IT ALL STARTED WITH MACARONI:

A TRIP THROUGH THE SHADOWY WORLD OF UBIT

By Mark B. Edwards

TABLE OF CONTENTS

I. It All Started With Macaroni ........................................................................................................... 2
II. Thus Says The Code .................................................................................................................. 3
III. What Constitutes a “Trade or Business?” ................................................................................ 4
IV. When is a Trade or Business “Regularly Carried On?” ......................................................... 5
V. When is a Business “Not Substantially Related” to the Exempt Purpose .............................. 6
VI. Exceptions Provided by the Code For Certain Business Activities .................................. 7
VII. Exclusion of Certain Income Provided by the Code ............................................................. 8
VIII. Debt Financed Income and Deductions ............................................................................. 10
IX. The Keys - Answers to Discussion Problems ....................................................................... 12

This outline was prepared for the 2005 Legal Forum by Mark B. Edwards (former Chancellor, Western North Carolina Annual Conference)

© September 2005 Mark B. Edwards
IT ALL STARTED WITH MACARONI:

A TRIP THROUGH THE SHADOWY WORLD OF UBIT

By

Mark B. Edwards

I. It All Started With Macaroni

A. In 1946, Henry Mueller, majority stockholder of the C. F. Mueller Co., died. H. T. Sorg, a business broker, conceived the idea of using the company as a vehicle to help the Law School of New York University. He put together a plan under which the University bought the company with 100% financing and operated the company thereafter. Profits from the sale of macaroni and other products went to the Law School.

B. The Internal Revenue Service sought to collect income tax on the earnings of the macaroni company, stating that it was unrelated to the University’s educational purposes. The United States Tax Court agreed. C. F. Mueller Co. v. Com’r, 14 T.C. 922 (1950).

C. On appeal, the Third Circuit Court of Appeals reversed the Tax Court, pointing out that the governing law looked only to the destination of the funds (i.e. the tax exempt university) and not to the source of the dollars. C. F. Mueller Co. v. Com’r, 190 F.2d 120 (3rd Cir. 1951).

D. In making its decision, the Court of Appeals had the luxury of knowing that, in the previous year, Congress had changed the statute, effective for tax years beginning after December 31, 1950.

E. These new statutes, embodied in sections 421 to 424 of the Internal Revenue Code of 1939, extended the concept of “unrelated business income” to the charitable world.

F. The purpose of the tax on unrelated business income is stated to be as follows:

1. The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of §501 organizations enables them to use their profits tax free to expand operations, while their competitors can expand only with the profits remaining after taxes... In neither the House Bill nor your committee’s bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. S. Rep. No. 2375, 81st Cong. 2d Sess. 27 (1950), 1950-2 C.B. 483, 504.
2. Thus there entered into the vocabulary of churches the acronyms UBIT (unrelated business income tax) and UBTI (unrelated business taxable income).

G. It was not until the Tax Reform Act of 1969, however, that the concept of “unrelated business income” was applied to churches for years beginning after December 31, 1969. See Regs. §1.511-2(a)(3)(iii).

II. Thus Says The Code

A. The provisions relating to the tax on unrelated business income (hereafter “UBIT”) are now set forth in sections 511 to 514 of the Internal Revenue Code of 1986 (hereinafter the “Code”)

B. Charitable organizations described in §501(c)(3) are subject to the UBIT. §511(a)(2)(A), (b)(2); Regs. §1.511-2(a)(1)(i), (b)(1).

1. This includes churches and conventions or associations of churches. Regs. §1.511-2(a)(3)(iii).

2. And churches cannot avoid these provisions by using subsidiaries because:

   a. §502 provides that an organization operated for the primary purpose of carrying on a trade or business for profit is not eligible for exemption from taxation because all of its profits are payable to an exempt organization.

   b. A subsidiary of an exempt organization is a nonexempt feeder organization if the subsidiary is operated for the primary purpose of carrying on a trade or business that would be an unrelated trade or business if regularly conducted by the exempt parent organization. Reg. §1.502-1(b).

   c. A feeder organization is not subject to the UBIT because it is not an exempt organization, but it is subject to the regular income tax provisions.

