

Unrelated Business Income Tax - A Departmental Primer

**The University of Tennessee-Knoxville
Office of Budget and Finance
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Tax Exempt or Not?

- The University of Tennessee is not subject to **Federal** Income Tax, right?

Yes and No

Tax-Exempt Status

- The University of Tennessee is exempt from federal income tax as a governmental unit of the State of Tennessee as described in Section 170(c)(1) of the Internal Revenue Code.
- This exemption extends only to income generated from activities related to the University's mission.
- Earnings from activities which are substantially unrelated to the University's exempt purposes are subject to the **unrelated business income tax**, even though these activities may generate revenue to support the University's exempt operations.

You & UBIT

To ensure compliance, each department should scrutinize any revenue generating activities (I and R accounts) for UBI. Today we will:

- Define UBI – what is it
- Review UBI Exceptions, Exclusions, and Deductions – how to calculate it
- Document & Report UBI – what to do with it

Historical Overview

In 1950, Congress enacted the unrelated business income tax with two purposes in mind:

1. To eliminate unfair competition between tax-exempt organizations and for-profit organizations in similar lines of business (level the playing field) and
2. To penalize tax-exempt organizations that conduct unrelated business activities instead of having to revoke their tax-exempt status.

Result: **Net income earned from the conduct of a trade or business unrelated to exempt purposes is taxed at the normal corporate tax rates.**

Definition: Unrelated Business

An unrelated business activity must meet all three of the following conditions:

- A trade or business
- Regularly carried on
- Not substantially related to exempt purposes

Trade or Business?

- The term “trade or business” is broadly interpreted by the IRS and generally includes any activities carried on for the production of income from the selling of goods or performance of services.
- If the University is selling goods or services to generate income, even if it is conducting the activity within a larger group of activities related to its exempt purpose, the activity is a trade or business. Thus, while a department may be carrying on its daily exempt function, it could also be carrying on activities that are unrelated and thus taxable.

Trade or Business Identifiers

- A trade or business must exhibit a profit motive.
- When an activity that is carried on for a profit incurs a loss, no part of the trade or business is excluded from the for-profit classification merely because its current operations does not result in a profit in a particular year.
- However, sustained, significant and repeated losses generated by unrelated activities may not be considered “trade or business” for lacking a profit motive (Rule of thumb – loss sustained 3 out of the past 5 years).

Trade or Business: Examples

- The University solicits, sells, and publishes advertisements for commercial vendors in its publication.
- Parking Services sells parking permits to the general public at an unrelated event.
- The Bookstore sells merchandise to the general public online.

Regularly Carried On?

- Business activities of an exempt organization ordinarily are considered regularly carried on if they show frequency, continuity and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

Regularly Carried On? (cont'd)

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.

Regularly Carried On? (cont'd)

More you need to know...

- Year round activities are regularly carried on even if they are conducted only one day a week.
- Seasonal activities may be considered regularly carried on, even though they are conducted only for a short period each year.

Regularly Carried On: Example

- A department operates a food stand for one week at a conference held on campus. Because the activity is a one-time occurrence and is unlikely to compete with for-profit food stores that operate year-round, the activity is **not** “regularly carried on.”
- However, the daily sales of food at the UC is “regularly carried on.”

Substantially Unrelated?

- The exempt purposes of UT are instruction, research and public service.
- A business activity is not substantially related to the University's exempt purpose unless it contributes importantly to accomplishing the exempt purpose (other than through the production of funds).
- Determining whether an activity contributes importantly to the accomplishment of an exempt purpose is dependent upon the facts and circumstances.

Substantially Unrelated: Example



Thompson Boling Arena

Related



UT Basketball game

May not be!



Monster Truck Pull

Review: Unrelated Business Tests

- Is the activity a trade or business?
- Is the activity regularly carried on?

and

- Is the activity not substantially related to the University's exempt purpose?

Remember: The activity must exhibit all 3 requirements to generate UBI. Also, it's not how you spend the money, but how you earn it! Check your I cost centers and R wbse's for potential UBI! Note: R accounts should NOT be used for sales activity.

UBI Activities: Examples

Some common examples of probable UBI generating activities are:

- Parking revenues generated from general public attendance at non-University sponsored events
- Most forms of commercial advertising
- Routine analytical or testing services to non-University users
- Travel tour programs that are not authentic educational activities
- Sales or rentals (some) to the general public

Exceptions

Following are some activities that are specifically excluded from the definition of UBI:

- Volunteer workforce
- Convenience of members
- Sales of donated merchandise
- Qualified Sponsorship
- Distribution of low cost articles
- Exchange or rental of member lists

Exception: Volunteer Workforce

- Any trade or business in which substantially all the work (85% or more) is performed for the organization by volunteers, without compensation, is **not** an unrelated trade or business.

