

Taxation of Unrelated Business Income

Income derived from activities unrelated to a tax-exempt organization's purposes is taxed as if earned by a comparable for-profit entity. Generally, such income is subject to tax at the regular corporate rates. In computing unrelated business income taxes, most recognized business deductions are available to exempt organizations.

UNRELATED BUSINESS INCOME

Unrelated business income is defined as income derived from 1) a trade or business, 2) which is regularly carried on, and 3) which is not substantially related to the performance of tax-exempt functions, i.e., it does not contribute importantly to the achievement of tax-exempt purposes. The fact that income was produced for use in furthering exempt purposes does not qualify the income as related; the income itself must be derived in the course of furthering an exempt purpose. For unrelated business income taxes to be incurred, all three elements must be present.

A. Trade or Business.

A trade or business, as defined by the Code, is widely encompassing. It includes any activity carried on for the production of income from the sale of goods or the performance of services. Characterization as a trade or business depends on the level of active participation by the exempt organization in generating revenue.

B. Regularly Carried On.

Business activities of exempt organizations will be deemed to be regularly carried based on frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. When activities are consistently promoted and carried on by the organization, they meet the requirement of regularity.

Even activities conducted intermittently or sporadically throughout the year may not be treated as regularly carried on. For instance, an occasional dance, or a hospital auxiliary's operation of a food stand for two weeks at a state fair is not considered regularly carried on.

The sale of advertising in a book published only once per year may be deemed to be an activity regularly carried on. The IRS ruled that since an exempt organization contracted with a commercial firm for the solicitation of advertising sales on a year round basis, the frequency of actual publication was not determinative.

C. Substantially Related.

Generally, income derived by an exempt organization is not taxed if the income-generating activity contributes importantly to the tax exempt purposes of the organization. Certain activities which even indirectly further exempt purposes may satisfy the "important contribution" requirement. Merchandise sales (stationary, clothing, and accessories) by a conservation organization are related activities because the products, containing the logo of the organization or other environmental reference, stimulate

interest in wildlife preservation. Likewise, related activities include the operation of a lawyer referral service by a bar association, the provision of group insurance for member agencies by a social welfare organization, and the sale of educational products by a higher education institution.

In contrast, activities that were ruled not to contribute importantly to exempt purposes include the provision of veterinary services for a fee by an animal cruelty prevention society, the sale of uniforms by a labor union, the provision of language translation services by an international trade promotion association, the management of health plans by a business league, and liquor sales by a veterans organization.

1. Fragmentation.

The fragmentation rule must be used for purposes of calculating gross unrelated income. The IRS fragments a tax-exempt organization's operation, run as an integrated whole, into component parts. The Code states, an activity does not lose identity as a trade of business merely because it carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

2. Retail Sales - Educational Organizations

Bookstore, pharmacy or convenience store sales that further the intellectual life of the campus community and specifically students, are related activity sales. Exempt items include books, computers, food, cosmetics, clothing, novelty items, supplies, candy etc.

3. Advertising

In perhaps the most widely cited application of the fragmentation rule, the sale of a monthly journal by medical organizations is considered to be related activity, but the sale of advertising within such periodicals is unrelated. The Supreme Court has held that such advertising is taxable even though it may have been educational or informational. For such advertising to be considered related activity, it must contribute to the accomplishment of an exempt purpose, as in the case of a university newspaper the purpose of which is to train students in journalism.

4. Hospitals (Pharmacy sales)

Similarly, the sale of pharmaceuticals by the pharmacy of an exempt hospital to patients of the hospital is related activity, though sale to the general public generates unrelated business income.

EXCLUSIONS FROM UNRELATED BUSINESS INCOME.

A. Passive Income.

Passive income, including interest, dividends, rents from real property, revenue from property sales, and royalty payments, is generally excluded from unrelated business income. If passive income is generated through controlled subsidiaries or through the use of borrowed funds, this exclusion may not apply and must be evaluated further.

