I. Judicial Developments

A. ABA Retirement Funds v. United States, 759 F.3d 718 (7th Cir. Ill. 2014), aff’g 2013 U.S. Dist LEXIS 60086 (N.D. Ill 2013).

1. The District’s Court’s analysis in the ABA Retirement Funds case helps with an understanding the judicial view of the UBIT, even though this was an exemption case. In 2013, the District Court by memorandum opinion upheld the Service’s assessment of income tax for 2000-2002 on ABA Retirement Funds, formerly known as the American Bar Retirement Association (“Retirement”). Retirement claimed status as a section 501(c)(6) trade association, promoting the use of tax-qualified retirement funds for members of the American Bar Association (“ABA”), which is also a section 501(c)(6) trade association. The District Court concluded that Retirement was engaged in providing services to individual lawyers who wanted such retirement plans rather than providing benefits to the legal profession.
generally, that Retirement engaged in a business normally carried on for profit and was not a mere “sponsor” of plans managed by professional investment managers, that Retirement had not been recognized by the Service as a trade association even though the Service had approved the retirement plans submitted to the Service by Retirement, and that Retirement could not demonstrate that it was an “integral part” of the ABA as a part of this last analysis, The District Court concluded that, had the ABA offered the retirement plans itself, the revenues generated would have been UBI.

2. The Court of Appeals upheld the decision of the District Court. The range of issues considered by the Court of Appeals were fewer than those addressed by the District Court. The Court of Appeals addressed only two issues: (1) Did Retirement improve the business conditions of the legal profession, and (2) was Retirement engaged in a business ordinarily conducted for profit? It answered the first negatively and the second affirmatively. The stated purposes of Retirement as well as its actual activities demonstrated that it served only individuals and not the legal profession, according to the Court. And even though an exempt organization might sponsor retirement plans without loss of exempt status (see Rev. Proc. 2000-20, 2000-1
C.B, 553), Retirement was much more than a sponsor; it was the fiduciary on behalf of the lawyers and law firms that enrolled in the retirement plans. Serving as a fiduciary for employment plans is a business activity, not an exempt activity, concluded the Court. It is this latter conclusion that may well have UBIT ramifications for trade associations or other exempt organizations that consider serving as more than a nominal participant in various income-generating activities.

II. Legislative Developments

A. H.R. 644 was adopted by the House of Representatives on February 12, 2015. It does not address UBIT issues, but the political struggle over this limited tax bill indicates how difficult changes in the UBIT statutory provisions would be.

1. Among the components of H.R. 644 are:

   a. Permanent extension of the income tax deduction for contributions of food inventory;

   b. Permanent extension of the rule allowing charitable contributions from IRAs; and
c. Permanent extension of the deduction for qualified conservation contributions.

2. The vote on the bill was 279 in favor, 137 against, and 16 not voting, so a two-thirds favorable vote.

   - Republicans—240 yes, only 1 no
   - Democrats—39 yes, 136 no

3. So why the partisan divide? Because two days before, on Feb. 10, 2015, the President released a formal statement of opposition to the bill. He gave two reasons for opposition:

   a. The provisions favor the wealthy; and

   b. The losses of revenue were not offset by an equivalent increase in revenues through higher taxation.

4. The President announced that he will likely veto the bill if it is presented to him for approval.

B. Comprehensive tax reform legislation, including several UBIT provisions, will be discussed in the Advisory Committee presentation.
III. Administrative Developments

A. Relatedness

1. **PLR 201510059.** Many of the past year’s private rulings from the IRS bear on UBI only indirectly, since they focus on exempt status rather than UBI. But the analysis of exempt status usually involves a determination of whether a set of activities is in furtherance of an exempt purpose, and a similar analysis applies for “relatedness” under the UBIT. This PLR is an example. The Service ruled that an organization formed to research, manufacture, and sell pharmaceutical products to the public did not qualify as exempt from federal income tax under section 501(c)(3). About half of its activities was manufacturing and sales, and the other half was the conduct of clinical trials for a cancer vaccine. The organization asserted that it operated to relieve the poor and distressed, but the Service ruled that this purpose was not served because the organization sold its products at market prices, operating in manner similar to private commercial entities, without any sales below cost for the poor and needy. Unfortunately, the ruling also cited as negative factors the ownership
of a for-profit business and the absence of independent board members.

