

UNRELATED BUSINESS INCOME OVERVIEW



OVERVIEW

- Define Unrelated Business Income and why it matters
 - Understand the Internal Revenue Service regulations
 - How do we identify it?
 - Importance of documentation
- Exclusions to Unrelated Business Income
- Activities that may generate Unrelated Business Income
 - Focus on Research and Service Contracts

Loyola University's Tax-Exempt Status

- Loyola University Chicago (LUC) is a tax-exempt educational institution under Internal Revenue Section 501(c)(3) as a not-for-profit.
- LUC is exempt from federal income tax for purposes of engaging in activities that further our mission: education and research.
- However, LUC is NOT exempt from federal income tax on income from activities that are **substantially unrelated** to our mission.
- The IRS enacted the unrelated business income tax to eliminate unfair competition between tax-exempt and for profit organizations
- All tax exempt organizations including churches are subject to it, except government entities.

Unrelated Business Income (UBI)

- The IRS defines unrelated business income as *income from a trade or business, regularly carried on, that is not substantially related to the charitable, education, or other purpose that is the basis of the organization's exemption*
- For an activity to be considered UBI, it must meet these **three** requirements:
 1. It is a trade or business
 2. It is regularly carried on, and
 3. It is NOT substantially related to furthering the exempt purpose of the organization
- If LUC generates net income from UBI activities, then that income is subject to **unrelated business income tax (UBIT)**, and the activity will be reportable on LUC's income tax return (Form 990-T)
- Failure to report these activities on LUC's tax return may lead to penalties and interest imposed by the IRS
- There are some exclusions and exceptions to the definition of unrelated business income

Unrelated Business Income (UBI) Criteria Review

1. Substantially unrelated to exempt purpose

- a. In order for an activity to be related, there must be a relationship between the activity that generates the revenue and LUC's exempt purpose (i.e. the activity must contribute to the accomplishment of LUC's exempt purpose)
- b. Indicating that the net income is to support student scholarships or to support departmental activities is not a supported cause. The IRS does not care what the use of those funds will be, they are concerned with how we generate them.

2. Trade or Business

- a. The intent of the activity is to generate a profit.

3. Regularly Carried on

- a. The IRS considers the frequency and continuity of the activity and the manner in which it is pursued to determine if it is regularly carried on.
 - i. Year round activities are considered regular even if conducted only one day a week
 - ii. Seasonal activities may be regularly carried on even though they are conducted for a short period during the year

Unrelated Business Income (UBI)

- University departments are increasingly looking for new opportunities to increase and bring in new revenues
- If the revenues of these new ventures are not related to our mission, they must be reviewed by the Tax Department for UBI determination
- The Health Sciences Campus works closely with the Loyola University Medical Center (LUMC), which is a separate tax entity. It should be noted that the hospital's mission, is not the same as LUC's.
 - It's important to make this distinction because what the hospital's doctors and staff may consider to be an activity that is in furtherance of LUMC's mission, it may not be for LUC.

What are the exclusions to UBI?

- The IRS considers the following revenue streams exclusions to UBI:
 - Passive income such as dividends, interest, and royalties where no active business participation and management is involved
 - Income produced from sales made primarily for the convenience of the organization's members, students, and employees – Note: The IRS contends that making sales "more convenient" for LUC students or employees rather than purchasing from a taxable entity does not fall within the scope of the exception
 - Rental income from real property so long as the property is not debt financed and NO services are rendered in connection with the rentals

Research Exclusions

- Income from certain research grants or contracts MAY be exempt from unrelated business income dependent on the type of research.
 - The following types of research are exempt:
 - i. Research performed for any level of government
 - ii. Research performed primarily for purposes of carrying on “fundamental” research, the results of which are freely made to the general public
- The regulations further limit these exclusions by providing that research incidental to commercial or industrial operations is NOT excluded.
- Testing and inspection of products or materials is not exempt.

