like portrayal of wildlife species combined with the detailed, informative messages regarding that species and the accompanying literature regarding the organization's objectives and programs."

Where revenue-producing activity has both related and unrelated aspects, the "fragmentation" rule must be used. The veterinary clinic discussed above is a good example. The clinic undertook both related and unrelated activities. For the purpose of calculating gross unrelated income, the fragmentation rule requires that the tax-exempt organization's operations, run as an integrated whole, has to be divided into its component parts. Section 513(c) states that "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purpose of the organization." In Rev. Rul. 68-581,[12] the Service ruled that the sale by an exempt voca-

tional school of articles made by its students would be considered a related activity, but sales by non-students would not be treated as exempt. In the case of a university bookstore, Ltr. Rul. 8025222 determined that the sale by a university bookstore of books, supplies, and accessories is regarded as a related activity, while the sale of items such as hair dryers and plants constitutes a taxable activity. Regarding advertising, one of the most frequently cited cases, *American College of Physicians,*[13] determined that the sale of a monthly medical journal was an exempt function activity while the sale of advertising associated with the publication was unrelated. The Supreme Court held that such advertising was taxable even though it may have been educational or informational. Based on an example in the regulations,[14] for advertising to be considered a related activity, it has to contribute to the accomplishment of the organization's exempt purpose.

EXHIBIT 2
Fixed and Variable Expenses in *RPI*.

Fixed Expenses	
Salaries and fringe benefits	$ 59,415
Operating expenditures	1,356
Repairs and maintenance	14,031
Depreciation	29,397
Total	$104,199
Variable Expenses	
Wages and fringe benefits	$108,347
Operating expenditures	63,550
Repairs and replacements	25,313
Total	$197,210
Total fixed and variable expenses	$301,409

Deductions

Section 512 defines UBTI as gross income derived from unrelated business activities less deductions *directly connected with* the activity. The regulations state that an item of expense is directly connected with an unrelated trade or business if it has a "proximate and primary relationship" to the conduct of that trade or business.[15] The regulations refer to "proximate and primary" relationships in terms of (1) expenses attributable to unrelated business activities alone, and (2) those attributable to the dual use of facilities or personnel. Under normal circumstances, there is little ambiguity about expenses related solely to either a related or unrelated activity. Sometimes, however, the situation becomes considerably more ambiguous.

One such confusing area involves deductions allowable when an organization incurs expenses both for activities that relate to its exempt purposes and activities that produce UBTI.[16] The regulations provide that, if facilities are used to carry on both exempt activities and unrelated trade or business activities, indirect expenses must be allocated between the two uses on a "reasonable" basis. If personnel are used by both the related and unrelated activities, expenses attributable to personnel (such as salaries, retirement, and benefits) also must be allocated between the two uses on a reasonable basis. The regulations further state that the portion of any items so allocated to the unrelated trade or business activity must be "proximately and primarily" related to that business activity, and are allowable as a deduction in computing UBTI only in a manner consistent with the Code, notably Sections 162 and 167.

Rensselaer Polytechnic Institute (RPI)[17] remains the most cited case in regards to allocation issues. *RPI* addresses a long-standing dispute between exempt organizations and the Service—allocating the indirect costs of dual use facilities for UBTI purposes.

Indirect costs are those that normally do not vary in proportion to actual use, such as salaries and fringe benefits, depreciation, repairs and replacements, and operating expenses. When a nonprofit organization uses one or more facilities for both exempt and nonexempt purposes, some portion of its indirect expenses—such as overhead and depreciation—can be deducted from its UBTI. The regulations are not particularly helpful in providing guidance. According to Reg. 1.512(a)-1(c), the allocation of expenses can be made on "any reasonable basis." The problem is determining what is reasonable and to whom.

There is an obvious conflict in the allocation of costs between a related activity and an unrelated activity. The Service naturally would

[13] 475 U.S. 834, 57 AFTR2d 86-1182 (1986).

[14] Reg. 1.513-1.

[15] Reg. 1.512(a)-1(a).

[16] Reg. 1.512(a)-1(c).

[17] 732 F.2d 1058, 53 AFTR2d 89-1167 (CA-2, 1984), *aff'g* 79 TC 967 (ED Ill., 1982).

