

UNRELATED BUSINESS INCOME TAX RULES: APPLICATION TO MEMBERSHIP AND USER FEES CHARGED BY AUXILIARY ORGANIZATIONS

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For over two decades the Auxiliary Organizations Association (AOA)¹ has commissioned and published professional papers for its members on timely governance and management subjects.

AOA continues the series with this monograph: to inform and guide auxiliary managers in structuring user and membership fee services to comply with applicable unrelated business income tax regulations and reporting requirements.

The analysis, conclusions and techniques in this monograph are those of the author, not AOA or its member organizations. This paper is not meant to, and should not be construed as, legal, accounting or other compliance advice. While the questions raised and discussed follow similar patterns, most issues are fact and circumstance sensitive, and should, therefore, be addressed and resolved by each organization in consultation with appropriate advisors. AOA will endeavor to keep this monograph up-to-date.

Auxiliaries, as tax-exempt organizations, often engage in a wide range of income-producing activities. The changing nature and scope of such services can lead to complex operating and tax compliance problems. Indeed, the distinction between educational exempt activity and commercial transactions is one of the most troublesome arenas in exempt organization policy and law. So, lets try to sort out these issues.

I. Background

An important starting point is an overview of the corporate, tax and charitable entity status of all auxiliary organizations. This will provide an appreciation of the public policy rationale behind the unrelated business income tax rules. As will be seen, it is essentially California law that pertains to how nonprofit organizations are structured, and mostly a federal framework that controls tax exemption issues.² Both state and federal laws weigh in on charitable entities, although with distinct objectives.

¹ The AOA, a California public benefit nonprofit corporation, is organized to develop and foster sound relationships between members and with their customers and clients; and to provide governance and management development programs, services and publications. AOA members are auxiliary organizations serving campuses within the California State University. The AOA is *not* an auxiliary organization.

² The California Revenue & Taxation Code includes parallel exempt business income rules. See footnote 4.

Corporate Status

Every auxiliary organization operating on a *CSU* campus or for the system has been formed as a separate legal entity under California corporation law, and each is authorized to function under the *Education Code* and *CSU* regulations and campus policies. They are not campus departments, although they have a relationship with the institution under law, regulations, policies, and by agreement(s), with oversight exercised by the Chancellor and campus presidents.

The auxiliary organizations within the *CSU* are all incorporated *nonprofit public benefit corporations* under the California Nonprofit Corporation Law.³ To incorporate, the auxiliary organization files a charter with the Secretary of State known in California as articles of incorporation. The Articles recite the general governance features of the entity, and the intent to organize for a nonprofit, public benefit purpose.

Such corporations are formed exclusively for charitable or public purposes and assets must be irrevocably dedicated to these purposes. If dissolved, they must distribute their assets to a similar entity.

Tax Status

Auxiliary organizations also have a common structural footing as tax-exempt organizations. Just as many nonprofit organizations benefit from incorporation, auxiliary organizations benefit from the tax advantages of exempt status under California and federal law.

At present every auxiliary organization qualifies and maintains a tax-exempt status -- organized and operated for exempt purposes.⁴ These entities are generally exempt from tax on the income and gifts they receive, and are able to offer their donors charitable tax deductions for their contributions. To maintain this status, auxiliary organizations must adhere closely to tax agency regulations, including periodic reports much like tax returns. Activity unrelated to the exempt purpose of the entity often requires special annual reports and can result in a liability for unrelated business income tax, and in cases where the unrelated activity is extensive, loss of tax-exempt status.

Charitable Organization Status

California law asserts considerable oversight of fundraising (soliciting) and use of gifted assets. The Attorney General runs the Registry of Charitable Trusts, and has authority over all nonprofit public benefit corporations engaged in seeking and using donated assets. Even though only certain auxiliary organizations are authorized to perform fundraising functions, under California law, all auxiliary organizations are technically “charitable organizations” by virtue of their status as nonprofit, public benefit organizations when they seek, obtain and expend gift assets. The *Nonprofit Integrity Act of 2004*⁵ set in place a number of operational

³ *Ibid* at §§5100-6910. General provisions and definitions that apply to all California nonprofit corporations appear in §§5000-5080.

⁴ *U.S. Internal Revenue Code* (IRC) §501(c)(3) and *California Revenue & Taxation Code* §23701d.

⁵ *California Government Code* §§12580-12599.7 and *Business and Professions Code* §17510.5.

requirements and financial standards, many of which extend to auxiliary organizations.

