THE PRINCIPLES OF UBIT

I. History of the Unrelated Business Income Tax
   A. Tax Exemption for the Income of Charitable Organizations
   B. Revenue Act of 1950
   C. Tax Reform Act of 1969

II. Basic Principles of the Unrelated Business Income Tax Issues
   A. Imposition of the Tax
   B. Definition of UBTI
   C. Deductions

III. Exceptions under IRC Section 513(a)
   A. Convenience Exception
   B. Volunteer Labor Exception

IV. Modifications under IRC Section 512(b)
   A. Interest and Dividends
   B. Royalties
   C. Rents
   D. Capital Gains
   E. Research

V. Unrelated Debt-Financed Income
   A. Background
   B. Exceptions
   C. General Rule and Definitions
   D. Computation
I. History of the Unrelated Business Income Tax.

A. Tax Exemption for the Income of Charitable Organizations.

1. Prior to the Revenue Act of 1950 charitable organizations generally paid no income tax on any income from any of their activities.

2. Justification for Tax Exemption.
   a. Non-profits are not driven by profit maximization motives, and profit maximization is a basic assumption underlying the “gross income less expenses” method of taxation. Boris I. Bittker & George K. Rapherdt, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 Yale L.J. 299, 304 (1976)
   b. House Committee on Ways and Means, “the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.” H.R. Rep. No. 1860, 75th Cong., 3rd Sess. 19 (1938)


   The Supreme Court upheld a decision that the income collected by a religious organization from its investments and the sales of some goods was not taxable. The case established the rule that taxation of income be determined by the destination of that income, not its source. The Court pointed out that charitable activities cannot be carried on without money and that making properties held by charitable organizations productive did not alter or enlarge their purpose. The Court quoted University v. People, 99 U.S. 309 (1878): "the purpose of a college or university is to give youth an education. The money which comes from the sale or rent of land dedicated to that object aids this purpose. Land so held and leased is held for school purposes, in the fullest and clearest sense."

4. Roche’s Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938). The court followed Trinidad and, held that a corporation owned by a foundation was tax exempt. The corporation operated a beach and bathhouses in New York.

5. C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3rd Cir. 1951).

   All of the taxpayer's stock was held by a voting trust for the benefit of New York University. The Third Circuit, citing a number of decisions, reversed the Tax Court and held that the income generated by the taxpayer was exempt from taxation. As the court stated, the rationale for exempting income of charitable organizations was "the benefit from revenue is outweighed by the benefit to the general public welfare gained through the encouragement of charity." The Third Circuit's decision came after the Revenue Act of 1950, but applied to an earlier year. However, publicity surrounding NYU was the impetus for the passage of the Revenue Act of 1950. (NYU also owned Howes Leather Co., American Limoges Cina, Inc., and the Ramsay Corporation – total value over $45,000,000. See New York Times article, “University Dollars Yielding Tax-Free Business Profits,” December 13, 1948.)
B. Revenue Act of 1950.

1. Rationale for taxing income of charitable organizations.
   a. Unfair Competition for Market share. Tax-free corporations would have more profit because they are not paying income taxes and could use the funds to increase their market share by reinvesting excess profits in the corporation.
   
   b. Unfair Competition for Capital. Tax-free corporations could outbid tax-paying corporations because they would be willing to accept a lower rate of return on the investment (Same rationale that allows tax-free bonds to allow a lower rate of return than non-tax exempt bonds.)
   
2. Enacted the predecessors of §§511-513.
   a. Allowed the taxation of the profits of business regularly carried on that was not substantially related to the purpose of the nonprofit organization.
   
   b. Excluded churches and their associations, as well as passive investment income.
   
3. Predecessor of §502. Feeder corporation with the primary purpose of conducting trade or business for profit was not tax exempt.
   
4. Predecessor of §514. Rental income from leases of real property for more than five years was taxable if the lessor had any unpaid debt that was incurred to acquire the leased property.
   
5. The Treasury Department adopted the regulations related to the 1950 Act in 1958.
   
6. The regulations were amended in 1967 when the "fragmentation rule" was adopted.


1. Amended §514 to cover all income received from unrelated business activity related to debt financed property.
   
2. §512(b)(15) – a measure to protect a radio station operated by Loyola University.
   
   a. Income tax free so long as 90% of income was transferred to the nonprofit organization and the station charged market-based prices.
   
   b. Returned to the destination-of-income analysis of Trinidad.
   
3. Added fragmentation rule in 513(c).
II. Basic Principles of the Unrelated Business Income Tax Issues.

A. Imposition of the Tax.

1. The tax is imposed upon private institutions by 511(a)(2)(A). Organizations described in 401(a) and 501(c) are subject to tax.
2. The tax is imposed upon state colleges and universities under 511(a)(2)(B).

