

UNRELATED BUSINESS INCOME REVIEW GUIDELINES

Under Internal Revenue Code Section 115, The University of Texas is tax-exempt as an instrumentality of the State of Texas (exemption letter dated March 20, 1984). The Internal Revenue Code provides that the exempt purposes of state colleges and universities include all of the purposes and functions described in Code Section 501(c)(3), and therefore for federal income tax purposes the University may engage 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. the University is not, however, exempt from tax imposed by Code Section 511, 512 and 513 on activities which are unrelated to those exempt purposes. Therefore, each activity must be scrutinized to determine whether an exempt purpose is also being served.

Three elements must be present for an activity to be considered unrelated to the University’s tax-exempt purposes:

- (1) the activity must be a “trade or business”,
- (2) it must be regularly carried on and,
- (3) it must not be substantially related to the University’s exempt purposes.

Code, Regulation, Ruling
or Other Citation

GENERAL

A. Trade or Business – Generally, a trade or business for unrelated business income tax purposes is any activity which is carried on for the production of income from the sale of goods or performance of services.

1.513-1(b)

B. Regularly Carried On – The regulations consider the frequency and continuity of the activity and the manner in which it is pursued. Thus, the unrelated business income tax applies only to a business activity which is regularly carried on as distinguished from commercial transaction which are sporadic or infrequent.

1.513-1(c)(1)

Short-term activities are not “regular” for an exempt organization, if the activities are of a kind normally conducted by a taxable 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. Further, seasonal activities may be regularly carried on even though they are conducted only for a short period each year.

1.513-1

- C. Related to University Exempt Purpose – To be related to the University’s educational or research exempt purpose, there must be a substantial casual relationship, i.e., the activity must contribute importantly to the accomplishment of the exempt purpose (other than the University’s need to produce income). 1.513-1(d)(2)
1. Size and Extent – Particular emphasis is placed on the size and extent of the activity. If an activity is conducted on a scale larger than reasonably necessary to carry out the exempt purpose, it is more likely to be treated as unrelated. 1.513-1(d)(3)
2. Dual Use of Assets or Facilities – 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. 1.513-1(d)(4)(iii)

STATUTORY EXCEPTIONS

Even if an activity meets the definition of an unrelated trade or business, it can avoid being taxed if it meets one of the following criteria:

- A. Volunteer Labor – Any activity in which substantially all (probably 85%) of the work of the trade or business if performed without compensation is exempt from tax. In assessing the contribution made by volunteers, the IRS considers such factors as the monetary value of the respective services rendered, the number of hours worked, the intrinsic importance of the volunteer work performed and the degree of reliance placed upon volunteers. 1.513-1(e)(1)

- B. Convenience of University Members – Any unrelated activity conducted primarily for the convenience of University students, faculty, staff or patients is exempt from tax. The convenience exception is applicable only to members of the University. Any sales to nonmembers, e.g., the general public, are taxable unless the sales are not “regular”. 1.513-1(e)(2)

With respect to alumni, the IRS has rules that they should be treated as the general public since nothing in the Code treats alumni any differently than the general public. PLR 8020010

- C. Donated Merchandise – Any unrelated activity engaged in the selling of merchandise, substantially all (again probably 85%) of which was received as gifts or contributions is exempt regardless of whether the labor to operate the activity is paid or volunteered. 1.513-1(e)(3)

MODIFICATION TO INCOME

The Code contains several modifications which have the effect of exempting various kinds of income from the unrelated business income tax. These include income from dividends, interest, annuities, royalties, rents from real property and certain forms of research. The modifications, however, generally do not apply to income derived from debt-financed property.

- A. Royalties – A royalty may be generally defined as a tax, duty or compensation paid to owners of a patent, copyright, mineral interest or other property right for the use of it or the right to exploit it. 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. 512(b)(2)
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 income. 73-193
- Amounts received from the exchanging or renting of member or donor lists recently have been held by the Tax Court to be royalties which are excluded from unrelated business taxable income. 513(h)(1)(B)
856-87, 94 T.C. No. 6, 2-26-90
- Amounts received from the exchanging or renting of member or donor lists recently have been held by the Tax Court to be royalties which are excluded from unrelated business taxable income.
- B. Rents – The rules covering rents vary depending on whether they are derived from real or personal property or from a mixed lease of both real and personal property. 1.512(b)-1(c)
1. Real Property – Generally, rents from real property are excluded. 1.512(b)-1(c)(ii)(a)
2. 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. 1.512(b)-1(c)(ii)(b)
3. 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 1.512(b)-1(c)(5)

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. The renting of parking spaces where an attendant is on duty is not considered to be rent from real property since services (the attendant) are being provided. Similarly, the provision of security services to a parking garage removes that rental from being considered to be from real property.