The federal standards applied to charitable organizations deal principally with donations and the tax consequences over such transactions.

II. Unrelated Business Activities

Introduction

At least in the initial analysis of *business activity* relatedness, auxiliary organizations benefit in a way from the fact that they can only perform functions⁶ authorized by the Trustees.⁷ The authorized Title 5 functions represent a kind of rough de facto test of relatedness under the law of tax-exempt organizations that circumscribes, then taxes some of the net income from unrelated trade or business activities. However, many of authorized functions are described in brief and/or broad terms, keeping open the issue of relatedness of certain activities incident to transactions carried on within those stated functions. The IRS and the courts have adopted specific rules covering many of these transactions.

UBIT Public Policy Rationale

The unrelated business rules at the federal level primarily seek to eliminate unfair competition by nonprofits with the for-profit sector by equalizing the tax treatment for nonprofit unrelated business with that of for-profits.⁸

Generally, unrelated business activity must be limited to less than a substantial portion of an exempt organization's total activities. Entities keeping within this constraint typically satisfy the *primary purpose test* requisite to continued tax-exempt status. If that test is not met, the IRS could deny or revoke exempt status. The "rule-of-thumb" threshold seems to be 20-30% of annual income, although the IRS steers more toward words rather than numbers.⁹ Remember: most net income from unrelated business activity must be reported¹⁰, and some of that income may be taxed at the corporate rate.

The taxation of the unrelated business activity of exempt organizations has long been viewed as being a more effective enforcement tool than denial or revocation of exempt status. Two concepts are at work: first, activities of the entity that are unrelated to its exempt purposes are segregated from related business activities, and the net income from unrelated business activities is taxed on a par with such net income earned by for-profit businesses.

⁶ The terms *function*, *activity* and *business transaction* are not synonymous. This paper makes the following distinctions: a *function* typically involves two or more major *activities*; an *activity* entails related tasks required to perform a service; and a *transaction* typically means an exchange of consideration for a service.

⁷ *California Code of Regulations*, Title 5, §42500(a)(1-12).

⁸ Other rationales have more recently been offered: producing revenue and reaching tax system equity.

⁹ E.g., IRS General Counsel Memorandum 39108 denied exempt status where the entity derived over ½ of its annual income from unrelated business. Measures of substantiality are commonly expressed in terms of percentages of expenditures or time, but it is a "fact-and-circumstances inquiry."

¹⁰ UBTI is reported on the IRS Form 990-T; for California, on FTB Form 109.

Unrelated business income (UBI) rules have broad application, and clearly include exempt organizations (with few exceptions)¹¹ as well as public institutions higher education (including entities owned or operated by them).¹²

There are three factors that typically subject an exempt entity's gross income to the computation of tax on unrelated business income. All three factors must be present:

- the income is from a *trade or business*; and
- the business is *regularly carried on*; and
- the conduct of the business is not *substantially related* to the performance by the entity of its exempt function(s).

Thus, for example, if an informed analysis concludes that the conduct of a regularly carried on trade or business at issue is substantially related to the performance of the organization's exempt function(s), income therefrom is exempt from UBI reporting and potential liability.

Certain types of business activity income and activities (identified and discussed below) are statutorily excluded or subject to certain modifications from UBI rules.

Definitions and Tests Behind the 3-Factors Test Terms

A considerable body of law, regulations and rulings has evolved over the three factors triggering the UBI rules. A summary of analysis of the definitions and tests behind these terms is necessarily focused on transactions involving service-user and membership fees charged by auxiliary organizations.

Trade or Business. "Any activity which is carried on for the production of income from the sale of goods or the performance of services" constitutes a *trade or business* under the UBI statutory authority.¹³ The term has an even broader definition under federal income tax law as applied to business expense deductions. Some courts have ruled that for an exempt entity to be engaged in a trade or business, it must be so engaged over an extended period.

Sometimes unrelated business activity fails to turn a profit. The "profit motive" test is itself a curious, often illusory factor in judging business activity.¹⁴

¹¹ IRC §511(a)(2)(A).

¹² IRC §511(a)(2)(B). "Governmental entities are generally excluded, but colleges and universities that are agencies or instrumentalities of a government or political subdivision of a government, or that are owned or operated by a government or such political subdivision or by any agency or instrumentality of one or more governments or political subdivisions of them (including any corporation wholly owned by one or more of these colleges or universities" .. are subject to UBI rules. See: Hopkins, *The Law of Tax-Exempt Organizations*, 9th Ed., at page 723.

