Strafford

UDFI for Exempt Organizations: Reporting Unrelated Debt-Financed Income on Form 990-T

Avoiding Costly Allocation Mistakes in the Sale of Encumbered Property

WEDNESDAY, FEBRUARY 3, 2016, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** – if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code**. You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT

For Additional Registrations:
-Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

UDFI for Exempt Organizations

February 3, 2016

Garrett M. Higgins, CPA, Partner

O'Connor Davies

ghiggins@odpkf.com

Elizabeth M. Mills, Senior Counsel

Proskauer Rose

emills@proskauer.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

UDFI for Exempt Organizations: Reporting Unrelated Debt-Financed Income on Form 990-T

ELIZABETH M. MILLS, *SENIOR COUNSEL*
PROSKAUER ROSE, CHICAGO

GARRETT M. HIGGINS, CPA, *PARTNER*
O'CONNOR DAVIES, NEW YORK

February 3, 2016

Part I

Overview

- **Who's tax-exempt under Section 501**
  - Organizations described in Section 501(c)
  - Pension trusts described in Section 401(a)
- **What's taxable**
  - Per Sections 511-512, income derived from activity unrelated to the organization's exempt purposes ("unrelated trade or business")
    - Regardless of use to which organization puts the income
  - Per modifications in Section 512(b), investment income in some situations
    - This is where UDFI comes in

O'CONNOR DAVIES AUDIT | TAX | ADVISORY

Proskauer

Overview

- **What's not taxable**
  - Contributions, grants, and dues
  - Income from related activities (except for Section 401(a) trusts)
  - Investment income in most situations, per Section 512 (b) modifications
- **Taxable income reported on Form 990-T and taxed at corporate or trust rates as applicable; estimated taxes due**

Section 512(b) Modifications

- **General exclusions from UBI**
  - 512(b)(1): interest and dividends
  - 512(b)(2): royalties
  - 512(b)(3): rents from real property
  - 512(b)(5): gain or loss from sale of property (other than inventory)
- **But Section 512(b)(4) provides that these exclusions don't apply to income from debt-financed property as defined in Section 514**

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Purpose of Debt-Financed Property Provisions

- Prevent exempt organizations from unfairly competing with taxable organizations for investment properties
- Without this provision, exempt organizations could borrow money, buy properties, and receive the income tax-free
- Thus, exempt investor would be able to pay higher price than taxable investor to get same investment return

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

What is UDFI

- **Income**
  - Including interest, dividends, rent, <u>and gain on sale</u>
- **From debt-financed property**
  - Property subject to acquisition indebtedness
  - That is not substantially all used for exempt purposes
- **In proportion to the portion of property that is debt-financed (average acquisition indebtedness divided by average basis of property)**

Part II

Form 990-T Filing Requirements and Thresholds

- **Organizations exempt under Sections 501(a) or 529(a) with <u>gross income</u> of $1,000 or more from an unrelated trade or business that is regularly carried on must file Form 990-T (Reg. Sec. 1.6012-2(e))**
  - Gross income is defined as:
    - Gross receipts less cost of goods sold (Reg. Sec. 1.61-3)
    - Gross receipts UDFI, Line 6, Col. A
- **Which parts to complete?**
  - Gross Income < $10,000 – Parts I-V only (No Schedules)
  - Gross Income > $10,000 – Parts I-V and applicable schedules

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Part III

Exceptions to Classification as Debt-Financed Property

- **Substantially all of the use of the property is substantially related to exempt purposes**
  - Substantially all = 85%
  - Property can be used for exempt purposes by owner or by affiliate
- **The income in question is already subject to UBI**
  - For example, rent is subject to UBI under Section 512(b)(13)
- **The property is used in a trade or business described in Section 513(a)(1), (2), or (3)**
- **Neighborhood land rule**

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

What is Debt-Financed Property

- **Property held to produce income**
- **With respect to which there is acquisition indebtedness**
  - Acquisition indebtedness is the unpaid amount of –
    - indebtedness incurred in connection with the acquisition or improvement of the property or
    - indebtedness incurred before acquisition or improvement of the property if indebtedness would not have been incurred but for acquisition or improvement of the property or
    - indebtedness incurred after acquisition or improvement of the property if indebtedness would not have been incurred but for acquisition or improvement of the property and this was reasonably foreseeable at the time of acquisition or improvement

Details on Acquisition Indebtedness

- **If property is sold and there was acquisition indebtedness in the preceding 12 months, it is debt-financed property**
- **Property received subject to a mortgage has acquisition indebtedness even if the recipient doesn't assume the debt**
- **Mortgaged property received by gift or bequest is not debt-financed property for 10 years after receipt if the recipient does not assume the debt or pay for equity**
  - In the case of a gift, the donor must have owned the property and put the mortgage on the property more than 10 years before the gift

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Details on Acquisition Indebtedness

- **Charitable gift annuities do not constitute debt for this purpose**
- **Intra-system borrowing – e.g., between parent and subsidiary – doesn't constitute debt for this purpose**
- **A partnership's debt is attributed to its tax-exempt partner**
  - However, can UDFI treatment be avoided if tax-exempt partner's portion of partnership debt is prepaid and property is released from mortgage?