4. Debt-Financed Property – The Code 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 a qualified organization to purchase real property where the following conditions are present:

514(c)(9)(c)(i)

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

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.

1.512(b)-1(c)(2)(iii)

C. Sponsored Research -- General – Income from certain research grants or contracts may be exempt from the unrelated business income tax depending on the type of research. The following types of research are exempt:

- Research performed for any level of government
- Research performed by a college, university, or hospital “for any person,” and
- Research performed for any person in the case of an organization operated primarily for purposes of carrying on “fundamental” research (as distinguished from “applied”), the results of which

512(b)(7)

512(b)(8)

512(b)(9)

are freely made available to the general public.

The regulations further limit these exclusions by providing that research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations. Ordinary testing and inspection of products or materials is not exempt.

1.512(b)-1(f)(4)

D. Clinical Trial/Drug Testing – Drug studies that are normally taxable may be made exempt by involving medical training or patient care:

- FDA drug testing in which drugs are offered to patients who have the disease for which eventual commercial use of a particular drug is intended, as contrasted to patients receiving care for unrelated medical reasons, has been determined to be a related activity exempt from UBIT.
- Testing of drugs solely to meet FDA requirements is taxable even though the test results are freely available for publication if it is not established that the testing contributes to the training of students or to patient care.
- Outside laboratory testing services providing an additional supply of human tissue samples needed for the training of medical students, interns, residents, medical technologists and nurses do not constitute an unrelated trade or business by virtue of contributing importantly to a hospital's medical education program.
- Where the performance of diagnostic laboratory testing is otherwise available within the community, testing of specimens from private office patients of a hospital's staff physicians constitutes an unrelated trade or business subject to UBIT.
- Normally taxable drug testing conducted by students has been held exempt.
- Experimental construction and production testing by students that was more than incidental was found exempt.
- Clinical testing of developmental equipment apart from student involvement was subject to UBIT.

PLR 8230002

68-373

85-109

85-110

PLR 7936006

PLR 8445007

PLR 7902019

SPECIAL CIRCUMSTANCES

There are special circumstances when an unrelated activity may be recognized as serving an exempt purpose. Whether such unique circumstances exist will be decided by the IRS on a case-by-case basis. The following are examples of unique circumstances:

85-110, 1985-2 C.B. 166

- Services or facilities otherwise unavailable in the community that fulfill an important community or medical need (see below) and
- Services, facilities, or equipment which are technically advanced or unique.

HOSPITAL SERVICES

A. Hospital Services Provided to Non-patients – Revenue generated from hospital pharmacy sales to non-patients and laboratory testing of non-patient specimens is considered unrelated business income. However, if the services are provided for the convenience of patients and employees of the hospital then the income is not taxable. 513(a)(2)

1. Pharmacies – Hospital pharmacy sales to the public directly compete with commercial pharmacies and are considered an unrelated trade or business unless the activity exists primarily for the convenience of patients and hospital staff. Additionally, the proceeds from sales made by a tax-exempt hospital pharmacy to private patients have been determine to be unrelated business income where the sales are far from casual, and the profits are “substantial”.

68-374
68-375

2. Lab Testing – As with pharmacy sales, laboratory testing of specimens from outside patients is potentially in competition with commercial enterprises performing the same function. This activity will be considered in unrelated trade or business unless the testing exists primarily for the benefit of the exempt hospital’s patients and employees or as part of an established teaching program.

1.513-1(b)

85-110, 1985-2 C.B. 166

3. Community need Exception – An exempt hospital’s testing of non-patient specimens may fulfill an important community medical need and thus serve the hospital’s exempt purposes.

For example, if testing facilities are otherwise unavailable within a reasonable distance from the hospital’s service are or are clearly unable or inadequate to conduct tests needed by non-patients, a hospital’s testing service may further its exempt function of promoting community health.