¹³ IRC §513(c).

¹⁴ Is there a business plan, marketing to expand service, competitive pricing? Frequent profits, or years of losses?

The courts have influenced how this factor is applied through the requirement in many UBI cases that the exempt entity trade or business have a profit motive.¹⁵ The IRS has also applied the *profit motive* test.¹⁶

Competition (fair or unfair, present or absent) is not a statutory or regulatory test for determining whether an activity is a *trade or business*. However, where there is a competition factor, courts can find an unrelated business based upon its commercial nature. The IRS now applies the *commerciality doctrine* to evaluate UBI situations, and in judging exempt status applications.

Fees charged by exempt entities for services related to their exempt purpose generate *exempt function revenue* without impact on their tax status.¹⁷ Multiple business activity net income gains and losses can typically be off-set to determine taxable income. The IRS does scrutinize service fees if the basis and/or rates appear to distract or inhibit the exempt nature of the activity offered.

Under the *fragmentation rule*, clustered business activities are unbundled and separately analyzed under UBI rules. An “activity does not lose identity as trade or business merely because it is carried on within a larger aggregate of similar activities or with a larger complex of other endeavors which may, or may not, be related to the exempt purpose of the organization.”¹⁸ This rule has particular relevance to business activity where the nature of the client or customer does not have a particular connection or relationship to the exempt entity. See further discussion below.

Regularly Carried On. When analyzing this factor, attention focuses principally upon the frequency and continuity of the income-generating activities, and how they are undertaken. To be *regularly carried on*, specific business activity of an exempt entity would be judged as comparable to that conducted on a for-profit basis, including business cycles of the similar for-profit sector.

The issue of “preparatory time” has met with some controversy and inconsistent results. The IRS position is typically that the time put into preparing for a business undertaking is a factor in judging whether an activity is *regularly carried on*, even where the activity itself is brief within a business cycle. Court rulings seem to discount “preparatory time” because tax regulations are silent on this factor. But the IRS disagrees with these holdings and continues to take a contrary view adverse to tax-exempt organizations.¹⁹

Substantially Related. The test is not that the organization needs or uses the transaction proceeds for its exempt purpose, but rather whether the business activity’s transaction is substantially related to the exempt purpose of the entity.

¹⁵ “The primary purpose for engaging in the activity must be for income or profit.” See Hopkins, *The Tax Law of Tax-Exempt Organizations*, 9th Ed., at pp. 725-6.

¹⁶ IRS Technical Advisory Memorandum 9719002.

¹⁷ Universities and like institutions generate exempt function revenue. See: IRC §170(b)(1)(A)(ii); Treas. Reg. §1.170A-9(e)(1)(ii).

¹⁸ IRC §513(c); Reg. §1.513-1(b).

¹⁹ See Hopkins, *supra*, at page 738.

As a general proposition, where the business transaction has a substantial causal relationship to the achievement of an exempt purpose (other than securing an income stream), this factor is met.

A “size and extent” test is often applied to judge whether an activity adds importantly to the accomplishment of an exempt purpose. Is there a match between the size and extent of activity (customer/client base) in relation to the nature and extent of exempt function supposedly to be served?

In cases involving exempt entity facilities, the “dual use rule” can come into play in circumstances where the facility is also utilized for nonexempt purposes.

Exempt use (related business) does not *per se* protect gross income from nonexempt uses from the UBI rules.²⁰

UBI can also result under the *exploitation rule*: an exempt service generates commercial prospects.²¹

III. Exempted Income and Activities

Excluded Income

It must be recalled that the public policy behind the UBI rules attempt to level the competitive-effects between tax-exempt entities and the for-profit sector. But certain income generated by tax-exempt organizations derives from activities that do not pose competition issues. So, there are so-called “modification rules” to the computation of gross income derived from an unrelated trade or business. These rules exempt passive income such as dividends, interest, royalties, and certain rents from UBI taxation. Although these “modification rules are outside the scope of this paper, they can sometimes come into play if the exempt organization is attempting to circumvent the UBI rules by mischaracterizing the business activity income as “rent.” See Appendix A, Travel Services case example.