B. Definition of UBTI.

1. Background.

Unrelated business taxable income is defined in Internal Revenue Code Section 512(a)(1) as "gross income derived by any organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b)." Section 512(b) includes a number of types of income that are excluded from UBTI, the most notable of which are: (1) dividends, (2) interest, (3) royalties, (4) rents from real property, (5) capital gains and losses, and (6) income from research.

2. Trade or Business.

a. Section 513(c) states "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or from the performance of services." It goes on to state that a trade or business does not lose its identity merely because it is carried on as part of a larger activity.

b. The IRS maintains that an activity must, at some point, produce a profit to be considered a trade or business.

c. The last sentence of Section 513(c) states "[w]here an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit."

d. Regulation 1.513-1(b) states that "for purposes of Section 513 the term 'trade or business' has the same meaning it has in Section 162...."

e. Treasury Regulation Examples [Treas. Reg. § 1.513-1(b)]

1) The regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2)

2) Activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the
exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

f. In *Louisiana Credit Union League v. United States*, 693 F.2 525 (5th Cir. 1982), the Fifth Circuit held that the proper test to determine whether an activity was a trade or business is whether the organization "is engaged in extensive activity over a substantial period of time with the intent to earn a profit."

g. In *Carolinas Farm & Power Equipment Dealers Ass'n v. United States*, 699 F.2 167 (4th Cir. 1983), the Court also used a profit motive test and held that the taxpayer was engaged in a trade or business.

h. In *Dennis v. Commissioner*, TC Memo 2010-216, Docket Nos. 6403-06, 23978-06 (filed October 5, 2010), the Tax Court held that, based on other factors, taxpayers conducted a horse breeding activity with the intent to make a profit even though they lost money from 1999 through 2004.

Deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine non-exclusive factors contained in Treas. Reg. § 1.183-2(b). Those factors are:

- the manner in which the taxpayer carried on the activity,
- the expertise of the taxpayer or his or her advisers,
- the time and effort expended by the taxpayer in carrying on the activity,
- the expectation that the assets used in the activity may appreciate in value,
- the success of the taxpayer in carrying on other similar or dissimilar activities,
- the taxpayer’s history of income or loss with respect to the activity,
- the amount of occasional profits, if any, which are earned,
- the financial status of the taxpayer, and
- elements of personal pleasure or recreation.”

In this case, taxpayers conducted a horse breeding activity with the intent to make a profit even though they lost money from 1999 through 2004. The court noted that the couple faced economic hardship and that the losses were real, not considered to be 'paper' losses.

The factors in 1.183-2(b) apply to individuals, not corporations, but can provide some guidance and are sometimes used by IRS auditors in UBI cases.

i. IRS Audit Approach.

The IRS has challenged a number of activities that continually produce losses. Their claim is that these activities do not constitute a trade or business, and therefore the
losses may not be used to offset activities that produce a profit.

The IRS maintains that an activity must, at some point, produce a profit to be considered a trade or business. They rely on Portland Golf Club v. Commissioner 110 S. Ct. 2780 (1990) and West Virginia State Medical Association v Commissioner, 91 T.C. 651(1998), aff'd. 882 F. 2d 123 (4th Cir. 1989). In Portland the taxpayer was a social club (they are subject to someone different rules regarding UBI).

Language from a Form 5701: the facts clearly show no desire on X’s part to operate its catering and recreation center activities at a profit. First, X has reported losses in nine consecutive years on these activities. Second, X indicated that these activities are budgeted to operate at breakeven or a loss with no future plans to make a profit.... Accordingly, X’s losses from its catering and recreation center activities are being disallowed in full because the required profit motive is not present with any and all claimed expenses limited to the reported income.

3. Not Substantially Related.

a. Section 513(a) defines "unrelated trade or business" as "any trade or business the conduct of which is not substantially related.....to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501...."

b. The determination regarding whether a trade or business is substantially related to a university's purpose depends on the facts and circumstances. To be substantially related an activity must contribute importantly to the accomplishment of the university's purposes.

c. The size and extent of business activities must be considered in determining whether they are substantially related. If they are conducted on a larger scale and more extensive than reasonably necessary for the performance of the exempt functions, they will be considered unrelated. The example in the regulation states that income generated from the sale of milk and cream by an exempt entity operating an experimental dairy herd would be related; however, if the product was further manufactured for the sale of ice cream or pastries, such sales would be unrelated. Regulation Section 1.513-1(d)(2).

d. There are many rulings discussing "relatedness"; however, most are limited to the facts of the specific ruling and do not provide a lot of helpful information for other circumstances.

e. Treasury Regulation Examples Treas. Reg. § 1.513-1(d).

M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances
derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

f. In PLR 201106019, the IRS reversed an earlier private letter ruling when it concludes that revenues derived from hotel rentals to persons other than students constitute unrelated taxable income tax (UBIT).

