**Exceptions to UBIT**

There are a number of modifications to income and statutory exceptions that are available under the UBIT regulations. These include the following:

* capital gains
* interest & dividends, annuities
* royalties where no active business participation is involved
* rents from real and some personal property
* income from certain forms of research
* income generated from donated services or property
* income from sales for the convenience of the organization's members
* special situations

## Definitions

**Capital Gains:** In general, gains and losses from selling property not held as inventory or for sale to customers in the ordinary course of a trade or business are excluded from the UBIT.

**Convenience of University/Agency Students, Faculty, and Staff:** Sales of otherwise taxable items may be exempt from tax under the "convenience" exception if sold to students, faculty, and staff (members). The convenience exception is applicable only to members of the university/agency. Any sales to non-members (e.g., the general-public) are taxable unless the sales are not "regular". (IRS Treasury Regulation 1.513-1(e)(2)). The IRS auditors will contend that merely by making sales "more convenient" than purchasing from a taxable entity does not fall within the scope of the exception. The IRS position is that the convenience exception does not apply to items with useful lives of more than 1 year. The convenience exception normally applies to the operation of on-campus vending machines, the sale of sundry items by campus bookstores (including, clothing and novelty items embossed with the University’s logo) and the laundering of dormitory linens and student clothing. (IRS Treasury Regulation 1.513-1(e)(3)). On-line sales do not qualify for the convenience exception.

**Donated Services or Property:**

1. Volunteer Labor: Any activity in which substantially all (approximately 85%) of the work of the trade or business is 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. (IRS Treasury Regulation 1.513-1(e)(1)).
2. Donated Merchandise: Any unrelated activity engaged in the selling of merchandise, substantially all (approximately 85%) of which was received as gifts or contributions is exempt regardless of whether the labor to operate the activity is paid or volunteered. (IRS Treasury Regulation 1.513-1(e)(3)).

**Interest and Dividends:**In general, interest and dividends are excluded from the UBIT, although there are exceptions relating to Controlled Corporations and Debt-Financed Income.

**License agreements:** The IRC Section 512(b)(2) royalty exclusion is commonly used by exempt organizations to exclude licensing fees from UBIT. The IRS generally agrees with this result, so long as the exempt organization plays a passive role in the licensing arrangement. However, where the exempt organization's involvement is active, the IRS will not characterize the payment as a royalty, excluded from UBIT.

One such situation is when the exempt organization is providing endorsements or services that are important to the success of the arrangement. In such cases, the IRS views the royalty payment as consideration for services performed and not a royalty. The IRS has recently begun to focus on this theory in deciding whether an exempt organization's licensing arrangement will be treated as a royalty. See IRS Letter Ruling 9527031 for an example of the IRS' rationale in regards to the provision of services.

**Mailing Lists and Affinity Cards:**Based on recent court cases (Mississippi State University Alumni Association, Inc. v. Commissioner; Sierra Club v. Commissioner; Alumni Association of the University of Oregon, Inc. v. Commissioner), a rough set of guidelines now exists for exempt organizations to rely upon in structuring a viable affinity credit card program. (Tax Court Memos 1993-199, 1996-33, and 1996-34).

Mailing lists of potential card users should be made available on a selective basis, and minimal staff time and expenses should be allocated to maintenance and marketing of the list. Organizations should avoid providing specific services (i.e., advertising, promotion, endorsements, etc.) other than reviewing the materials for quality control. The agreement should expressly provide that the organization will not provide specific services. When services are provided, make sure they are "de minimis" or "courtesy" services.

If the arrangement necessitates the provision of substantial services, create a separate agreement for the service component and allocate a portion of the income to services. This will avoid "tainting" the entire amount of income thus avoiding the full amount to be considered UBI. Prepare a separate mailing list agreement. If income from a mailing list is ultimately determined to be UBIT, then the intertwining of the mailing list with any other component of the licensing program may taint the entire transaction and cause all the income to be subject to UBIT. (IRS Letter Ruling 9029047). By specifically terming the arrangement a "licensing agreement" and referring to the payments as "royalties", the exempt organization can avoid a certain amount of discrepancy.