Excluded Activities

The law considers certain convenience businesses to be exempted activities from UBI taxation. Certain auxiliary organization user/membership fee transactions may fall within this somewhat nebulous exemption. In general terms, the exemption holds if “...the business is primarily for the convenience of its “members, students, patients, officers, or employees.”²² In following the evolution of this exemption through the courts, and as viewed by the IRS, it is apparent that there is often a divergence of application. In one case, the court held that the class of “members” referred to “any group of persons who are closely associated

²⁰ The fee income from general public use of campus facilities primarily for students, faculty and staff for education and health/recreation purposes, is likely subject to UBI. IRS Technical Advisory Memorandum 9645004 (dual use of campus golf course).

²¹ IRS Private Letter Ruling 7823062. Access to a university athletic facility by students obtained by a general student fee. Outside use may trigger the exploitation rule. If separate use charges are applied on students, faculty, and outsiders, any UBI derives from the dual-use rule.

²² IRC §513(a)(2); see also Rev. Rul. 81-19, 1981-1 C.B. 354; Rev. Rul. 69-268, 1969-1 C.B. 160; Rev. Rul. 55-676, 1955-2 C.B. 266. Cf. *Carle Foundation v. United States*, 611 F.2d. 1192 (7th Cir. 1979), cert. Den., 449 U.S. 824 (1980).

with the entity involved and who are necessary to the achievement of the organization's purpose."²³ The IRS has held to more narrow views.²⁴ However, the Service has ruled that the exemption was available to a group of another, albeit related, entity.²⁵

In a strict sense, the *convenience business doctrine* extends only to those who have the requisite relationship directly with the exempt organization.

IV. UBI Rules and Auxiliary Organization Activities

Several of the rather broad Title 5 auxiliary organization functions can entail specifically, or by extension, income-generating services to students, faculty, campus staff, and in some cases, relatives, alumni, and the general public. Such services usually involve a service charge (fee).²⁶

- Student Body Organization Programs
- Bookstores, Food Services, and Campus Services
- Housing
- Student Union Programs
- Supplementary Health Services
- Instructionally-related Programs
- Alumni Programs

Within these broad functions, a range of business activities and related transactions can emerge. These are all worthy of analysis for UBI implications. For example:

- Recreation Centers (involving a variety of internal facilities and programs offered to on- and off-campus users)
- Child Care Centers (that may or may not have an instructional element)
- Sports and Event Facilities (direct events and licensing to 3d parties for events/meetings)
- Banking and Credit Unions
- Testing Services
- Student Union facilities rented for meetings/conferences to off-campus users
- Travel Services
- Reprographic Services
- Repair Services (computers, bikes, autos)

Such service activities can be strictly commercial²⁷ in nature, or may be designed more as educational support programs -- or serve a combination of both. Under

²³ *St. Luke's Hospital of Kansas City v. United States*, 494 F. Supp. 85, 92 (W.D. Mo. 1980).

²⁴ Rev. Rul. 85-109, 1985-2 C.B. 165,166; and Tech. Adv. Mem. 9645004.

²⁵ Priv. Ltr. Rul. 9535023 (non-precedent).

²⁶ See California Code of Regulations, Title 5, §42500(a).

²⁷ Ed. Code §89905 requires auxiliary commercial services to be self-supporting.

UBI rules, many of these services can be properly designated as *business activities*.

Special Treatment of Auxiliary Organizations Providing Child Care?

IRC § 501(k) expanded the statutory definition of “educational” purposes for Section 501(c)(3) child care organizations to include the “providing care of children away from their homes if – (1) substantially all of the care provided by the organization is for purposes of enabling individuals [their parents] to be gainfully employed, and (2) the services provided by the organization are available to the general public.”²⁸ Congress enacted this because of harsh IRS legal opinion²⁹ that day care referrals and assistance information to the general public is a commercial activity, not a charitable or educational activity. This opinion modified an earlier view that these activities were not unrelated business when engaged in by an exempt organization the primary purpose of which was the operation of child care centers. This earlier opinion also held that specialized child care assistance to employers in the organization’s locale is not a *tax-exempt* activity.³⁰

It is the IRS view that a child-care facility will not qualify under IRC § 501(k) if it provides enrollment preference for the children of employees of a specific employer(s).³¹ The 501(k) definition was not intended to affect or expand the meaning of the statutory terms educational or charitable, except when considering child care organizations as having an *educational* purpose.

