



Unrelated Business Taxable Income (UBTI)

Definitions, Exceptions and Examples



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Trade or Business

The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization.

Regularly Carried On

Business activities ordinarily are considered regularly carried on if they show a frequency and continuity and are pursued in a manner similar to comparable commercial activities of taxable businesses. Where the activity is normally undertaken by a business only on a seasonal basis, the conduct of such activities by an organization during a significant portion of the season would be considered regularly carried on. An activity that is considered only occasionally or periodically, however, will generally not be considered regularly carried on if it is conducted without the competitive and promotion efforts typical of commercial endeavors.

Substantially Related to Exempt Purpose

A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing the organization's charitable, scientific, or educational purposes, without regard to how the organization uses the income produced by the activity. Whether an activity contributes importantly depends in each case on the facts involved.

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. To the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. That part in excess of what is needed to accomplish the exempt purpose would be considered an unrelated trade or business.

Excluded Trade or Business Activities

The following activities are specifically excluded from the definition of unrelated trade or business:

Volunteer workforce (IRC Section 513(a)(1))

Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.

Activities for the Convenience of the University System (IRC Section 513(a)(1))

A trade or business carried on by a university system primarily for the convenience of its members, students, patients, officers and employees is considered a related trade or business.

This exclusion ordinarily encompasses the sale of provision of services to employees of a tax-exempt organization, students of a university, or patients of health care institution to the extent the ready availability of such goods or service makes a reasonably significant contribution toward their avoidance of undue inconvenience. Note that in PLR 9645004 the IRS stated that alumni are considered members of the general public, and therefore, sales and services to alumni cannot be excluded from tax under the IRC Section 513(a)(2).

Qualified Sponsorship Payments (IRC Section 513(i))

1. Soliciting and receiving qualified sponsorship payments (QSP) is not an unrelated trade or business and such payments are not considered unrelated business income. A QSP is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgement of the business name, logo, or product lines in connection with the organization's activities. "Use or acknowledgement" does not include advertising of the sponsor's products and services.

EXAMPLE: Organizers of an annual student picnic receive a payment from a local car dealership in exchange for inclusion of the dealer's logo on a sign at the entry of the picnic grounds. The payment is a QSP and is not subject to unrelated business income tax.

2. Providing facilities, services, complimentary tickets or other privileges to the sponsor in connection with a QSP does not affect whether the payment is a QSP. Instead, the provision of such privileges is treated as a separate transaction in determining whether the university would have unrelated business income from the payment. If such additional privileges are not of substantial benefit, the payment will not be subject to tax.
3. A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services. Advertising includes:
 - Messages containing qualitative or comparative language, price information or other indications of savings or value
 - Endorsements
 - Inducements to purchase, sell or use the products or services.
4. The use of promotional logos or slogans that are an established part of the sponsor's identity is not, by itself, advertising. Mere distribution or display of a sponsor's product by a university to the public at a sponsored event, whether free or for remuneration, is considered use for acknowledgement of the product rather than advertising.

EXAMPLE: The organizers of the picnic described above have put together a commemorative program for the event. In exchange for the dealer's sponsorship payment, the dealer is able to place a full color advertisement in the program and display an automobile on the picnic grounds in addition to placing its logo on the sign at the entry to the picnic grounds. In this case, the value of the advertisement would be considered unrelated business income and the value of the logo placement and the right to display would be exempt.

5. A payment is not a QSP if its amount is contingent upon the level of attendance at the event, broadcast ratings, or other factors indicating the degree of public exposure to the event.
6. The selling of donated merchandise is not an unrelated trade or business.

EXAMPLE: Treasure Market is an auction of items donated to an auxiliary in support of the Art Department. The proceeds from the sale of the items donated are not unrelated business income.

Exclusions/Modifications from Unrelated Business Income¹

The following types of income are generally excluded when figuring unrelated business income. However, the exclusions do not necessarily apply to income from debt-financed assets (described below):

Dividends (IRC Section 512(b)(1))

Dividends received are not subject to the UBTI, unless the stock purchase was debt financed (IRC Section 514), or unless the dividends are paid by an S-Corporation (see further details on S Corporation in “Other Sources of Unrelated Business Income section).

Interest and Income from Annuities (IRC Section 512(b)(1))

Interest and income from annuities are not subject to UBTI, unless such items of income are paid by a controlled corporation (IRC Section 512(b)(13) or are subject to the UBTI as debt-financed income under IRC Section 514.