2. **PLR 201452020.** This PLR is another example of the connection between exemption and relatedness. The Service ruled that the organization was not exempt under section 501(c)(3). It primarily ran a travel website, which was not substantially related to any exempt purpose. Organization sold travel services for fee set by for profit company; thus prices were similar to commercial rates offered by for profit organizations with which it competed.

3. **PLR 201430018.** The “relatedness” of certain activities to the exempt purpose of a section 501(c)(6) trade association was questioned in this PLR, focusing on both exempt status and UBI. The organization was formed to serve as a “regional transmission organization” under the authority of the Federal Energy Regulatory Commission (“FERC”) and to improve the condition of the electric power and electricity business. At the instance of FERC, it proposed to take on the role of a direct buyer and seller of power (a “central counterparty”) in markets it administered. The Service ruled that those activities would not adversely affect its section 501(c)(6) exemption or result in UBI. Its
purpose was to reduce disruptions, administer market-based regulation of wholesale electricity market, and ensure that rates were reasonable. Notably, no net profit or loss was expected, so it is not clear why UBI was an issue or whether there would have been a different result if net income had been anticipated.

4. **PLR 201426029.** The difference between a related activity and an activity covered by a section 512(b) exemption can be easily overlooked. This is illustrated by this recent PLR addressing “testing” and “certification” activities. This ruling involved a “parent” section 501(c)(6) trade association that created standards for a particular industry and a “subsidiary” organization that conducted testing and certification based on those standards. “Testing” is excluded from the term “scientific research” for purposes of applying the section 512(b) exceptions for research, but that distinction was apparently deemed irrelevant by the Service in this case. The Service ruled that income received by the subsidiary from the activities of its testing laboratory and its certification process was not UBI because it furthered the quality and standards of the industry and created confidence in the products of the industry.
5. **PLR 201503018.** Tax-exempt organizations frequently develop intellectual property, procedures or other knowledge that can be used to create financial benefits for the EO. A common technique for avoiding UBI in those situations is to transfer the valuable idea to a controlled business corporation. This was the situation addressed by this ruling. A section 501(c)(3) educational institution licensed to a for-profit company owned by it software created by the EO. The Service ruled that the EO's ownership of this business entity would not adversely affect exempt status. Because the company was a separate entity for tax purposes, the company's activities and income would not be attributed to the EO nor would they generate UBI for the EO. Important facts for the author of the PLR were that the business organization's president was neither a director nor employee of the EO and that services provided by the EO to the business corporation were not reimbursed at cost but at fair market value.

6. **PLR 201444043.** An investment in rental-income generating real estate by or through a limited liability company was found not to impair the tax-exempt status of the EO. Even though the LLC provided some services to the tenants of the real property, its income was still rent protected from UBIT by section 512(b)(3). The EO was not operated
for primary purpose of carrying on unrelated trade or business, so it retained its section 501(c)(3) status.

7. **PLR 201440023.** The Service ruled that an agreement between section 501(c)(3) organization and for-profit media organization to make the EO’s research results available to users of the business organization’s electronic products and services for a fee would not jeopardize the EO’s exempt status.

8. **PLR 201424025.** This ruling indicates very careful thought and planning by the organization. Unfortunately, it was so careful the Service took 5 years to issue a ruling. But at least the ruling was favorable. The focus was whether an apparent contribution to a hospital was really a contractual payment in consideration for agreements made by an affiliate. An agreement was entered into between a section 509(a)(3) tax exempt supporting organization that was the parent of a healthcare system and an independent nonprofit health insurer. This followed a contribution by the insurer to a hospital in the healthcare system, to be used for expansion of medical services. After examining each contractual commitment by the parent,
the Service ruled that they did not jeopardize the EO’s exempt status and that the contribution did not constitute UBIT.

9. **PLR 2014423028.** The Service ruled that a section 501(c)(3) public entity originally organized to finance purchase, sale and market federally-guaranteed student loans could change its activities to provide for direct loans to students without loss of its exempt status or generating UBIT.

10. **PLR 2014429029.** The Service ruled that toys and other merchandise sold at a gift shop of a section 501(c)(3) museum would not generate UBI. The museum and associated research center were focused on exploration of the solar system; the toys, books and documentary videos sold in the gift shop all pertained to space exploration. Moreover, even coffee mugs that contained reproduction of newspaper articles reporting on solar discoveries contributed importantly to the museum’s exempt purpose.