[18] See *North Carolina Citizens for Business and Industry,* 64 AFTR2d 5504 (Cls. Ct., 1989); *American Medical Assn.*, 668 F. Supp. 1085, 61 AFTR2d 88-731 (ND Ill., 1987).

EXHIBIT 3
Allocation of Fixed and Variable Expenses in *RPI*.

RPI Allocation:

$$\text{Fixed expenses plus variable expenses} \times \frac{\text{Unrelated use}}{\text{Total use}} = \text{Deductible portion of expenses}$$

$$\$301{,}409 \times \frac{1{,}586}{4{,}698} = \$100{,}592$$

IRS Allocation:

(1)

$$\text{Fixed expenses} \times \frac{\text{Unrelated use}}{\text{Total use}} = \text{Deductable portion of fixed expenses}$$

$$\$104{,}199 \times \frac{1{,}586}{8{,}760} = \$18{,}651$$

(2)

$$\text{Variable expenses} \times \frac{\text{Unrelated use}}{\text{Total use}} = \text{Deductable portion of variable expenses}$$

$$\$197{,}210 \times \frac{1{,}586}{6{,}507} = \$47{,}518$$

(3)

Deductible fixed expenses	$18,651
Deductible variable expenses	47,518
Total deductible expenses	$66,169

argue for a greater allocation to the related activity, thereby eliminating a deduction against UBTI. The exempt organization, by contrast, would naturally argue that the costs should be allocated to the unrelated business activity, thereby not allowing the expense to go to waste by offsetting tax-exempt income.

Unfortunately, there is no simple answer. The correct answer comes with an understanding of the rationale of the parties. Although the IRS still maintains a hard line on allocation, the courts appear to have given more favorable treatment to a more taxpayer-friendly position.[18] The IRS certainly has not given up on its position, and exempt organizations will have to continue to provide more documentation as to allocation.

The facts in *RPI* were straight-forward and few were disputed by the parties. RPI is a non-profit educational organization exempt under Section 501(c)(3). It owned and operated a fieldhouse that it used for two purposes:

- Student uses such as physical education, college ice hockey, student ice skating, and other activities related to RPI's tax-exempt educational activities.
- Commercial activities and events, such as commercial ice shows and public ice skating that do not fall within the school's tax-exempt purpose.

RPI and the Service agreed on the unrelated nature of the gross income at issue and its amount—gross receipts for the period (for the tax year ending in 1974) came to $476,613. They did not agree on the allocation of expenses, which fell into three distinct categories:

- *Direct expenses.* These were expenses that could be identified with particular commercial uses. They were referred to by the parties as "event costs." Included in these cost were contract and labor costs attributable to specific events and the total amount of RPI's general and administrative expenses ($8,050), which the parties agreed were allocable to the unrelated

business activities. These costs totaled $371,407 for the period, and both parties agreed that they were deductible from gross unrelated income.

- *Variable expenses.* These were expenses that varied in proportion to the actual use of the fieldhouse (utilities, for example), but could not be identified with particular events. These expenses totaled $197,200 and were allocated on the basis of actual use.
- *Fixed expenses.* This category included costs that did not vary in proportion to the actual use of the facility and would have been incurred with or without the commercial events. Examples of this type of expense are salaries and fringe benefits, deprecation, repairs and replacements, and operating expenses. These expenses amounted to $104,199.

Where revenue-producing activity has both related and unrelated aspects, the 'fragmentation' rule must be used.

The breakdown of the fixed and variable expenses is shown in Exhibit 2 on page 32. The total of fixed and variable expenses was $301,409.

Exhibit 3 on page 33 shows the core of the RPI dispute—how these expenses were to be allocated to related and unrelated use. As indicated previously, there was no dispute over allocating the direct "event" costs.

In allocating variable expenses, both parties agreed on the proper approach—costs should be allocated according to the ratio of hours of unrelated use to hours of overall use. They also agreed on the amount of unrelated use—1,568 hours. The dispute in allocating variable expenses was one of fact. RPI said that there were 4,698 hours of actual use, while the service said the figure was 6,507.[19]

The central issue in the case was a far more important disagreement and concerned the ratio to be used in allocating fixed costs. RPI contended that it was entitled to allocate the fixed expenses using the same formula it used for variable expenses—the ratio of unrelated use to total actual use. Thus, it used the same fraction—the total number of hours that the fieldhouse was used for commercial events, divided by the total number of hours the fieldhouse was used for all activities and events.