Previously, in PLR 200625035, the IRS concluded that providing living quarters in buildings owned by the school to the following was not UBIT: students, and faculty, temporary living quarters to family members of student and faculty, potential students and their family members, guests who are speakers at the institution and those who are guests of other non-affiliated non-profit organizations in the immediate geographic area.

g. PLR 201037037 denied an organization charitable status under IRC Section 501(c)(3). Among other items, the IRS concluded that an organization that conducted research pursuant to sponsor contracts to assist with obtaining FDA approval for certain drugs served a commercial purpose and not a charitable purpose. This ruling provides a good discussion of when research may be subject to taxation.

h. In PLR 201031034, the IRS denied an organization charitable status under IRC Section 501(c)(3). Among other items, the organization proposed conducting travel tours, which the IRS concluded were much like a sightseeing tour rather than educational in nature.

The ruling cites authority that discusses the issue. Rev. Rul. 77-430 involved an organization that conducted weekend religious retreats whereby the participants spent most of their time on spiritual and religious activities (but were allowed to use the organization’s recreational activities in their limited free time), and Rev. Rul. 77-336 which involved a cruise travel tour that was held to be primarily devoted to dining, socializing, and sightseeing (even though religious and educational activities were available four hours a day).

In addition, the IRS concluded that even though the organization operated on a “no profit, no loss” basis it was not entitled to charitable status (citing Rev. Rul. 72-369).
The Tax Court in Ocean Pines Association, Inc. v. Commissioner of Internal Revenue, 135 TC No. 13 (August 30, 2010) held that a homeowner’s association that is exempt as a welfare organization under IRC Section 501(c)(4) was subject to UBIT on revenues derived from parking lots. The activity was unrelated to its exempt purpose and did not meet the real property rental exception.

Sales of Merchandise via Website – PLR 200722028

A charity in addition to educational materials on the treatment and study of breast cancer, offers merchandise for sale via its website. The merchandise includes apparel, jewelry, pins, home and special gifts.

The IRS concludes that the sales are related to the organization’s exempt purpose and is not subject to UBIT. The charity’s purpose is to eradicate breast cancer through education and the items for sale are inherently educational, providing information on breast cancer. Each item includes the R symbol for breast cancer as well as a toll-free number and web site address of the charity as a package enclosure.

The IRS cite revenue rulings 73-104 and 73-105 that concluded that the sale of greeting cards of art works by an art museum and the reproductions of art works by art museums contributes importantly to the achievement of the educational purposes of the museums.

4. Regularly Carried On.

a. In addition to being unrelated, a trade or business must be regularly carried on to create unrelated business taxable income. Generally, the IRS compares the time span for a comparable commercial activity to that for the activity conducted by the university.

b. Regulation 1.513-1(c) discusses the definition of "regularly carried on." The regulation states that the manner of conducting the activities must be compared with the manner in which commercial activities of the same type are normally pursued by non-exempt organizations. Activities engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. The regulation indicates that income producing or fund raising activities lasting only a short period of time conducted on an annual basis would not be considered regularly carried on.

c. Treasury Regulation Examples – 1.513-1(c).

i. The operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business.

ii. The conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular
iii. The operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

d. In *NCAA v. Commissioner*, 92 T.C. 456 (1989), reversed 914 F. 2d 1417 (10th Cir. 1990) the issue was whether an activity was regularly carried on. The 10th Circuit Court of Appeals reversed the Tax Court and held that production of the NCAA's Final Four basketball program was not regularly carried on. The court indicated that it should consider the business of selling advertising space since that was the business that the Commissioner contended generated unrelated taxable income. The court stated that since the publication of advertising is generally conducted on a year round basis, that if the NCAA's sale of program advertising was conducted for only a few weeks, that time period alone, could not, standing alone, convert the NCAA's business into one regularly carried on. The court stated: "the tournament must be considered the actual time span of the business activities sought to be taxed here." The court rejected the IRS argument that preliminary time spent to solicit advertisements and prepare them for publication should be included in the determination of whether the activity was regularly carried on. The court mentioned the example in the regulations of a sandwich stand operated at a state fair and that the regulation did not mention time spent in planning the activities, building the stand, or purchasing the supplies.

e. Real Estate Broker Commissions – PLR 201015037.

S was the President and Chief Executive Officer of a § 501(c)(3) exempt organization. In addition to his role as President and CEO of the exempt organization, S was also a licensed real estate broker and was the sole proprietor of T. S’s employment agreement with the exempt organization only permitted him to use his real estate broker’s license for the benefit of the exempt organization. The exempt organization entered into a lease with a third-party to rent office space. S served as the co-broker on behalf of the exempt organization in the lease negotiations and received a commission check payable to T. S indorsed the check over to the exempt organization as required by his employment agreement. Real estate transactions of this nature are not typical for the exempt organization and this is the only instance in five years in which the exempt organization has received a real estate commission. The exempt organization’s receipt of a brokerage commission did not result in the imposition of unrelated business income tax because the leasing activity is not “regularly carried on” by the exempt organization within the meaning of § 513.


