

# Basics Of The Unrelated Business Income Tax

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## Are universities required to pay income taxes?

There is a common belief that universities such as Harvard are exempt from all Federal income taxes. This is in fact not the case. Harvard is subject to taxation at regular corporate rates on income from business activities that are not substantially related to its charitable purposes. Such income is known as "unrelated business taxable income" or "UBTI."

Prior to 1950, charitable organizations were shielded from tax on their income-producing activities, provided that the income was to be used for charitable purposes. This was known as the "destination of income" test. However, tax-paying businesses, perceiving that the charitable sector was engaging in unfair competition, pressured Congress in 1950 to enact a tax on charities' unrelated business income. One oft-cited example of such unfair competition was New York University's ownership of the Mueller's pasta company, from which it derived substantial tax-free revenues.

The structure for taxing unrelated business income, introduced in the Revenue Act of 1950 and broadened in 1969, is found in Sections 511 through 515 of the Internal Revenue Code. As you will see, it significantly impacts the activities of universities and other "tax-exempts." While tax is not imposed on income from Harvard's educational and research activities, such as tuition received from students or grants for sponsored research, many of Harvard's activities are subject to taxation. The term "tax-exempt" is therefore somewhat misleading.

## What is "unrelated business taxable income"?

"Unrelated business taxable income" is defined as the gross income derived from any unrelated trade or business which is regularly carried on by an organization, less the deductions directly connected with carrying on such trade or business. Three basic requirements follow from this definition before tax will be imposed on an activity of the University:

1. The activity must be a "trade or business";
2. The activity must be "regularly carried on"; and
3. The activity must be "unrelated" to Harvard's exempt educational mission

## How is a "trade or business" defined?

A "trade or business" is an activity carried on for the production of income from the sale of goods or the performance of services. This definition is generally seen as requiring both a profit motive and some actual level of activity, the latter to distinguish a business from a mere investment. In situations where Harvard engages in joint activities with, or on behalf of, other institutions and there is a mere pass-through of costs, no "trade or business" exists. In other situations where Harvard subsidizes an event, such as certain alumni travel tours, there again is no "trade or business."

It should be borne in mind that, in identifying a "trade or business," the Internal Revenue Service ("IRS") may isolate the component parts of an activity under what is known as the "fragmentation rule." An example would be the regular sale of commercial advertising in an educational journal, which is viewed by the IRS as a separate enterprise, distinct from the educational publishing activities. Another example would be the sale of toys or souvenirs in the museum shop of an art museum; although the sale of prints or other art-related items may advance the museum's exempt purposes, the sale of unrelated toys or souvenirs is seen as a separate, taxable activity.

### **When is an activity deemed to be "regularly carried on"?**

This determination is made by comparing a tax-exempt's activity with similar activities of commercial enterprises. If the frequency and continuity of the activity, and the manner in which it is undertaken, are similar to comparable undertakings by taxable entities, the activity will be deemed to be "regularly carried on." The requirement that an activity be "regularly carried on" can shield certain short-term activities from taxation. For instance, the periodic book sales conducted by Harvard's libraries do not constitute taxable businesses, because they are not carried on with the regularity of sales by commercial bookstores. Another example is the occasional publication by the University of advertising in programs for musical or dramatic performances. Where an advertising sales agency is hired to sell such advertising, however, the agency's activities may be attributed to the University, making the sale of advertising a business that is "regularly carried on." Activities will not be deemed to be "regularly carried on" merely because they are conducted on an annually recurrent basis. The Income Tax Regulations give the example of an annual dance for charity. Many of the activities conducted by Harvard student groups will be shielded from taxation by the requirements that they constitute a "trade or business" and be "regularly carried on."

### **How does one determine if activities are substantially related to an entity's exempt purposes?**

The IRS deems an activity to be "substantially related" only if the activity itself

makes an important contribution to accomplishing the exempt purposes of the institution. It is not sufficient that the activity produces income which will be devoted to achieving the exempt purposes. Additionally, if the scale of an activity exceeds that necessary to accomplish the exempt purposes, income from the excess activity will be deemed unrelated.

The manner in which this criterion for taxation has been applied is best illustrated by a few examples.

