Understanding Unrelated Business Income Tax

Reviewed and Updated for NAIS by Howard Silver, Hogan Lovells U.S. L.L.P.

At one time, tax-exempt organizations, including independent schools, could own and operate businesses without incurring tax on the theory that the income generated by the business was used to support charitable purposes. This test permitted nonprofits to use tax-free business earnings to expand their operations at the expense of their for-profit competitors. In order to eliminate this unfair competition, Congress enacted legislation to impose tax on the “unrelated business taxable income” or “UBTI” of certain otherwise exempt organizations. The tax itself, imposed on the same tax basis as that on commercial enterprises, is generally referred to as the “unrelated business income tax” or “UBIT”. A brief summary of the tax, as well as some specific scenarios that NAIS schools may encounter, are set forth below. Citations to the Internal Revenue Code, Treasury Regulations, and relevant IRS rulings and court cases are provided, to assist you and your school’s legal counsel in analyzing specific issues.

Q. **What constitutes UBTI?**
A. UBTI, as defined in IRC Section 512, is the gross income derived from an unrelated trade or business regularly carried on, less deductions directly connected with such business. This definition contains two key requirements: the business must first be unrelated, and then must be regularly carried on, in order to constitute UBTI.

Q. **What is an “unrelated trade or business”?**
A. An unrelated trade or business includes any trade or business that is not substantially related to your school’s tax-exempt purposes (primarily education, as well
as any other charitable purposes -- e.g., religion -- that your school serves). An activity is _substantially related_ if it contributes importantly or is causally related to your school’s exempt purpose(s), but is _not_ substantially related to the extent it is conducted on a scale larger than reasonably necessary to perform functions in furtherance of this purpose. To illustrate, an on-campus bookstore that sells textbooks and other supplies to students is substantially related to a school’s exempt purposes; an on-campus shop that sells non-academic merchandise to the general public is not. See IRC Section 513 and Treas. Reg. § 1.513-1(d) for a more detailed discussion of unrelated trades or businesses.

Q. What does “regularly carried on” mean?
A. An unrelated activity must be conducted on a regular basis in order to generate UBTI. For example, the sale of advertising by volunteers in an annual program for a school play does not generate UBTI. If a commercial advertising firm is engaged to solicit advertising under a full-year contract, however, the activity is considered to be regularly carried on and the advertising income derived therefrom will be UBTI. See Rev. Rul. 73-424, 73-2 C.B. 190, as distinguished by Rev. Rul. 75-201, 75-1 C.B. 164. In _National Collegiate Athletic Association v. Commissioner_, 914 F. 2d 1417 (10th Cir. 1990) the court concluded that advertising in programs for the annual three-week NCAA basketball tournament was not, for purposes of the UBTI tests, an activity that was regularly carried on. The IRS has strongly disagreed with this result.

Q. _What happens if related and unrelated business activities are combined?_
A. An activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities that may be related to your school’s exempt purposes. For instance, the IRS may fragment the activities of the school yearbook program by taxing its advertising income, or of a school bookstore by taxing the net revenues derived from sales of merchandise (e.g., CDs and DVDs) unrelated to the school’s tax-exempt purpose. See Rev. Rul. 82-139, 1982-2 C.B. 108, where a bar association journal’s income from the publication of commercial advertising of products and services was taxed, but the publication of legal notices for a fee was not an unrelated trade or business. See also Rev. Rul. 73-105, 1973-1 C.B. 264 where a tax-exempt folk art museum realized UBTI from sale of scientific books unrelated to its exhibits.
Q. Are there any exceptions to the general rules set forth above?
A. Yes. They include:

- **Passive investment income.**
  By definition, UBIT does not encompass passive investment income, which includes interest, dividends, payments with respect to security loans, loan commitment fees, annuities, capital gain, rents from real estate, and royalties. IRC Section 512(b).

- **Rental income.**
  Although income generated by the rental of real estate is passive, income from rendering services is not rental income unless the services are limited to those routinely provided by a landlord. For example, cleaning exits and entrances and removal of trash is routine, but daily maid service and other services provided primarily for convenience of tenants is not routine and so will generate UBITI. Although leasing of school facilities, such as athletic facilities, dormitories, or classrooms, will likely generate passive rental income, the rental of school facilities to persons other than its students is likely to generate UBITI if the school provides collateral services such as meals and maintenance.

- **Income generated by volunteer labor.**
  Business activities in which substantially all the work is performed by volunteers -- e.g., a carwash fundraiser run by the cheerleading team -- do not generate UBITI. IRC Section 513(a)(1).

- **Income from the sale of donated goods.**
  Income from sales of donated goods (e.g., a bake sale or a fundraising auction1) does not generate UBITI. See IRC Section 513(a)(3) and Rev. Rul. 56-152, 1956-1 C.B. 56.

