WRONG PLAN INVESTMENTS CAN CREATE UNRELATED BUSINESS TAX INCOME

If an exempt employee trust invests in an asset producing unrelated business taxable income, not only will the trust become taxable, but the trustee may have personal liability for mismanaging the trust's funds.

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Many investors, including owners of small businesses and self-employed professionals, find themselves with large balances in their individual retirement accounts (IRAs), Keogh plans, and other qualified retirement vehicles, due to both operational successes caused in the context of a strong economy, and significant run-ups in the values of investment securities thanks to a long- lived bull market in the US. When searching for ways to diversify the makeup of these portfolios, investors may be tempted to put these retirement funds into entrepreneurial businesses and other entities that are seeking start-up or venture capital. Such non-traditional investments can have unexpected income tax consequences for the unwary.

Current earnings from IRAs and other pension plans generally are exempt from income taxation. In certain circumstances, however, qualified retirement plans can be subject to tax on unrelated business taxable income (UBTI). [1] Most tax practitioners have not been concerned with these UBTI provisions in relation to IRAs and pension plans, since they are usually a concern of charitable and other exempt organizations or trusts. Recently, an IRS ruling emphasized the importance of being careful when dealing with self-directed IRA and pension investments to avoid the potential surprise of UBTI problems.

Unrelated Business Taxable Income

To mitigate any unfair advantage when competing with taxable entities, the federal tax on UBTI is designed to treat an otherwise exempt organization as if it were subject to the corporate income tax. Accordingly, a tax is applied to income generated by significant commercial activities that are not related to an entity's exempt purpose. For such unrelated activities, the entity's tax exemption is neutralized, and it holds no tax advantage over its competitors in the marketplace.

UBTI is defined by Section 512(a)(1) as gross income derived by any organization or trust from any unrelated trade or business, less the deductions allowed that are directly connected with the carrying on of that trade or business. (Generally, IRAs and other pension plans are exempt organization trusts if they meet the plan qualification requirements and receive the tax-advantaged treatment of retirement plans.) UBTI is taxable to an exempt organization or trust to the extent it exceeds $1,000 per year. [2] According to the Regulations, for an exempt organization or trust to conduct an "unrelated trade or business," three factors must be present.

- The exempt organization or trust must be engaged in a trade or business. [3]
- The trade or business must be regularly carried on. [4]
- The conduct of the trade or business must not be substantially related to the organization or trust's exempt purpose. [5]

Certain activities are exempt from UBTI treatment even if all three of these tests are met. Section 513 (a) allows several such exceptions, but these seldom are encountered in the context of the qualified retirement plan.

Trade or business. Trade or business has the same meaning here as it has for Section 162. Thus, activities carried on for the production of income from the sale of goods and services would generally be a trade or business for UBTI purposes. In addition, for UBTI purposes, the Regulations hold that a trade or business is not limited to integrated aggregates of assets, activities, and goodwill that normally comprise a trade or business for other Code provisions.

Example. An exempt university bookstore sells textbooks and other items such as T-shirts, mugs, snack food, and other general merchandise. The bookstore would not have UBTI from the textbook sales since that activity is related to its exempt purpose (education). Profits on the sale of most other items, however, would be UBTI.

Example. An exempt organization or trust can be engaged in a trade or business when it sells and publishes commercial advertising in periodicals related to its exempt purpose or when it conducts insurance programs for its members.

Regularly carried on. A commercial activity need not turn a profit to be classified as an unrelated trade or business. In determining if a trade or business is regularly carried on within the meaning of Section 512, though, the frequency and continuity of the activity is examined. The IRS states that this test must be applied in light of the purpose of the unrelated business income tax, i.e., to place exempt organization or trust business activities on the same tax basis as the nonexempt business endeavors with which they compete in the marketplace. Thus, exempt organization or trust business activities are deemed to be regularly carried on if they pursue the desired operations in a manner generally similar to comparable commercial activities.

Example. A youth football league sets up a sandwich stand for a weekend at the annual playoffs. The profit from the sandwich stand would not be unrelated business taxable income because the stand would not compete with similar facilities that a taxpaying organization would ordinarily operate year-round. A church operating a commercial parking lot on weekdays when the lot is not used for church activities, however, would be conducting a regular trade or business and that venture would produce UBTI.

Related to the exempt purpose. If the conduct of a trade or business by an exempt organization or trust produces income that is not substantially related to the purpose for which the exemption was granted, such income may be UBTI. To be a *related* trade or business, the conduct of the business activity must have a causal relationship to the achievement of the exempt purpose other than through the production of income. The relationship also must contribute *substantially* to the exempt purpose of the entity, or the trade or business will be subject to the unrelated business tax. Generally, the facts and circumstances surrounding an activity and the exempt purpose of the organization or trust determine if a substantial relationship exists. [6]

There is no "use of the funds" waiver of this test, i.e., even though the profits resulting from the unrelated business are used to support the exempt activities of the organization, the profits may still be UBTI. Sales of merchandise created in accomplishing the entity's exempt purpose generally are found to be related to such exempt purpose, and do not constitute an unrelated trade or business. Use of entity assets and facilities are held to a similar test.

Example. The Teachers Retirement Fund, an exempt organization, operates an oil field. All profits are allocated to the retirement accounts of those vested in the plan. The oil field constitutes an unrelated trade or business.

Example. The Rehabilitation Clinic, an exempt organization, accepts small appliances for repairs. Patients of the clinic are supervised as they carry out these repairs. Charges for the repairs can be significantly less than those required by commercial repair operations. The business is related to the Clinic's exempt purpose.

Example. The Big Museum, an exempt organization, conducts meetings and seminars in its large lecture hall, inviting experts to address groups of donors and the general public as part of an ongoing series. When the lecture hall is not scheduled for such events, promoters bring in rock musicians who sell tickets to their concerts presented to the public in the lecture hall. Profits from the concerts totally fund the Children's Expo event, exposing grade school students to the museum for the first time. The concert business is not related to the exempt purpose of the museum.

Compliance aspects. IRAs and other pension plans are taxed on unrelated business income at the regular corporate tax rates. They report UBTI on Form 990-T, which is due on the 15th day of the fourth month following the close of the tax year (for a calendar-year taxpayer, April 15th). For other exempt organizations that must file Form 990-T, the return is due on the 15th day of the fifth month following the close of the tax year (May 15th for a calendar-year taxpayer). [7]

Partnership investments

If an exempt organization or trust is a partner in a partnership that generates UBTI, it reports its share (whether or not distributed) of the unrelated business taxable income from the partnership. This is true whether the exempt organization or trust is a general or limited partner. [8] It appears to make little difference how the exempt organization or trust received the partnership interest.

1

Section 408(e)(1).

2

Section 512(b)(12).

3

Reg. 1.513-1(b).

4

Reg. 1.513-1(c).

5

Reg. 1.513-1(d).