The following activities have been deemed related to an entity's exempt purposes:

- The sponsoring by a university of performances by professional theater companies and symphony orchestras for students and faculty members, where members of the general public were also admitted and the performances were advertised. The presentation of such dramatic and musical events was deemed to contribute importantly to the educational and cultural functions of the university.
- A university's backing of a campus newspaper which was operated by its students and which published paid advertising, where the solicitation, sale, and publication of the advertising were conducted by students. The advertising business, although commercial in nature, was seen as contributing importantly to the students' training.
- An exempt organization's conduct of international tours utilizing commercial tour operators, where the tours were designed to study specific topics, recommended reading lists and course books were provided and formal classroom lectures were given by college faculty members (representing about 40% of the tour days), with additional lectures on field trips (comprising approximately 25% of the tour days) given to illustrate the classroom work

The preceding illustrations should be contrasted with the following activities, which were found to be unrelated to the respective entities' exempt purposes:

- A state university's sponsorship of rock concerts and other professional entertainment events staged in a university facility, where the university's College of Fine Arts had no input into the selection of events, tickets were sold off-campus, no discounts were offered to students, and it was determined that the sole criteria used in sponsoring events was profitability.
- The operation of a radio station by a university which was found to be predominantly commercial in nature, even though it also served as a laboratory for training students in radio, as a medium for adult education and as a means of promoting the university.
- The conduct of domestic travel tours by an exempt organization which highlighted both the educational and social/recreational aspects of the tours, where there were no reading lists or classroom-type presentations, accompanying lecturers were limited to approximately six hours during the seven-day tours and the brochures advertising the tours emphasized the hours of free time and the availability of shopping.

An analysis of the preceding examples underscores the point that determinations of "relatedness" are highly fact-specific.

## **Are any unrelated business activities of an exempt organization excepted from taxation?**

Yes, certain activities which would otherwise meet the above criteria for unrelated trades or businesses are specifically excluded from taxation. The most significant of these are the following:

- Activities for the convenience of members,
- Activities performed by volunteers,
- Sales of donated merchandise,
- Distribution of low-cost articles, and
- Exchanges or rentals of membership lists between charities.

In addition, certain forms of passive income are statutorily excluded from the definition of unrelated business taxable income.

## **What is the "convenience exception"?**

The "convenience exception" eliminates the tax on the activities of an exempt organization undertaken "primarily for the convenience of its members, students, patients, officers, or employees." Examples of activities which have qualified for this exception include the operation by colleges of dormitories, cafeterias, laundries, and bookstores for the convenience of students, faculty, or staff, the operation of fitness centers by hospitals for patients and staff, the operation of hospital gift shops for visitors, and the operation of a snack bar and cafeteria by a museum for staff and public visitors.

## **What activities qualify for the "volunteer exception"?**

An organization does not engage in an unrelated trade or business if "substantially all the work in carrying on such trade or business is performed for the organization without compensation." There is no bright-line rule for determining what constitutes "substantially all" the work, although one ruling indicated that volunteers' performance of approximately 87% of the total hours worked was sufficient.

Cases and rulings have also indicated that expense reimbursements and small rewards will not destroy the voluntary, noncompensatory nature of the employment.

Examples of volunteer activities which have been deemed nontaxable include the sale of advertising in a concert book by volunteers raising funds for an exempt symphony orchestra, the staging of weekly dances by volunteer firefighters, and the operation of a museum shop by volunteers selling and renting works of art.

## What are examples of the other exempted activities?

The exclusion of businesses selling merchandise that was contributed to the organization was originally intended to exempt thrift shops, such as those operated by the Salvation Army or Goodwill Industries, from the UBTI rules. The exclusion can also be used, however, to shield income from charity book drives, rummage sales, or bake sales. Such activities may, in many cases, also be exempted as not being "regularly carried on" or under the "volunteer exception."

The distribution of low-cost articles in soliciting charitable contributions is also excluded, preventing such distributions from being deemed taxable sales of such items. Commonly distributed items are key-chains, calendars, pens, maps, etc. To qualify, the distribution must be made without the request or consent of the recipient, who must be entitled to retain the item whether or not a donation is made. For these purposes, a "low-cost article" is one worth no more than a prescribed dollar amount; this amount was \$5.00 in 1988 and is annually adjusted for inflation, reaching \$6.70 in 1996.

The sale or rental of membership lists or lists of donors between charities is also exempted from the UBTI rules. There are also a number of exemptions for specific activities like agricultural fairs, trade shows, and bingo games.

## Why is Harvard not taxed on investment gains from its endowment?

Certain categories of passive income are specifically excluded from the definition of the term "unrelated business taxable income." Such passive income includes all dividends, interest, annuities, and royalties, gains from the sale of property, rents from real property, and income derived from research. There are a number of special rules related to the various categories of passive income which will be addressed in the questions below. These modifications to taxable income act to exclude all of the gains from normal passive investment activities, such as the gains Harvard realizes from investment of its endowment.