Common revenue generating activities considered UBI

- Advertising – Most commonly sponsorships that provide an advertising benefit
- Conference, Meeting, and Catering activities to the public
- Fitness Center Memberships to the public
- Service contracts where the service LUC is providing is not related to our educational mission
- Sales of items (tangible/nontangible) not related to our educational mission
- Other less common activities: Exclusivity contracts, restaurant operations, partnerships, alumni organized vacations

* The listing above is not all inclusive, but intended to give you common examples

UBI that can arise from Service Contracts

- What is a service contract? An agreement between two persons or businesses where one agrees to provide a specified service to the other.
- For each service contract that the University enters into, the following should be answered in *advance* of the agreement being signed when possible:
 1. Does the activity have a significant relationship to LUC's educational mission?
 2. Who is benefitting from this service? The LUC Community (students, faculty staff) or an external organization?
 3. How often will this activity occur?
 4. Is the intent to make a profit either now or in the future?
 5. Who is providing the service? Any student participation?

UBI Recap

Why do LUC departments need to be aware of UBI revenue streams?

- The Net income of these activities must be reported on the fiscal year Form 990-T tax return
- Any activities that generate a net income, will be subject to an unrelated business income tax for federal tax purposes of 21% and a State income tax of 9.5%, combined rate of 30.5%. (Income Tax Rates as of 2019)
- Example: ABC Department has unrelated business income of \$5,000 after all expenses and revenues for the activity have been summarized. The \$5,000 UBI will be reported on Form 990-T and the department will be charged with an income tax expense of \$1,525. The adjusted net income after taxes will now be \$3,475.
- In addition to tracking the revenue streams, any expenses directly attributed to these activities must be tracked and documented. Some of these expense allocations maybe be partial wages of a faculty or staff member, or other non-salary expenses. The responsibility of tracking these expenses is on the department that provides the service.
- Documentation is key in order to support the determination that a revenue activity will be unrelated business income or not.

IRS Revenue Ruling on University Research

IRS rules that Clinical Testing of Developmental Equipment is Taxable

Scenario: A university entered into a contract with a for-profit entity for the purpose of conducting research into blood smear testing. The commercial entity had developed an automatic blood-testing instrument and was interested in seeing it work and tested in a clinical setting. During a one-year period, the university conducted experiments using the instrument and compared its results with current methods of blood smear study. *It was not established that students were involved in the experiments.* The research results were available for publication.

The IRS determined that while the experiments conducted using the instrument were clearly related to the university's research purpose, the primary purpose of the research contract between the parties was the development and perfection of an instrument for marketing. Consequently, the Service held that income derived from the research was subject to the UBIT. (IRS Letter Ruling 7902019)

IRS Revenue Ruling on University Testing

IRS rules Drug testing conducted by students is exempt

Scenario: A medical college undertook studies for five pharmaceutical manufacturers to explore the effects of certain drug products on the diagnosis and treatment of various human afflictions. In all five studies, the medical college was responsible for the design and management of the studies including data collection and analysis. The studies were conducted by the professors, technicians, and graduate students of the college. The results of the studies were subsequently published in scholarly journals and used in the instruction of graduate students.

The IRS determined that the studies were not merely quality control programs but were central to the college's "basic purposes of promoting and teaching medical science". Consequently, the studies did not constitute unrelated business activities. (IRS Letter Ruling 7936006).

IRS Revenue Ruling on University Testing

IRS rules Production testing conducted by students is exempt

Scenario: A state university offered use of its radiation and nuclear science laboratories to pharmaceutical companies and other commercial entities to generate income for research. Experimental construction and production testing were conducted for the companies within the laboratories. Undergraduate and graduate students either actively participated in the experiments contracted for by the industries or were brought in as observers to review the results of each new project cycle. Moreover, the projects generated numerous publications, presentations, and a series of seminars. Fifty-six undergraduates and postgraduate degrees were also a direct result of the major service projects.

The IRS held that this contribution to the university's educational purpose was more than incidental and therefore, the income generated from these service contracts was not unrelated business income. (IRS Letter Ruling 8445007).

FOR QUESTIONS ON UNRELATED BUSINESS INCOME,
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