An employee of § 501(c)(3) exempt church designed computer software for the church’s use. The church later sold the software to a third-party and received cash proceeds and a perpetual license in return. The IRS found that this sale did not
generate unrelated business income because the church did not “regularly carry on” the business of selling intellectual property rights. The IRS noted the sale of intellectual property rights is not a “continuous and consistent income producing activity” since it was a one-time sale and the church has no plans of selling intellectual property rights in the future.

g. The courts and the IRS have agreed that gain derived from the frequent and continuous sale of parcels of real estate may trigger UBIT.

A court held that gain derived by an exempt school for mentally disabled children that sold 22 parcels of real estate over a 2 year period was subject to UBIT (Parkland Residential School, Inc. v Commissioner, T.C.M 1983-139[CCH Dec. 39,964(M)]). Another court ruled that the organization could not support that the primary purpose of the sales made to members of the general public was to increase the organization's membership (compare to the court case Junaluska Assembly Housing, Inc. v. Commissioner, 86 T.C. 1114 (1986) [DDH Dec. 43.077].

Rev. Rul. 55-449, 1955-2 C.B. 599, concluded that the construction and sale of 80 houses by an exempt foundation for the purpose of raising funds for a period of 18 months constituted a taxable activity.

In PLR 200047049, dated August 2, 2002, the IRS concluded that sales of real estate parcels did not further the charitable mission of the organization since the sales were not substantially related to its exempt purposes. The sole criterion for the sales appeared to be the amount of the buyer’s offer and that the sales were marketed to maximize profits. Also, the sales did not meet the exception under 512(b)(5) due to the frequency, continuity and size of the sales as well as the extent of the improvements.

In PLR 200119061, dated February 14, 2001, the IRS concluded that the sales were not substantially related to the organization’s exempt purpose since the property was sold to develop residential property and not to further the outreach program. The organization conducted a land purchase program as a means to further its charitable purposes of spreading outreach programs. In carrying out its charitable mission of the last 15 years, A purchased 38 tracts of land, 14 of which were used as part of the group’s exemption, 12 that were sold to third parties (all profitable but one) and the remainder were held for future exempt use or sales potential. Properties sold to third parties represented land either originally intended to be used for charitable purposes or were purchased as a means to obtain other property necessary to fulfill its mission.

C. Deductions.

1. IRC § 512(a)(1) requires permissible deductions to be directly connected with the carrying on of a trade or business.

2. Expense Allocation.
a. The manner in which colleges and universities allocate expenses to unrelated business activities is also a major concern for the IRS.

b. In 1997 NACUBO produced a draft revenue procedure creating safe harbors for allocation of expenses for purposes of determining unrelated business income; however, the IRS has refused to provide any guidance in this area.

c. Regulation 1.512(a)-1(a) states that to be deductible in computing unrelated business income expenses must be directly connected with the carrying on the unrelated activity. They must have a proximate and primary relationship to that activity.

d. Regulation 1.512(a)-1(c) provides that when facilities or personnel are used for both exempt activities and to conduct unrelated trade or business activities, expenses shall be allocated between the two on a reasonable basis. Depreciation, overhead, and salaries are examples of expenses mentioned in the regulation.

e. In Rensselaer Polytechnic Institute v. Com’r, 53 AFTR 2d 84-1167 (1984), the Second Circuit affirmed the Tax Court decision upholding the Taxpayer’s allocation of fixed expenses based on actual use of the facility. The court agreed that such an allocation method was reasonable within the meaning of the regulations. The Taxpayer multiplied total fixed expenses by a fraction, whose numerator was the total number of hours the facility was used for unrelated activities, and whose denominator was the total number of hours the facility was used for all activities. The IRS argued that the denominator should be the total time the facility was available for use.

f. Regulation 1.512(a)-1(e), example 1: W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other advertising materials to its members, charging the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from an unrelated trade or business activity. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business, or allocable to such business under the rule of paragraph (c) of this section, are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business activity and an allocable portion of the salaries of personnel used both to carry on exempt activities, and to conduct the unrelated business activity. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity—W's membership—but are incurred primarily in connection with W's fundamental purpose as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it.
III. **Exceptions under IRC Section 513(a)**

A. Convenience Exception - IRC Section 513(a) excludes from taxation or UBIT any trade or business which is carried on by charitable organizations or state colleges or universities primarily for the convenience of their members, students, patients, officers, or employees.

