



Unrelated Business Income
Basic Concepts and UGA Applicability
University of Georgia
October 13, 2009

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Objectives

After this presentation, we hope you will:

- Understand the basic elements of Unrelated Business Income (UBI)**
 - So that you can at least identify situations that may be problematic

- Have a better understanding of the UBI implications of specific UGA programs and activities**
 - We are not offering tax opinions on your programs, but providing general information—tax issues are very fact specific and require research to come up with correct position

- Have answers to some of your burning questions**



Tax Exempt or Not?

Isn't the University exempt from Federal Income Tax?

Yes and No



Tax-Exempt Activities

- The University is tax-exempt as an instrumentality of the State of Georgia under Section 115 of Internal Revenue Code. [The Foundation is exempt under Section 501(c)(3).]
- The University is exempt from federal income tax for engaging in activities which further its educational purpose.



Taxable Activities

- ❑ However, the University is not exempt from income tax imposed on activities which are substantially *unrelated* to those exempt purposes, even though these activities may bring in funds to support the University's exempt operations.



Unrelated Business Income - History

- It all started with macaroni!!!
- Mueller Macaroni was owned and operated by New York University Law School. Profits went to the school.
- IRS challenged that producing macaroni was not related to educational purpose.
 - Previously only looked at “destination of funds” rather than the source of the income
- Unrelated business income became taxable in 1950.



What is Unrelated Business Income? 3-Prong Test

- Trade or business
- Regularly carried on
- Not substantially related to organization's exempt purpose

UBI – Trade or Business

- ❑ **Broadly interpreted by IRS**
- ❑ **Any activity carried on for the production of income**





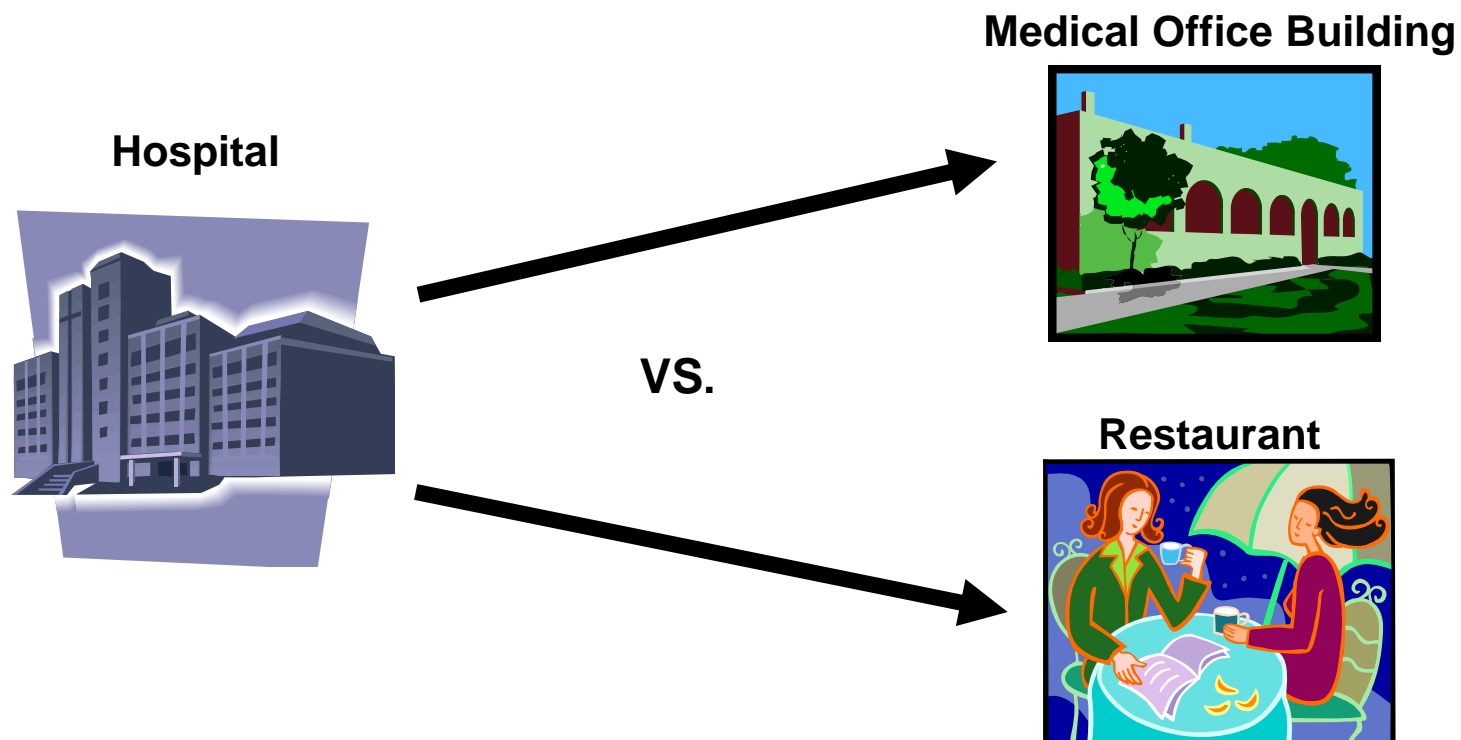
Regularly Carried On

- ❑ A frequency or continuity of the activities similar to the activities of a comparable taxable enterprise.