C. The statutory process for determining the income subject to the UBIT (this income figure being called the Unrelated Business Taxable Income or UBTI) is set forth as follows:

1. §511 imposes a tax on the UBTI of an exempt organization.

2. §512 requires the organization to include in UBTI the gross income derived from any unrelated trade or business it carries on, reduced by allowable deductions applicable to the activity, subject to certain modifications and exclusions.

3. §513 defines what an unrelated trade or business is.
4. §514 adds to UBTI a special kind of income, income derived from debt financed property.

D. These rules are incredibly complicated and, being inherently factual, have generated extensive and ongoing litigation. We cannot hope to cover them in any great detail due to limitations in space and time. However, a general statement of the rules can be made. From the statutory provisions and the regulations issued by the Internal Revenue Service to explain them, a three-part test has been developed for determining UBTI. See Reg. §1.513-1(b). As articulated by the United States Supreme Court in *U.S. v. American Bar Endowment*, 477 U.S. 105, 109-110 (1986), gross income from an activity carried on by an exempt organization is subject to UBIT if the following three criteria are present:

1. The activity constitutes a “trade or business;”

2. The activity is “regularly carried on” by the organization; and

3. The conduct of the activity is “not substantially related” to the performance of the organization’s exempt purpose.

E. Our next step is to examine each of these three tests to see how it is applied.

III. **What Constitutes a “Trade or Business?”**

A. The term “trade or business” includes any activity that is carried on for the production of income from the sale of goods or the performance of services. §513(c).

1. Under §162, a trade or business is generally an activity engaged in for the primary purpose of generating income or profit.

2. This profit motive test is often used by the courts and the Service to determine if an activity of an exempt organization is a trade or business.

3. Other factors to be considered in making this determination include the degree of involvement by the organization, the making of a substantial profit over a period of time, and whether the activity is similar to activities engaged in by commercial enterprises.

4. The Regulations offer this statement of the rationale of the statute:

   a. 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 activities business endeavors with which they compete. Regs. §1.513-1(b).
b. Thus passive investment activities of the exempt organization are not considered to be a trade or business. See Hill Family Foundation v. U.S., 347 F. Supp. 1225 (D. Minn 1972).

c. Moreover, as we will see later, dividends, interest, royalties and other income from investment activity are expressly excluded from the UBIT under §512(b).

B. Here are some factual examples for discussion:

1. A church maintains a shop within its facilities. The shop sells bibles, religious books, and souvenirs of the town in which it is located. Is there any application of the UBIT? [See Key IX.A.]

2. A church has a wilderness area near to the town in which it is located. It conducts regular retreats for its members and permits others to use the facilities at other times for a small charge. UBIT? [See Key IX.B.]

IV. When is a Trade or Business “Regularly Carried On?”

A. In determining if a business is “regularly carried on,” the most important considerations are the frequency and continuity with which the activities are conducted, and the manner in which they are pursued. Regs. §1.513-1(c)(1).

1. One test is to compare the time span over which the activity is operated with the normal time span of comparable commercial activities of taxable enterprises. Regs. §1.513-1(c)(2)(i).

2. If the activity is an intermittent one, that is, one that is carried on discontinuously or periodically, it is generally not considered to be regularly carried on if it is conducted without the competitive and promotional efforts typical of commercial activities. Regs. §1.513-1(c)(2)(ii).

3. And if the activity is both intermittent and infrequent, neither the recurrence nor the manner of conduct will cause them to be treated as “regularly carried on.” Regs. §1.513-1(c)(2)(iii).

B. Here are some factual examples for discussion.

1. A church has an extensive facility in a downtown location. Its parking lot is used for its members, staff and students through the week and on Sundays. On Saturday, however, the parking lot is available to members of the public for a fee comparable to nearby private lots. Is there a question of taxation? [See Key IX.C.]

2. A church located near the state capital operates a sandwich stand for two weeks each year at the state fair. Its prices are comparable to private operations at the fair. Query! [See Key IX.D.]
3. A church sells Christmas cards to its members. The sale starts in September with the delivery of the cards to the members asking for a “contribution”. There are follow-up mailings to the congregation over an eight-week period. Are the card sales regularly carried on? [See Key IX.E.]

