Basic: UBIT Fundamentals, Definitions and Exceptions

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Overview

- UBIT background
- Definition of Unrelated Business Income
- Exclusions from UBIT
- Special Rules
- Cost Allocation

UBIT Background

- First enacted by Congress in 1950 to eliminate unfair competition between tax-exempt and for-profit organizations.
- Under UBIT, an organization could no longer qualify for exemption merely because its profits were destined for charitable purposes.
- Revenue Act of 1951 expanded scope of UBIT to include public colleges and universities.

UBIT Background

- Tax Reform Act of 1969 extended UBIT to all tax-exempt organizations (including churches), except government entities.
- House Ways and Means Subcommittee held hearings on UBIT in June 1987--no consensus reached on proposed legislation.

Definition of UBIT

Unrelated business income is defined as gross income derived by an exempt organization from any unrelated trade or business that is regularly carried on:

- Trade or Business
- Regularly Carried On
- Not Substantially Related to Exempt Purpose

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Trade or Business

IRC Sec 513 (c):

- Trade or business includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Trade or Business

- At some point, an activity must produce a profit to be considered a trade or business.
- No part of a trade or business shall be excluded from the classification as unrelated trade or business merely because it does not result in a profit.

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Regularly Carried On

Reg. Sec. 1-513-1 (c):

- Trade or business must be regularly carried on. IRS generally compares time span of comparable commercial activity to time span of activity conducted by exempt organization.

Regularly Carried On

- Activities engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.

- Income producing or fundraising activities lasting only a short period of time on an annual basis would not be considered regularly carried on.

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Regularly Carried On

NCAA v. Commissioner:

- Appeals court held that preparatory time not included in determining whether activity was regularly carried on.
- Length of tournament (3 weeks) and fact it was held annually were determinant.

Not Substantially Related

IRC Sec. 513(a):

- Any trade or business, the conduct of which is not substantially related to the performance of the organization's charitable, educational or other purpose that constitutes basis for exemption under Sec. 501 (c)(3).
- Examples include instruction, research and patient care.

Not Substantially Related

- Whether a trade or business is substantially related to an organization's purpose depends on the facts and circumstances.

- Activity must contribute importantly to the accomplishment of the exempt purpose.

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Exclusions from UBI

- Interest, dividends, and annuities
- Capital gains
- Royalties
- Rent from real property
- Research
- Business conducted by volunteers
- Convenience exception
- Sale of donated merchandise
- Qualified sponsorship payments

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Interest and Dividends

IRC Sec. 512(b)(1):

- Interest, dividends and payments connected with loans and annuities are exempt from UBIT.

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Interest and Dividends

- Securities purchased on margin are considered debt-financed property and subject to UBIT.
- See Ocean Cove Corp. Retirement Plan & Trust v. United States.

Capital Gains

IRC Sec. 512(b)(5):

- All gains and losses from the sale, exchange, or other disposition of property are excluded from the computation of an organization's UBTI.

- Exclusion does not apply to property that is treated as inventory in the hands of the institution or property that is held primarily for sale to customers in the ordinary course of trade or business.

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Royalties

IRC Sec. 512(b)(2):

- All royalties excluded whether measured by production or by gross or taxable income from the property.
- Royalties are defined as payments for the use of the payee's intangible property--trademarks, patents and copyrights.

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Royalties

Exceptions to the exclusion for royalties:

- Debt-financed property--Property held to produce income that has acquisition related indebtedness.
- Substantial services--Active involvement in enterprise generating the revenue.

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Case Law: Royalties

- Oregon State Alumni Association v. Commr-- Tax Court held that alumni association not in the business of selling its mailing list.

- Mississippi State University Alumni, Inc. v. Commr--Tax Court held that sale of mailing list, approval of solicitation materials, and provision of credit card applications to alumni did not constitute the provision of services.

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Case Law: Royalties

- Sierra Club v. Commr.--Sale of mailing list and logo were related to intangible property and not subject to UBIT.

- Texas Farm Bureau vs. US--Payments an exempt agricultural organization received from an insurance company for use of its name and logo were held not to be royalties. Plaintiff provided insurance company with substantial services, including secretarial and clerical help, stationary and postage.

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Rent from Real Property

IRC Sec. 512(b)(3):

- Rent from real property and certain personal property leased with real property is excluded from UBIT.

Rendering of Services with Rents

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- Amounts paid for occupancy of space are not excludable rents if owner provides services for convenience of occupant.

- Services are considered rendered to occupant if primarily for his/her convenience, and go beyond usual services rendered in connection with rental of rooms or other space.