The Service argued that fixed expenses must be allocated, not according to the time of actual use, but on the time available for use. Its position was that the denominator of the fraction should be the number of hours in the year—8,760.

Although the parties agreed on many of the facts in the case, the points on which they differed had a significant financial impact. RPI said that $100,592 (roughly a third) of its fixed and variable expenses were allocable to unrelated activities, and therefore deductible from gross unrelated income. The Service, however, said that only $66,169 (little more than a fifth) of those expenses could be allocated to unrelated activities. The Tax Court agreed with RPI's method of allocation based on actual use, which it found reasonable within the meaning of the Code.[20]

The Service appealed the Tax Court's decision, arguing that the Tax Court's otherwise reasonable allocation based on actual use does not satisfy the statutory requirement that an expense must be directly connected with the unrelated business activity to be deductible. It also argued that strict application of the "directly connected with" language of the statute is necessary to prevent serious abuse of the tax exemption privilege.

In its resolution of the matter, the Second Circuit took the position that expenses that have been allocated on a "reasonable basis," including indirect expenses for facilities and personnel, are by definition "proximately and primarily related." As such they are "directly connected with" the unrelated business activity and expressly are made deductible by the regulations. Because its allocations were reasonable, the Second Circuit (as the Tax Court did before it) rejected the Service's allocation based on overall availability. It its 2016 work plan, the IRS is again looking at the issue of "dual use of facilities." Guidance is expected to be forthcoming later on this year.

Circuit Court Judge Mansfield dissented from the Second Circuit's decision, agreeing with the position that the Service still maintains. Before addressing the issue of reasonableness, Judge Mansfield wrote that the majority was wrong in its basic reasoning, which assumed that tax-exempt organizations are to

[19] The Service's figure for overall actual use included time spent on resurfacing the ice, maintenance and repair, and unspecified "down time." The Tax Court and the Second Circuit included on the resurfacing time.

[20] Reg. 1.512(a)-1(c), "Dual Use of Facilities or Personnel," states that where "facilities or personnel are used both to carry on exempt functions and to conduct an unrelated trade or business, determine whether expenses, depreciation, and similar items are allocated between the two uses on a reasonable basis. Deductible items must bear a proximate and primary relationship to the business activity to which they are allocated."

[21] *RPI, supra* note 17 at 53 AFTR2d 84-1171.

be governed by the same standards as commercial enterprises. RPI, he said, is a tax-exempt institution only because it has dedicated itself and its property in perpetuity to "charitable" and "educational" purposes. If the institution conducts income-producing unrelated activities, the only deductions should be those directly connected to that income. He thought that the court was being asked to divert reasonable expenses that were attributable to educational purposes. He said, "it could reasonably be argued that since RPI would, absent part-time use of its fixed assets for commercial purposes, be required to absorb all depreciation of such assets, no such depreciation is directly connect with its commercial business operations."[21]

The core of the Service's argument, which is not without merit, was that RPI's allocation is at odds with its exempt purpose, and the consequent exempt purpose of having a field house in the first place. The Service claimed the RPI's method of allocation was unreasonable because, by including depreciation for periods when the field house was not being used at all, it violated the rule that expenses must be "directly connected" with the unrelated activity, and only with the unrelated activity, if they are to be deductible from the income the activity generates. All other expenses, it said, were connected with having a facility that, like RPI itself, had a purpose that supported exemption under Section 501(c)(3).

The majority of the Second Circuit, however, said that the Service was asking for a more stringent interpretation of the "directly connected" standard in this situation than applies to commercial expenses under Reg. 1.162-1(a). The Service's approach essentially would deny depreciation deductions for an unrelated business when its assets are idle.

The majority also said that to apply the statute as the Service interpreted it would not fulfill the congressional purpose of placing private enterprise on an equal level with competing businesses run by tax-exempt institutions. Unlike business enterprises, the exempt would be unable to allocate any of its indirect expenses to those periods during which the field house was not be used at all. Again, the Service's reply would be that the field house existed for educational purposes; it was not created as a commercial venture. If it had been, it most likely would have been placed on a for-profit subsidiary with the university owning the stock.

