

William Marsh Rice University Unrelated Business Income Tax Guidance

I. General Requirements for Unrelated Business Income (UBI)

A. Trade or Business

- Activity must be conducted with intent to make profit (e.g. a goal to break-even does not show profit motive)
- Will not be excluded from being considered UBI merely because it did not generate profit
- If loss at least 3 years in a row, consider "hobby loss" rule and remove from UBI reporting

B. Regularly Carried On

- Show a frequency and continuity
- Pursued in a manner similar to comparable commercial activities of for-profit organizations
- Activities engaged in only "discontinuously or periodically" won't be considered "regularly carried on" if without competitive and promotional efforts

C. Not Substantially Related to the University's Exempt Purpose (i.e. education, research)

- Size and extent of the activities in relation to the nature and extent of the exempt function
- Regardless whether income produced from the activity is used for exempt function

II. Statutory Exemptions from UBI

A. Volunteer Labor

- Revenue generated from an activity where substantially all the work is performed by volunteers does not generate UBI.
- Substantially all is not defined in the tax codes. Tax Court held in one case 77% work done by volunteers failed the test, in another case 91% of full time work and 94% of all work done by volunteers met the test; IRS held in other areas of the tax law that substantially all requirement is met if it equals or exceed 85%. -- So in general we can apply the 85% rule.
- The IRS position is that the performance of services must be a material income-producing factor in order for the volunteer-services exemption to apply (Rev. Rul. 78-144).

B. Convenience of Members

- Activities for convenience of members, students, patients, officers, or employees excluded from UBI
- Laundry operated by college for laundering dormitory linens and students' clothing is not UBI
- Sales to alumni do not qualify for convenience exception (TAM 9645004) thus not excluded from UBI
- Items embossed with university emblem met the convenience exception (TAM 8025222) thus not UBI

C. Selling 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.

III. Certain Income Normally Not Treated as UBI

A. Dividends, interest, annuities and other investment income

- Normally not UBI
- However if debt-financed property, part of that income should be considered UBI
- Securities purchased on margin are considered debt-financed property and subject to UBI if the liability remains outstanding

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B. Royalties

- Royalties normally not UBI
- Must relate to use of a valuable right, e.g. use of trademark, trade names, copyrights, patents, professional athlete's name or photograph etc.
- However if debt-financed property, part of that income should be considered UBI

C. Capital Gains

- All gains or losses from sale, exchange or other disposition of property are excluded from UBI
- Exclusion does not apply if property is debt-financed
- Exclusion does not apply to inventory in the hands of institution, or property held primarily for sale to customers in the ordinary course of trade or business

D. Rental Income

- Real property rents:
Rents from real property, including elevators and escalators, generally are not considered UBI, except:
 - a. Property is debt-financed and does not fall within any of the debt-financed property exceptions
 - b. Rent is from a controlled corporation; to the extent such rent reduced UBI of the controlled corp
 - c. Rent is calculated as a percentage of the tenant-lessee's **net income**
 - d. Payment includes compensation for services rendered to the lessee
 - e. More than 50% of the rent is attributable to personal property leased with the real property
- Rents from personal property are not excluded from UBI (e.g. audio&video equipment, tables and chairs)
- Special rules for "mixed leases" of both real and personal property:
 - (1) If personal property less than 10% of total rents - none is UBI
 - (2) If personal property more than 10% but not more than 50% of the total rents - only the rents attributable to the personal property considered as UBI
 - (3) If personal property more than 50% of total rents - all rents are considered UBI
- Rents will be considered as UBI if based on net income or net profits from the leased property
- Payment for occupying space when personal services are also rendered to the occupant does not constitute rent from real property. Therefore renting hotel rooms, rooms in boarding houses or tourist homes, and space in parking lots or warehouses are not considered rent for real property
- IRS has determined rental of parking spaces to general public is not rent from real property, regardless of whether any services are provided.

E. Research Income

- Research for the United States, or any of its agencies or instrumentalities, or a state or political subdivision thereof, is generally excluded from UBI.
- Research done by a college, university or hospital generally excluded from UBI, regardless of the recipient (e.g. commercial companies). If the research activities are not otherwise treated as related activities because they further neither charitable (i.e., promotion of health), educational, nor scientific purposes (e.g., because the college, university, or hospital fails to satisfy the publication requirement), then the resulting revenues are still exempt from the UBIT. All research-generated revenues, including but not limited to commercially sponsored research revenues, are nontaxable under Section 512(b)(8).
- Research defined: IRS appears to exclude "applied" research (as compared to fundamental research) from its own definition of the term when it states that research does not include activities of a type ordinarily carried on as part of a commercial or industrial operation (e.g., ordinary testing or inspection of materials or products, or the design or construction of equipment or buildings)
- The IRS has held that an organization receiving income from performing applied research could exclude that income from UBI if the research involved experimental construction, and the results of the research were normally made available to the general public (Ltr. Rul. 7924009).

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- Institutions of higher education can engage in technology transfer, avoiding unrelated business income taxation by enabling for-profit entities to commercialize the discoveries and receiving subsequent compensation in the form of nontaxable royalties (e.g., PLR 200326035). Where, however, the activity constitutes mere testing, it will not qualify as research (e.g., PLR 7902019).

IV. Debt-Financed Property

A. Definition

Generally debt-financed property is any property -

- Held to produce income, and
- With acquisition indebtedness at any time during the tax year or, if the property was disposed of during the year, at any time during the 12 months before the disposition.

B. Exempt Use of Property

- If substantially all of the property's use is directly related to the performance of an organization's exempt purpose, then it's not debt-financed property.