¹ The exclusions/modifications listed only apply if it is otherwise determined that the income producing activity constitutes an unrelated trade or business. In other words, if the activity is not regularly carried on, if it is substantially related to the organization's tax exempt purpose, OR if it does not constitute a trade or business, income for the activity is not subject to UBTI, and no further inquiry into these exceptions/modifications is warranted.

Royalties (IRC Section 512(b)(2))

Royalties are not subject to UBTI unless such items of income are paid by a controlled corporation under IRC section 512(b)(13) or are subject to UBTI as debt financed income under IRC section 514. Rev. Rul. 81-178, states “to be a royalty, payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names or copyrights, whether or not payment is based on the use made of such property, or ordinarily classified as royalties. Similarly, payments for the use of a professional’s athlete’s name, photograph, likeness, or facsimile signature are characterized as royalties. Royalties do not include payment for personal services.”

Please note that the exclusion for royalties is sometimes combined with corporate sponsorships or property use arrangements. Sponsorships are paid for having the University display the name of a sponsor, acknowledging its donation. Royalties are payments made to the University for allowing the payor to use the University’s name or for access to some other intangible property owned by the University, such as a copyright or patent.

EXAMPLES:

- A university and for-profit entity enter into an agreement for the licensing of a patent owned by the University and the agreement requires the University to perform specific acts of more than an incidental nature, this would be subject to UBTI because all or part of the fees paid for the use of the patent are payment for the services. (Rev. Rul. 73-193).
- A university enters into an agreement with Ace Communications providing them with the right to broadcast the university athletic events. This type of agreement would be classified as a royalty and excluded from UBTI.
- A university enters into an agreement with Apparel Company X and the agreement includes elements of sponsorship (Official supplier of the footwear and athletics apparel) and royalty (university grants to Apparel Company X of the right and to use logo in connection with

their promotion of Apparel Company X products). Excluded from UBTI as a royalty and sponsorship.

- Mercury, an upstart in sports apparel, pays a university a fixed percentage of its sales of its sportswear line, which features the university's logo. In addition, the agreement also includes personal appearances by several of the university coaches at the unveiling of the product line. The coaches also have committed (in whole or in part) to endorse the apparel line. The inclusion of personal services in the royalty arrangement causes the loss of the royalty income tax exclusion and this would be subject to UBTI.
- Unrelated business income does not include royalty income from licensees of patents owned by a university that were assigned to it by inventors for specific percentages of future royalties.

Rents from Real Property

All rents from real property are generally excluded from Unrelated Business Income (UBI) tax provided:

- The rental payments are not based on income or profits of any person from property leased other than an amount based on a fixed percentage of receipts or sales.
- The rental income is not paid by a controlled corporation (IRC Section 512(b)(13))
- The property is not debt financed under IRC section 514; and
- The lease value of any personal property leased in conjunction with the real property does not exceed 10% of total rents. If separate leases are entered into with respect to real and personal property, and such properties have an integrated use (one or more leases for personal property to be used upon such real property), all such leases shall be considered as one lease.

If income from the lease of personal property is more than 10% but does not exceed 50%, rent attributable to the real property is excluded from UBI, while rent for the use of the personal property shall be subject to the UBI tax. If more than 50% of the total rent

received or accrued under the lease is attributable to personal property, the entire lease is subject to UBI tax.

- If the lease involves the provision of services, such services must be limited to the type of services rendered in connection with the rental of rooms or other space of occupancy only (Treas. Regs. Section 1.512(b)-1(c)(5)).

EXAMPLES:

- A university lease of a blacktop along with an office building to another entity that will use it as a parking lot for patrons of the leased building, is the lease of real property. In contrast, the university's lease of parking spaces to individuals (i.e., the operation of a parking lot) is considered the provision of services, not the lease of real property, and income from such leases would be UBI, unless such leases contribute importantly to the university's tax exempt purpose or meets the convenience exception (for example, the lease of parking spaces to employees). (See Private Letter Ruling (PLR) 9835001 and Revenue Ruling 69-269.) discuss this example in detail.
- Venture, an exciting new restaurant, leases space from the university. The university provides furnishing of heat and light, cleaning of public entrances, exits, stairways, lobbies, the collection of trash, etc. Under IRC section 512(b)(3), these services provided would be in connection with the lease of property for the protection of the property rather than for the convenience of the lessee (Venture), and income from such a lease will qualify as an exception and exempt from UBI.
- Similar facts as the previous example with Venture, except that the university provides the following services: maid service, linen/laundry services, and catering. These services would be deemed render for the convenience of the occupant (Venture), rather than services rendered in connection with the rental of space. Income from the lease attributable to the services will be subject to the UBI tax if the services can be reasonably separated from the lease of the property (PLR 7902019).