1. The person must have the relationship directly with the organization. However, employees of a related entity qualify.\(^1\)

2. Member is defined to include any group of persons limited in size who are closely associated with the entity involved and who are necessary to the achievement of the organization’s purposes.\(^2\)

3. Spouses and children do not qualify for this exception.

4. The court has defined, in another context, “primarily” to be “of first importance” or “principally”.\(^3\) However, it is not necessary to demonstrate that no other alternatives are available.\(^4\)

5. Failure to meet this exception subjects the entire activity to UBIT unless excluded on other grounds.

6. Examples:
   
   a. The use of an exempt fitness center by its own employees or employees of an affiliated entity qualifies for this exception.\(^5\)
   
   b. A laboratory’s analysis and testing of its patient’s specimens qualify for this exception.\(^6\)
   
   c. A state university that operates a book and supply store and a cafeteria and restaurant on the campus for its student body and faculty qualifies for this exception.\(^7\)
   
   d. The operation of a laundry service by a tax-exempt university primarily for the convenience of its students, officers or employees, qualifies for this exception.\(^8\)
   
   e. Other examples include sales of novelty items with embossed colleges’ or universities’ logos, including clothing, jewelry, pillows, beer mugs, and other low-cost sundry items. Also, the use of an organization’s parking lot.\(^9\)

B. Volunteer Labor Exception – IRC Section 513(a) excludes from UBIT a trade or business whereby substantially all the work is performed for the organization without compensation.

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\(^1\) PLR 9535023 (May 1995).
\(^4\) St. Luke’s Hospital, see footnote (2).
\(^5\) IRS Letter Ruling 200444030 (Aug. 05, 2004).
\(^8\) Rev. Rul. 55-676, 1955-2 CB 266.
\(^9\) General Counsel Memorandum 35811 (May 7, 1974); TAM 8025222 (1980); PLR 199949045 (1999).
1. The courts tend to agree with the IRS which defines “substantially all” in most contexts as 85%.

The one court found, based on total hours worked, that 77% did not meet the exception\(^{10}\) whereas another court found that 91% of the full-time work and 94% of all work qualified.\(^{11}\)

2. The term ‘without compensation’ must not include cash or non-cash economic benefits in exchange for the services provided.

The court in St. Joseph Farms held that a critical component is a ‘but-for’ test between the payments and the services provided (a religious order that operated a farm was excluded from UBIT since the monks were volunteers).\(^{12}\)

3. The IRS and courts agree that reimbursement of expenses does not constitute compensation.\(^{13}\)

However, contrast with the court in Smith-Dodd wherein a social welfare organization that conducted weekly bingo games paid its workers $8 for 4 hours of work each week arguing that the payments merely reimbursed the employees for their expenses. The court disagreed.\(^{14}\)

4. The performance of services must be a material income-producing factor in conducting the activity.\(^{15}\)

With respect to an organization’s activity, the IRS concluded that although the work in carrying on the rental activity may be performed without compensation, the performance of services in this case is not a material income-producing factor in the business.\(^{16}\)

5. Examples:
   a. The Treasury Regulations provide that an exempt orphanage operating a retail store that sells items to the general public is excluded from UBIT when substantially all the work is performed by volunteers without compensation.\(^{17}\)
   b. The production and sale of phonograph records by volunteers qualified for this exception.\(^{18}\)

\(^{10}\) Waco Lodge No. 166 v. Commissioner, 696 F.2d 372 (5th Cir. 1983), aff’g 42 T.C.M. (CCH) 1202 (1981).
\(^{12}\) Id.
\(^{17}\) Treas. Reg. Sec. _1.513-1(e)_.
\(^{18}\) Green County Medical Soc’y Found. v. United States, 345 F. Supp. 900, 902 (W.D. Mo. 1972)
c. A trade association excluded its advertising revenues from UBIT since the activity was conducted by volunteers.19

d. Letter ruling 9605001 provides that income derived from conducting catering services and tending bar is excluded from UBIT when substantially all the labor consist of volunteers.

IV. Modifications under IRC Section 512(b)

A. Interest and Dividends

IRC Section 512(b)(1) excludes from UBIT dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities.

Also excluded are securities loans and annuities, income from notional principal contracts and other substantially similar income from ordinary investments.20

B. Royalties

1. IRC Section 512(b)(2) excludes all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property.

However, royalties do not include income from a working interest in a mineral property that the payee is not relieved of its share of its development costs.21

2. General Definition of Royalties

a. Although not defined by this IRC section, royalties are generally defined as payments for the use of the payee's intangible property (such as trademarks, patents, or copyrights).

b. Black's Law Dictionary (6th ed. 1979) defines royalty as "compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in respect to each copy of his work which is sold, or to an inventor in respect to each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property."

c. With respect to personal holding company rules, Regulation Section 1.543-1(b)(3) states "[t]he term royalties (other than mineral, oil, or gas royalties or certain copyright royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. It does not, however, include rents."

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19 PLR 9302023 (1993).
d. Royalties are also defined in Proposed Reg. Sec. 1.1362-3(d)(5)(iii)(A) as "all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property."

e. IRS Publication 598 states that to be considered a royalty, a payment must relate to the use of a valuable right. Examples include the use of a name, photograph, likeness, or facsimile signature.

