

UTS103 – UNRELATED BUSINESS INCOME BASIC RULES, GUIDELINES, AND EXAMPLES

The Internal Revenue Code (IRC) imposes federal income tax on activities of state colleges and universities that are unrelated to its exempt purpose. An activity is considered unrelated, and hence taxable, if the activity is:

- (1) a “trade or business”
- (2) regularly carried on, and
- (3) not substantially related to a college or university’s exempt purposes.

However, any exempt purpose or function described in Section 501(c)(3) of the IRC is related to the exempt purpose of The University of Texas System and its institutions. Thus for federal income tax purposes any activity that is charitable, scientific, testing for public safety, literary, educational, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals is related to its exempt purpose. The following provides some general rules, guidelines and examples that can be used to understand the potential income tax risk for engaging in a specific conduct. With these broad purposes as backdrop, the determination of whether an activity is related or unrelated will depend upon specific facts, therefore, each activity must be reviewed by the Office of General Counsel to determine whether an exempt purpose is being served.

<u>GENERAL</u>	Code, Regulation, Ruling or Other Citation
1. <u>Trade or Business</u> – Generally, a trade or business for unrelated business income tax purposes is any activity which is carried on for the <u>production of income</u> from the sale of goods or performance of services.	1.513-1(b)
2. <u>Regularly Carried On</u> – The regulations consider the frequency and continuity of the activity and the manner in which it is pursued. Thus, the unrelated business income tax applies only to a business activity which is regularly carried on as distinguished from commercial transaction which are sporadic or infrequent.	1.513-1(c)(1)
2.1. A Short-term activity of a kind normally conducted by a taxable business on a year-round basis not “regular” for an exempt organization. Intermittent, casual or sporadic activities are likely not regularly carried on.	1.513-1
2.2. Year-round activities are regular, however, even if conducted only one day a week.	
2.3. Seasonal activities may also be regular even though they are conducted only for a short period each year.	
3. <u>Not Substantially Related</u> – For an activity to be substantially related to an exempt purpose of University an activity <u>must contribute</u> importantly to the accomplishment of that purpose (other than the University’s need to produce income).	1.513-1(d)(2)
3.1 <u>Size and Extent</u> – Particular emphasis is placed on the size and extent of the activity. If an activity is conducted on a scale larger than reasonably necessary to carry out the exempt purpose, it is more likely to be treated as unrelated.	1.513-1(d)(3)

- 3.2 Dual Use of Assets or Facilities – Use for both exempt and commercial purposes will not necessarily exempt the income derived from commercial use unless the business activity “contributes importantly” to the accomplishment of an exempt purpose. 1.513-1(d)(4)(iii)

STATUTORY EXCEPTIONS

Even if an activity is an unrelated trade or business, the income derived can avoid taxation if it meets one of the following exceptions:

4. Volunteer Labor – Any activity in which substantially all (probably 85%) of the work of the trade or business is performed without compensation is exempt from tax. In assessing the contribution made by volunteers, the IRS considers such factors as the monetary value of the respective services rendered, the number of hours worked, the intrinsic importance of the volunteer work performed and the degree of reliance placed upon volunteers. 1.513-1(e)(1)

5. Convenience of University Members – Any unrelated activity conducted primarily for the convenience of University students, faculty, staff or patients is exempt from tax. The convenience exception is applicable only to members of the University. Any sales to nonmembers, e.g., the general public, are taxable unless the sales are not “regular.” 1.513-1(e)(2)

The IRS has ruled that alumni should be treated as the general public since nothing in the Code treats alumni any differently than the general public. PLR 8020010

6. Donated Merchandise – The selling of merchandise, substantially all (again probably 85%) of which was received as a gift or charitable contributions is exempt regardless of whether the labor to operate the activity is paid or unpaid. 1.513-1(e)(3)

MODIFICATION TO INCOME

In addition to the above exceptions, the IRC contains several modifications which effectively exempt various income streams from the unrelated business income tax. These modifications, which are generally inapplicable if debt-financed property is involved, include:

7. Royalties – A royalty is the compensation paid to owners of a patent, copyright, mineral interest or other property right for the use of it or the right to exploit it. The royalty exclusion includes overriding royalties, net profits royalties and royalty income received from licenses by the University as the legal and beneficial owner of patents assigned to it by inventors. 512(b)(2)
1.512(b)-1(b)

7.1 However, where the royalty income is derived in part from the performance of services, the payment will not constitute royalty income. 73-193

7.2 Income from renting of member or donor lists is royalties 513(h)(1)(B)

and excluded from unrelated business taxable income.