V. When is a Business “Not Substantially Related” to the Exempt Purpose

A. To be liable for the UBIT, the exempt organization must carry on a business “the conduct of which is not substantially related…to the exercise or performance by such organization of its …function constituting the basis for its exemption under section 501…. §513(a); Regs. §1.513-1(a).

B. A trade or business is a related business if the conduct of it has a causal relationship to the achievement of an organization’s exempt purpose, and for the business to be “substantially related,” the causal relationship must be a substantial one. Regs. §1.513-1(d)(2). Put another way, the conduct of the business activity must contribute importantly to the accomplishment of the organization’s exempt purpose. Regs. §1.513-1(d)(2).

C. This determination is essentially a factual one, to be decided by the court or IRS after an examination of all the facts and circumstances.

1. One factor considered is the size and extent of the business activity in relation to the nature and extent of the exempt function that the activity purports to serve. Regs. §1.513-1(d)(3).

2. Another factor is the nature of the benefit derived by the exempt organization. If the activity benefits individual members in proportion to the payments they make, the activity is likely to be deemed unrelated.

D. NOTE: the fact that the organization uses the profits from the activity for one or more exempt purposes does not in itself make the underlying business activity a related one. §513(a).

E. Here are some factual examples for discussion.

1. A church operates a parish nurse program. Frequently the nurse given shots to members of the congregation, things like flu shots, tetanus shots, insulin shots, etc. A fee is charged over and above the cost of the medicine being administered. Query. [See Key IX.F.]

2. A church has recently erected a new family life building offering to the congregation a full range of exercise and athletic options. Members of the general public are permitted to use the exercise facilities upon payment of a fee. Is there exposure to the UBIT rules? [See Key IX.G.]
3. A church organizes travel tours for its members to sites of religious meaning. An outside tour company handles the arrangements and remits a portion of each traveler’s fee to the church. The church handles all promotions, and the senior pastor goes on the journey to answer questions and to lead worship services. There is entertainment nightly and optional side trips are offered. Related or not? [See Key IX.H for more discussion and factual variations.]

VI. Exceptions Provided by the Code For Certain Business Activities

A. Even if a trade or business would otherwise be deemed unrelated within the meaning of the statute, Congress has provided some exceptions to remove some of them from the reach of the UBIT.

B. There are a ten (10) exceptions from the definition of “unrelated trade or business” currently provided in the Code. However, not all of them are relevant to normal church affairs. Those that are relevant are as follows:

1. Section 513(a)(1) provides that a trade or business in not deemed “unrelated” if substantially all the work done in the business is done for the organization without compensation. This is commonly referred to as the “volunteer exception.”
   
a. The volunteer exception is not restricted to a particular kind of business so long as the performance of services (done by the volunteers) is a material income-producing factor. Rev. Rul. 78-144, 1978-1 C. B. 168.

b. There are three questions commonly encountered in this exception:

   (1) What constitutes the “work” related to the activity?

   (2) What constitutes “substantially all” of the work?

   (3) Do non-monetary or insubstantial benefits constitute “compensation” to the workers?

   c. Factual example: The UMW of a church operates a retail store that sells merchandise to the general public. No important exempt function of the church is served by the activity, and all profits are used in the work of the UMW. All work in operating the store is done by the ladies who receive no compensation. Is this exempt from UBIT? [See Key 9.]

2. Section 513(a)(3) provides that there is no unrelated trade or business where the exempt entity sells merchandise, substantially all of which has been received as donations. This is called the “thrift shop” exception because…

   a. This was enacted specifically to exempt from the UBIT the proceeds of thrift store sales. Regs. §1.513-1(e).
b. While there are no specific guidelines as to what constitutes “substantially all,” most commentators believe that the exception is available if at least 85% of the merchandise is donated. See Regs. §1.5149B0-1(b)(1)(ii).

c. Factual example: Same facts as in paragraph 1.c above except that all items sold by the store are donated by local merchants upon the request of members of the UMW. While many of the clerks are volunteers, the daily manager and the bookkeeper are salaried and full time employees. UBIT? [See Key IX.J.]

3. Section 513(f)(1) exempts the income from certain bingo games from the scope of UBIT. Section 513(f)(2) sets out three requirements to be met for this exception to apply:

   a. The game is conducted where the wagers are made, winners are determined and the prizes are paid in the presence of all persons participating in the game.

   b. The game is not an activity ordinarily carried out on a commercial basis.

   c. The conduct of the game does not violate any state or local law.