- **Income from activities for the convenience of certain individuals.**
  UBITI is not generated by business activities conducted for the convenience of students, teachers, staff, or the like -- for instance, a school laundry or cafeteria. IRC Section 513(a)(2).

- **Income from bingo games.**

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1 See NAIS Auctions & Raffles: Do’s, Don’ts, Hows, and Whys 2nd Edition at www.nais.org
Income from bingo (but not other games of chance) will not be considered UBTI if the activity is legal under state law and the games are not carried on in a jurisdiction where bingo is ordinarily “carried on” commercially. IRC Section 513(f). “Instant bingo”, however, which is played by tearing a ticket along a perforated line to reveal a combination of numbers, is specifically excluded from the definition of bingo under Treas. Reg. §1.513-5(d) and will produce UBTI.

Q. Are there any exceptions to the exceptions noted above?
A. Yes – in particular, there is one very important exception to the exceptions. In general, the passive income exception described above does not protect income generated by assets acquired or improved with borrowed funds. IRC Section 514. This rule often comes into play when a school owns rental real estate that is mortgaged, although any passive income generated by debt-financed assets may trigger this exception to the exception. Remember, though, that if the income is generated by activities substantially related to a school’s exempt purposes, there is no “unrelated trade or business” and so no need to apply the UBTI exceptions in the first place. Accordingly, student boarding fees for residence in a debt-financed dormitory will not generate UBTI; income from mortgaged apartments rented to the general public, however, will give rise to UBTI. To further complicate matters, IRC Section 514(c)(9) excepts certain real property investments made by a school and its affiliated supporting organizations from the exception to the exception.

Q. If my school rents its facilities for summer school programs, sports camps, Elderhostels, banquets, weddings, and the like, does rental income from these activities generate UBTI?
A. It depends on the nature of the income and how it fits (or doesn't fit) within the exceptions listed above. For instance:

- Passive Rental Income. As discussed above, the rental of school facilities to persons other than the school’s own students is likely to be treated as UBTI if the school provides collateral services such as meals or cleaning services.
- Special Events. A one-time rental -- e.g., for a single wedding -- is unlikely to be considered “regularly carried on” and so should not generate UBTI. A pattern of regular rentals, however, is “regularly carried on”, and will generate UBTI if ancillary services, such as catering, are provided.
- Educational Activities. Educational activities such as summer school programs, Elderhostels, and sports camps sponsored by the school are related to the school’s exempt purposes and so do not generate UBTI. However, if the activities are not sponsored by the school and the school provides collateral services, they will generate UBTI.

Q. Do items sold in the school bookstore generate UBTI?
A. It depends on the particular item. As noted above, the IRS applies a fragmentation rule and considers the income from each item separately. Items such as course books, supplies, computer hardware and software, and athletic wear necessary for participation in a school’s athletic programs are related to the school’s exempt purposes and do not generate UBTI. Such items as health and beauty supplies, snacks, and drinks often fall within the convenience exception and thus often are exempt from UBIT. Items that do not fall under the convenience exception and that have a useful life of more than a year (i.e., items that will likely continue to be used after the school year, such as clothes, appliances, posters and plants) do generate UBTI.

Q. Does my school need to operate at a loss to avoid UBIT?
A. No. The UBIT rules do not require charitable organizations to operate their charitable activities at a loss. Related and unrelated income do not offset each other for tax purposes; even if your school receives substantial net revenue from donations, tuition, and other related revenues and only a small amount of UBTI, only the UBTI will be taxed.

Q. Could my school lose its tax-exempt status because of excessive unrelated trade or business activity?
A. Yes, in an extreme case. If unrelated activities become excessive in relation to total activities, your school risks losing its Section 501(c)(3) status. There is no hard-and-fast rule as to how much commercial activity is “too much”. As a general matter, however, it is recommended that no more than 15%, and ideally less than 5%, of your school’s revenues be derived from unrelated activities. If your school has aggregate unrelated activities likely to exceed 15%, consideration should be given as to how best to protect the school’s 501(c)(3) status, e.g., by placing some or all of the unrelated activities into a taxable corporation controlled by the school.
Q. *How is UBIT calculated?*

A. The tax itself, technically imposed under IRC Section 511, is calculated as if the UBIT had been generated by a commercial entity. If your school is organized as a corporation, this means that corporate tax rates will apply; the rare school organized as a trust will be taxed instead at trust rates. See Treas. Reg. § 1.512(a)-1 for detailed instructions on calculating UBIT.

Q. *How is UBIT reported?*

A. UBIT is reported and paid to the IRS on Form 990-T. Form 990-T is due 4 months and 15 days after the close of a taxable year, at the same time as Form 990.

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