- A university contemplates building and operating a full-service hotel on campus to house visiting scholars, parents, visiting athletic teams and guests. The operation of the hotel is an unrelated business activity.

Research Income (IRC Section 512(b)(7)-(8))

“Scientific Research” performed for the Federal or state government, and “scientific research” performed by a college, university, or hospital for any person is excluded from UBTI treatment. In addition, scientific research includes efforts to discover new applications of products or drugs to improve the ability to treat various diseases (TAM 7936006).

The term research does not include activities of the type normally carried on incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment.

EXAMPLES:

- A university medical center performs a research study for an unrelated tax-exempt hospital that involves scientific principles in developing a blood test to detect a particular syndrome. This activity would be excluded from UBI under IRC Section 512(b)(8) because it constitutes scientific research.
- A university is contracted to provide assistance to a membership soybean association board that is an unrelated exempt organization. The purpose of the agreement is for the university to research the soybeans. The activity would be excluded from UBI under IRC Section 512(b)(8) because the university is applying scientific principles in seeking to improve the soybean and its yields.

Please see the Scientific Research Checklist to assist you in determining whether a particular contract meets the requirement under IRC Section 512(b)(8).

Capital Gains (IRC Section 512(b)(5))

Gains or losses from the sale, exchange or other disposition of property are exempt from UBI other than:

- Stock in trade or other property of a kind that would properly be included in inventory;
- Property held primarily for sale to customers in the ordinary course of a trade or business, or
- Cutting of timber that an organization has elected to consider as a sale of timber.

Gain or loss from the sale of S-corporation stock is subject to tax as UBTI. Also this exclusion does not apply to debt-financed property under IRC Section 514.

Options or Securities

Any gain from the lapse or termination of options to buy or sell securities is excluded from unrelated business income, but only if written in the course of the organization's investment activities.

Other Sources of Unrelated Business Income

Partnership Income (IRC Section 512(c))

Each item of income received from an entity treated as a partnership for tax purposes (general partnership, limited partnership, limited liability partnership, limited liability company, or income from a joint operating agreement) retains its character in the hands of the recipient organization in determining whether such item is subject to the UBI tax. Thus, if the partnership receives dividend income, the organization's allocable share of such dividend income will not be subject to tax because of the special exclusion of dividends. If the partnership receives rent from personal property, the organization's allocable share of such rental income will be subject to tax as UBTI.

S Corporation Income (IRC Section 512(e)(2))

The share of any income of an "S" corporation will be taxable regardless of the actual source or nature of the income. A university's share of any interest or dividend income (otherwise exempt) from an "S" corporation will be subject to tax.

Controlled Corporation Rules (IRC Section 512(b)(13))

Interest, annuities, royalties and rents from a controlled taxable corporation are subject to tax, if those items reduced the tax of the controlled corporation. For purposes of these rules, an entity is considered to be controlled by the tax-exempt parent where the parent owns more than 50% of the stock in a corporation or more than a 50% of the profits, capital, or beneficial interests of a partnership or other entity. In addition, the constructive ownership rules of section 318 are applied, so that the controlled corporation status will apply to an organization indirectly owing more than 50 percent of the voting power or value of another entity (such as through a second-tier subsidiary).

EXAMPLE: The Eatery is a wholly owned, taxable subsidiary corporation of a university. The Eatery has a taxable income of \$150,000 and pays all necessary taxes. It has taken a deduction of \$25,000 for the rent that it pays to the university. The \$25,000 rent amount is unrelated business income to the university.

Debt-Financed Income (IRC Section 514)

Provides that income generated from an asset that is subject to a current indebtedness is subject to UBTI under a ratio calculation, to the extent the property is not used in an activity substantially related to the organization's tax-exempt purposes. IRC Section 514(b) provides that the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (see below) at any time during the taxable year (or 12-month period). Property includes real estate, tangible personal property and corporate stock.

- Acquisition indebtedness is the unpaid amount of debt incurred by the organization:
 - When acquiring or improving property
 - Before acquiring or improving property if the debt would not have been incurred except for the acquisition or improvement
 - After acquiring or improving property if the debt would not have been incurred except for the acquisition or was reasonably foreseeable when the property was acquired or improved.

- Real property debts of an educational institution are generally exempt from the acquisition indebtedness rules.

If substantially all (85% or more) of the use of any property is substantially related to the organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include the generation of income.

If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property the organization uses for exempt purposes. Neighborhood property is that which is contiguous to the owned property or within one mile if it is not practical to acquire contiguous property.

After 5 years, the organization must satisfy the IRS that exempt use will occur with the next 5 years.