Any expenses incurred by the exempt organization in connection with the production, preparation or mailing of solicitation materials should be reimbursed by the bank, financing institution, or other commercial entity, so as to minimize the risk that these activities are deemed to make up part of the consideration for the licensing payments. (Tax Court Memos 1993-199, 1996-33, and 1996-34).

**Rental Income:**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.

* Rents - Real Property

Rents from real property not debt financed are excluded from taxable income. (IRS Treasury Regulation 1.512(b)-1(c)(ii)(a)) provided:

1. Property is not debt financed;
2. Additional services are not rendered;
3. Are not dependent on a percentage of profits.

Amounts received by the University/Agency do not qualify as excludable rents if the University/Agency 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 for occupancy only. (IRS Treasury Regulation 1.512(b)-1(c)(5)).

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. (IRS Treasury Regulation 1.512(b)-1(c)(2)(iii)).

* Rents - Personal Property (Equipment, etc)

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. 10% or less is considered incidental and not subject to tax;
2. 11-50% is considered taxable in proportion to the percent of personal property rents to the total rents; and
3. 51% or more is considered 100% taxable. (IRS Treasury Regulation 1.512(b)-1(c)(ii)(b)).

Remember -Leases vs. Management Contracts vs. Joint Ventures. It is important that both written agreements and the actions of the University are structured to get the UBIT treatment intended. For example, if facilities are leased to an outside entity and the intent is to exclude the lease payments under the rental exclusion: (1) Make sure the contract is written as a bona fide lease and that the outside entity isn’t acting as an agent for the University in return for a management fee; (2) Make sure the University is not providing any services to the lessee that would negate the landlord/tenant relationship; (3) Make sure the payments to the University are not contingent on net income.

**Research:** 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:

1. Research performed for any level of government (IRC Section 512(b)(7));
2. Research performed by a college, university, or hospital "for any person" (IRC Section   512(b)(8));    and
3. 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 (IRC Section 512(b)(9)).

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. (IRS Treasury Regulation 1.512(b)-1(f)(4)).  Engaging in marketing, operating, or manufacturing activities after the research phase is complete often results in UBI.

**Royalties:** A royalty is defined as a payment for the use of a valuable intangible property right. Usually this means payments for the right to use the University’s name, logos, copyrights, patents, etc. It could also mean payments for the right to sell goods and services on campus, the right to sell advertising in the University’s publications, the right to use a mailing list to sell products to students, faculty, or alumni, etc. If the University provides more than minimal services, the IRS will attempt to reallocate some or all of the royalty payment as taxable services income.

**Sale of By-Products:** The sale of products resulting from research activities may or may not be exempt from UBIT. If the product is sold in substantially the same state it is in on completion of the research, the sale does not constitute unrelated business income. However, if further manufacture or processing of the product occurs, the gross income is considered unrelated. (IRS Treasury Regulation 1.513-1(d)(4)).
An example of their distinction is as follows:
An experimental dairy herd maintained for scientific purposes by a research organization produces milk and cream in the ordinary course of operation of the project. The sale of the milk and cream would not be gross income from conduct of unrelated trade or business. On the other hand, if the research organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless:

1. The manufacturing activities themselves contribute importantly to the accomplishment of the exempt purpose of the organization (i.e. education of students); or
2. The research produces more raw milk than can be sold as milk in its normal period of shelf life. This causes further processing to be done of the excess raw milk to obtain products that have a longer shelf life to avoid spoilage.

**Special Circumstances:** There are special circumstances in which an unrelated activity may be recognized as serving an exempt purpose. The IRS will decide whether such unique circumstances exist on a case-by-case basis. The following are examples of unique circumstances (IRS Revenue Ruling 85-110, 1985-2 CB 166):

1. Services or facilities otherwise unavailable in the community that fulfill an important community or medical need (see section 9); and
2. Services, facilities, or equipment which are technically advance or unique