3. Case Law – The IRS challenges certain payment arrangements (mostly affinity credit card or mailing list programs) as royalties, arguing that the exempt organization is being compensated for services rendered or has entered into an agency relationship.

a. In the Oregon State case, the court held that the affinity credit and mailing list program was royalty income not subject to UBIT.22

The court pointed out that the taxpayer did not regularly rent its mailing list and devoted minimal staff time to the affinity card program. The court noted that "a desire to make money, standing alone, [does not] establish that [the taxpayer] is engaged in a trade or business."

b. In the Mississippi State case, the court held that payments received by the taxpayer related to its affinity credit card and mailing list program were royalty income excluded from UBIT.23 The court concluded that the bank paid the taxpayer for its endorsement, to use its mailing list, and for the use of its "walking bulldog" trademark. Services were limited to the following:

i. Make credit card application forms available in its office and mail application forms to one or two alumni who requested them.

ii. Review and approve marketing materials. Provide mailing list to the bank, give messages to the bank to print on monthly credit card statements, and inform it of campus events.

iii. Take application forms to local alumni chapter meetings and make them available to alumni, and write an article about the affinity credit card program in the alumni association newsletter.

iv. Allow the bank to send endorsement messages on the taxpayer's stationery with the taxpayer's executive director's facsimile signature.

c. In the first Sierra Club case, the court held that the revenues generated from the rental of mailing lists were royalties excluded from UBIT. However, the Court remanded the Tax Court's grant of summary judgment on the issue of whether income generated by an affinity credit card program was royalty income.24

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22 Oregon State Alumni Association, Inc. v. Com'r., T.C. Memo 1996-34, aff'd. 193 F. 3d 1098 (9th Cir. 1999).
23 Mississippi State University Alumni, Inc. v. Commissioner, T.C. Memo 1997-397.
24 Sierra Club v. Commissioner, Case No. 95-70112 (9th Circuit 1996).
d. In the next Sierra Club case, the Tax Court held that fees related to the Sierra Club's affinity credit card program were not compensation for services but royalties.\(^{25}\)

The court addressed the following arguments made by the IRS.

i. The court rejected the IRS contention that the taxpayer was in control of marketing plans for the credit card program. The fact that the taxpayer had the right of approval of marketing materials was consistent with the Taxpayer's right to protect its property interest and its good name and marks.

ii. The court rejected the IRS contention that the taxpayer offered the credit card program as a member service. The taxpayer's membership services department did not handle inquiries regarding the affinity credit card program and did not answer member's questions simply because they were not in control of the program.

iii. The fact that the program was advertised in the taxpayer's national magazine and in local chapter publications did not change the result. Usual rates were charged for the advertising and nothing in the card agreement required the taxpayer to accept advertisements.

iv. The court found that the taxpayer's agreement to cooperate was not an agreement to endorse or promote the credit card program beyond the endorsement that necessarily results from the Taxpayer's license of its logo, name, and other intangibles.

C. Rents

1. IRC Section 512(b) excludes from UBIT rents from real property; provided, certain restrictions are met.

   Personal property is excluded only if it is leased together with real property and the amount of total rent attributable to the personal property is incidental.\(^ {26}\)

   a. “Incidental” is defined as rent attributable to personal property that is 10% or less of the total rent.

   b. If the rent attributable to personal property is between 10 to 50%, then that amount is subject to taxation.

   c. If such rent is in excess of 50%, none of the rent is eligible for the exception.

2. However, certain rental arrangements may not qualify for this exception.

   a. It is disguised as a distribution of profits from a partnership or similar venture.\(^ {27}\)

   b. It depends, in whole or part, on the income or profits of any person operating the rented property.\(^ {28}\)

\(^ {25}\) Sierra Club Inc. v. Commissioner, T.C. Memo 1999-86 (March 23, 1999).

\(^ {26}\) Treasury Regulation 1.512(b)-1(c).

\(^ {27}\) Treasury Regulation 1.512(b)-1.

\(^ {28}\) Treasury Regulation 1.512(b)-1(c)(2)(iii)(b).
i. The regulations on net profits cross reference a regulation regarding real estate investment trusts (REITs). These regulations hold that fixed payments made by a tenant to its landlord may be tainted if the property is subleased and the sublessee made payments to the tenant from profits. A partial exception applies, however.29

ii. The Madden court held that if a portion of the rental payment is based on net profits, then the entire payment is taxable.30 However, fixed percentages or percentages of gross receipts or sales are permitted arrangements.

c. It includes the rendering of substantial services.

i. The regulations define substantial services as those services rendered to the occupant that are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.31

ii. Permitted services include furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc.

iii. Non-permitted uses include maid services.

iv. The courts, however, provide a broader explanation of insubstantial services, i.e. the Madden court held that parking, maintenance of the grounds, security and obtaining licenses and permits were permitted services.

d. When the rental arrangement is ‘substantially related’ to the organization’s exempt purposes.

e. When the arrangement is a license.