VII. Exclusion of Certain Income Provided by the Code

   A. Even if the business is regularly carried on and not related to the exempt purposes and not covered within one of the exceptions mentioned above, there are some types of income (as distinguished from businesses) that is not subject to the UBIT.

   B. Again, not all of these exclusions are relevant to activities carried on by churches, but the following ones are.

      1. Section 512(b)(1) removes passive income and related deductions from the scope of the UBIT. Included are the following items:

         a. Dividends;

         b. Interest;

         c. Annuities; and

         d. Royalties.

      2. Of these, only royalties have generated much controversy. In general, a royalty is a payment for the use of a right, regardless of whether the property represented by the right is used. See Com’r v. Wodehouse, 337 U.S. 369 (1949).
a. Royalties are normally received from books, stories, plays, copyrights, trademarks, trade names, formulas and patents. They are also received from utilization of natural resources such as coal, oil, minerals or timber. See Regs. §1.61-8(a).

b. Royalties do not include sums received for services rendered. Rev. Rul. 81-178, 1981-1 C.B. 135. Thus an exempt organization can lose royalty status if it is actively involved in the development and/or management of the underlying asset.

c. Factual example: The senior minister of a UM church writes a book and transfers ownership of the copyright to the church. Situation 1 – The church arranges for the printing, publicity and retail sale of the book, including advertising. Situation 2 – The church licenses the publication rights to a commercial publisher in return for stated royalties. In which case, if either, does UBIT apply? [See Key 11.]

3. Certain rents are also exempt from UBTI under §513(b)(3).

a. Rents are exempt if they are from real property and if they are from personal property leased with the real property, provided that the rents from personal property must be incidental to the real property rental. §513(b)(3)(A) and (C); Regs. §1.512(b)-1(c)(2)(ii).

b. Rents are not exempt under three circumstances:

(1) The exclusion does not apply if more than 50% of the total rent is attributable to personal property. §513(b)(3)(B)(i).

(2) The exclusion does not apply if the rents are determined in whole or in part by the income or profits of the rented assets. §513(b)(3)(B)(ii).

(3) The exclusion does not apply to payments for the occupancy of rooms where services are also rendered to the tenant. Regs.§1.512(b)-1(c)(5).

c. Factual example: A church is asked by a local cellular company to lease space within its steeple for placement of a telephone antenna. Will UBIT apply here? [See Key 12.]

4. Finally, the Code excludes from UBTI all gains or losses from the sale or exchange of property other than inventory-type assets or property for sale to customers in the ordinary course of business. §512(b)(5).

5. Factual example: A UMC conference center sells lots to people who wish to live there and take advantage of its program of learning. The center also provides municipal services (water, trash collection, road maintenance, etc.) to
individuals living there. It also provides amenities such as tennis courts, golf
course and swimming pool, which can be used by residents for a small fee.
Which income, if any, is subject to UBIT? [See Key 13.]

VIII. Debt Financed Income and Deductions

A. Under §514, certain income and deductions that otherwise would be outside the
scope of UBIT are included because they are received because of debt financed
property.

B. The term “debt-financed property” is defined in §514(b)(1) as property (real or
personal) having the following two characteristics:

1. The property is held to produce income; and
2. There is acquisition indebtedness with respect to the property at any time
during the tax year.

C. The income required under characteristic one can be any kind of income –
dividends, interest, royalties, rents, even capital gain upon sale. Regs. §1.514(b)-
1(a).

D. The second characteristic – that there be an acquisition indebtedness – means a
debt incurred in connection with the acquisition or improvement of the property,
whether the debt is incurred before, after or at the time of the acquisition or
improvement. §514(c)(1).