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Details on Acquisition Indebtedness

- Securities purchased on margin are debt-financed property
- Use of tax-exempt bond proceeds to purchase investments consistent with arbitrage restrictions does not create debt-financed property

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Special Rules Under Section 514(c)(9)

- **Some exempt organizations can invest in real estate on a debt-financed basis without incurring UDFI**
  - Section 170(b)(1)(A)(ii) educational organizations
  - Section 501(c)(25) title-holding companies
  - Section 401(a) pension trusts

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Special Rules Under Section 514(c)(9)

- **Conditions for this treatment**
  - Price for real estate must be fixed at the time of acquisition or improvement
  - Amount or time of payment of debt can’t depend on income from property
  - Property can’t be leased to or financed by a related party
  - If property is owned by a partnership, rules on permissible allocations

O’CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Part IV

O'CONNOR DAVIES

PKF An Independent Member of PKF International

Proskauer

Calculating Unrelated Debt Financed Income

- **UDFI reported on Form 990-T, Schedule E**
  - Exceptions:
    - Social Clubs
    - VEBA's
- **Information needed to calculate UDFI**
  - Gross income from debt-financed property
  - Deductions directly connected debt-financed property
  - Average acquisition indebtedness
  - Average adjusted basis

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Calculating Unrelated Debt Financed Income

- **Gross income from debt-financed property**
  - Revenue attributable to property that is debt financed and used in an unrelated trade or business
  - Revenue can be:
    - Interest, Dividends, Rents, Royalties
    - Gain or Loss from debt financed property
  - UDFI calculated as follows:
    - Debt-basis % x gross income from debt-financed property
    - Debt-basis % = Average acquisition indebtedness ÷ average adjusted basis of property for the year

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Calculating Unrelated Debt Financed Income

- **Deductions directly connected to debt-financed property**
  - Allowed same deductions as a taxable entity provided they are “directly connected” with the debt financed property or its income
  - “Directly connected” – expenses that have a proximate and primary relationship to the property or its income
  - Allowable deductions reduce debt-financed income only to the extent of the debt/basis %
  - Straight line depreciation only
  - Reported on Form 990-T, Schedule E, Column 3(a)&(b)

Calculating Unrelated Debt Financed Income

- **Example - applying the debt financed percentage**

  An exempt organization, receives $20,000 of rent from a building which it owns. The deductions directly connected with this building are property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the manager of the building. The debt/basis percentage is 50%. The Foundation reports the following in calculating UBI:

Rental Income	$ 10,000
Property Taxes	(2,500)
Interest Expense	(2,500)
Wage Expense	(7,500)

Calculating Unrelated Debt Financed Income

- **Average acquisition indebtedness**
  - Average principal debt outstanding during the portion of the tax year the property is held by the organization
  - Computed as follows:
    - Determining the outstanding debt on the first day of each calendar month during the tax year the property is held
    - Adding these amounts together, and
    - Dividing the result by the total number of months during the tax year the organization held the property
  - Reported on Form 990-T, Schedule E, Column 4

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Calculating Unrelated Debt Financed Income

- **Example – calculation of average acquisition indebtedness**

  A section 501(c)(3) tax-exempt, calendar-year organization, purchased an office building for $510,000, using $300,000 of borrowed funds. Effective August 1 of the current year, the organization began making monthly payments on the first day of each month to retire the debt. A portion of each payment ($10,000) was applied to principal, with the balance going to interest expense.

