

## **Unrelated Business Income (UBI)**

UNL is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code on income from activities that are substantially related to its educational and research missions, which form the basis for the University's tax exemption.

However, if UNL were to carry on a trade or business activity that is not substantially related to its exempt purposes, it would be subject to tax on the net income of such a business activity, even though it may bring in funds to support UNL's exempt operations.

### **UBI Defined**

Unrelated Business Income is the income from a trade or business activity that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity. Thus, for UBI to occur, three requirements must be met: (1) a trade or business activity, (2) which is regularly carried on, and (3) is not substantially related to the tax-exempt purpose of the University. Each one of these requirements is briefly described below.

### **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 identity 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 purposes of the organization.

### **Regularly Carried On**

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

### **Substantially Related to Exempt Purpose**

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.

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. To the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. That part in excess of what is needed to accomplish the exempt purpose would be considered an unrelated trade or business.

## **Excluded Trade or Business Activities**

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

### **Volunteer workforce**

Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.

### **Activities for the Convenience of the University**

A trade or business carried on by a university primarily for the convenience of its members, students, patients, officers and employees is considered a related trade or business.

### **Qualified Sponsorship Payments**

1. Soliciting and receiving qualified sponsorship payments (QSP) is not an unrelated trade or business and such payments are not considered unrelated business income. A QSP is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgement of the business name, logo, or product lines in connection with the organizations activities. "Use or acknowledgement" does not include advertising of the sponsor's products and services.

#### EXAMPLE:

Organizers of an annual student picnic receive a payment from a local car dealership in exchange for inclusion of the dealer's logo on a sign at the entry of the picnic grounds. The payment is a QSP and is not subject to unrelated business income tax.

2. Providing facilities, services, complimentary tickets or other privileges to the sponsor in connection with a QSP does not affect whether the payment is a QSP. Instead the provision of such privileges is treated as a separate transaction in determining whether the university would have unrelated business income from the payment. If such additional privileges are not of substantial benefit, the payment will not be subject to tax.
3. A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services. Advertising includes:
  - Messages containing qualitative or comparative language, price information or other indications of savings or value
  - Endorsements
  - Inducements to purchase, sell or use the products or services.
4. The use of promotional logos or slogans that are an established part of the sponsor's identity is not, by itself, advertising. Mere distribution or display of a sponsor's product by an university to the public at a sponsored event, whether free or for remuneration, is considered use for acknowledgement of the product rather than advertising.

#### EXAMPLE:

The organizers of the picnic described above have put together a commemorative program for the event. In exchange for the dealer's sponsorship payment, the dealer is able to place a full color advertisement in the program and display an automobile on the picnic grounds in addition to placing its logo on the sign at the entry to the picnic grounds. In this case, the value of the advertisement would be considered unrelated business income and the value of the logo placement and the right to display would be exempt.

5. A payment is not a QSP if its amount is contingent upon the level of attendance at the event, broadcast ratings, or other factors indicating the degree of public exposure to the event.
6. The selling of donated merchandise is not an unrelated trade or business.

EXAMPLE:

Treasure Market is an auction of items donated to an auxiliary in support of the Art Department. The proceeds from the sale of the items donated are not unrelated business income.

## Unrelated Business Income (UBI)

### Exclusions from Unrelated Business Income

The following types of income are generally excluded when figuring unrelated business income. However, the exclusions do not necessarily apply to income from debt-financed assets (described below):

1. All dividends, interest, annuities, payments with respect to securities, loans, and income from notional principal contracts.
2. Payments received with respect to a securities loan are excluded from unrelated business income only if the loan is made under an agreement that:
  - Provides for the return to the organization of securities identical to those loaned;
  - Requires payments of amounts equivalent to all interest, dividends and other distributions that the owner of the securities is entitled to during the period of the loan;
  - Does not reduce the organization's risk of loss or opportunity to gain on the securities;
  - Contains reasonable procedures to adequately "collateralize" the securities loan at daily fair market value, and
  - Permits the organization to terminate the loan upon notice of not more than five business days.
3. Payments with respect to securities loans include dividends and interest from the underlying securities, income from the collateral security or investment thereof, or fees based upon the period of time the securities are on loan.
4. Royalties, including overriding royalties, are excluded from unrelated business income. A royalty is a payment relating to the use of a valuable right, including trademarks, trade names or copyrights.

