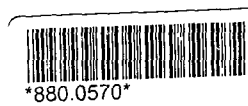
State of California



Memorandum

To : Mr. Jim Barga

Date : June 20, 1989

From : Richard H. Ochsner RHO

Subject : Unrelated Business Taxable Income

This is in response to your memo to Verne Walton of May 24 on the above subject inviting comments on your interpretation of Chapter 1606 of the Statutes of 1988 (SB 2407) which added section 214.05 to the Revenue and Taxation Code. You state that you intend to apply section 214.05 only if the organization and its property first meet all of the requirements of section 214. Your interpretation is correct. This question was discussed several times with the author's staff and it is clear both from our discussions and the language of section 214.05 that the Legislature intended to limit the application of the provisions of that section to property which otherwise met all of the requirements of the Welfare Exemption.

Since section 214.05 is an entirely new concept, I would also recommend that we keep a complete administrative record of the application of this section. We should try to keep track not only of how many applications come within its provisions each year but also keep tract of the amount of staff time involved in administering its provisions. After we have two or three years' experience, we may find it appropriate to suggest some changes in the law to make it more effective or suggest a repeal if it does not appear that the provision is efficient.

As indicated in your memo, the definition of unrelated business taxable income found in section 512 of the Internal Revenue Code is a net income concept. Thus, even though a business may have income from an unrelated business activity, it may not have unrelated business taxable income, as defined in section 512, if the expenses from that activity exceeds the income. Once it is determined that the property or some portion of it has produced unrelated business taxable income, however, the Welfare Exemption is limited by subdivision (b) of section 214.05 to the proportion of the value of the portion of the property producing unrelated business taxable income that the total gross income exempt from taxation produced by that portion of the property bares to the total gross income attributable to that portion of the property. Thus, once unrelated business taxable income is produced, then the

disallowance is based upon comparisons of total gross incomes not on net income.

Your memo states that of the six claimants found to have unrelated business taxable income, you do not know if the income was earned on the property that is being submitted for exemption. This statement puzzles me since the provisions of subdivision (b) contemplate that, if possible, the portions of the property producing the unrelated business taxable income will be identified. Further, subdivision (d) requires that the claimant submit various types of information to assist in administering this provision. The Board is expressly given the power to secure any information it needs. Thus, it is not clear to me why we do not know what activities produced the unrelated taxable income and where those activities were conducted on the property. I would point out that two additional positions were budgeted for the exemption unit largely because of the additional duties imposed by Chapter 1606. It does not appear that we have any reasonable excuse for not having the necessary information. I would suggest that we go back to the claimant's and get this information if it is at all possible. Otherwise, we should be prepared to demonstrate to the Department of Finance and the Legislature why we are unable to secure this information.

RHO:cb
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cc: Mr. John W. Hagerty
Mr. Verne Walton
Mr. Charlie Knudsen
Mr. J. Kenneth McManigal
Mrs. Margaret S. Boatwright