Modifications

Section 512(b) provides for a series of "modifications" whereby various forms of income, which are normally taxed, will be exempt. Whether a particular type of income falls within one of the modifications is based on a test of facts and circumstances. In reviewing the major sources of modifications, organizations need to keep in mind a number of "exceptions to the exceptions." The one that most often affects exempt organizations is Section 514, which deals with "debt-financed income" (see below).

The list of modifications is long, and not all are within the scope of this article. A discussion of some of the more commonly encountered modifications follows.

Investment income. Section 512(b)(1) excludes all dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, annuities, and all deductions directly connected with such income. This, however, assumes a relatively "passive" role in the investment activity on the part of the organization. Normally, interest and dividends earned through a partnership (when debt financing is not an issue) are covered by the modification. However, if the partnership is an investment partnership conducting activity through a trade or business typically reporting the income on Schedule K-1 of Form 1065 ("U.S. Return of Partnership Income") the earnings could be taxable.

Section 512(b)(2) excludes all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property. According to Ltr. Rul. 7741004, however, royalties do not include income from a working interest in a mineral property if the payee is not relieved of its share of the development costs. Exclusion is based on a "gross" arrangement rather than a "net" arrangement. In order to be classified as passive, the tax-exempt organization cannot bear the risk of loss.

Royalties are not defined in the Code, but a generally accepted definition would include payments for the use of the payee's intangible property such as trademarks, patents, licenses, and copyrights. Royalties are generally a share of the profit reserved by an owner for permitting another to use the organization's property.

In the tax-exempt arena, the royalty arrangement that has received the most notoriety has been affinity credit cards. In a typical affinity card arrangement, a commercial joint venture

partner pays the tax-exempt organization a percentage of sales in exchange for the use of its logo and mailing list.

The initial problem arose in 1987 with Ltr. Rul. 8747066. There, an organization requested a ruling on an affinity arrangement with a bank related to credit card usage. The organization initially received a favorable ruling, but within 90 days the Service decided to reconsider.[22] That set off a battle that lasted until the Ninth Circuit's decision in *Sierra Club,*[23] holding that the royalty payments received were only royalties and not payments for services. At that point, the Service basically determined that it would not pursue the issue.

If facilities are used to carry on both exempt and unrelated activities, indirect expenses must be allocated between the two on a 'reasonable' basis.

One important issue remained after that. In order to respect the passive nature of the affinity card program if the rental of mailing lists is involved, the card program and the list rental have to be two separate arrangements. Including both in the same arrangement can change the nature of the overall arrangement, converting the amounts received from a passive royalties excludable from UBTI to payments for services rendered through the active participation of the organization. In that latter case, the exemption would not apply and the payments would be UBTI.

Section 512(b)(3) excludes rents from real property as long as certain conditions are met. In the case of personal property rented along with the real property, the exception depends on the amount of rent associated with the personal property, as follows:

- If less than 10% of the total rent is attributable to the rent of the personal property, it is excluded along with the real property rent.
- If the rent associated with the personal property amounts to between 10% and 50% of the total rent, only that portion of the rent is subject to taxation.
- If more than half of the rent is attributable to the rent of the personal property, none of the rent is eligible for the modification and is fully taxable.

The passive nature of rental activities generally rests on whether "substantial services" have been rendered to the occupant. Reg. 1.512(b)-1(c)(5) states that "services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy." Thus, supplying maid service constitutes a substantial service, whereas furnishing heat and lights; cleaning of public entrances, exits, stairways, and lobbies; collecting trash; etc. are not considered as substantial services rendered to the occupant.

Section 512(b)(5) excludes all gains or losses from the sale, exchange, or other disposition of property other than (1) stock in trade or other property of a kind that would properly be included in the inventory of the organization if on hand at the close of the tax year or (2) property held primarily for sale to customers in the ordinary course of a trade or business.

This modification also excludes the gains or losses recognized, in connection with the organization's investment activities, from (1) the lapse or termination of options to buy or sell securities or real property and from (2) the forfeiture of good-faith deposits for the purchase, sale, or lease of real property in connection with the organization's investment activities. Note that these exclusions apply only when the aforementioned activities are not being conducted as a trade or business.