1. Interest and Dividends.

Most interest and dividends, including annuities and payments relating to loaned securities, are excluded from unrelated business income. Note however, that partnership income, including income derived by passive investors (i.e., limited partners), is treated as unrelated business income.

2. Rent From Real Property.

Income derived from the rental of real property is usually excluded from taxation. However, income derived from the rent of personal property is not excludable. In the case of a lease containing both real and personal property, if more than 50% of the rent is derived from personal property then none of the rental income is excludable.

If the amount of rental income is dependent on a percentage of the lessee's sales or profits, the rental income will not qualify for exclusion. Regulations reason that such division of profits connects the exempt organization with the active conduct of a business. Therefore, the rental payments can not be considered passive.

Rental income may also be taxable if the lease involves the performance of services beyond those normally provided by a landlord. For instance, normal maintenance and repairs may be provided by the exempt organization/lessor. If additional cleaning, laundry, or other personal services are provided, the rental income will be construed as derived from a trade or business.

3. The Sale of Property.

Gains or losses from the sale or other disposition of property are generally not taxed as unrelated income. Under this provision, all income that would normally be considered capital gain income is excluded from taxation.

4. Royalties.

Royalty income is excluded from taxation. Excludable royalties include payments from the licensing of patents, trademarks, and mineral rights. In contrast to the rules regarding rental payments, receipts may still be considered royalty income when the payment is based on gross profits. In particular, revenues derived from a share of the gross profits of a gas producing property were ruled to be royalty payments. Exempt organizations have attempted to classify, as royalties, payments that are in fact fees for services. The IRS, ignores contractual language and looks to the true substance of such transactions. However, a venture that would otherwise produce taxable proceeds can be legitimately structured as a royalty arrangement. The royalty exclusion is commonly used by exempt organizations to exclude licensing fees from UBIT. The IRS generally agrees with this result, so long as the exempt organization plays a passive role in the licensing arrangement. However, where the exempt organization's involvement is active, the IRS will not characterize the payment as a royalty, excluded from UBIT.

5. Research Activities.

There are three primary exclusions available for scientific research activities. First, income is not unrelated if "derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof." Second, income derived for research by colleges,

universities, and hospitals is excluded. Third, income derived by exempt organizations which operate primarily for scientific research purposes and make the research results available to the public free of charge is untaxed.

The term "research" does include fundamental and basic research which may include testing of pharmaceuticals for the development of new products. However, research does not include activities that are incidental to ordinary business operations, such as the testing or inspection of commercial products or materials.

6. Volunteer Activities.

Activities that would otherwise be unrelated are deemed to be related if "substantially all the work in carrying on such trade or business is performed for the organization without compensation. A museum program operated by volunteers 95% of the total time was deemed to be substantially operated by volunteers.

7. Sales of Contributed Property

"The selling of merchandise, substantially all of which has been received by the organization as gifts or contributions" is not an unrelated trade or business. This exception is most commonly used by thrift shops which sell donated clothes and other items to the general public.

8. Activities for Convenience of Members, Employees et al.

A trade or business carried on by an exempt organization "primarily for the convenience of its members, students, patients, officers or employees" is not taxable. Thus, the operation by an art museum of a cafeteria and snack bar for use by its staff and visiting members of the public is considered a related activity, as is the operation of gift shop, and parking lot for the staff, patients, and visitors of a hospital.

The operation of a dormitory, dining facility or laundry by a college for its students qualifies under this exclusion, but if operated primarily for the benefit of the public it is an unrelated business.

9. Membership and Mailing Lists.

The sale or exchange by 501(c)(3) organizations to other 501(c)(3) organizations of their membership or mailing lists is specifically excluded from taxation and may include affinity credit card mailing lists if no services are rendered by the exempt organization.

10. Low Cost Items.

Income derived from the sale of low cost articles such as T-shirts and coffee mugs, by 501(c)(3) organizations only, are excluded from taxation if their distribution is "incidental to the solicitation of charitable contributions. A low cost item is defined as any article costing the exempt organization (not the recipient) no more than \$5, based on 1987 dollars and adjusted for inflation annually. If more than one item is distributed to a single recipient in a calendar year, then the aggregate of the items is treated as one article.