"Substantially all" is defined as 85% or more of the use of the property.

e.g. Sec.501(c)(3) church owns 7-story office building acquired with borrowed funds; 6 floors used for its tax-exempt purposes, 1 floor leased as retail space and not related to its exempt purpose. Since more than 85% (6/7) is related to its exempt function, income from leasing the 1 floor to retail is not unrelated debt-financed income.

- If less than 85% property used for exempt purpose, only the portion used for exempt purpose is excluded from debt-financed property.
- Leasing debt-financed property to another tax-exempt (but not related or controlled) entity may be substantially related to the performance of lessor's exempt purposes; if so, such property would be exempt from the debt-financed property rules. (Ltr. Ruls.200843036)

C. Real Property Acquired by a Qualified Organization with Debt [Sec.514(c)(9)]

- Qualified organization is narrowly defined. Includes Sec.501(c)(3) colleges and universities and Sec.501(c)(25) title holding companies
- Debt-finance UBI rule does not apply to qualified organizations. Therefore, e.g. rental income from investment real property owned by Rice with borrowed money is not treated as UBI

D. Property Used in an Unrelated Business

- Debt-financed property does not include any property that produces income already included as UBI.
- However upon its disposition any gain that is not UBI may be included as income from debt-financed property
- Real property rents not treated as UBI; however no equivalent rule for personal property rental

E. Research Activities

- To the extent debt-financed property produces research income excluded from UBI because of research income exception, the property is not subject to the debt-financed property rules

F. Income Exempt from UBI Rules

- Debt-financed property rules do not apply to property used in an activity -
 - a. Carried on by unpaid volunteers
 - b. Performed for the convenience of members, students, officers, employees etc.
 - c. Involved selling of donated merchandise

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G. Neighborhood Land Rule

- Real property acquired with borrowed funds for future use (within 10 years after acquisition) may be temporarily used to produce income without being subject to the debt-financed property rules.
- Specific requirements need to be met for application of the neighborhood land rule. E.g. in general the property cannot be subject to a lease for a term more than 5 years.
- At least 90 days before the end of the fifth year from the acquisition of the property, the IRS should be given sufficient information to prove the organization is reasonably certain to use the property for an exempt purpose before the end of the original 10 years.

V. Advertising Treated as UBI

- Advertising will be treated as UBI if messages containing:
 - qualitative or comparative language (e.g. Kroger - Fresh food, Low prices)
 - price information or other indications of savings (e.g. coupon for purchase)
 - an endorsement
 - an inducement to purchase, sell or use a company, service, facility or product (call for action)
- The unrelated business taxable income produced by advertising revenue in an organization's periodicals (magazines) normally is determined by calculating four amounts: (1) gross advertising income, (2) direct advertising costs, (3) circulation income, and (4) readership costs.

VI. Qualified Sponsorship Payment (QSP) Not Treated as UBI

- **QSP defined:** payment (whether in money, property, or services) by an entity engaged in a trade or business to an exempt organization without an "arrangement or expectation" that the sponsor will receive an "substantial return benefit".
- QSP is not treated as UBI.
 - If there is substantial return benefit, QSP is the total \$\$ payment subtracts \$\$ value of substantial return benefit
- **2% Safe Harbor Rule:**
Benefits disregarded if FMV of all benefits (except use or acknowledgement) provided during the year are not more than 2% of total payment. If the benefits exceed 2% of the entire payment, the FMV of the benefits is a substantial return benefit, not just the excess.
- **A substantial return benefit includes:**
 - a. Advertising
 - b. An exclusive provider arrangement
 - c. Providing facilities, services, or other privileges to the payor or persons designated by the payor (subject to a de minimis exception)
 - d. Granting the payor or persons designated by the payor an exclusive or nonexclusive right to use an intangible asset, such as a trademark, patent, logo, or designation of the exempt organization.
- Payor will receive no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines
- No advertising
- The amount of the payment not contingent, by contract or otherwise, upon such factors as broadcast ratings or attendance at an event
- **6 acceptable actions:**
 - (1) Listing the name, log, or product line of sponsor
 - (2) Awarding exclusive sponsorship award
 - (3) Providing logos or slogans that do not contain any qualitative language or comparative description of the products

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- (4) Listing of payor's locations, addresses, phone numbers, and internet addresses
- (5) Providing value-neutral descriptions of the sponsor's product display
- (6) Listing sponsor's brands or trade names

VII. Exclusive Provider Arrangement Does not Necessarily Create UBI

- Exclusive provider arrangement defined as: arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity.
- The IRS clarified that exclusive provider arrangement does not automatically create UBI.
- Example: Company (C) agrees to pay University (U) \$X in a multiyear deal if U agrees to permit only the sale of C products in campus vending machines, cafeterias/snack bars and at U sporting events. U is not obligated to provide any services to earn the contract payments. It merely agrees to keep C competitors off campus. No UBI.
- If tax exempt organization does perform services in conjunction with exclusivity, services provided to (benefits received by) the for-profit company should be analyzed under UBI rules, i.e. is it a *trade or business*, *regularly carried on*, and *not substantially related to the exempt purposes*.

VIII. Relief of Government Burden not UBI

1. Does the activity involve the performance of an essential governmental service?
 - i. Was the activity previously undertaken by the governmental unit?
 - ii. Will the governmental unit be exercising any on-going supervision of the activity?
 - iii. Have there been formal legislative or other official actions of the governmental unit recognizing Rice as acting on behalf of the government?
 - iv. Is the activity an integral part of a larger governmental program?