

# Overview of Unrelated Business Income Tax

Prepared by  
Sara Mercer  
University of Oklahoma  
Financial Support Services  
July 2006

# History of Unrelated Business Income (UBI)

- Tax-exempt does NOT mean an organization or institution is tax-exempt from all taxes.
- C&U are interested in maximizing revenue from any income-producing activities.
- Tax-exempt organizations are subject to a special tax at normal corporate income tax rates on net income generated on unrelated activities.

# History continued

- The UBI tax was enacted in 1950.
  - To give IRS a means to penalize an organization other than revoking tax-exempt status (C&U likely would never reach revocation)
  - Create an equal playing field with for profit businesses
- Macaroni and UBI???
  - Destination of Income test
  - *C.F. Mueller Co. vs. Comm'r.*

# Internal Revenue Code

Relevant statutes within the IRC are:

- IRC Sections 511 through 515
- Section 511 is the statute that imposes the income tax. Applies to:
  - Section 501(c)(3) tax-exempt organizations
  - State colleges and universities (see copy of statute attached)

# Current UBI statute

- Three requirements must be present to be a UBI activity.
  1. a trade or business,
  2. regularly carried on, and
  3. not substantially related to the institution's exempt educational purposes.
- Subject to exceptions

# “Trade or Business” Requirement

- Any activity carried on for production of income (e.g., profit motive).
- Broadly interpreted by IRS.
- Does the activity generate a profit on a year after year, consistent basis?
- C&U use this element as a shield to argue an activity is not a UBI activity.
- IRS may use it as a sword; easy to pass this test

# Fragmentation Rule

- An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities, which may be related to the exempt (educational) purposes.
- Examples:
  - campus bookstore, golf course

# “Regularly Carried On” Requirement

- An 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 entities.”
- General factors IRS reviews:
  - time span activity is conducted (sandwich shop)
  - IRS counts preparation time (NCAA case)

# “Not Substantially Related” Requirement

- An activity will be related only if there is a “causal relationship” between it and the organization’s exempt purposes and will be substantially related only if the causal relationship is a substantial one and “contributes importantly” to the conduct of the organization’s exempt purposes.
- C&U primary exempt purpose is educational, conducting research is a secondary purpose.

# “Not Substantially Related” continued

- Other activities by their nature are easy to determine whether they meet this or don't meet this (e.g., college bookstore).
- Most activities fall somewhere in the middle.
- Evolving issue is whether community benefit and service is an exempt purpose?
  - wellness/rec facilities open to the general public, swimming lessons to the community

# Statutory Exceptions

- Capital gains are not UBI activities
  - stock and bond transactions
  - sales of land, building, equipment (even if used 100% in an unrelated activity)
  - Exception to exception is inventory sales
- Interest and Dividends
  - Exception to exception is interest/dividends from a controlled corporation
  - Interest/dividends that are debt-financed

# Rental Income Exception

- Rental Income exception:
  - rental of real property is not UBI
  - rental of personal property is UBI
  - rental of personal property leased with real property may be UBI (10%, 10-50%, 50%)
- Rent may be based on a percentage of sales, but it should be gross sales, not net income.
- Are there any services provided to the lessee? IRS permits only de minimis services.

# Royalty Exception

- Royalty income is not UBI.
- Royalty – payment for use of a valuable intangible right.
- Third parties often make payments to C&U for a number of different “intangible property rights.”
  - right to sell products on campus, right to sell advertising in school publications or athletic programs, right to use school mailing list, right to use school logo on products

# Royalty Exception cont.

- IRS current position is that it looks to see whether the licensor is required to perform services for the licensee. If yes, the IRS bifurcates the royalty agreement and treats the FMV of the services as an unrelated activity.
- Certain services may be permissible (quality control).

# Research Activities

- C&U often enter into contracts with governmental agencies and private businesses to conduct research.
- May not have to resort to this statutory exception because the nature of the research project may be substantially related to the educational mission of the institution; for example, students are involved.

# Research Activities cont.

- Scientific research in the public interest is also considered “substantially related” to a C&U.
- In order to meet this tax-exemption criteria, it has three additional tests:
  - must be “scientific research”
  - must not be conducted incident to commercial or industrial operations
  - research must be conducted in public interest

# Research Activities cont.

- 3 possible exceptions:
  - Research performed for the U.S. or its political subdivisions
  - Research performed by a college, university or hospital
  - Research by an organization whose primary purpose is fundamental research, the results of which are freely available to the general public (research organization)

# Convenience Exception

Trade or business carried on by a tax-exempt institution, primarily for the convenience of its members, students, patients, officers, or employees is not treated as UBI activity.

