

UNRELATED BUSINESS INCOME TAX

Tax exempt organizations, including state colleges and universities, may be subject to federal income tax on net income derived from regularly carried on business activities not related to achieving tax exempt purposes.

I. DETERMINING THE GROSS INCOME SUBJECT TO TAX: To generate unrelated business income (UBI), a revenue-producing activity must meet a three-part test:

1. The activity must be a “*trade or business*”
2. The activity must be “*regularly carried on*” and
3. The conduct of the activity must be “*not substantially related*” to a tax-exempt purpose.

The “Trade or Business” Requirement. In general, a trade or business is any activity that is carried on for the production of income, involves the sale of goods or services, and has the general characteristics of a business enterprise. Profit motive is usually the determinative factor, and objective evidence of a profit motive is given greater weight than statements by an organization’s representatives. The making of a profit over a period of time is considered strong evidence of a profit motive. Conversely, failing to make a profit over a period of time is evidence that the activity lacks a profit motive. Conducting activities similar to activities conducted by commercial entities also may indicate the intent to profit. Under the so-called “*fragmentation rule,*” the IRS can carve-out components of an activity and treat that “fragment” as a separate trade or business. For example, University athletic facilities might be used to conduct both related events and unrelated events. The IRS would carve out the unrelated events and consider them an unrelated business.

The “Regularly Carried on” Requirement. In general, a business activity is regularly carried on if it manifests a “frequency and continuity” and is pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

The “Not Substantially Related” Requirement. To be a related activity, the conduct of the activity must contribute importantly to achieving a tax exempt purpose. How the funds are used is not a factor. The University’s tax exempt purposes include education, research, lessening the burdens of government, and others. Characterizing a business activity as a related business requires an analysis that shows how conducting the activity -- i.e., how selling the goods or the performing the services -- contributes *importantly* to accomplishing the University’s exempt purposes. Conducting an activity on a larger scale than is necessary to achieve a tax exempt purpose could also result in UBI, as could charging fees to the general public equivalent to what a commercial business would charge.

II. STATUTORY EXCEPTIONS TO THE UBIT:

Capital Gains. In general, gains and losses from selling property not held as inventory or for sale to customers in the ordinary course of a trade or business are excluded from the UBIT.

Interest and Dividends. In general, interest and dividends are excluded from the UBIT, although there are exceptions relating to Controlled Corporations and Debt-Financed Income.

Rental Income. Rents from real property are excluded from the UBIT. When personal property is leased together with the real property: (1) if the rent attributable to the personal property is not more than 10% of the total rent, all the rent qualifies for the rental exclusion; (2) if the rent attributable to the personal property is 10% – 50% of the total rent, the amount attributable to the real property qualifies for the rental exclusion; (3) if the rent attributable to the personal property is more than 50% of the total rent, none of the rent qualifies for the rental exclusion. If the rent depends in whole or in part on the net income or profits of *any person* from operating the property, the rental exclusion is not available. If the University *provides services* to the lessee other than services normally provided by a landlord to a tenant – heat and light, trash pick-up, etc. – the rental exclusion is not available.

Royalties. A royalty is defined as a payment for the use of a valuable intangible property right. Usually this means payments for the right to use the University’s name, logos, copyrights, patents, etc. It could also mean payments for the right to sell goods and services on campus, the right to sell advertising in the University’s publications, the right to use a mailing list to sell products to students, faculty, or alumni, etc. If the University *provides more than minimal services*, the IRS will attempt to reallocate some or all of the royalty payment as taxable services income.

License agreements. If the University’s intention is to exclude revenue under the royalty exclusion, it is important to structure the license agreements so that the revenue qualifies as a royalty and the IRS cannot re-characterize it as either profits from a joint venture or compensation for services rendered.

Quality Control Rights. The University could be involved in activities aimed at protecting the University’s reputation without jeopardizing the royalty exclusion, such as making sure the quality of the product or service meets certain standards, as opposed to becoming involved in marketing or other business-related concerns.

Agency Relationship. Either the terms of the agreement or the actual conduct of the parties could cause the IRS to argue that the purported licensee is really the University’s agent.

Research. For a University, income from conducting research is excluded from the UBIT, no matter for whom the research is conducted. The issue is how to define the term “research.” Commercial testing, quality control testing, or other types of activities normally carried on as part of commercial or industrial operations usually do not meet the definition of research. Engaging in marketing, operating, or manufacturing activities after the research phase is complete often results in UBI.

Volunteer Exclusion. Generally, if substantially all the work is performed by volunteers working without compensation, the activity is not considered an unrelated trade or business. “Substantially all” generally means at least 85% of the work. Services must be a material income-producing factor.

Convenience Exception. A trade or business operated primarily for the convenience of students, faculty, and staff is excluded from the UBIT. The convenience exception generally covers items like campus laundries, vending machines on campus, toothpaste sold at the bookstore, clothing and novelty items embossed with the University’s logo, etc. Items with a useful life greater than 1-yr generally do not come under the convenience exception. The IRS takes the position that sales to alumnae are not excludible under the convenience exception.

