

# University of Utah

## Unrelated Business Income Tax

### November 10, 2015

Presented by:

Kelly Peterson, CPA

Manager, Tax Services

Phone: 581-6699

Email: [Kelly.Peterson@admin.utah.edu](mailto:Kelly.Peterson@admin.utah.edu)

# University of Utah

## Unrelated Business Income Tax

### November 10, 2015

#### Agenda

- Unrelated Business Income Concepts
- Exceptions to Unrelated Business Income
- University UBIT Activities
- Reporting Requirements
- UBI Best Practices

# UBI in General

All federally tax exempt organizations have been granted tax exempt status because they are organized and operated primarily to pursue one or more exempt purposes.

# UBI in General

In spite of tax exempt status, a tax exempt organization is potentially subject to a special unrelated business income tax (UBIT) that is imposed at the normal corporate tax rates on the net income earned by the entity from the conduct of a trade or business that is unrelated to its exempt purpose. (IRC section 511).

# UBI in General

- Exempt organizations are not prohibited from conducting UBI activities as long as the UBI activities are not predominant.
- Organizations must consider for budgeting purposes that any net income stream from the activity will be reduced by applicable federal and state UBIT.

# UBI in General

- State colleges and universities are subject to UBIT as stated in IRC section 511(a)(2)(b)

# General Definition

"Unrelated business income" is defined as gross income derived by an exempt organization, less direct expenses, from an activity which satisfies all of the following criteria:

- the activity is a trade or business
- the trade or business is regularly carried on
- the trade or business is not substantially related to the organization's exempt purpose

# Definitions-Trade or Business

- Any activity carried on for the production of income that involves the sale of goods or the performance of services
- and that otherwise has the characteristics of a business enterprise (IRC Regulation section 1.513-1(b))



# Definitions-Trade or Business

- Rarely does an income-producing activity fail to be treated as a trade or business.
- However, if an activity consistently produces losses, it will generally be treated as a nontrade or business because there is a lack of a profit motive

# Definitions-Regularly Carried On

- A trade or business activity is regularly carried on if it manifests a frequency and continuity, and is pursued in a manner generally similar to comparable commercial activities of nonexempt organizations (IRC Regulation section 1.513-1(c)(1))
- Consider the frequency of the activity on the campus as a whole
- Activities lasting only a short period of time on an annual basis would not be considered regularly carried on.

# Definitions-Not Substantially Related

- Under this requirement, the trade or business must be one which is not substantially related to the exercise or performance by the exempt organization for the purpose or function constituting the basis for its exemption
- An activity will not be considered related to exempt functions merely because the profits from the activity are used by the organization to support its exempt activities
- The determination of whether a business activity is related or unrelated has been the subject of numerous court cases and IRS rulings.

# Definitions-Not Substantially Related cont'd

- Each activity needs an analysis of the facts
- The trade or business is related if the conduct of the activity has a causal relationship to the achievement of the organization's exempt purpose and the relationship is substantial
- The regulations also provide that the activity must contribute importantly to the accomplishment of the organization's exempt purpose (Regulation section 1.513-1(d))

# Mission of the University

- The University of Utah is an institution of higher learning organized under the constitution and laws of the state of Utah as a body corporate and politic, controlled and supported by the people of the state.

# Mission of the University, cont'd

- The mission of the University of Utah is to serve the people of Utah and the world through the discovery, creation and application of knowledge; through the dissemination of knowledge by teaching, publication, artistic presentation and technology transfer; and through community engagement. As a preeminent research and teaching university with national and global reach, the University cultivates an academic environment in which the highest standards of intellectual integrity and scholarship are practiced. Students at the University learn from and collaborate with faculty who are at the forefront of their disciplines. The University faculty and staff are committed to helping students excel. We zealously preserve academic freedom, promote diversity and equal opportunity, and respect individual beliefs. We advance rigorous interdisciplinary inquiry, international involvement, and social responsibility.

# Statutory Exceptions to UBI

- Royalties
- Capital Gains
- Interest and Dividends
- Sale of donated merchandise
- Convenience exception
- Research
- Rental income
- Business conducted by volunteers

# Statutory Exceptions to UBI

- **Royalties** are a type of income specifically excluded from the unrelated business income tax under IRC section 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.
- **Capital Gains Transactions**-All gains and losses from the sale, exchange, or other disposition of property are excluded from a charitable organization's computation of unrelated business income under IRC section 512(b)(5)



# Statutory Exceptions to UBI, cont'd

- **Interest and Dividends** received by a charitable organization are excluded from unrelated business income (IRC section 512(b)(1))
- **Sale of donated merchandise**-the income is from the sale of merchandise substantially all of which was donated to the organization (IRC section 513(a)(3))

# Statutory Exceptions to UBI cont'd

- **Convenience Exception to Unrelated Business Income**-An activity carried on by a charitable organization **primarily** for the convenience of its members, students, patients, officers, or employees is not treated or taxed as an unrelated trade or business under IRC section 513(a)(2)
  - Notice who is excluded: alumni, general public
  - Examples at U-Bookstore, campus restaurants

# Statutory Exceptions to UBI cont'd

- **Research excluded from UBI**
  - Income derived from research for the US government, or any of its agencies or instrumentalities, or any State or political subdivision (IRC section 512(b)(7))
  - Research performed for any person in the case of a college, university or hospital (IRC section 512(b)(8))
  - Research performed by an organization operated primarily to carry on fundamental research the results of which are freely available to the general public (IRC 512(b)(9))
  - Significant involvement by the institution's students in the research activity.