COMPUTATION AND PAYMENT OF UNRELATED BUSINESS INCOME TAXES

Unrelated business taxable income is the gross income derived from an unrelated trade or business less deductions which are directly connected to the carrying on of such trade or business. Unrelated taxable income is subject to the regular corporate income tax rates. Exempt organizations must also make quarterly estimated tax payments under the same rules applicable to corporate income.

When an exempt organization derives income from two or more unrelated activities, unrelated taxable income is the aggregate of all unrelated income minus the aggregate of all allowable deductions

Where staff time is used to conduct both exempt and unrelated activities, deductions must be allocated between the uses on a reasonable basis. Similarly, the dual use of facilities must use a reasonable consistent basis for allocation of expenses such as utilities, depreciation and maintenance.

EXAMPLES OF UNRELATED AND RELATED ACTIVITIES:

The following are examples of activities that are not related to the mission of the University and subject to unrelated business income tax:

Income from advertising placed by a company in an athletic or performing arts program.

Income from advertising on the Internet.

Sale of mailing lists or other data to commercial entities where services are rendered.

Gift shop sales to the public (evaluated on an item-by-item basis).

Sale of advertising space in a RU Journal or regularly scheduled periodical.

A hyperlink from a RU web site to a sponsor's web site where an endorsement appears by RU for the sponsor's product.

Commercially sponsored scientific research if the results are not made available to the public or directed toward benefiting the public.

Rental of apartments to the general public where the building is financed by tax exempt bonds.

Rental of sports facilities such as stadiums, soccer fields, etc. where services are provided.

A travel tour programs operated by a college/department or the alumni association that are not authentic educational activities (i.e. sightseeing, recreational, social, cruise, etc.)

Rental payments for the lease of space on antenna towers and transmission facilities.

Summer Sports Camps that are not part of educational programs offered by the University.

Corporate sponsorship payments where the sponsor receives a substantial return benefit that has a fair market value of more than 2 percent of the entire payment.

Pharmacy sales to the general public.

Commercial activities exploiting the University's educational purpose.

Joint ventures with for-profit organizations such as technology transfers forming partnerships with individuals, corporations, or limited liability companies that do not serve the University's charitable purposes and do benefit the for-profit partner and/or insiders.

Professional entertainment events operated in a commercial manner and not part of an educational program.

Exclusive provider arrangements where the University performs substantial services.

Direct operation of parking lots.

Hotel room sales to the general public and alumni.

Advertising in the telephone directory or yearbook.

Dual use of assets or facilities for public events including evening hours.

Intellectual property where substantial services are provided in connection with the activity (facts and circumstances must be evaluated).

A fitness center sells memberships to the general public.

Book publishing where the University owns the rights to a book which does not relate to the educational purposes of the University (i.e. exploits the book in a commercial manner).

Golf course use by alumni and the general public

The following are examples of activities that are related to the mission of the University:

A hyperlink from a RU web site to a sponsor's web site where "no" endorsement appears by RU for the sponsor's product, and contains comparative language.

Computer time sold to university departments.

Conferences, workshops, or seminars held for university departments

Income from advertising placed on the University newspaper when the newspaper is run by the students as part of an educational program.

Sale of books and class material, and other items needed in the course of students living on campus by the bookstore.

Meetings, conferences and seminars where education or training is provided by RU.

Non-patient diagnostic laboratory testing performed by a teaching hospital on specimens needed for the conduct of its teaching activities.

The sale of broadcasting rights for athletic events.

Gold course use by students, faculty or staff

Sponsoring entertainment events for the appearance of RU performing arts students or professional theater companies and symphony orchestras that present drama and musical performances for students, faculty, and the general public.

Intellectual property royalties as a result of licensing to a third party.

Sales of computers and other related products to students, faculty and staff used for educational or job purposes.