Royalties do not include payment for personal services

EXAMPLES:

Ace Sportswear, an independent for profit operator of sports clothing business, pays a university a fixed percentage of its sales of its sportswear line, which features the university's logo. The university is exempt from tax on the royalty income derived from this arrangement.

Mercury, an upstart in sports apparel, arranges the same deal as Ace. Also included are personal appearances by several of the university coaches at the unveiling of the product line. The coaches also have committed (in whole or in part) to endorse the apparel line. The inclusion of personal services in the royalty arrangement causes the loss of the royalty income tax exclusion.

Unrelated business income does not include royalty income from licensees of patents owned by a university that were assigned to it by inventors for specific percentages of future royalties.

5. Rents from real property are generally excluded from unrelated business income. Rents from personal property are not excluded. In the event of a mix of personal and real property, the entire lease is exempt if the portion due to personal property is less than 10%. If the portion is between 10% and 50% personal property, then only the portion attributable to the real property is exempt. If the portion of personal property exceeds 50%, the entire lease is subject to tax.

The rental exclusion does not apply to leases based upon a percentage of the profit earned by the tenant. To be exempt, a lease must be either a fixed amount of rent or a percentage of sales or a combination thereof.

#### EXAMPLES:

A university rents retail space to vendors in a building owned by the university. The tenants pay the university a guaranteed monthly rent and additional rent should their sales exceed agreed upon levels. The rent so derived is excluded from taxable income.

Venture, an exciting new restaurant, proposes to compensate the university by offering 25% of its profits in exchange for a space in the building. Proceeds to the university from such an arrangement are unrelated business income.

The rental exclusion does not apply when personal services are also rendered to the tenant. In addition, the exclusion does not apply to rental of hotel rooms, rooms in boarding houses or tourist homes, or spaces in parking lots or warehouses.

#### EXAMPLE:

A university contemplates building and operating a full service hotel on campus to house visiting scholars, parents, visiting athletic teams and guests. The operation of the hotel is an unrelated business activity.

6. Income from research at a university is exempt, whether fundamental or applied. The term research does not include activities of the type normally carried on incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment.
7. Gains or losses from the sale, exchange or other disposition of property are exempt from unrelated business income other than:
  - Stock in trade or other property of a kind that would properly be included in inventory;
  - Property held primarily for sale to customers in the ordinary course of a trade or business, or

- Cutting of timber that an organization has elected to consider as a sale of timber.
8. Any gain from the lapse or termination of options to buy or sell securities is excluded from unrelated business income, but only if written in the course of the organization's investment activities.

### **Other Sources of Unrelated Business Income**

1. A university may have unrelated business income as a member of a partnership. If so, it must include its share of the taxable income of the partnership as though it had operated the business itself.
2. The share of any income of an "S" corporation will be taxable regardless of the actual source or nature of the income. A university's share of any interest or dividend income (otherwise exempt) from an "S" corporation will be subject to tax.
3. Interest, annuities, royalties and rents from a controlled taxable corporation are subject to tax, if those items reduced the tax of the controlled corporation. To be controlled, the exempt organization must own more than 50% of the stock in a corporation or more than a 50% interest in a partnership.

#### **EXAMPLE:**

The Eatery is a wholly owned, taxable subsidiary corporation of a university. The Eatery has a taxable income of \$150,000 and pays all necessary taxes. It has taken a deduction of \$25,000 for the rent that it pays to the university. The \$25,000 rent amount is unrelated business income to the university.

4. Investment income that would otherwise be excluded from tax must be included to the extent it is derived from debt-financed property. The term debt-financed property means any property held to produce income (including gain on sale) for which there is an acquisition indebtedness at any time during the tax year or during the 12-month period prior to the property's disposal. Property includes real estate, tangible personal property and corporate stock.
5. Acquisition indebtedness is the unpaid amount of debt incurred by the organization:
  - When acquiring or improving property
  - Before acquiring or improving property if the debt would not have been incurred except for the acquisition or improvement
  - After acquiring or improving property if the debt would not have been incurred except for the acquisition or was reasonably foreseeable when the property was acquired or improved.
6. Real property debts of an educational institution are generally exempt from the acquisition indebtedness rules.

If substantially all (85% or more) of the use of any property is substantially related to the organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include the generation of income.

If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property the organization uses for exempt purposes. Neighborhood property is that which is contiguous to the owned property or within one mile if it is not practical to acquire contiguous property.

After 5 years, the organization must satisfy the IRS that exempt use will occur with the next 5 years.