Controlled entities. Section 512(b)(13) modifies the first three modifications discussed above. This can produce an unexpected and unpleasant result for tax-exempt organizations that are part of a multi-entity group made up of both for-profits and nonprofits. The surprise can come when a "controlling organization" receives certain payments from a "controlled organization" that reduce the controlled entity's net unrelated income or increase its net unrelated loss. In those circumstances, the controlling organization must include that payment as UBTI notwithstanding Sections 512(b)(1), (2), or (3).

It is fairly common for members of a multi-entity group to enter into various arrangements with one another. These might include lending money, royalties, licensing arrangements, and rental arrangements. Each one of these categories is potentially tax exempt under the previously discussed modifications. However, if the controlled party can take a deduction, the controlling party would have UBTI by virtue of Section 512(b)(13). For example, assume that a tax-exempt parent lends a wholly owned taxable subsidiary funds to begin operations. If the interest payments are deductible on the part of the subsidiary, the exempt parent will have tax-

able income if certain conditions are met. Section 512(b)(13)(D) provides that if a tax-exempt controlling entity either receives or accrues a payment from a controlled entity, the income will be UBTI to the extent that the controlled entity is able to take a deduction.

Under Section 512(b)(13)(D)(i), a controlling organization is deemed to control a taxable entity if:

- In the case of a corporation, it owns (by vote or value) more than 50% of the stock in such corporation.
- In the case of a partnership, it owns more than 50% of the profits interest or capital interest in such partnership.
- In any other case, it owns more than 50% of the beneficial interest in the entity.

The constructive ownership rules of Section 318 apply in the attribution of indirect ownership for purposes of Section 512(b)(13).

Unrelated debt-financed income. Another modification of the modifications, referred to above, applies when property has been financed by indebtedness. Section 512(b)(4) taxes income excluded from UBTI under Sections 512(b)(1), (2), (3), or (5) when two conditions are present: (1) the income arises from property acquired or improved with borrowed funds and (2) the production of income is unrelated to the purpose for which the organization was created. Section 514 contains the rules for applying Section 512(b)(4).

Debt-financed property. As a general matter, debt-financed property means any property that is held to produce income (e.g. rental real estate, tangible personal property, and corporate stock) and with respect to which there is "acquisition indebtedness" at any time during the tax year.[24] For these purposes, "income" also refers to realized gain on the disposition of such property. Consequently, if any property that was held to produce income by an organization is disposed of at a gain during the tax year, and there was acquisition indebtedness outstanding with respect to that property at any time during the 12-month period preceding the date of disposition, the property is considered debt-financed property.

There are, however, a number of exceptions:

- If substantially all of the property—that is, at least 85% of it—is used in a manner consistent with the organization's exempt purpose, the property would not be considered debt-financed property.[25] The extent to which a property is used in carrying out an exempt purpose is based on all the surrounding facts and circumstances. This exception can be applied in different ways—(1) a comparison of the portion of time the property is used for exempt purposes to the total time such property is used for all purposes; (2) a comparison of the portion of such property that is used for exempt purposes with the portion of the property that is used in general; or (3) a combination of (1) and (2). For example, assume that an organization rents out 20% of its debt-financed property to an unrelated business one day a week. Because the facility is in use five days a week, the usage represents 20% of the week times 20% of the space. That means its unrelated use is 4% of its total use, which is well below the 15% threshold.
- Property used in an unrelated trade or business is not treated as debt-financed property.[26] For example, Section 514 would not apply to rents from personal property, or in cases where the rent was coming from a controlled organization described in Section 512(b)(13), discussed above.
- Property will not be treated as debt-financed property to the extent that it is used for research activities and the income produced is otherwise excluded from UBTI under Section 512(b)(7), (8), or (9).[27]
- Property that falls within the "neighborhood land rule" will not be treated as debt-financed property.[28] This rule can apply if an organization acquires real property with the intent of using it pursuant to its exempt purpose within ten years. Such property will not be treated as debt-financed property if it is in the neighborhood of other property used by the organization for exempt purposes and the intent to use the acquired property for exempt purposes is not abandoned.
- Property that produces income from an activity excluded from the definition of "unrelated trade or business" under Section 513(a) will not be treated as debt-financed property.[29]

There are three categories of businesses that are excluded from the definition of an unrelated trade or business for this last purpose:

- Any trade or business in which substantially all the work is performed for the organization by

Another modification of the modifications applies when property has been financed by indebtedness.