Auxiliary organizations engaged in child care operations are not likely the child care organizations contemplated under Section 501(k), since a) they are not organized “for the primary purpose of operating such services, and b) most campus child care centers operate on a “service preference” basis.

IRC § 501(k) cannot be relied upon to support a UBI exemption determination by an auxiliary organization engaged in child-care services unless it can qualify as a child care organization under that statute.

Planning and Documenting “Substantial Relationships”

Prudent planning for auxiliary services should include an appropriate feasibility and business plan approved by the university that clearly documents how the following factors directly relate: 1) the institution and auxiliary mission(s) (exempt purposes); 2) the service (business activity) and the auxiliary purpose(s); 3) the customers/client connection to 1 and 3; and the business activity to one or more

²⁸ The reference to the words *general public* means that the IRC §501(k) organization cannot be racially discriminatory, unless it is also classified under IRC §170(b)(1)(A)(ii). See IRS Gen. Couns. Memo 39757.

²⁹ IRS Gen. Couns. Mem. 39872.

³⁰ IRS Gen. Couns. Mem. 39622. The IRS rationale for this narrow view was that the employers gained a substantial benefit the operation of their qualified dependent care assistance programs. *Specialized child care assistance plans* are operated under IRC § 129, which provides that gross income of an employee does not include amounts paid or incurred by the employer for eligible dependent care assistance.

³¹ IRS Gen. Couns. Mem. 39613.

of the Title 5 auxiliary organizations functions, identified in the operating agreement and support service lease.³²

Appendix A describes a series of **Hypothetical Cases** involving campus auxiliary organizations engaged in fee-based business activity services that raise and analyze typical facts and circumstances that relate to the application of UBI rules.

The **Critical Factors Checklist** in Appendix B is a practical tool to identify and analyze organization business activity transactions in relation to UBI rules. Conclusions reached from the use of this tool over significant business activity should be shared with legal counsel and accounting/audit advisors for closure.

V. Tax Structure, Computations & Reporting: An Overview

Tax Structure and Deduction Rules

Most tax-exempt entities pay at the following corporate rates for unrelated business income tax due:

<u>Taxable Income</u>	<u>Rate (%)</u>
\$50,000 or less	15
\$50,000-\$75,000	25
Over \$75,000	34

An additional 5% surtax is applied on taxable unrelated income between \$100,000 and \$335,000 – resulting in a marginal 39% tax rate for that range.

UBTI (unrelated business tax income) is the total gross income derived from an *unrelated trade or business*, regularly carried on by the reporting entity, less allowable business deductions (directly connected thereto). UBTI computations include certain modifications to both the gross income and business deduction figures where the organization conducts two or more unrelated business activities: aggregate gross income from all unrelated activities, less the aggregate of allowable deductions from all unrelated activities.³³ Loss incurred from an unrelated business may be offset against any net gain from another unrelated activity as long as the loss activity had a profit motive.

Allowable and adequately substantiated UBTI deduction items (such as expenses, depreciation, etc.) must have both a proximate and primary relationship to the nonexempt business activity. Organizations engaged in more than a single unrelated business activity should *aggregate* income and deductions from all such activity. Related losses may be offset against net gain from other unrelated activity (assuming the loss activity has a profit objective).

³² See Monograph Appendix D, “SCORE Organization Planning Guide” online resource for strategic, feasibility and business planning techniques.

³³ Treas. Regs. § 1.512(a)-1(a).

A \$1,000 deduction is specifically allowed, but should not be taken in calculating a net operating loss.³⁴ An amount of gross UBTI in excess of that amount requires filing a Form 990T. Carryover of a net operating loss is allowable as a deduction, with the carryover limited to or from years during which the organization was subject to UBIT.³⁵

Where business activities of an organization are related to both exempt and unrelated business purposes, overhead and labor costs should be allocated between the two based upon a reasonable and documented allocation method.

Typical key factors and treatment considerations in computing UBTI liability are listed in Appendix C.

Reporting Requirements

Tax-exempt entities are required to make quarterly estimated payments of the tax on unrelated business income, using corporate income tax rules.³⁶ Revenue and expenses for unrelated business activity are reported to the IRS using Form 990-T. California reports are filed with the Franchise Tax Board on Form FTB-109.

VI. Resources and References

Appendix D lists resources and references to aid in understanding and applying UBI rules and reporting requirements.