- ❑ An activity should not be considered as regularly carried on if it is:
 - On a very infrequent basis;
 - For a short period of time during the year; or
 - Without competitive and promotional efforts.

Not Substantially Related

- ❑ The activity does not contribute to the accomplishment of the organization's exempt purpose.
- ❑ Simply supporting exempt activities *does not* make something related!





Principal Exclusions from UBI

GOOD NEWS: There are certain exceptions in the Internal Revenue Code to exclude activities from UBI.



Exception: Volunteer Workforce

- ❑ If the activity is conducted by volunteers 85 percent or more of the time, the activity is not an unrelated business.



Exception: Sales of Donated Merchandise

- ❑ **If activity constitutes the sale of donated merchandise, it is not an unrelated business**
 - Example:
 - Thrift store



Exception: Convenience of Members

- ❑ **Certain activities carried on primarily for the convenience of members of the University, students, faculty, and employees are also exempt.**
 - Examples:
 - University cafeteria
 - Convenience items sold in the bookstore (examples: mints, aspirin, etc.)



Other Exceptions – Investment Income

- ❑ Dividends

- ❑ Interest
 - **Rationale for exclusion: Income derived in a “passive” manner generally is income that is not acquired as the result of a competitive activity, and therefore, should not be taxed**

- ❑ Exceptions:
 - **Income from controlled subsidiaries (>50% owned)**
 - **Investment income that is debt-financed**



Other Exceptions – Capital Gains

- ❑ This includes gains from the disposition of property
 - **Example:**
 - **Stocks and bonds**
 - **Sales of land, building and equipment**

- ❑ Exception to Exception:
 - **Sale of inventory or property held primarily for sale to customers**
 - **If property was debt financed within last 12 months**



Royalty Exception

- ❑ Royalty income is generally not UBI.
- ❑ Royalty - payment for use of valuable intangible right.
- ❑ Third parties often make payments to Universities for a number of different “intangible property rights”
 - **Examples: Right to use school mailing list, right to use school logo on products (i.e. credit card)**
- ❑ Exception: If University has to perform services in exchange for payment.



More Exceptions – Rental Income from Real Property

- ❑ Rental income derived from the rental of *real* property is excluded from UBI

- ❑ Exception: Rental of real property contingent on net profits
 - Note: Contingency on gross revenues is fine

- ❑ Note: Read Lease carefully!



Rental Income - Real AND Personal Property

- ❑ **Rental income from leases of both real and personal property are subject to the following rules:**
 - **If 10% or less from personal property** – considered incidental and not UBI in accordance with real property rental income exclusion
 - **11-50% from personal property** - taxable in proportion to the percentage of personal property rent to the total rents
 - **51% or more from personal property** – 100% taxable



Rents with Substantial Services

- ❑ **If substantial services are provided to the tenant, income could be UBI.**
 - **Example:** University leases its stadium for several months to a professional football team. The university furnishes all utilities and is responsible for ground maintenance. It also provides dressing rooms, linens, and stadium security services for the team.
 - **Conclusion:** Leasing of the stadium is an unrelated trade or business. The substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only.



Debt-Financed Property

- ❑ **Normally excluded income (such as rental, royalties, interest, dividends and capital gains) is at least partially taxable if there is acquisition debt on the property:**
 - Mortgage or other financing on real estate
 - Organization borrowed to make an investment (margin loans)
 - Pass through investment vehicle (e.g., LLC) borrowed to finance its income (common with real estate investments)

- ❑ ***Important*—not applicable to state universities real estate but *is* applicable to related foundations unless they are supporting organizations under 509(a)(3) or income derived from research activities**



Debt-Financed Property - Exceptions

- ❑ **Rental income from debt-financed property may still be excluded from UBI under the following circumstances:**
 - If less than 15% of the space is rented out
 - If the lessee's mission contributes importantly to the exempt purpose of the lessor



Advertising vs. Corporate Sponsorship

- ❑ **Qualified Sponsorship:** a payment made by a business to the University in return for which the business receives no substantial benefits other than use or acknowledgement of its products or services:
 - **Substantial benefits:** Primarily advertising
 - **Biggest Issue:** Distinguishing advertising from an acknowledgment (corporate sponsorship):
 - Advertising is UBI
 - Corporate sponsorship is not



Advertising

Definition:

- Messages containing qualitative or comparative language
- Price information or other indications of savings or value
- An endorsement
- An inducement to purchase, sell, or use any company, service, facility or product.

Possible exception: Are students involved (i.e. school newspaper)? May be educational.