[22] Ltr. Rul. 8823109.
[23] 86 F.3d 1526, 78 AFTR2d 96-5005 (CA-9, 1996).
[24] Reg. 1.514(b)-1.
[25] Reg. 1.514(b)-1(b)(ii).
[26] Section 514(b)(1)(B).
[27] Section 514(b)(1)(C).
[28] Section 514(b)(3)(A).

EXHIBIT 4
Amount Includible in UBTL.

$$\text{UDFI} = \text{Gross Income From Property} \times \frac{\text{Average Aquisiton Indebtedness}}{\text{Average Adjusted Basis}}$$

volunteers. This leaves the question as to what constitutes "substantially all." While not specifically addressed, note the 85% test used above for the rule on "substantially all" of the property being used for the organization's exempt purpose. In the volunteer worker context, this could allow for a paid supervisor.

- Any trade or business carried on by an organization described in Section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees. Two examples would be the college bookstore and the hospital cafeteria.
- Any trade or business that consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

Acquisition indebtedness. For purposes of determining whether an organization has debt-financed property, one must first examine whether that entity has what is known as "acquisition indebtedness."[30] This term is defined as the outstanding amount of indebtedness incurred by a tax-exempt organization before, during, or after acquisition if such indebtedness would not have been incurred but for such acquisition or improvement of the property. For indebtedness incurred after the acquisition or improvement, incurring the indebtedness must have been reasonably foreseeable at the time of the acquisition or improvement.

Whether the debt was reasonably foreseeable depends on the facts and circumstances of each situation. The fact that an organization did not actually foresee the need for the incurrence of indebtedness prior to the acquisition or improvement does not necessarily mean that subsequently incurring indebtedness was not reasonably foreseeable.

The regulations give the example of an exempt organization that pledges some of its investment securities with a bank for a loan.[31] It uses the proceeds of the loan to buy an office building that it leases to the public for non-exempt purposes. The outstanding principal indebtedness with respect to the loan constitutes acquisition indebtedness, incurred prior to the acquisition, that would not have been incurred but for such acquisition.

If an exempt organization acquires property for its exempt purpose with acquisition indebtedness, and later changes the use of the property to a non-exempt purpose, the property will be treated as debt-financed property as of the point of conversion. For calculation purposes, the unpaid mortgage balance, at the point of conversion, will become the beginning acquisition indebtedness.

In the case of property acquired subject to a mortgage, the amount of the outstanding principal indebtedness secured by the indebtedness is treated as acquisition indebtedness with respect to the property even though the organization did not assume or agree to pay such indebtedness. This rule applies without regard as to whether the property was acquired by purchase, gift, devise, bequest, or any other means.

For purposes of debt financing, liens that are similar to mortgages are treated as mortgages. A lien is treated as similar to a mortgage if title to property is encumbered by the lien for the benefit of a creditor. Liens similar to mortgages include, but are not limited to, deeds of trust, conditional sales contracts, chattel mortgages security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow, and tax liens.

There is fairly significant relief from the acquisition indebtedness rules for mortgaged property that is acquired by bequest, devise, or gift.[32] If property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by the mortgage is not to be treated as acquisition indebtedness during the ten-year period following the date of acquisition. The date of acquisition is the actual date on which the organization receives the property rather than the date of death of the decedent making the bequest. In the case of gifts, the outstanding principal indebtedness secured by a mortgage is not

treated as acquisition indebtedness during the ten-year period following the date of such gift so long as the mortgage was placed on the property more than five years before the date of the gift and the property was held by the donor for more than five years before the date of gift. These exceptions do not apply if the exempt organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent.

An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is considered to be a continuation of the old indebtedness to the extent that the outstanding principal amount thereof is not increased.[33] If the modified obligation exceeds the pre-existing indebtedness, the excess is treated as a separate indebtedness for this purpose.

The primary focus here is whether the outstanding indebtedness is increased. The following are examples of acts that result in the extension or renewal of an obligation:

- Substitution of liens to secure the obligation.
- Substitution of obligees, whether or not with the consent of the organization.
- Renewal, extension, or acceleration of the payment terms of the obligation.
- Addition, deletion, or substitution of sureties or other primary or secondary obligors.