Generally, in situations where unrelated taxable income might arise from an unusual investment activity, a separate subsidiary corporation might be formed to undertake the activity. There are special rules governing income received from such controlled subsidiaries, designed to prevent taxable unrelated income from being converted to tax-free passive income. These rules prevent interest, rents, royalties, and annuities from being received tax-free from the subsidiary, where the parent has 80% control of the subsidiary and the subsidiary is engaged in an unrelated business activity. Simply put, the rules render taxable the passive income received by the parent in the proportion that the subsidiary's unrelated income bears to its total taxable income (determined, in the case of exempt subsidiaries, as if they were taxable). This treatment does not apply to dividends, which represent income already taxed at the subsidiary level.

## Is all research income exempt from tax?

The extent of this exclusion depends on the type of organization performing the research, the entity for which research is undertaken, and the nature of the research activities. Income from research for the United States or any of its agencies, or for any state or any of its political subdivisions, is always exempt. For organizations operated primarily to carry on fundamental or basic research (as distinguished from applied research), research for any person is exempt if the results of the research are freely available to the general public.

For colleges, universities, and hospitals there is an even broader exemption: all research for any person, whether fundamental or applied, is exempt. This results from a specific statutory exemption, but the research might also be seen as a related activity, being within the charitable purposes of the university.

The difficulty arises in determining what is "research." The Income Tax Regulations state that "the term 'research' does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."

The IRS has ruled that the clinical testing of drugs for a pharmaceutical company, to obtain FDA approval of the marketing of the drugs, is not research. The testing was seen as incident to the drug company's commercial operations.

On the other hand, in a decision involving a research institute organized by the Illinois Institute of Technology, the court determined that the institute's collection and analysis of gaseous pollutants for a munitions manufacturer, to determine the efficiency of a particular scrubber, was not testing incident to commercial operations, but part of the institute's research relating to the control of harmful emissions. The court focused on the following factors in making its determination that the activity constituted "research":

- The use of observation or experimentation to verify facts or natural laws;
- The need for advanced scientific or technical expertise;
- The addition to knowledge in a particular scientific field;
- The application of mathematical reasoning; and
- The systematization of scientific knowledge in the collection and presentation of information

Numerous questions have arisen in recent years in attempting to classify university activities as research. The answers are not always clear and it is assumed that this will be an area of contention for years to come.

## What rentals are excluded from unrelated business income?

In most instances, rents from the lease of real property are excluded from unrelated business income, while rentals of personal property are taxable. There are, however, several qualifications to these generalizations.

If the rental covers both real and personal property, the rents will be totally tax-exempt only if the income attributable to the personal property is "incidental," defined as being not in excess of 10% of the total rents. If the personal property portion exceeds 50% of the total, the entire rent will be taxable. For situations between these extremes, only amounts attributable to the personal property will be taxable.

To be excludable from income, rentals can not be based on the income or profits to be derived from the leased property. Rentals based on a percentage of gross revenues are excludable, but rents based, in whole or in part, on net profits are taxable.

If substantial services are rendered by the exempt organization in connection with a lease, the activity will not be deemed passive and the rental income will be taxable.

The following services have tainted otherwise non-taxable rental income:

- Providing grounds maintenance, security, and an equipped dressing room in connection with the leasing of a stadium to a professional sports team;
- Running a box office and concession stand in connection with the lease of an auditorium; and
- Operating a dining hall to serve tenants renting apartments.

The Regulations indicate that the rendering of services customarily offered by a landlord in connection with the rental of space, such as the furnishing of heat and light, the collection of trash, and the cleaning of common areas, will not disqualify the rentals.

## **What payments are considered royalties?**

Royalties, according to the IRS, are payments for the use of valuable property rights. This will include payments for the use of an exempt organization's trademarks, trade names, copyrights, and patents, regardless of whether the payments are based on the level of use of the property rights.

As with rentals, royalty income must be passive income related to a property right and not the provision of substantial services by the exempt organization. As an example, the IRS has ruled that license payments received by an exempt organization, that patented and licensed inventions made by the faculty and staff of unrelated educational and scientific institutions, who remained the beneficial owners of the patents, constituted taxable income for services rendered and not exempt royalties. The IRS has recognized, however, that licensing fees received by an exempt organization that patented and licensed inventions assigned to it by inventors at a related university in exchange for a percentage of future revenues, would constitute royalties and not fees for services, where the organization was the legal and beneficial owner of the patents.

The reach of the royalty exclusion is a subject of considerable dispute. An area which has spawned significant controversy is the participation by charities in "affinity credit card" programs. These programs involve the marketing of credit cards to the members of an exempt organization. The organization will generally

license its name and logo and the use of its mailing lists to the credit card company in exchange for a payment based on the sales resulting from members' use of the cards. The IRS has attempted to characterize these programs as joint ventures between the exempt entity and the credit card company, denying passive royalty treatment to the receipts of the exempt. Recent Tax Court cases, most notably those involving the Sierra Club, have favored the taxpayer, but the issue is far from resolved.

