

UNRELATED BUSINESS INCOME EVALUATION GUIDELINES

Under Internal Revenue Code Section 115, The University of Tennessee is tax-exempt as an instrumentality of the State of Tennessee (exemption letter dated March 27, 1998). The Internal Revenue Code provides that the exempt purposes of state colleges and universities 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 Sections 511, 512 and 513 on activities which are unrelated to those exempt purposes and must file Form 990-T on gross income from an unrelated trade or business of \$1,000 or more. 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.

	<u>Code, Regulation, Ruling or Other Citation</u>
<u>GENERAL</u>	
A. <u>Trade or Business</u> – The term "trade or business" generally includes any activity carried on for the <u>production of income</u> 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.	1.513-1(b)
B. <u>Regularly Carried On</u> – Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.	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. <u>Related to University Exempt Purpose</u> – To be related to the University's educational or research exempt purpose, there must be a substantial causal relationship, i.e., the activity <u>must contribute importantly</u> to the accomplishment of the exempt purpose (other than the University's need to produce income).	1.513-1(d)(2)

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| 1. <u>Size and Extent</u> – 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. <u>Dual Use of Assets or Facilities</u> – When an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. The test is whether the activities contribute importantly to the accomplishment of exempt purposes. | 1.513-1(d)(4)(iii) |
| 3. <u>Exploitation of Exempt Function</u> – Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make the commercial activities a related trade or business. Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business. An example of exploitation of an exempt function is commercial advertising in a professional journal or periodical. | 1.513-1(d)(4)(iv) |

STATUTORY EXCEPTIONS

Even if an activity meets the definition of an unrelated trade or business, it may not be subject to tax if it meets one of the following criteria:

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| A. <u>Volunteer Labor</u> – Any activity in which substantially all (probably 85%) of the work of the trade or business is performed by <u>unpaid</u> volunteers 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. <u>Convenience of University Members</u> – Any unrelated activity conducted primarily for the convenience of University students, faculty, staff or patients is exempt from tax. The convenience exception is applicable <u>only</u> 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 ruled 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 (probably 85%) of which was received as gifts or contributions, is exempt regardless of whether the labor to operate the activity is paid or unpaid. 1.513-1(e)(3)
- D. **Low-Cost Articles** – Activities relating to the distribution of low-cost articles incidental to soliciting charitable donations are exempt from tax. A distribution is considered incidental if: (1) the recipient did not request the distribution; (2) the distribution is made without the express consent of the recipient; and (3) the article is accompanied by a request for a charitable contribution to the organization and a statement that the recipient may keep the low cost article regardless of whether a contribution is made. The maximum cost of a low cost article is \$9.10 for 2008. 513(h)
- E. **Mailing Lists** – Unrelated business income does not include the exchange or rental of mailing lists between two tax-exempt organizations. 513(h)(1)(B)

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** – To be considered a royalty, a payment must relate to the use of a valuable right. Payments for trademarks, trade names, or copyrights are ordinarily considered royalties. 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. 81-178, 1981-2 C.B. 135
1.512(b)-1(b),
76-297, 1976-2 C.B. 178

However, where the royalty income is derived in part from the performance of services, the payment will not constitute royalty income. Therefore, payments for personal appearances and interviews are not excluded as royalties and must be included in figuring unrelated business taxable income. 73-193, 1973-1 C.B. 262

Amounts received from the exchanging or renting of member or donor lists recently have been held to be royalties which are excluded from unrelated business taxable income, where minimal services are provided. 513(h)(1)(B)
PLR 200601033

- B. **Rents** – Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property are not excluded. However, special rules apply to “mixed leases” 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: 1.512(b)-1(c)(ii)(b)
 - 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 total rents.
 - 51% or more is considered 100% taxable

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 her convenience and are other than those usually rendered in connection with the rental of rooms or other space of occupancy only. 1.512(b)-1(c)(5)

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 rental of 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 512(b)(7)
- research performed by a college, university, or hospital “for any person,” and 512(b)(8)
- 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 are freely made available to the general public 512(b)(9)

The regulations further limit these exclusions by providing that research does not include activities of a type ordinarily carried on incidental 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. PLR 8230002
- 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. 68-373
- 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. 85-109
- 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. 85-110
- Normally taxable drug testing conducted by students has been ruled exempt. PLR 7936006
- Experimental construction and production testing by PLR 8445007

students that was more than incidental was found exempt.

- Clinical testing of developmental equipment apart from student involvement was subject to UBIT.

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 as 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)

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.

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

For example, if testing facilities are otherwise unavailable within a reasonable distance from where 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.

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

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

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 another 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.

69-633

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

513(a)(2)

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)
- However, the publication of advertising in programs for sport events or music or drama performances will not ordinarily be deemed to be the regular carrying on of a trade or business. 1.513-1(c)(2)(ii)
- 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)
- C. Corporate Sponsorship Income** – Generally, contributions received by a charitable organization are not considered unrelated business income if the organization does not provide a valuable service or benefit to the donor. However, if an organization goes beyond mere acknowledgement of a contribution and extensively promotes the sponsor of a special event, such as a post-season tournament, bowl game, or fundraiser, the income may be subject to tax because a valuable benefit or service in the form of advertising is being provided in exchange for the contribution. Furthermore, if an organization, in exchange for a payment, agrees that products or services that compete with the sponsor’s products or services will not be sold or provided in connection with one or more activities of the organization, the portion of the payment attributable to the exclusive provider arrangement may be considered taxable income. 1.513-4

1. Non-Taxable Acknowledgements – Sponsorship activities that merely acknowledge a corporate sponsorship payment by using the following means of sponsor identification are not considered taxable:
 - a. The name of the corporation in the title of an event;
 - b. Sponsor logos and slogans that do not contain comparative or qualitative descriptions of the sponsor's products, services, facilities, or companies;
 - c. Sponsor locations and telephone numbers;
 - d. Value neutral descriptions, including displays or visual depictions, of a sponsor's product-line or services; or
 - e. Sponsor brand or trade names and product or service listings.

Incidental recognition of a contributor as a benefactor is also not considered taxable advertising. Examples of such acknowledgements include:

- a. Naming a university professorship, scholarship, or building after a benefactor;
- b. Acknowledging the underwriting of a public radio or television program or museum exhibition; and
- c. Listing a contributor to a fund-raising event or to a performing arts organization in an accompanying program.

2. Taxable Advertising – Messages or other program materials broadcast or otherwise transmitted, published, displayed, or distributed in connection with a specific sponsored event to promote a company, service, facility, or product in exchange for a corporate sponsorship payment are considered taxable advertising. For example, the presence of the following factors would indicate that an exempt organization is engaged in advertising for a corporate sponsor:
 - a. Qualitative or comparative language;
 - b. Price information or other indications of savings or value associated with a product or service;
 - c. A call to action;
 - d. An endorsement; or
 - e. An inducement to buy, sell, rent, or lease the sponsor's product or service. (Distribution of a sponsor's products at a sponsored event whether for a fee or free is not considered an inducement to buy.)

In addition, if the amount of a sponsorship payment is contingent, by contract or otherwise, upon such factors as broadcast ratings or attendance at an event, the payment is considered advertising.

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.