III. CONTROLLED SUBSIDIARIES: The interest, rents, and royalty exclusions may not apply if they are received from certain “controlled” organizations. A company is controlled if the University owns more than 50% of the stock determined by vote or value. An unincorporated association or a partnership is controlled if the University owns more than 50% of the profits, capital, or beneficial interests. Other organizations are controlled if more than 80% of the directors or trustees are representatives of, or are directly or indirectly controlled by, the University parent. An individual is a representative of the University if he is a trustee, director, agent, or employee of the University, and a director or trustee is deemed to be “controlled” by the University parent if the institution has the power to remove the individual and appoint a new director or trustee.

IV. UNRELATED DEBT-FINANCED INCOME: In 1969 Congress enacted the debt-financing rules to prevent allegedly abusive transactions. The rules were designed to tax the investment income attributable to property (real, tangible, and intangible) acquired with borrowed funds.

General rule: Basically, the net investment income (gross investment income less directly related investment expenses) from property acquired with debt is taxed in the same ratio as the debt that was used to make the acquisition. In other words, if you borrow 50% of the purchase price, 50% of the net investment income produced by the property is taxed.

Special rules and exceptions. For colleges and universities, real property is accepted. Debt-financed purchases of income-producing personal or intangible property are subject to the debt-financing rules; however, if at least 85% of the use is for related purposes, the property is not treated as debt-financed property. If less than 85% of the use is for related purposes, only the unrelated use will be subject to the debt-financed income rules. Therefore, if the University borrows money to purchase equipment or intangible property and uses the property less than 85% for related purposes, UBI may be an issue.

V. DEDUCTIONS: Two tests must be met for an expense to be deductible: (1) it must be *allowable as a business deduction* under the tax code – i.e., all the “ordinary and necessary” business expenses, depreciation, amortization, etc.; (2) it must be *directly connected with the carrying on of the unrelated trade or business* – i.e., “proximate and primary.” One court has held that this means the dominant reason in incurring the expense is to further the organization’s unrelated business. Some expenses are 100% deductible – e.g., the salary of a person who spends 100% of his time on the unrelated trade or business; 100% of the depreciation attributable to equipment used 100% in the unrelated trade or business. In many cases, however, personnel, facilities, and equipment are used both in related and unrelated activities. For these assets, expenses, depreciation and similar items

attributable to them must be allocated on a “*reasonable basis*,” and the portion allocated to the unrelated trade or business must be proximately and primarily related to the unrelated business.

Generally, allocations should be based on something that can be substantiated – gross receipts, contemporaneous labor records, records of equipment use, etc. In one ruling, the IRS and Tax Court denied an allocated overhead deduction because the organization failed to justify the propriety of its seemingly randomly estimated 50% allocation rate. Adequate records must be maintained to show the specific items of gross receipts and disbursements and to substantiate the amounts reported on the UBIT return. The IRS disallowed virtually all of the direct expenses claimed by one university because the university did not prove that the amounts were expended or, if expended, that they were expended for the designated purposes. Indirect cost deductions were also disallowed as not based on a reasonable method. (This case was ultimately settled prior to trial and all of the expenses were allowed.)

The IRS can be expected to carefully review the expense allocations of activities that result in losses because losses from an organization’s unprofitable businesses are used to offset gains from the organization’s profitable businesses. For example, if the IRS determines that certain indirect salary and overhead costs were unreasonably allocated to the particular loss activity, the claimed loss will be reduced or will disappear all together. Also, if a particular activity results in losses year-after-year, the IRS may contend that the activity is not undertaken with the intent to earn a profit, and is therefore not a trade or business. The IRS could also contend that a loss activity is “related” to the University’s exempt purposes, thereby preventing the loss from being used to offset UBI.

VI. OTHER UBIT ISSUES TO KEEP IN MIND:

Leases vs. Management Contracts vs. Joint Ventures. It is important that both written agreements and the actions of the University are structured to get the UBIT treatment intended. For example, if facilities are leased to an outside entity and the intent is to exclude the lease payments under the rental exclusion: (1) Make sure the contract is written as a bona fide lease and that the outside entity isn’t acting as an agent for the University in return for a management fee; (2) Make sure the University is not providing any services to the lessee that would negate the landlord/tenant relationship; (3) Make sure the payments to the University are not contingent on net income.

Advertising vs. Corporate Sponsorships.

Participating In Joint Ventures And Partnerships. In general, the University has to include in its UBI its share of the gross income from any activity conducted by the partnership that would not be a related activity if the University conducted the activity itself. Any income so included is still subject to the UBI modifications and exceptions. For example, if the University were a partner in a partnership that operates a factory and also owns stock in a corporation, the University would include in its UBI the income derived from the operation of the factory, but not its share of any dividends received by the partnership from the corporation.

❗ Please contact the University Treasurer’s Office for clarification or discussion about any of the issues raised in this summary.