## **What is unrelated debt-financed income?**

There is a significant exception to the rules on passive income discussed above. Where indebtedness was incurred to acquire property producing such passive income, the portion of the income attributable to the debt (the "unrelated debt-financed income") will be taxable. For example, if a rental property producing unrelated income is purchased with a 20% down payment and the balance financed by a mortgage, 80% of the rentals received will be taxable.

The rules relating to debt-financed income were originally designed to prevent certain tax-advantaged sale-leaseback transactions between charities and the owners of businesses. Instances where the rules are currently encountered by charities include purchases of securities on margin, donations to a charity of mortgaged realty, and the receipt by a charity of interests in partnerships which have incurred debt.

The rules on unrelated debt-financed income are quite complex and beyond the scope of this guide.

## **Are any expenses of an unrelated activity deductible?**

Tax-exempts are permitted to deduct the business expenses, depreciation and similar items that are directly connected with the carrying on of an unrelated trade or business. To be directly connected with the business activity, the deductible item must have a "proximate and primary" relationship to the carrying on of the business.

Items attributable solely to the conduct of the unrelated trade or business are deemed to meet the "proximate and primary" test and qualify for deduction to the extent generally allowable for business expenses. Items attributable to both exempt activities and unrelated businesses are to be allocated between the two uses on a reasonable basis. For instance, if an employee spends 25% of the employee's time in an unrelated business activity, an allocation of 25% of the employee's salary to the activity would be reasonable.

Where a trade or business is exploiting an exempt activity, certain expenses may not be deductible, if viewed as in furtherance of the exempt purposes and not directly related to the business activities. For example, the advertising expenses incurred by

an exempt organization in attracting new members would not be deductible from income that the organization receives for distributing advertising to its members. Each exempt organization is permitted a specific deduction of \$1,000. This is a single deduction for the organization and is not multiplied for additional unrelated businesses.

Losses in one unrelated activity may be used to offset income from another. However, if such losses are continuing, the IRS may claim that the activity is conducted without a profit motive and eliminate the losses. Net operating losses from unrelated business activities may be carried back for 3 years or forward for 15 years.

## **How does the university report its unrelated business income?**

The University reports its unrelated business income on IRS Form 990-T, Exempt Organization Business Income Tax Return. This return is required of all organizations with gross income from unrelated trades or businesses of \$1,000 or more. The Form 990-T is due 4 months after the conclusion of the organization's tax year. Because Harvard's tax year ends on June 30th of each year, the return is due by November 15th.

An automatic 6-month extension for filing may be requested. Harvard generally requests this extension to provide sufficient time for all departments to report their final figures. This extends the time for filing until May 15th of the succeeding year. Payment of the applicable tax for the year is due by November 15th, regardless of whether an extension for filing has been requested. Therefore, the General Accounting Office, which is responsible for the filing, will require tentative financial figures well in advance of that date. The University is also required to make quarterly estimated tax payments.

## **Does engaging in unrelated business activities jeopardize Harvard's tax-exempt status?**

Harvard qualifies for tax-exempt status under the provisions of Section 501(c)(3) of the Internal Revenue Code, relating to corporations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes." The term "exclusively" is not strictly construed, but an organization will not qualify for tax-exempt status if more than an "insubstantial part" of its activities is unrelated to its exempt purposes.

There is no specific rule for determining when the unrelated business activities of an organization are excessive. In one instance, the IRS revoked the tax-exempt status of an agricultural society where, on average, more than 30% of the organization's revenues came from the operation of an automobile racetrack. In another case, the IRS permitted unrelated income that did not exceed 5%. As a

general rule, no more than 10% of an organization's gross revenues should be unrelated.

At Harvard, unrelated revenues have been substantially less than 5% of total revenues, so that this has not been an issue to date. The more pressing concern currently is that we accurately identify and report our unrelated business income. Failure to timely remit the tax due on such amounts can subject the University to the payment of interest and penalties. Interest runs from the original due date of the tax return at rates determined by the Treasury Secretary from time to time. The penalty for nonpayment is 0.5% of the unpaid tax per month, to a maximum of 25% of such tax.

It is hoped that this booklet will increase awareness of Harvard's reporting and tax obligations, and reduce exposure to tax liabilities in the event of an audit.

Departments contemplating activities with UBTI implications are required to first clear such activities with the Office of the Vice President for Finance. Where such activities are undertaken, accurate records of all income and expenses will be required for purposes of the Form 990-T, and the tax attributable to any UBTI will be charged to the department.

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This publication of the Office of the General Counsel was prepared by University Attorney Gregory L. Poppe.