Under Section 514(c)(4), acquisition indebtedness does not include incurring an indebtedness inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption.

One other significant exception applies to educational institutions. Section 514(c)(9) provides that acquisition indebtedness does not include indebtedness incurred by a "qualified organization" to acquire or improve real property. "Qualified organizations" include (1) educational organizations described in Section 170(b)(1)(A)(ii) and affiliated support organizations described in Section 509(a)(3), (2) qualified trusts under Section 401, (3) title-holding companies described in Section 501(c)(25), or (4) church-provided retirement accounts described in Section 403(b)(9).

However, this exception to acquisition indebtedness does *not* apply if:

- The price of the acquisition or improvement is not a fixed amount.
- The amount of any indebtedness, or the time for making any payment, is dependent in whole or in part on any revenue or income from the real property.
- After the acquisition, the real property is leased to the seller or related person.
- A qualified trust acquires the property from, or after the acquisition leases it to, a related plan or a person related to such a plan.
- The seller or a related person provides a school with financing in connection with the acquisition or improvement.
- The real property is held by a partnership unless the partnership is made up of qualified organizations.

Computation. As shown in Exhibit 4 on page 38, the unrelated debt-financed income from a debt-financed property is the percentage of the gross income received from the property that is proportional to the debt on the property.

The average adjusted basis and the average acquisition indebtedness refer to the average over the period during which the property was in the hands of the organization. The average adjusted basis is calculated from the adjusted basis on the first and last days of that period.[34] The average acquisition indebtedness is calculated from the amount of such indebtedness on the first day of each month in that period.[35]

The gains and losses from the sale or other disposition of debt-financed property need to be considered in the computation of debt-financed income. The amount to be included in UBTI is the gain or loss times the percentage represented by the highest acquisition indebtedness on the property for the 12-month period before disposition divided by the average adjusted basis of the property, as shown by Exhibit 4 on page 38.

Fractions rule. The "fractions rule" established by Section 514(c)(9)(E) and the associated regulations are beyond the scope of this article.[36] However, readers need to be aware of its well-deserved reputation for being a difficult and complex area of tax law. The rule comes into play when some types of tax-exempt qualified organizations (educational organizations and pension funds) wish to acquire real estate on a leveraged basis through a partnership without incurring an unrelated busi-

There is fairly significant relief from the acquisition indebtedness rules for mortgaged property that is acquired by bequest, devise, or gift.

[29] Section 514(b)(1)(D), Section 513(a).
[30] Reg. 1.514(c)-1.
[31] Reg. 1.514(c)-1(a)(2), Example 1.
[32] Reg. 1.514(c)-1(b)(3).
[33] Reg. 1.514(c)-1(c).
[34] Reg. 1.514(a)-1(a)(2).
[35] Reg. 1.514(a)-1(a)(3).
[36] Kahn, "Help With Fractions: A Fractions Rule Primer," Tax Notes, 2/22/10, page 953.

ness income tax on what would otherwise be debt-financed income. On a basic level, compliance with the fractions rule requires that the partnership agreement fall within the substantial economic effect safe harbor of Reg. 1.704-1(b), and that allocations under the partnership agreement cannot result in any qualified organization having a percentage share of overall partnership income in any tax year that is greater than its overall percentage of partnership loss for the tax year in which its share of loss will be the smallest.

Conclusion

Unrelated business taxable income deals with a series of rules that illustrate a compromise; an accommodation that seeks to strike a balance between fairness to the taxpayer and the need to collect revenue on the part of the Service. As long as the rules remain complex, the Service will continue to challenge and the taxpayers will continue to protest. As long as the Code continues to rely on reasonableness in the computation of UBTI there will always be a dispute between the parties.

Reasonableness is based on core knowledge of a subject matter and an attempt not to be prejudiced by the desire for a specific outcome. UBTI relies on primarily three elements—the existence of a trade or business, its being regularly carried on, and its lack of a direct relation to the organization's exempt purpose. With adequate knowledge in these three arenas, organizations and their tax consultants should be able to make a reasonable determination as to whether the organization has UBTI and, if so, how to adequately manage it. ■