68-376, 1968-2 C.B. 246

4. Hospital Patients – The following persons will be considered patients” of a hospital for purposes of IRC 513(a)(2):

Inpatients (receiving general or emergency diagnostic, therapeutic, or preventive health services), a former patient refilling a prescription, and a person receiving medical services as part of a hospital administered home care program, or receiving medical care and services in a hospital affiliated extended care facility

The IRS has ruled that private patients of doctors who are affiliated with the hospital but engaged in private practice in a nearby building are to be regarded as the general public.

- B. Services Provided to Another Tax Exempt Hospital – 510(e)91)(A)
Hospitals often perform service i.e., data processing, purchasing, warehousing, billing and collection, food, laboratory, personnel (including selection, testing, training, and educational), printing, clinical communications, industrial engineering, records center, etc. for other hospitals. Under certain circumstances, these services may not result in unrelated trade or business income for the hospital providing the services. Such services performed by an exempt hospital for other exempt hospital do not constitute unrelated business income if the:

- Services are provided at a fee that does not exceed actual costs including straight-line depreciation and reasonable rate of return on capital goods used to provide the service,
- Services are furnished solely to hospitals service not more than 100 in patients, and
- Services are consistent with the recipient hospital’s exempt function

The exception, however, does not apply to services not listed above, such as laundry services. An exempt hospital performing laundry services for another hospital is engaged in an unrelated trade or business.

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- C. Services Provided to a Hospital not Tax-Exempt – As with 513(a)(2)
services provided to a non-patients, the income received from services provided to a hospital which is not tax-exempt will be considered unrelated.

ADVERTISING

A. Advertising – The sale of advertising may be taxable even if the activity is carried on within a larger complex of other endeavors which are substantially related to an organization’s exempt purpose (e.g., the publication of a newsletter, magazine or scholarly journal). 513(c)

1. Related – Advertising in a college newspaper as part of an instructional program or advertising which serves an “informational function” as opposed to serving a means of stimulating demand for products may be considered related to an organization’s exempt purpose.

2. Unrelated – The IRS considers general consumer advertising in an exempt organization’s journal as “trade or business” since it does not “contribute importantly” to the organization’s exempt purpose. 1.513-1(d)(4)(iv)

B. Student Participation – Consumer advertising may be regarded as related to the University’s exempt purpose if students are actively involved in the solicitation, sale and publication of the advertising under the supervision and instruction of the University.

For example, a campus newspaper operated by students publishes paid advertising. Although the services rendered to the advertisers are of a commercial character, the advertising business contributes importantly to the University’s educational program through the training and participation of students involved. 1.513-1(d)(4)(iv)
Example (5)

JOINT VENTURES

Generally, income from a joint venture will not be taxable if it contributes importantly to the University’s exempt purpose or if it is carried on for the convenience of the University community. However, joint venture relationships have been scrutinized by the IRS to ensure that a tax-exempt organization is not serving the taxable purpose of the for-profit entity.

RELIEF OF GOVERNMENTAL BURDEN

The Treasury Regulations include the term “lessening the burdens of government” as one of the several purposes under which an organization may qualify for tax-exempt status. 1.501(c)(3)-1(d)(2)

To determine whether an activity qualifies for this exemption, it is first necessary to identify the functions that the governmental unit considers to be its burdens and, second, under what conditions an organization’s activities are to be recognized as actually “lessening” such burdens. GCM 37401

A. Identification of Governmental Burden – In order for an activity to be considered a governmental burden there must

be an “objective manifestation” on the part of the government that it considers a particular activity to be one of its burdens. For example, the governmental unit may invite the University to take part in an activity actually being performed by the government, or act jointly with the university in the conduct of an activity. However, the fact that an organization is engaged in an activity that is sometimes undertaken by a government or that the government (or one of its officials) expresses approval of the organization and its activities is insufficient to establish that the organization is lessening the burdens of government.

B. Lessening the Governmental Burden – In determining that an organization actually lessens a governmental burden it is necessary to consider such factors as whether the governmental unit:

- had previously undertaken the activity;
- will be exercising ongoing supervision of the activity;
- has formally recognized by legislative or other official actions that the organization is acting on behalf of the government.

A favorable working relationship between the organization and the governmental unit it purports to serve is a strong indication that the activity lessens the burdens of government..

Please refer to the Internal Revenue Code sections, Treasury Regulations, and Revenue Rulings cited for additional information regarding the tax status of an activity.