Acknowledgement

- ❑ **Examples:**
 - **The payor's brand or trade names**
 - **Logos and slogans that do not contain qualitative or comparative descriptions of the payor's products or services**
 - **Exclusive Sponsorship Agreements**



Fragmentation Concept

- ❑ **Activity** may still be considered a trade or business even though it is an integral part of a cluster of activities that may be related to an exempt purpose

- ❑ **Example:**
 - Commercial advertising in a journal containing editorial material related to an exempt purpose



Book Store – Fragmentation Rule

- ❑ **May require an analysis of each item sold to determine if related to exempt purpose**
 - **Convenience items (mints, aspirin, etc.) sold in the bookstore are not considered unrelated**
 - Note: Clothing and other items (pillows, mugs) with the University logo fall under the convenience exception.
 - **However, sale of items in the bookstore with a useful life of longer than one year (i.e., laptops) may generate UBI.**



Research Activities

- ❑ **Universities often enter into contracts with government agencies and private businesses to conduct research.**
- ❑ **Research income may be exempt in certain circumstances:**
 - **“Substantially Related” Research: If the research project is substantially related to the educational mission of the institution.**
 - Example: If students are involved, activity may be considered educational.
 - **Research conducted for the federal or state government.**



Scientific Research

- ❑ **“Scientific research in the public interest” is also considered “substantially related” to a university**

- ❑ **3 Criteria:**
 - **Must be “scientific research” – supervised by professionals; designed to solve a problem**

 - **Must not be conducted incident to commercial or industrial operations**
 - Example: Testing for pharmaceutical companies is usually unrelated.

 - **Research must be conducted in public interest – results made available to the general public**



Sale of Byproducts

- ❑ **If product is sold in substantially the same state as upon completion of research, the sale does not generate UBI.**
 - Examples:
 - Experimental dairy produces milk during the ordinary course of the research project

- ❑ **Income from byproducts can also be excluded if the activity that produces the byproduct is considered educational.**
 - Examples:
 - Items made in a training program
 - Milk from a vet school dairy



Hotel Activities

- ❑ **Not considered real estate rental due to services being provided (so debt-finance exclusion doesn't work for state universities)**

- ❑ **Held by IRS to be taxable in many situations for state universities:**
 - Rooms for general public or spectators at sporting events
 - Meetings of unrelated organizations

- ❑ **Generally non-taxable:**
 - Guest facility or lecturers
 - Campus visits by prospective students and families
 - Educational meetings

- ❑ **Should carefully consider tracking use by type of guest so UBI and non-UBI can be allocated**



Summer Camp Programs

❑ Look at on case by case basis:

- Run by the university?
- Or a third party commercial party paying a fee? (May be a coach)
- Related to the broad exempt purpose of the university (educational)?
 - Note: Sports camps are considered educational if operated by the university itself.
- Issue: Is the agreement considered a rental agreement of only space or are substantial services also included? (food, linens in dorm rooms)



Golf Course

- Many cases on this—classic dual use of facilities**
- Student and educational use -- typically non-UBI**
- Public use -- generally UBI**
- Use for outside charitable tournaments (if done regularly) -- probably UBI since for-profit courses do the same**
- Pro-shop sales might have to be broken out into convenience use by students and those to general public**



PGA Golf Tournament

- Generally, organizations that put these on are set up to support community charities and utilize the events to provide that support—assume that UGA motivation is similar?
- Not regularly carried on and volunteer exclusion likely to make most of the income non-UBI
- But a careful examination of the various revenue streams would be in order (i.e., Is the advertising carried out over too long a period to be considered as not regularly carried on?)



Services to the Public Clinics, Vision Services, Etc.

- ❑ **Really requires analysis on a number of possible questions:**
 - Are students being trained through these programs?
 - Do the services provide something educational to the public?
 - Are the programs commercial in nature (i.e., are there private companies offering the same?)
 - Convenience exception?



Allowable Deductions

- ❑ **Unrelated business income tax is imposed on the *net taxable income* from the unrelated activities.**

- ❑ **While much attention is focused on the amount of UBI, of equal importance, is to what extent the university can deduct expenses to offset UBI.**

- ❑ **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
 - Expenses must be “directly connected” with carrying on of the unrelated trade or business.



Allowable Deductions – Dual Use Facilities

- ❑ **Universities often use assets and/or personnel in both exempt and unrelated activities.**
 - Examples:
 - Auditorium used for theater classes and rock concerts open to the general public
 - Ice rink used for physical education classes and by general public
 - Student union rented out for weddings
 - Golf course

- ❑ **Indirect cost allocations – expenses must be allocated between exempt and unrelated activities on a reasonable basis**



Net Operating Losses

- ❑ **Net operating loss rules are available to tax-exempt organizations, including universities.**
 - Current law is back 2, forward 20 years. This is helpful to offset income from profitable activities.

- ❑ **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).**



UBI- Policies & Procedures

- ❑ **Key components to minimizing risk:**
 - **Written policies and procedures**
 - **Centralized Control to ensure consistent application of the law**
 - Familiarity with tax issues
 - Ensure potential contracts are reviewed for tax issues
 - **Maintain adequate documentation**
 - **Education**
 - **Assessment of existing exposure**



Conclusion

- UBIT is NOT necessary BAD!**
- In fact, it may generate significant revenue for the university**
- The key is to analyze and report on 990-T**



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QUESTIONS ?