

Unrelated Business Income Tax (“UBIT”)

General Guidelines

1. Federal Income Tax Exemption and Income Unrelated to the Exempt Purpose

The University of Arizona is tax-exempt as an instrumentality of the State of Arizona under Section 115 of Internal Revenue Code. The University is exempt from federal income tax for engaging in activities which include 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. However, the University is not exempt from income tax imposed on activities which are substantially unrelated to those exempt purposes, even though these activities may bring in funds to support the University’s exempt operations.

This section defines the Unrelated Business Income and lists the particular statutory exclusions from unrelated business activities and taxable income. Materials are based on IRS Publication 598, Internal Revenue Codes, IRS Treasury Regulations and IRS rulings.

2. Definition of Unrelated Business Income (“UBI”)

Unrelated Business Income is the income from a trade or business that is regularly carried on by an organization and that is not substantially related to the performance of the organization’s exempt purpose, except that the organization uses the profits derived from this activity. In order to determine whether a particular activity that the University engages in will generate taxable income, the following three elements must **all** be present:

- The activity must be “a trade or business”;
- The trade or business must be regularly carried on, AND
- The conduct or the trade or business is substantially unrelated to the exempt purpose

(1) 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 identify 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 purpose of the organization.

- A trade or business must exhibit intent to profit from the activity.
- Where an activity carried on for profit is an unrelated trade or business, not part of the trade or business is excluded merely because it does not result in profit.
- However, sustained, significant, and repeated losses generated by unrelated activities may not be considered “trade or business” for lacking of profit motive.

If the University charges substantially below the cost of its goods or services, then the activity is not a “trade or business”, and the losses are not allowed to offset against the income derived from a for-profit unrelated business. On the other hand, if the business is conducted in a competitive manner, then it is considered strong evidence of a profit motive (Reg. 1.513-(b)).

(2) Regularly Carried On

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

An activity should not be considered as regularly carried on if it is (a) on a very infrequent basis; (b) for a short period of time during the year; or (c) without competitive and promotional efforts.

Activities over a period of only a few weeks are not "regular" for an exempt organization if the same kind of activities is normally conducted by a nonexempt business on a year-round basis. Intermittent, casual or sporadic activities are generally not regular. However, year round activities are regular even if they are conducted only one day a week. Furthermore, seasonal activities may be considered regularly carried on, even though they are conducted only for a short period each year (Reg. 1.513-1 (c)(2)).

(3) Substantially unrelated

A business activity is not substantially related to an organization’s exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Whether an activity contributes importantly depends in each case on the facts involved (Reg. 1.513-1(d)(2)).

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activity involved must be considered. If an activity is conducted on a scale larger than reasonably necessary to carry out the exempt purpose, the part of the activity that is more than needed to accomplish the exempt purpose is considered unrelated (Reg. 1.513-1(d)(3)).

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 exempt purposes (Reg. 1.513-1(d)(4)(iii)).

3. Exclusion from Unrelated Business Activities

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

(1) Volunteer workforce

Any trade or business in which substantially all of the work (probably 85%) is performed without compensation is not unrelated trade or business. In assessing the contribution made by volunteers, the IRS considers factors such as the monetary value of the respective service rendered, the number hours worked, the intrinsic importance of the volunteer work performed, and the degree of reliance placed upon volunteers (Reg. 1.513-(e)(1)).

(2) Convenience of members

Any activity carried on primarily for the convenience of University members such as students, patients, officers, or employees, is not unrelated trade or business. Any sales to nonmembers, e.g. the general public, are unrelated and taxable, unless the sales are not regularly carried on (Reg. 1.513-1(e)(2)).

The IRS has ruled that alumni should be treated the same as members of the general public (PLR 8020010).

(3) Selling donated merchandise

A trade or business that consists selling merchandises, substantially all (probably 85%) of which the University received as gifts or contributions, is not an unrelated trade or business (Reg. 1.513-1(e)(3)).

(4) Qualified Sponsorship

See UBI Specific Circumstances and Guidelines: Corporate Sponsorship

4. Modification of Unrelated Business Income

Generally, unrelated business income is taxable, but certain items of unrelated business income and related deductions are excluded from UBI treatment. The modifications, however, generally do not apply to income derived from debt-financed property.

(1) Certain investment income

- Interest from bank accounts
- Annuities
- Payments with respect to securities loans, and
- Any other incomes from routine investments, including notional principal contracts, which the IRS determines are largely similar to these types of income.

(2) Royalties

A royalty is a payment related to the use of a valuable right, including trademarks, trade names, and copyrights, etc. 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 (IRC 512(b)(2) and Reg. 1.512(b)-1(b)).

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

(3) Rents

Real Property – Generally, rents from real property are excluded (Reg. 1.512-(b)-1(c)(ii)(a)).

Personal Property – Rents from personal property are excluded only if there is a mixed lease and the rents attributable to the personal property are an “incidental” part of the total rents received under the lease. The following rules apply to personal property rents:

- 10% or less is considered incidental and not subject to tax.
- 11-50% is considered taxable in proportion to the percent of personal property rents to the total rents.
- 51% or more is considered 100% taxable (Reg. 1.512(b)-1(c)(ii)(b)).

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 to the occupant if they are primarily for his or her convenience and are other than those usually rendered in connection with the rental of rooms or other space of occupancy only. 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 (Reg. 1.512(b)-1(c)(5)).

Percentage – Rents dependent on profits or income derived by the University from real property do not qualify for the exclusion unless they are based on a fixed

percentage of gross receipts or sales. Rents based on a percentage of net profits are taxable (Reg. 1.512-(b)-1(c)(2)(iii)).

(4) Gains or losses from sale of property

This includes gains and losses from the disposition of property, other than inventory or property held primarily for sales to customers.

(5) Research income

Income from certain research grants or contracts may be exempt from the UBIT depending on the type of research. The following type of research are exempt:

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

However, the regulations further limit these exclusions by providing that “research” for this purpose does not include activities ordinarily carried on as an incident to industrial operations, such as ordinary testing or inspection of products (Reg. 1.512(b)-1(f)(4)).

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" (GCM 39196).

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 (Rev. Rul. 68-373, 1968-2 C.B. 206).

5. Exceptions to Debt-financed property

(1) Property related to exempt purpose

If substantially all (85% or more) of the use of any property is substantially related to an organization’s exempt purpose, the property is not treated as debt-financed property. To extend to which the property is used for a particular purpose is determined by a comparison of time the property is used for exempt purpose with the total time the property is used, or a comparison of the part of the property that is used for exempt purposes with the part used for all purpose, or both of these comparisons.

(2) Acquisition of real estate by qualified organizations

The Internal Revenue Code also 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 the University to purchase real property where the following conditions are present:

- the purchase price is a fixed amount,
- 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.
- the real property is not leased back to the seller or a party related to the seller, and
- 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 (IRC 514 (c)(9)).