E. As always under the Internal Revenue Code, there are exceptions to the general
rules. Those which would be relevant for church activities are as follows:

1. The concept of debt-finance property does not include property whose use is
substantially related to the conduct of the exempt functions of the
organization. §514(b)(1)(A).
   a. Property is considered “substantially related” of 85% or more of its use is
devoted to the exempt function. §514(b)(1)(A)(i).
   b. If less than 85% is so used, the portion used for exempt purposes can still
be exempt while the balance is taxable. §514(b)(1)(A)(ii).
2. The term does not include property to the extent income from it is already
subject to the UBIT. §514(b)(1)(B).
3. Property used in a trade or business that is excepted from UBIT under the
volunteer exception or the donations exception is not subject to the debt-
financed property rules. §514(b)(1)(D).
4. Perhaps most importantly for churches, the debt-financed rules do not apply to land acquired for a prospective exempt use within 15 years of the date of its acquisition. §514(b)(3).

a. Generally the land must meet the following requirements under §514(b)(3)(A) for this exception to apply:

(1) The property is real property to be used within 10 years for a substantially related purpose;

(2) The property is in the neighborhood of other land owned by the organization and used in a substantially related function; and

(3) The organization does not abandon its intent to use the property for exempt purposes within 10 years.

(4) To expand upon the “neighborhood” requirement, Regs. §1.514(b)-1(d)(1) provides these requirements:

(a) The acquired property is contiguous with the previously owned property;

(b) The acquired property would be contiguous but for a road, street, railroad, stream, etc., or

(c) It is located within one mile of such property and it is not reasonable to purchase closer property.

b. For churches, these rules are modified to exclude the neighborhood requirement and to extend the time period to 15 years. §514(b)(3)(E).

c. Thus if a church acquires property for use in an exempt function commencing within 15 years of the acquisition, the property is not debt-financed property so long as the church does not abandon its plan.

d. However, after the first 5 years of the period, the church must obtain a ruling that the exempt use is likely to commence within the 15-year period. Regs. §1.514(b)-1(e)(2).

F. Here are some factual examples to discuss.

1. A church no longer needs its educational building so it sells it for $3,000,000. It receives $1,000,000 down and a mortgage for $2,000,000. It then builds a new educational building for $4,000,000, paying $1,000,000 and borrowing $2,500,000 from a bank. It retains the mortgage received in the sale as an investment. If there any debt-financed property here? [See Key 14.]
2. A church is building a new sanctuary. During the process, a cellular telephone company indicates a desire to lease space in the steeple for an antenna. In order to accommodate the antenna, the height and dimensions of the steeple are changed and an extra $250,000 is borrowed to pay for the changes. [See Key IX.O.]

IX. The Keys – Answers to Discussion Problems

A. Rev. Rul. 73-195, 1973-1 C.B. 264. The sales of souvenirs were held to constitute income subject to UBIT.

B. Rev. Rul. 78-98, 1978-1 C.B 167. Use by the public was held to be taxable. Query, could a church find comfort in its exempt purpose of evangelism and outreach?

C. Regs. §1.513-1(c)(2)(i). The parking lot was held to be regularly carried on.

D. Regs. §1.513-1(c)(2)(i). Held not to be regularly carried on.

E. Veterans of Foreign Wars v. Com’r, 89 T.C. 7 (1987), Held the sales were regularly carried on.

F. Rev. Rul. 68-374, 1968-2 C.B. 242 (Situation 1). Held not related to purposes of the hospital where sales were to the public. If sales limited to the congregation, perhaps result would be different.


H. Regs. §1.513-7(a) provides that the determination of whether travel is “related” to the exempt function is a factual determination to be made on a tour-by-tour basis. In Regs. §1.513-7(b), seven examples are set forth, of which Examples 1 and 7 are most closely on point. In both cases, the tours were deemed to be unrelated to the exempt purpose.

I. Regs. §1.513-1(e). Held to be within the volunteer exception.

J. Regs. §1.513-1(e). Held to be within the thrift shop exception.

K. See Rev. Rul. 69-430, 1969-2 C.B. 129. In situation 1, UBIT applies, but in Situation 2, it does not because of the royalty exception. But note that the ruling said “the book does not contribute importantly to the exempt purpose.: Query, what if the book were a book of devotions or theology?

L. Probably exempt.
M. TAM 200047049. Sales of lots is UBTI; municipal services are exempt; and user fees from persons not registrants in its programs are also UBTI.

N. Regs. §1.513-1(c)-1(a)(2), Example 3(a). The retention of the mortgage makes it debt-financed property.

O. Very close case; too close to call.