**B. Passive Income**

1. **PLR 201435017.** This ruling involves a straight-forward application of the single member LLC rules. The Service ruled that a charitable trust’s ownership of a LLC that owned land and building would not
generate UBIT because of the rental income exception of section 512(b)(3).

2. **PLR 201422027.** Operation by tax-exempt private foundation of an apartment complex contributed to it was not “business enterprise” under section 4943(d)(3)(B) because at least 95% of its gross income was passive income, according to the Service. It also ruled that income from operations, including parking space rentals, was “rent from real property” that was not taxable.

3. **PLR 201423011.** The tax rules for real estate investment trusts (“REITs”) are similar to but not identical with, the section 512(b) exclusion of rental income from UBI. Because of the similarity of concepts, REIT rulings often indicate the Service’s likely analysis in the UBI area. In this ruling, a REIT provided tenants with information technology infrastructure, including basic server services and cross-connect services for tenants’ telecommunication carriers. The Service ruled that the revenue generated from these activities was “rents from real property” under section 856(c) and that revenue to taxable REIT sub for non-customary services would not affect the result.
4. **PLR 201434024.** The Service ruled that a section 664(d) charitable remainder unitrust that proposed to invest in a hedge fund would not generate UBI. The hedge fund used short sales of stock to balance its purchases of stock. Short sales are accomplished by borrowing stock to be sold and then repaying the lender’s stock at a later time, hopefully purchased for less than the amount received in the short sale. Based on long-standing precedent, the Service ruled that an obligation to repay stock is not indebtedness for section 514 purposes. The Service also ruled that the dividends on stock earned while stock was pledged as collateral was excluded from UBIT and that purchases of long positions in stocks using cash proceeds from short sales did not result in “acquisition indebtedness” for purposes of section 514(c).

5. **PLR 201434026.** Borrowing of stocks by fund entering into short positions, purchase of long positions in stocks, and use of long positions in stocks as collateral would not result in acquisition indebtedness under section 514(c). None of distributive share of fund’s income or gain would be treated as debt-financed property under section 514(b).
6. **PLR 201430017.** The Service ruled that dividends from foreign corporation, formed to managed section 501(c)(3) organization’s foreign investing, would be dividend income and thus excluded from UBIT under section 512(b)(1). None of income from corporation would be attributable to insurance income, and at least 95 percent of income would be from passive investments under section 954(c)(1)(A).

7. **PLR 201418061.** Investment in funds that were in business of investing in stock with emphasis on maintaining neutral trading position between long and short positions as proposed by section 501(c)(3) exempt private non-operating foundation would not result in “acquisition indebtedness” under section 514(c) nor would same generate “debt-financed property” under section 514(b).

8. **PLR201445015.** It has become more common for EOs to merge in efforts to promote efficiency, streamline management, and reduce overhead costs, but little attention has been given to the tax consequences of mergers. This PLR did go through the analysis in a case involving commonly-controlled, tax-exempt healthcare organizations: a hospital, a nursing home, a management company, and the parent organization. In an extended analysis, the Service
concluded that the charitable activities of the hospital and nursing home would not change, so the charitable nature of the organizations would continue after the merger. The interesting part of the ruling is the analysis that the merger was effectively a transfer of assets and liabilities, that the transfer generated a gain, but that UBIT would not be imposed on the gain due to the fact that there was no “regularly conducted” business of selling assets and that, even if so, the section 512(b)(5) exclusion for capital gains would apply.

C. SPECIAL UBI RULES

1. PLR 201512006. Section 512(a)(3) creates a special UBI rule for three types of exempt organizations: section 501(c)(7) social clubs, section 501(c)(9) voluntary employees’ beneficiary associations (“VEBAs”), and section 501(c)(17) supplemental unemployment compensation benefit trusts. Even more detailed rules are contained in section 512(a)(3)(E) for (c)(9) and (c)(17) organizations. The last year produced an unusually large member of rulings involving section 501(c)(a) VEBAs that worked to transfer assets among different accounts maintained by the VEBAs. In this first ruling, a trust established to administer benefits for employees of company that went
out of business won ruling that it was a welfare benefit fund maintained per collective bargaining agreement and limitations otherwise imposed by section 512(a)(3)(E) on amounts set-aside to provide welfare benefits that can be treated as exempt function income did not apply.