A lease gives the tenant exclusive possession of the premises to all parties, including the owner, whereas a royalty permits the licensee only general possession of the premises, e.g. wall space to advertise its products.32

D. Capital Gains

1. IRC Section 512(b)(5) excludes from UBIT all gains or losses from the sale, exchange, or other disposition of property other than

a. stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

b. property held primarily for sale to customers in the ordinary course of the trade or business.

29 Treasury Regulation 1.856-4.
30 T.C. Memo 1997-395 (8/97).
31 Treas. Reg. 1.512(b)-1(c)(5).
Also, excluded are gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities or real property, and from the forfeiture of good-faith deposits for the purchase, sale, or lease of real property in connection with the organization's investment activities. Please note that this section does not apply to the cutting of timber.

2. The term ‘property held primarily for sale to customers in the ordinary course of the trade or business’ is defined by a multi-factor test.

   a. The purpose for which the asset was acquired,
   b. the cost of the property,
   c. the extent of the improvements made,
   d. the proximity of the sale to the purchase of land,
   e. the purpose for which the property was held,
   f. the prevailing market conditions,
   g. the frequency, continuity and size of the sales,
   h. the activities of the seller in the improvement and disposition of the property.\(^{33}\)

   This analysis is commonly used when the exempt organization sells parceled property.\(^{34}\)

3. Property acquired by donations may be viewed as UBIT.\(^{35}\)

4. Sales of stock and securities

   The courts tend to distinguish between ‘dealer’ and ‘trader’ to determine whether the gains or losses from these capital assets meet this exception. The trader does not sell to customers.\(^{36}\)

E. Research

1. IRC Sections 512(b)(7), (8) and (9) provide income derived from the following research activities are excluded from UBIT.

   a. Research performed for any government agency or instrumentality.
   b. Research performed by a college, university or hospital for any person.

       Please note that certain research activities can be related to the school’s mission, e.g. significant involvement by the university’s students.

   c. Fundamental research performed by an organization operated primarily for such purpose, the results of which are freely available to the general public.

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\(^{34}\) PLR 201049047 (2001); PLR 200510029 (2005).

\(^{35}\) Ehram v. Commissioner, 120 F.2d 607, (9th Cir. 1941); U.S. v. Winthrop, 417 F.2d 905 (5th Cir. 1969).

\(^{36}\) Kemon v. Commissioner, 16 T.C. 1026 (1951).
i. If the organization agrees to withhold publication beyond the time reasonably necessary to obtain patents, or agrees to forego publication entirely, the income is subject to tax.  

ii. This exception can be used by organizations that do not qualify as scientific organizations that conduct research in the public interest as provided by the regulations.

2. Research does not include activities incident to commercial or industrial operations, such as the ordinary testing or inspection of materials or products or the designing or construction of equipment or buildings.

The IRS defines ‘testing’ as activities in which no standard procedure is used, no intellectual questions are posed, the work is routine and repetitive, and the procedure is merely a matter of quality and control.

a. The IRS concluded that testing performed for commercial entities of either products for pre-market clearance, or air samples or like substances for compliance with environmental laws, such as the Toxic Substances Act, may be considered an unrelated business activity.

b. Revenues from blood smear testing were considered to be subject to UBIT. A university entered into a contract with a private company to test an instrument which performs automatic blood smear testing for the purposes of marketing.

c. The IRS concluded that revenues from the performance of laboratory tests on specimens of individuals that the organization received from private physicians and from individuals referred to the organization by hospitals with over 100 beds, except for Rubella testing, were subject to UBIT.

V. Unrelated Debt-Financed Income

A. Background

1. Debt-financed rules pre-1969

Prior to the Tax Reform Act of 1969, certain exempt organizations, including charitable organizations, were subject to tax as unrelated business income tax (UBIT) on rental income from real property when that property was acquired with borrowed funds.

2. Debt-financed rules post-1969

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38 Treas. Reg. 1.501(c)(3)-1(d)(5).
40 General Counsel Memorandum (GCM) 39883 (1992).
41 Letter Ruling 8409055, (Nov. 29, 1983).
a. Legislative Change - However, due to certain abusive transactions that arose, Congress responded with a more comprehensive tax than previously provided and introduced Internal Revenue Code (IRC) Section 514, Unrelated Debt-Financed Income.

b. Rationale - The abuse included charitable organizations that purchased businesses and investments with minimal risk while the taxpayer received tax advantages. The taxpayer received income from the sale of the property in the form of capital gains and was entitled to deduct a significant rental payment.

c. Example - Typical transaction included the following: Taxpayer (T) sells corporation to Charitable Organization (CO). CO makes payments based on net profits of business. CO liquidates the business and leases the business assets to Newco, managed and partially owned by T. Newco pays 80% of its net profits as rent to CO, who, in turn, pays 90% of this rent to T.44

3. Criticisms

These rules are subject to criticism by commentators on the grounds that they fail to meet the intended purpose behind the rules, creating unnecessary restraints on investment activities.45

B. General Rule and Definitions

1. General Rule

a. Exception to the exception - Unrelated debt-financed income rules subject to taxation certain forms of investment income received by a tax-exempt organization, which income would otherwise be excluded from taxation.

b. IRC Section 514 – This provision applies to property that is held to produce investment income when there is an ‘acquisition indebtedness’ attributed to that property.