Rendering of Services with Rents

- Maid or linen services go beyond usual services; furnishing heat and light and cleaning of public entrances do not.

- IRS has determined rental of parking spaces to general public is not rent from real property, regardless of whether any services are provided.

Rents from Personal Property

- Rents from personal property must be an incidental part of the total rents received to be excludable.   Rules on personal property rents:

  -- 10% or less is incidental and not taxable

  -- 11-50% taxable in proportion to total rents

  -- 51% or more is 100% taxable

Research

IRC 512(b)(7-9)--Excludable research:

- Research done for the United States or any of its agencies or instrumentalities.
- Research done by a college, university or hospital.

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Research

Excludable research (continued):

- Research done by organizations operated primarily for the purpose of carrying on fundamental research the results of which are freely available to the public.
- Research does not include testing, e.g., clinical trials.

Business Conducted by Volunteers

IRC Sec. 513(a)(1):

- If substantially all the work in carrying on the business is performed by volunteers, the activity is not an unrelated trade or business.
- Substantially all not defined in the Code.

Business Conducted by Volunteers

- Waco Lodge v. Commr.--Tax Court held that 77% of the work done by volunteers was not sufficient to constitute substantially all.

- St. Joseph Farms of Ind. Et al vs. Commr.--Tax Court held that where 91% of full time work and 94% of all work done by volunteers, the test was met.

- IRS has held in other areas of the tax law that the substantially all test is met if the activity equals or exceeds 85% (TAM 8433010).

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Sale of Donated Merchandise

IRC Sec 513(a)(3):

- Sale of merchandise that has been received as a gift or contribution does not constitute unrelated business income.
- Auctions and similar sales of donated items can be conducted without creating UBTI.

Convenience Exception

IRC Sec. 513(a)(2):

- An activity carried on for the convenience of members, students, patients, officers or employees is not an unrelated trade or business.

- Sales to alumni do not qualify for the convenience exception (TAM 9645004).

Convenience Exception

- Sales of clothing with useful life of more than one year did not qualify for convenience exception.
- Items embossed with university emblem qualified for the exception (TAM 8025222).

Qualified Sponsorship Payments (QSP)

IRC Sec. 513(i)—Exclusion for QSPs:

- Payment from a person engaged in a trade or business, with no expectation of any substantial benefit other than use or acknowledgement of the name or logo of person's trade or business.
- Use may be in connection with activities of organization, but may not include advertising products or services.

Taxable Advertising

- Messages or other program materials broadcast or otherwise displayed in connection with a specific sponsored event to promote a company in exchange for a corporate sponsorship payment is considered taxable advertising.

Taxable Advertising

Following factors would indicate that an organization is engaged in advertising:

- Qualitative of comparative language,
- Price of savings information,
- A call to action,
- An endorsement, or
- An inducement to buy, sell, rent or lease sponsor's product or service.

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Special Rules

IRC Sec. 512(b)(13)--Controlled entities:

- Exclusion from UBIT for interest, annuities, rents and royalties does not apply if those items are received from a controlled entity.
- Controlled entity defined as one in which the exempt entity owns more than a 50% beneficial interest, e.g., stock of corporation or profits/capital interests of partnership.

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Special Rules (cont.)

IRC Sec. 512(e)--S Corporations:

- All income from an S Corp is taxable regardless of activities conducted by S Corp.
- Interest, dividend or capital gain income subject to UBIT.
- Any gain or loss on disposition of S Corp shares would also be taxable.

Special Rules (cont.)

IRC Sec. 514--Unrelated Debt-Financed Income:

- Income generated by debt-financed property treated as UBTI.
- Debt-financed property defined as any type of property held to produce income, with respect to which there is acquisition indebtedness.
- Exception for real property acquired by colleges and universities using debt.

Cost Allocation

Reg. Sec. 1.512(a)-1(a):

- Deductions from income must be allowable tax deductions.
- Deductions must be directly connected with the trade or business, i.e., "proximate and primary" relationship.

Cost Allocation

Dual Use Facilities:

- Facilities or personnel that are used to conduct both exempt and non-exempt activities.
- Expenses, depreciation and similar items must be allocated on a "reasonable basis."

Cost Allocation

Expense Allocation Methods (listed in IRS Compliance Questionnaire):

- Gross receipts for facilities costs
- Actual time in use for fixed facility costs
- Time available for fixed facility costs
- Other

Cost Allocation

NACUBO Cost Allocation Project

- Three-tiered cost allocation proposal
- http://www.nacubo.org/documents/business_topics/DraftRevenueProcedureFINAL.pdf