2. **PLR 201501014.** Income generated by assets transferred from section 419(e) retirement funding account established under group insurance policy to section 501(c)(9) VEBA that was a separate welfare benefit fund under collective bargaining agreement was not subject to UBIT.

3. **PLR 201451044.** Termination of trust created by sponsor of section 501(c)(9) VEBA trust following lump sum payments to eligible participants and reversion of net assets to sponsor did not result in section 4976(b)(1)(C) “disqualified benefit” nor result in section 4976 excise tax liability; nor was reversion “trade or business” within meaning of Treas. Reg. § 1.513-1(a).

4. **PLR 201441019 and PLR 20144022.** These two virtually identical rulings addressed a VEBA’s transfer of assets from a life insurance reserve to a health reserve for retirees to provide medical and dental benefits to retired employees. The Service ruled that the transfer
would not cause the VEBA to fail to qualify under section 501(c)(9). In addition, the IRS ruled that the income generated thereby would not be subject to UBIT.

5. **PLR 201434025.** Because a VEBA-owned LLC was a disregarded entity and its activities were treated as those of the VEBA, a settlement amount paid to the LLC by debtors was treated as if paid to the VEBA. It was exempt function income under section 512(a)(3)(B), and no portion would be UBIT for the VEBA, ruled the Service.

6. **PLR 201429028.** Social clubs exempt under section 501(c)(7) face a series of requirements for maintaining exempt status and avoiding UBIT. The general principle is that social clubs must primarily serve their members and preclude significant use by non-members. If non-member income is received, it may negate exempt status or, if not, result in UBIT. These principles were illustrated in this ruling in which the Service revoked an organization’s tax-exempt status under section 501(c)(7). The Service found that the organization had an established pattern of receiving less than half of its gross income from its membership. The Service deems more than 15% non-member use of a club’s facilities to be too much. Moreover, the organization
advertised the availability of its facilities for use by the general public, providing evidence that it engaged in business and was not operated exclusively for pleasure, recreation, or social purposes. The Service also concluded that, if revocation of exempt status was not upheld, the organization's investment income and non-member income, including rental income, should be subject to UBIT.

7. **PLR 201501015.** IRS revoked organization’s tax exemption under section 501(c)(7) as club because non-member income exceeded 15 percent of total gross receipts. Club advertised use of its facilities to general public, reflecting evidence that it was engaged in a business and was not being operated exclusively for pleasure, recreation, or social purposes.

8. **PLR 201430019.** A social club that focused on a particular type of automobile had a section 501(c)(7) group tax exemption. It generated three types of income that illustrate yet another refinement to the 35% and 15% rules on non-member revenue. The revenue sources were magazine advertising, sponsorship payments for club racing events, and an annual raffle. Only members participated in the raffle; anyone could advertise or sponsor, but only if related to the purposes of the
club. The Service determined that only “traditional” sources of club revenue could be received from non-members under the 35% and 15% tests, but that all three of these revenue sources were traditional ones. Even so, the advertising and sponsorship revenues were UBI, and section 513(i) does not apply to protect the latter. However, since only members could participate in annual car raffle, such income was “exempt function income” that was excluded from UBI by virtue of section 512(a)(3)(A).

9. **PLR 201441018.** A creative solution to a potential excess business holdings problem created an interesting UBIT result for a private foundation that became the owner of the stock of an S corporation that was engaged in the business of serving as a securities broker-dealer and registered investment advisor. Upon the termination of a trust that existed for the benefit of the private foundation and private parties, the private foundation would receive stock that was in excess of 2% of the outstanding shares, and disqualified persons would receive in excess of 35%. So the private foundation had a potential excess business holding problem. To address the problem, the company involved proposed to create an employee stock ownership plan (“ESOP”) to purchase the stock from the private foundation during the five year
disposition period provided by section 4943. Until the stock was purchased by the ESOP, the foundation would be treated as receiving its proportionate share of the income of the company. The Service ruled that the magnitude of the income from the for-profit business of the company did not jeopardize the foundation’s exempt status, but that the income would be taxable as UBI. The foundation appears to have accepted that result and sought only to assure itself that the pass-through income would not be taxed both as UBI and under the section 4940 excise tax provisions.