856-87, 94 T.C. No. 6, 2-26-90

8. Rents – The rules for rents depend on whether the revenue is derived from real or personal property or from a mixed lease of both real and personal property. 1.512(b)-1(c)
- 8.1 Real Property – Generally, rents from real property are excluded. 1.512(b)-1(c)(ii)(a)
- 8.2 Personal Property – There are three separate rules for rents from personal property in a mixed lease: 1.512(b)-1(c)(ii)(b)
- If rent from personal property is “incidental” (i.e. 10% or less) of the total rent received under the lease, then the personal property rent is not subject to tax;
 - If rent from personal property is 11-50% of the total rents then the personal property is taxable in proportion to the percent of personal property rent to total rent; and
 - If rent from personal property is at least 51% then 100% of the total rent is taxable.
- 8.3 Rendering of Services – Amounts paid for the occupancy of space do not qualify as excludable rents if the owner of the property renders services for the convenience of the occupant. Services are considered rendered for the convenience of the occupant, if they are primarily for his or her convenience and are not usually rendered in connection with the rental of rooms or other space of occupancy only. 1.512(b)-1(c)(5)
- For example, the supplying of maid or linen services constitutes such services whereas the furnishing of heat and light, cleaning of public entrances, exits, stairways, or lobbies does not. The renting of parking spaces where an attendant is on duty is not considered to be rent from real property since services (the attendant) are being provided. Similarly, the provision of security services to a parking garage removes that rental from being considered rental of real property⁴.
- 8.4 Debt-Financed Property – The IRC contains an exception to the debt-financed property rules for the acquisition of real estate by “qualified organizations,” including educational institutions. The term “acquisition indebtedness” does not include debt incurred by a qualified organization to purchase real property where the following conditions are present: 514(c)(9)(c)(i)
- (a) the purchase price is a fixed amount
 - (b) the amount of an indebtedness and the time for payment of such indebtedness are not dependent on revenue, income, or profits derived from the real property
 - (c) the real property is not leased back to the seller or a party related to the seller, and
 - (d) if the real property is held by a partnership and one or more of the partners is not a qualified organization, then

allocations to the partners must be qualified allocations or must not have as a principal purpose the avoidance of income tax

1.512(b)-1(c)(2)(iii)

8.5 Percentage Rents – Rents based on profits or income derived by a tenant of real property do not qualify for this exclusion. However, rents can be based on a fixed percentage of gross receipts or sales.

9. Sponsored Research -- General – Income from certain research grants or contracts may be exempt from the unrelated business income tax depending on the type of research. The following research is exempt:

- research performed for any level of government; 512(b)(7)
- research performed by a college, university, or hospital “for any person”; and 512(b)(8)
- research performed for any person by an organization operated primarily for purposes of carrying on “fundamental” research (as distinguished from “applied”), the results of which are freely made available to the general public 512(b)(9)

The regulations further limit these exclusions by providing that ordinary testing, inspection of products or materials, and other research incidental to commercial or industrial operations is taxable. 1.512(b)-1(f)(4)

10. Clinical Trial/Drug Testing – Drug studies are not research and are normally taxable but may be made exempt by involving medical training or patient care:

- FDA drug testing in which drugs are offered to patients who have the disease for which eventual commercial use of a particular drug is intended, as contrasted to patients receiving care for unrelated medical reasons, has been determined to be a related activity exempt from UBIT. PLR 8230002
- Testing of drugs solely to meet FDA requirements is taxable even though the test results are freely available for publication if it is not established that the testing contributes to the training of students or to patient care. 68-373
- Outside laboratory testing services providing an additional supply of human tissue samples needed for the training of medical students, interns, residents, medical technologists and nurses do not constitute an unrelated trade or business by virtue of contributing importantly to a hospital’s medical education program. 85-109
- Where the performance of diagnostic laboratory testing is otherwise available within the community, testing of specimens from private office patients of a hospital’s staff physicians constitutes an unrelated trade or business subject to UBIT. 85-110
- Otherwise taxable drug testing conducted by students is exempt. PLR 7936006
- Experimental construction and production testing by PLR 8445007

students that was more than incidental was found exempt.

- Clinical testing of developmental equipment apart from student involvement was subject to UBIT.

PLR 7902019

SPECIAL CIRCUMSTANCES

11. There are special circumstances when an unrelated activity may be recognized as serving an exempt purpose. Whether such unique circumstances exist will be decided on a case-by-case basis. The following are examples of unique circumstances:

85-110, 1985-2 C.B. 166

- Services or facilities otherwise unavailable in the community that fulfill an important community or medical need (see below) and
- Services, facilities, or equipment which are technically advanced or unique.

HOSPITAL SERVICES

12. Hospital Services Provided to Non-patients – Revenue generated from hospital pharmacy sales to non-patients and laboratory tests of a non-patient specimen is considered unrelated business income.