  The average acquisition indebtedness for the current year for the building is $275,000, calculated as follows:

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Calculating Unrelated Debt Financed Income

- **Example – calculation of average acquisition indebtedness**

Month	Indebtedness – 1st day of the Month
July	$ 300,000
August	$ 290,000
September	$ 280,000
October	$ 270,000
November	$ 260,000
December	$ 250,000
	$ 1,650,000
Average ($1,650,000 / 6)	$ 275,000

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Calculating Unrelated Debt Financed Income

- **Average adjusted basis**
  - Calculated as of the first and last day during the tax year
  - Property's adjusted basis includes:
    - Original cost
    - Plus additions or improvements
    - Less accumulated depreciation or amortization
  - Adjusted basis BOY + EOY / 2
  - Reported on Form 990-T, Schedule E, Column 5

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Case Study 1: Debt-Financed Property

An exempt organization owns a debt-financed building that is used for non-exempt purposes and generates $240,000 of rental income. Expenses are $100,000 for depreciation and $90,000 for other expenses that relate to the entire building. The average acquisition indebtedness is $1,890,000, and the average adjusted basis is $2,650,000, as calculated below:

To calculate the average acquisition indebtedness, you need to determine the outstanding debt on the first day of each calendar month, add these amounts together and divide it by the number of months during the year the organization held the property. For the average adjusted basis, the beginning of the year basis is added to the end of the year basis, and divided by two.

Average Acquisition Calculation

Beginning Balance	**1,955,000**
January-16	1,945,000
February-16	1,935,000
March-16	1,925,000
April-16	1,915,000
May-16	1,905,000
June-16	1,895,000
July-16	1,885,000
August-16	1,875,000
September-16	1,865,000
October-16	1,855,000
November-16	1,845,000
December-16	1,835,000
Average Debt	**1,890,000**
Monthly Payment	10,000

Average Adjusted Basis Calculation

Beginning Balance	2,700,000
Ending Balance	2,600,000
Average Basis	2,650,000

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Case Study 1: Debt-Financed Property (cont'd)

Schedule E - Unrelated Debt-Financed Income (see instructions)

1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property (a) Straight line depreciation (attach schedule) STATEMENT 8	3. (b) Other deductions (attach schedule) STATEMENT 9
(1) RENTAL PROPERTY	240,000.	100,000.	90,000.
(2)			
(3)			
(4)			

	4. Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	5. Average adjusted basis of or allocable to debt-financed property (attach schedule)	6. Column 4 divided by column 5	7. Gross income reportable (column 2 x column 6)	8. Allocable deductions (column 6 x total of columns 3(a) and 3(b))
(1)	1,890,000.	2,650,000.	71.32%	171,168.	135,508.
(2)			%		
(3)			%		
(4)			%		
				Enter here and on page 1, Part I, line 7, column (A).	Enter here and on page 1, Part I, line 7, column (B).
Totals			▶	171,168.	135,508.
Total dividends-received deductions included in column 8				▶	0.

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer

Case Study 2: Dual – Use Property

If substantially all (85% or more) of the use of any property is substantially related to an organization's exempt purposes, the property is not treated as debt-financed property. However, if that related use of the property falls below 85%, then a portion of the rental income is taxable. Using the same numbers as Case Study 1, if 60% of the building is used for unrelated purposes then only 60% of the expenses, average acquisition indebtedness and the average adjusted basis would be used in the unrelated business income calculation.

Schedule E - Unrelated Debt-Financed Income (see instructions)

	1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property (a) Straight line depreciation (attach schedule)	3. (b) Other deductions (attach schedule)
			STATEMENT 8	STATEMENT 9
(1)	RENTAL PROPERTY	140,000.	60,000.	54,000.
(2)				
(3)				
(4)				

	4. Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	5. Average adjusted basis of or allocable to debt-financed property (attach schedule)	6. Column 4 divided by column 5	7. Gross income reportable (column 2 x column 6)	8. Allocable deductions (column 6 x total of columns 3(a) and 3(b))
(1)	1,134,000.	1,590,000.	71.32%	99,848.	81,305.
(2)			%		
(3)			%		
(4)			%		
				Enter here and on page 1, Part I, line 7, column (A).	Enter here and on page 1, Part I, line 7, column (B).
Totals			▶	99,848.	81,305.
Total dividends-received deductions included in column 8				▶	0.

O'CONNOR DAVIES

AUDIT | TAX | ADVISORY

Proskauer

O'CONNOR DAVIES

PKF An Independent Member of PKF International

Proskauer

Part V

IRS Audit "triggers" leading to increases in UBTI

- **Primary reasons for examinations and adjustments:**
  - IRS initiatives
    - 2016 Workplan – Tax Gap
    - Compliance check - UDFI
  - Misclassification of trade or business
    - Lack of profit motive
    - Misclassified related activities
  - Misallocation of expenses
  - Computational errors
  - Disallowed net operating losses

Disclaimer

Any tax advice included in this written communication was not intended or written to be used, and it cannot be used, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency

O'CONNOR DAVIES
AUDIT | TAX | ADVISORY

Proskauer