



UBI TAX NOT APPLIED TO RECEIVABLES LEFT BY DECEDENT

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Andrew M. Nerney and Andrew Brett Seiken, associates in Cummings & Lockwood's Private Clients Group, published an article entitled "UBI Tax Not Applied to Receivables Left by Decedent" which appeared on *Trusts & Estates* magazine website on July 26, 2016.

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Originally, all business income of charities and other exempt organizations was free from taxation. It wasn't uncommon, however, for many exempt organizations to generate income from activities that were unrelated to such organization's exempt purpose. Seen by tax-paying organizations as generating unfair competition, Congress created the unrelated business income (UBI) tax as part of the Revenue Act of 1950.¹ Today, the tax on UBI is imposed on the unrelated business taxable income of most exempt organizations. As the name implies, gross income subject to the tax includes income from a trade or business activity if the trade or business activity isn't substantially related to the organization's exempt purpose. A question arises: What happens if the exempt organization is the beneficiary of such income but didn't conduct the activities that created the benefit? The Internal Revenue Service, in Private Letter Ruling 201626004 (released June 24, 2016), answered this very question.

Legal Practice Distributed to Private Foundation

A decedent died, leaving a private foundation (PF) exempt from federal income taxation under Internal Revenue Code Section 501(c)(3) and a successful legal practice organized as a professional limited liability company and treated as an S corporation for federal income tax purposes. On the decedent's death, the legal practice was to be dissolved and all assets were to be distributed to the PF. Assets transferred to the PF included receivables relating to legal services provided by the legal practice. Such receivables represented the law firm's share of the remaining unpaid balance of the attorney's fees awarded on settlement of lawsuits. At no point after the decedent's death was the estate, legal practice or the PF conducting any business with respect to the receivables other than receiving payments relating to the satisfaction of such receivables. Such receivables, it was stipulated: (1) were comprised solely of income from services previously provided by the legal practice, including the decedent; (2) weren't debt-financed property; and (3) aren't gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

Imposition of the UBI Tax

Today, the tax on UBI is imposed on exempt organizations by IRC Section 511(a)(1). The IRC asserts the general rule² that gross income of an exempt organization subject to the tax imposed by Section 511 is includible in the computation of UBI if:

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It's income from a *trade or business*;

Such trade or business is *regularly carried on* by the organization; and

The conduct of such trade or business is *not substantially related* (other than through the production of funds) to the organization's performance of its exempt function.

A *trade or business*, according to Treasury Regulations Section 1.513-1(b), has the same meaning it has in IRS Section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

To determine whether a trade or business is *regularly carried on*, Treas. Regs. Section 1.513-1(c)(1) says regard must be had for the frequency and continuity with which the activities productive of the income are conducted and the manner in which they're pursued. As for the activities of an exempt organization, such activities will be deemed to be *regularly carried on* if they manifest a frequency and continuity and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

For purposes of Section 513, a trade or business is deemed *substantially related* to an exempt organization's exempt purpose "only if the causal relationship is a substantial one." Thus, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes if the conduct of a trade or business will be deemed to be substantially related to purposes for which the exemption is granted. On the other hand, when the production or distribution of the goods or the performance of the services doesn't contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services doesn't derive from the conduct of related trade or business. Such a conclusion of whether an activity is substantially related to an organization's exempt purpose depends on the facts and circumstances involved in each case.

No Finding of UBI

The legal services that led to the creation of the receivables were at no point carried out by the PF. As such, the PF couldn't be said to have been in the "trade or business" of providing legal services. The PF was merely the distributee of the assets of the estate and the recipient of the payments. Having performed no activity other than receiving payments, the income resulting from the receivables isn't UBI within the meaning of Section 512(a) and isn't subject to the tax on UBI described in Section 511(a).

Endnotes

1. P.L. 81-814, Section 301(a).
2. Subject to some exceptions. See Internal Revenue Code Sections 512, 513.