# Statutory Exceptions to UBI cont'd

- **For Research to be excluded from UBI must meet the following three tests:**
  - **It must be “scientific research”, includes:**
    - practical and applied research
    - If professional skill was involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth
    - The process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning.
  - **The scientific research must not be conducted incident to commercial or industrial operations defined as:**
    - 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.
  - **The research must be conducted in the public interest**

# Statutory Exceptions to UBI cont'd

- **Rental Income**

IRC section 512(b)(3) provides that certain types of rental income received by a charitable organization are exempt from unrelated business income

# Statutory Exceptions to UBI-Rent cont'd

- Restrictions on UBI rental exemption
  - Rent must be of real property
  - If personal property is leased with the real property, the exclusion will apply, but only if the amount of the rent attributable to the personal property is incidental (less than 10%) to the amount of total rent determined at the time the property is leased (Regulation section 1.512(b)-1(c)(2))

# Statutory Exceptions to UBI-Rent cont'd

- If rent attributable to the personal property is 10 to 50 percent, the amount of rent attributable to the real property (but not to the personal property) still qualifies for UBI rental income exclusion
- However, if the personal property rent exceeds 50 percent of the total rent, none of the rent is eligible for UBI exclusion

# Statutory Exceptions to UBI-Rent cont'd

- The UBI rental income exclusion is not available if the rent depends in whole or in part, on the income or profits from operating the rented property
- It is permissible, however, to base the rental payments on a fixed percentage of receipts or sales (IRC section 512(b)(3)(B)(ii))



# Statutory Exceptions to UBI-Rent cont'd

- UBI rental income exclusion does not apply if services are (1) rendered primarily for the convenience of the occupant, and (2) of a nature customarily rendered in connection with the rental of rooms or other space for occupancy only (Regulation section 1.512(b)-1(c)(5))

# Statutory Exceptions to UBI-Rent cont'd

- The example mentioned in the regulations concerning disqualifying services is maid services provided in the case of hotel room occupancy. In contrast, the provision of heat and light, cleaning of public areas and the collection of trash are not disqualifying services

# Statutory Exceptions to UBI-Rent cont'd

- IRS authority does not provide much additional guidance to regulations
- Maintenance, security, linen service are disqualifying services (Revenue Ruling 80-298)
- Administrative services to lessee such as collecting membership fees and scheduling are disqualifying services (Revenue Ruling 80-297)
- Provision of utilities and janitorial services are not disqualifying services (Revenue Ruling 69-178)

# Statutory Exceptions to UBI

- **Business Conducted by Volunteers**
  - Substantially all the work in carrying on the business is performed by volunteers
    - IRS has defined a 85% or greater

# UBI-Supplementary Guidance

- Oftentimes law does not address specific fact patterns
- Law alone leaves many questions unanswered
- Activities may need evaluation based on supplementary authority such as court cases and IRS pronouncements

# Examples of Supplementary Guidance

- Exempt org gift shops-Revenue Ruling 73-104, PLR 9720002
- Rental of university facilities-Revenue Rulings 80-298, 80-297, 69-178

# Examples of Supplementary Guidance

- University Catering-IRS Announcement 93-2
- University hotel-GCM 38060
- University bookstores-TAM 8025222, IRS College and University Examination Guidelines Announcement 94-112

# University UBIT activities

- To the extent University conducts activities where there is supplementary authority outlining treatment, we would be expected to follow such authority
  - Examples include, Tennis Center, Red Zone retail stores, Alumni House, Guest House, etc.



# UBI Reporting

- University's fiscal year UBI tax return is due November 15<sup>th</sup>
- Information of UBI activity income and expenses due to Tax Services September 15<sup>th</sup>
- Tax Services will add additional expenses such as overhead, any allocable bond interest expense and any allocable depreciation expense-this may further reduce UBI income

# UBI Reporting

- Tax Services consolidates campus wide UBI activities on tax return
- University officer signs return-under penalty of perjury-that return is COMPLETE and ACCURATE
- Tax Services allocates activity's share of federal and state UBIT back to department

# UBI Best Practices

- If contemplating UBI activities, involve Tax Services
- Tax Services will:
  - Look for UBI exceptions and document applicability
  - Help you understand your budget on the activity, what is potential tax affect
  - Review model contracts to look for ways to reduce UBI

# UBI Best Practices

- If activity serves related and unrelated purposes, departments need to track allocation of use throughout the year
- Examples-catering, rental of facilities
- Expense allocations are based on such percentages

# UBI Best Practices

- Summary information, P&L, allocation of use and other necessary yearly information goes to Tax Services for reporting
- All documentation supporting UBI activity should be maintained at the department level for a period of four years

# UBI - Miscellaneous

- Discussion only relates to UBI, not to any other type of tax, i.e. sales tax
- Utah law follows federal law for purposes of UBI

# Unrelated Business Income Tax

QUESTIONS??

# University of Utah

## Unrelated Business Income Tax

### November 10, 2015

Presented by:

Kelly Peterson, CPA

Manager, Tax Services

Phone: 581-6699

Email: [Kelly.Peterson@admin.utah.edu](mailto:Kelly.Peterson@admin.utah.edu)