513(a)(2)

13. Pharmacies – Pharmacy sales to the public directly competes with commercial pharmacies and are considered an unrelated unless the activity exists primarily for the convenience of patients and hospital staff. Proceeds from sales made by a tax-exempt hospital pharmacy to private patients have been held unrelated income where the sales are far from casual, and the profits are “substantial.”

68-374
68-375
1.513-1(b)
TAM8349006

14. Lab Testing – Like pharmacy sales, laboratory testing of specimens from outside patients is potentially in competition with commercial enterprises performing the same function. This activity will be unrelated unless the testing exists primarily for the benefit of the exempt hospital’s patients and employees or students are a part of an established teaching program.

Rev Rul 85-109,
1985-2 C.B. 165
Announcement 92-83,
1992-22 I.R.B. 59

15. Community Need Exception – Testing of non-patient specimen may fulfill an important community need and thus serve an exempt purposes. For example, if testing facilities are unavailable within a reasonable distance of a hospital’s service area, or are clearly unable or inadequate to conduct tests needed by non-patients, a hospital’s testing service may further its exempt function of promoting community health.

85-110, 1985-2 C.B. 166
TAM201428030
PLR9851054
Announcement 92-83,
1992-22 I.R.B. 59
TAM8246018

16. Hospital Patients – Providing healthcare services is related and the the following persons are considered “patients” of a hospital for purposes of IRC 513(a)(2): inpatients (receiving general or emergency diagnostic, therapeutic, or preventive health services); a former patient refilling a prescription; and a person receiving medical services as part of a hospital administered home care program, or receiving medical care and services in a hospital affiliated extended care facility.

68-376, 1968-2 C.B. 246

The IRS has ruled that private patients of doctors who are affiliated with the hospital but engaged in private practice in a nearby building are to be regarded as the general public.

17. Services Provided to Another Tax Exempt Hospital – Performing certain service (i.e. data processing, purchasing, warehousing, billing and collection, food, laboratory, printing, clinical communications, industrial engineering, records center, personnel selection, personnel testing, training, and education, and etc.) for other exempt hospitals do not constitute unrelated business income if the:
- 501(e)(1)(A)
GCM39799

- services are provided at a fee that does not exceed actual costs including straight-line depreciation and reasonable rate of return on capital goods used to provide the service,
- services are furnished solely to hospitals service not more than 100 in patients, and
- services are consistent with the recipient hospital’s exempt function

The exception, however, does not apply to services not listed above, such as laundry services. An exempt hospital performing laundry services for another hospital is engaged in an unrelated trade or business.

69-633, 1969-2 C.B. 121
HCSC-Laundry v. United States , 450 U.S. 1 (1981)

18. Services Provided to a Hospital not Tax-Exempt – As with services provided to a non-patients, the income received from services provided to a hospital which is not tax-exempt will be considered unrelated.
- 513(a)(2)

ADVERTISING

19. Advertising – The sale of advertising will be taxable even if the activity is carried on within a larger complex of other endeavors which are substantially related to an organization’s exempt purpose (e.g., the publication of a newsletter, magazine or scholarly journal).
- 513(c)

Related Advertising – Ads in a college newspaper as part of an instructional program which serves an “informational function” as opposed to serving a means of stimulating demand for products may be considered related to an organization’s exempt purpose.

Unrelated Advertising – General consumer advertising in an exempt organization’s journal is considered a “unrelated trade or business” since it does not “contribute importantly” to the organization’s exempt purpose.

1.513-1(d)(4)(iv)

Student Participation – Students actively soliciting, selling and publishing advertisements as part of a learning process under the supervision and instruction of the University is related.

1.513-1(d)(4)(iv), Ex. (5)

JOINT VENTURES & PARTNERSHIPS

Announcement 92-83

20. Joint ventures and partnerships must be scrutinized to ensure that the University is not serving a for-profit entity. Generally, income from a joint venture will not be taxable if it contributes importantly to an exempt purpose or it is carried on for the convenience of the University community.

Rev. Rul. 79-222
Service Bolt & Nut Co. v. Commissioner, 724 F.2d 519 (6th Cir. 1983), aff'g, 78 T.C. 812 (1982)

RELIEF OF GOVERNMENTAL BURDEN

21. The phrase “lessening the burdens of government” is one of several exempt purposes by which an organization may qualify for tax-exempt status.

1.501(c)(3)-1(d)(2)

To determine whether an activity qualifies for this exemption, first, it is necessary to identify the functions that the government unit considers to be its burdens and, second, under what conditions an organization’s activities are to be recognized as actually “lessening” such burdens.