# Convenience Exception cont.

Issues unique to C&U:

- Are alumni considered “members” within the convenience exception?
  - they are limited in size, closely associated with the institution, and necessary to achievement of the institution’s purposes.
- C&U bookstores selling clothing items. Does that fall within the “convenience exception?”
  - IRS says “yes” IF embossed with school logo.

# Other Exceptions

- Volunteer activities
  - if a trade or business in which substantially all the work is conducted by volunteers, the activity is not UBI.
- Donated goods
  - income from sale of merchandise, substantially all of which has been donated, is not UBI (thrift shop).

# Exception to the Exception: Unrelated Debt-Financed Income

- Investment income attributable to property acquired by a tax-exempt organization with borrowed funds is treated as UBI.
  - Debt-financed property is any type of property (real, personal, intangible) held to produce income with respect to which there is acquisition indebtedness.
  - Exception to the exception to the exception: C&U that acquire real property with debt (borrowed \$\$\$). Such property is not treated as acquired through “acquisition indebtedness.” Only applies to real property, not personal property.

# Allowable Deductions

- Unrelated business income tax is imposed on net taxable income from the unrelated activities.
- In order for an expense to be deductible, it must meet two tests:
  - expense must be allowable as a deduction under one of the tax code provisions that allow business deductions for for-profit companies; and
  - expense must be “directly connected” with carrying on of the unrelated trade or business.
    - Allocation between exempt and unrelated activities must be done on a reasonable basis

# Net Operating Losses

- Net operating loss rules are available to tax-exempt organizations, including C&U.
  - current law is back 2, forward 20 years.
- Remember if an activity is generating losses year after year, IRS may argue the activity does not meet the “trade or business” requirement (no profit motive).

# C&U Activities

- Advertising revenue is per se UBI:
  - Exploitation/promotion of organization's name, services or products in return for payment (student newspaper, game programs, school magazines).
  - Are students involved? May be educational.
- Corporate sponsorship is not generally UBI:
  - Payment made by a corporation or business to a CorU, in return for which the company receives some mention or acknowledgment of its products or services.
    - logos, slogans, sponsor's locations/phone numbers/Internet address, display of sponsor's products are all okay

# Technology Transfer Issues

- Royalties may be generated from technology transfers (e.g., patents)
- Tax issues arise in such transactions
- University – possible characterizations:
  - Nontaxable royalty income (royalty exception)
  - Nontaxable income from research (research exception)
- Employee/professor – Royalty vs. compensation for services:
  - Taxable in either case but if treat as royalty, not subject to employment taxes

# Tax-exempt Bonds

- With using tax-exempt bonds to fund construction and capital projects, there are also strict tax rules.
- State and local bonds issued to finance state and local government activities.
- Private activity bond = 10% or more of the bond proceeds are used in a trade or business conducted by a nongovernmental unit.

# Tax-exempt Bonds

- If a bond is a private activity bond, the interest is taxable.
- This rule on private activity bonds does not apply if the entity benefited is a 501(c)(3) organization, including state C&U.
- Bond proceeds must be used in furtherance of the charitable or educational mission.
- At least 95% of the net proceeds must be used in furtherance of the exempt purpose.
  - use by general public does not count as private, nonexempt use.

# Tax-exempt Bonds

- If bond-financed facilities are used by an institution for purposes not related to its exempt purposes, the use is considered “private use” and is impermissible.
- Definition of “unrelated trade or business” for the bond rules is not the same as for income tax rules.

# Tax-exempt Bonds

- What is arbitrage?
  - Investing the proceeds from the bond offering in a higher earning investment portfolio than the bond interest rate until proceeds are needed
- Issuer of the bonds must rebate to the U.S. (IRS) these arbitrage profits.
- Must involve bond counsel to monitor compliance with these complex issues.
- IRS is planning to aggressively audit organizations, including C&U, that have issued tax-exempt bonds.

# UBI – Policies & Procedures

Key components to minimizing risk:

- Written policies and procedures
- Centralized Control
- Maintain adequate documentation
- Education
- Assessment of existing exposure

# UBI – Policies and Procedures

## Centralized control:

- Control point to ensure consistent application of the law
- Familiarity with tax issues
- Ensure that potential contracts are reviewed for tax issues, and revised as appropriate
- Achieve by appointing a responsible party

# Tax Forms

- UBIT is NOT necessarily BAD!
- For state colleges and universities, to report UBI activities, prepare and file:
  - Form 990-T, *Exempt Organization Business Income Tax Return*
- For private colleges and universities, file:
  - Form 990-T, *Exempt Organization Business Income Tax Return*
  - Form 990, *Return of Organization Exempt from Income Tax* (general information return)

# Questions?

Contact Stacy Thompson  
in Financial Support Services

Phone: 325-4997

Email: [sthompson@ou.edu](mailto:sthompson@ou.edu)