Exception: Convenience of Members

- Trades or businesses operated primarily for the convenience of members of the University are also exempt. University members include students, faculty, employees, officers, and patients.
- For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing is not an unrelated trade or business.
- Alumni and family of University members are considered general public for UBIT purposes and do not qualify for the convenience exception.
- Sales of clothing with a useful life > 1 year did not qualify for exception; emblem embossed items met the exception.

Exception: Sales of Donated Merchandise

- A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not an unrelated trade or business.
- For example, a department auctions donated merchandise to the general public, with the proceeds going to the University, is **not** an unrelated trade or business.

Exception: Qualified Sponsorship

- An unrelated trade or business will not include the activity of soliciting or receiving “qualified sponsorship payments”.
- A “qualified sponsorship payment” is one made to the University where the business making the payment receives in return no substantial benefit other than the use or acknowledgement of the business’s name or logo in connection with activities conducted by the University.

Qualified Sponsorship (cont'd)

Use or acknowledgement is defined as:

- Logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities or company
- A list of the sponsor's locations, telephone numbers or Internet address
- Value-neutral descriptions, including displays and visual depictions, of the sponsor's product lines or services
- The sponsor's brand or trade names and product or service listing.

Taxable Advertising

Advertising is taxable as unrelated business income and will be treated as a substantial return benefit. It is defined as any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility, or product. Advertising includes:

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

A single message that contains both advertising and an acknowledgment is advertising.

Exception: Distribution of Low Cost Articles

Unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions. A distribution is considered incidental to the solicitation of a charitable contribution if:

1. The recipient did not request the distribution,
2. The distribution is made without the express consent of the recipient, and
3. The article is accompanied by a request for a charitable contribution to the organization and a statement that the recipient may keep the low cost article regardless of whether a contribution is made.

For 2016, the maximum cost of a low cost article is \$10.60.

Exception: Exchange or Rental of Mailing Lists

- The exchange or rental of member or donor lists between tax-exempt organizations that are eligible to receive charitable contributions is not included in the term unrelated trade or business.

Exclusions

In addition to Exceptions, the following types of income (and deductions directly connected with the income) are generally excluded when figuring unrelated business taxable income.

- Investment income – dividends, interest, etc.
- Gains or losses from the sale of property (does not include inventory or property held primarily for sales to customers)
- Rents from real property
- Royalty income
- Research income

Exclusion: Rents

Rents from real property, including elevators and escalators, are excludable when calculating UBI.

However, the exclusion does **not** apply to:

- Rents from personal property*-see mixed lease on next slide.
- Rents from real property based on net profit
- Rents from real property when personal services are provided (i.e., hotel room, attended parking lots), or
- Rents from debt-financed real property (if 85% or more of the real property is used for exempt purpose, the real property is not considered debt-financed)

Rents (cont'd)

Rents from a mixed lease of personal property and real property:

- If 10% or less from personal property – incidental and excludable under rents from real property rule
- If 11-50% from personal property – taxable in proportion to the percent of personal property rents to the total rents
- 51% or more from personal property – 100% taxable

Exclusion: Royalty Income

- A royalty is the payment for the use of a valuable right like a trademark, trade name, or copyright. Similarly, payments for the use of an athlete's name, photo, likeness, or facsimile signature are also considered royalties.
- To preserve the royalty characterization, any services provided by the University should be limited to quality control activities. Providing more than minimal services may cause a portion of the royalty payment to be treated as compensation and thus taxable for UBI purposes.
- Be careful not to confuse royalties with payments for services. For example, payments for interviews or personal appearances cannot be excluded from the UBI tax calculation.

Exclusion: Research Income

- Revenues generated by research (whether fundamental or applied) performed by the University is excluded from Unrelated Business Income.
- However, the term “research” for this purpose does **not** include activities ordinarily carried on as an incident to industrial operations, such as ordinary testing (e.g., clinical trials) or inspection of products.

Research Income (cont'd)

- IRS has defined “ordinary testing” as those activities where "a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive and the procedure is merely a matter of quality control."
- IRS also rules that a project is "ordinary testing" if the work is performed to satisfy a federal or state regulation requiring such an evaluation before a product may be marketed.

Deductions

To qualify as allowable deductions in computing unrelated business taxable income, the expenses, depreciation, and similar items generally must be allowable income tax deductions that are directly connected with carrying on an unrelated trade or business. They cannot be directly connected with excluded income.

- Allowable Income Tax Deduction – Any ordinary and necessary expense paid or incurred during a taxable year in carrying on a trade or business is deductible.
- Directly Connected – This test is met if the expense has a “proximate and primary relationship” to the conduct of the trade or business (i.e., the dominant reason in incurring the expense is to further the unrelated business).