2. Definitions

a. “Property” - Property includes any and all property, including real property, securities, and intangible assets.

b. “Income” - Income includes interest, dividends, royalties and rent otherwise excluded under IRC Sections 511-513.

c. “Acquisition indebtedness” – acquisition indebtedness is defined generally as indebtedness incurred to acquire or improve the property.

Note that for property acquired subject to a mortgage or other similar lien, the amount of indebtedness secured by such obligation shall be considered as such indebtedness even though the organization did not assume or agree to pay it.\textsuperscript{46} Certain exceptions apply to such property that is donated.

Further, Internal Revenue Manual (IRM) 7.27.10.3 concludes that an extension, renewal or refinancing of an obligation that is related to a pre-existing indebtedness is considered a continuation of the old indebtedness. Any excess is treated as separate debt.\textsuperscript{47}

Also, any modification is considered an extension or renewal of the original obligation, e.g. substituting a lien to secure an obligation.

C. Exceptions

1. ‘Debt-financed’ property – Exceptions to this term include the following:
   a. Related property - Property where all of its use is substantially related to the charitable purposes of the organization, (or, if less than substantially all of its use, to the extent that it is substantially related property),
   b. UBIT previously - Property that is subject to tax as UBIT,
   c. Statutory exceptions - Property to the extent income is derived from the convenience exception, volunteer labor exception, or the exception for sales of merchandise received as gifts.
   d. Research - Property to the extent income is derived from research.\textsuperscript{48}

Income must be from research for the United States or any of its agencies or instrumentalities or for any state or political subdivision; any person in the case of a college, university, or hospital; or any person in the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public.\textsuperscript{49}

2. ‘Acquisition indebtedness’ – Exceptions to this term include the following:
   a. Exempt Purpose - Indebtedness incurred in the performance or exercise of an organization’s tax-exempt purpose or function,

\textsuperscript{46} Treas. Reg. 1.514(c)-1(a)(3), Example 4, presumes that indebtedness includes non-recourse financing arrangements.
\textsuperscript{47} Treas. Reg. 1.514(c)-1(c)(1).
\textsuperscript{48} IRC Section 514(b)(1)(B).
\textsuperscript{49} IRC Sections 514(b)(1)(D) and 512(b)(7)(8) and (9).
b. Charitable Gift Annuity

c. FHA – Certain federal financing, including qualified small business investment companies.

d. Securities Exchange - Obligation to return collateral security pursuant to a securities lending agreement.

3. Real Estate Exception

a. Educational Institutions - A specific exception that applies to the higher education community includes IRC Section 514(c)(9). This section provides that colleges and universities, defined as qualified organizations, may acquire real property with debt and be excluded from acquisition indebtedness.  

b. Affiliates - This exception includes organizations that support educational institutions, such as, alumni associations and foundations; provided, the organization qualifies as a supporting organization under IRC Section 509(a).

c. Partnerships - However, additional limitations are imposed on educational institutions that invest in real property through partnerships with qualified and non-qualified partners.

4. Neighborhood land rule

a. Neighborhood land - Another exception applies to exempt organizations for land acquired for tax-exempt purposes when the property is located within a neighborhood of other property owned by the organization, and which it plans to use for exempt purposes within ten years from the date of acquisition.

b. IRS Approval - The rule applies after the first five years of the 10-year period only if the IRS gives approval of the future use of the property.

c. Limitations – Limitations apply to structures currently on the land at the time of acquisition.

5. Multi-parent title holding companies - Special rules apply for IRC Section 501(c)(25) title holding companies.

D. Computation

1. Average Acquisition Indebtedness.

a. Operations - When property is determined to be “debt-financed property” under IRC Section 514, the debt-financed income that is subject to tax is derived by applying
the percentage of annual average ‘acquisition indebtedness’ outstanding throughout the year over the annual adjusted basis of the property.

b. Sales - For property disposed of during the year, average acquisition indebtedness is defined as the highest acquisition indebtedness during the preceding 12 months. The reason is to avoid any abuse from paying-off the borrowed amount immediately prior to the sale.

2. Depreciation – If the debt-financed property is of a character which is subject to the allowance for depreciation provided by IRC Section 167, the allowance shall be computed only by use of the straight-line method.

54 IRC Sections 514(a) and (c)(7).