GCM 37401

21.1 Identification of Governmental Burden – In order for an activity to be considered a governmental burden there must be an “objective manifestation” on the part of the government that it considers a particular activity to be one of its burdens. For example, the governmental unit may invite the University to take part in an activity actually being performed by the government, or act jointly with the university in the conduct of an activity. However, the fact that an organization is engaged in an activity that is sometimes undertaken by a government or that the government (or one of its officials) expresses approval of the organization and its activities is insufficient to establish that the organization is lessening the burdens of government.

21.2 Lessening the Governmental Burden – In determining that an organization actually lessens a governmental burden it is necessary to consider such factors as whether the government:

- has previously undertaken the activity;
- will be exercising ongoing supervision of the activity;
- has formally recognized by legislative or other official actions that the organization is acting on behalf of the government.

A favorable working relationship between the organization and The governmental unit it purports to serve is a strong indication that the activity lessens the burdens of government.

EXAMPLES OF ACTIVITIES THAT MAY CREATE UNRELATED BUSINESS INCOME TAX

Activity Unit	Activity Description
Computer Center, Academic Computing, Computer Services	<ul style="list-style-type: none">• Sale of computer services to non-university users• Sale of computer services to non-profit research institutes and governmental agencies• Sale of programming services to non-university users
Business Administration, Arts, Management, etc.	<ul style="list-style-type: none">• Sale of advertising space in periodicals [Note: If there is both advertising and circulation revenue, tax is paid on the lower of the net advertising revenue or net combined advertising/circulation revenue. If there is no advertising revenue, no tax is paid on circulation revenue.]
Recreational Sports	<ul style="list-style-type: none">• Rental of recreation equipment to the general public and alumni• Sale of recreation membership cards (swimming privilege, etc.) to the general public and alumni
Plant	<ul style="list-style-type: none">• Provision of substantial services or use of personal property in connection with rental of real property• Rental of hotel lodging, meeting halls or student housing to non-university users• Rental of office space to non-university users• Rental of personal property such as telescopes, microscopes or other technical equipment to non-university users• Sales of excess utility capacity of non-university entities, including contractors working on university projects <p>Note: Income from operating a performing arts theater or sponsoring symphony concerts open to the public and employing professional performers will be nontaxable because these contribute importantly to the overall educational function of a university – Reg. 1.513-1(d)(4)(iv)[Example (2)] (1987).</p>
Parking Services	<ul style="list-style-type: none">• Rental of parking spaces to non-university users with services (attendant, guard, etc.) provided
Analytical Laboratory	<ul style="list-style-type: none">• Sale of routine analytical services to non-university users• Rental of laboratory facilities to non-university users• Rental of scientific instruments to non-university users
Ophthalmology	<ul style="list-style-type: none">• Sale of ophthalmology services to a private company• Sale of contract lens services to non-university users
Pathology	<ul style="list-style-type: none">• Sale of drug testing services to outside employers
Pediatrics	<ul style="list-style-type: none">• Metabolic Genetics Screening Laboratory analytical services to non-university users
Hydraulics Lab	<ul style="list-style-type: none">• Sale of calibration services to non-university users

Auxiliary Activities

- Catering (food services, etc.) to non-university users
- Cafeteria/restaurant service to non-university users [Note: The operation of campus soft drink and food vending machines and laundromat facilities will be nontaxable under the “convenient” exception—Rev. Rul. 81-19, 1981-1 C.B. 353.]
- Gift shop or book store sales of items unrelated to the University’s exempt purpose [Whether or not such sales fall under the “convenience” exception depends upon whether the store is used primarily by the university community vs. the public at large; whether the articles are “expendable;” and whether the store is located in an area convenient to other commercial facilities selling similar products.]
- Mail order catalog sales

[Note: Income from an athletic event and from the sale of broadcast rights to such events will be nontaxable related income – Rev. Rul. 80-296, 1980-2 C.B. 195.]

Media Resources

- Sale of audio-visual services to non-university users
- Sale of advertising on university television and radio stations

Printing and Reprographics

- Sale of printing services to non-university users
- Publication of non-educational material

Electron Microscope Facility

- Rental of electron microscope facility to non-university users

Center for Magnetic Recording Research

- Sale of translation services to non-university users

Sports Training Camp

- Rental of campus facilities to professional sports team

Psychology

- Psychological test protocols scored and interpreted for police and security agencies

Neurosciences Image Analysis

- Rental of image analysis equipment to non-university users

Infectious Diseases

- Drug study not involving students or patients

Pharmacy

- Pharmacy sales (both prescription and non-prescription) to non-patients

Marine Facility

- Sale of aquarium collecting services to non-university users

Child Care Center

- Sale of child care services to non-university users

Endowment

- Income from mineral operating interests
- Cash surrender value of life insurance borrowed and reinvested

Continuing Education

- Training programs customized for particular users (as distinguished from presentation of educational materials of general application)

Travel Center

- Travel agency operation for non-university users
- Conducting tours which are not educational