Deductions (cont'd)

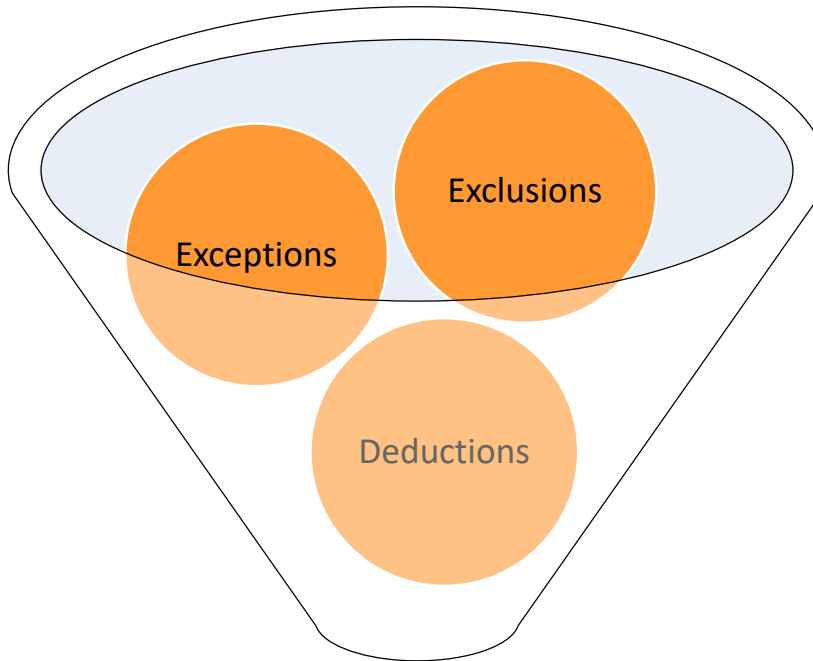
- Deductions that are solely attributable to the conduct of the trade or business are fully deductible.
- Where there is dual use of facilities and/or personnel for both related and unrelated purposes, expenses must be allocated on a “reasonable basis”. Some suggested allocation methods are:
 1. Gross receipts for facilities costs
 2. Actual time in use for fixed facility costs
 3. Time available for fixed facility costs
- Charitable contributions made to another qualifying organization are deductible whether or not directly connected.

To Recap...

External Unrelated
Sales



Goods or services sold to customers other than UT departments (includes unrelated sales to students, faculty, staff).



Less:

Exceptions:

- Volunteer workforce
- Member convenience
- Sale of donated merchandise
- Qualified sponsorship
- Distribution of low cost materials
- Exchange/rental mailing list

Exclusions/Modifications:

- Investment income (divs, int, etc)
- Gains/losses from sale of property
- Real property rents
- Royalty income
- Research income

Deductions:

- Allowable income tax deductions
- Expenses directly connected
- Dual use - allocate

Unrelated Business

Taxable Income

Potential Areas of UBI

Advertising

- Printed Publications
- Other Printed Materials
- Internet
- Facilities (Billboard, Scoreboard, etc)
- TV/Radio Broadcasting

Corporate Sponsorships

- Printed materials including publications
- Events
- Internet
- Facilities (Billboard, Scoreboard, etc)
- TV/Radio Broadcasting

Rental

- Facility Rental

Rental (cont'd)

- Rental of Arena
- Recreation Center Usage
- Athletic Facilities Usage
- Personal Property Rental
- Telecom Related or Broadcast Tower
- Other Rentals

Other

- Catalog Sales
- Internet Sales
- Travel Tours
- Broadcast Rights
- Royalties from Oil & Gas Interests
- Affinity Cards
- Mailing List Rentals

Potential Areas of UBI (cont'd)

Other (cont'd)

Logo Usage
Working Interest in Oil, Gas, etc.
Other Royalties
Exclusive Use Contracts
Commercial Research
Patents
Copyrights and Trade Names or Trade Secrets
Operation of Hotel
Operation of Conference Center
Operation of Restaurant
Catering Services
Food Services
Credit Card Promotions
Computer Services
Bartering

Other (cont'd)

Parking Lot Operations
Power Generations
Bookstore
Golf Course
Partnership Allocations
S-Corp Allocations
Income from Controlled Entities

What's Next?

- Departments that have external sales should complete the tax questionnaire, if you have not already done so, and submit it to the Office of Budget & Finance as soon as possible.
- The Office of Budget & Finance will review the questionnaire and seek a determination from the Controller's Office whether the activity is subject to UBI.
- If determined to be subject to UBI, the financial worksheet reporting FY 20xx data must be submitted annually to the Office of Budget & Finance by August 24.
- On the Controller's website, <http://controller.tennessee.edu/>, under the Tax link and on the Budget & Finance website, <https://budget.utk.edu/>, Best Practices Section, you will find resources related to UBI.
- **Remember - R accounts should generally not be used to record sales activity to the general public. Contact the Office of Budget and Finance to discuss if you have this situation.**
- **ANY DEPARTMENT OR UNIT CONDUCTING UNRELATED BUSINESS ACTIVITIES THAT ARE NOT BEING REPORTED TO THE CBO SHOULD CONTACT THE OFFICE OF BUDGET & FINANCE IMMEDIATELY.**

For more information...

- FI0330 – Unrelated Business Taxable Income
- IRS Publication 598 at www.irs.gov
- The Tax Law of Colleges and Universities,
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