VII. Conclusion

For auxiliary organization managers the complexity of federal tax law can seem daunting. Its' language is detailed, always changing, and frequently enforced with considerable consequences. However, the perceived mystery and fear surrounding UBIT is unfounded. Resolving unrelated business tax issues just requires: 1) an objective awareness of the specific facts and circumstances surrounding the activity and attendant transactions; 2) access to a reliable analytical tool; and 3) professional advice in narrow situations.

The focus of this paper has been narrow: auxiliary organization membership and user fees that may pose UBIT reporting/liability potential. It is not an exhaustive analysis or even a general survey of the broader UBIT arena, and must not be relied upon as compliance advice, legal or otherwise. It should, however, help spot relevant facts and circumstances, provide useful tools, examples and references for analysis, and trigger further consultation when required.

It is hoped that this limited objective has been met.

³⁴ IRC §512(b)(12).

³⁵ *Ibid* §512(b)(6)

³⁶ The IRS Form 990-W is used for making quarterly reports. See Appendix D.

AUXILIARY BUSINESS ACTIVITY

HYPOTHETICAL CASES

Child Care Center Cases:

Situation A

Facts & Circumstances – University A includes an academic/research unit having an authorized collaborative relationship with the American Red Cross (ARC), a tax-exempt organization. The ARC built and operates a campus facility through a ground lease with the University's Foundation (an auxiliary organization). The Foundation has operating authority from the University to sublease campus property for educational and research purposes.

ARC employees are eligible for many campus services available to University students, faculty and staff, including child care services operated the Associated Students, Inc. (ASI), an auxiliary organization. The Articles of Incorporation and Bylaws of the ASI provide for educational support services as a purpose of the organization. The ASI and the University have entered into an Operating Agreement and Support Service Lease that authorizes the ASI to operate the Child Care Center as a "Campus Program" under Title 5. The ASI charges a user fee to ARC employees who enroll their children in the Child Care Center.

Issue – Is the income derived from ARC employee child-care user fees the result of *unrelated business activity*, and therefore subject to UBI reporting requirements?

Analysis – The Child Care Center -- operated by the ASI as an authorized Title 5 auxiliary organization function – and engaged in services to ARC employees, appears on the surface to meet the 3-factor UBI rule test: a *business activity* that is *regularly carried on* for those not substantially related to the ASI purposes.

The extension of ASI child-care services to ARC employees might be viewed as falling within the statutory *convenience business exception* if the University and the ARC have established a formal collaborative relationship that includes the operation of an ARC facility on the campus, and there is a clear and convincing educational relationship between the University and the ARC.

Conclusion – The ARC employee child-care user fees could be determined as exempt from UBI rules. See IRS Private Letter Ruling 9535023 (non-precedent).

[Note: The Child Care Center is not an IRC § 501(k) child-care organization, and this statutory category should not be relied upon for a UBIT exemption. See Monograph discussion at page 7. The extension of campus facility services for fees charged to the general public would undoubtedly trigger the "dual use" rule and likely UBI reporting requirements on a portion of the transactions allocated as *unrelated business activity*. See monograph discussion.]

Situation B

Facts & Circumstances – The student body organization (an auxiliary organization) at University B operates a campus child-care service on a fee basis for the students, faculty and staff parents. University policy, the operating agreement and support service lease, and the student body organization charter and board policy are generally aligned to authorize such support services.

APPENDIX A

However, this same campus facility also provides parents in the community with child-care at a below-market fee rate under a program utilizing University student-interns receiving credit in child development course credit.

Issues – To what extent are the child-care services to community parents subject to UBIT as *unrelated business activity*? How should the UBTI be calculated and reported?

Analysis – There appear to be two plausible arguments that services provided community parents may not be *unrelated business activity*: such services are not a trade or business using the *profit motive test*; and that these services are sufficiently related to and support the University's educational mission by providing instructional training circumstances for students enrolled in child development coursework.

In support of these positions, the auxiliary organization should be prepared, on a current, documented basis, to have:

- 1) analyzed its community parent-fee rate against the prevailing market rate, and its *fragmented* income and expenses, to arrive at the internal determination that this portion of its services does not meet UBTI definition of a trade or business; and
- 2) traced through how the community children served by the center afford the student-interns learning experiences not otherwise obtained from children of University students, faculty or staff.

Conclusion – If the auxiliary organization can reasonably establish that the child-care services provided community parents fails the *trade or business* test or meets the *related* test, there would be no *unrelated business activity* to report. Otherwise, there should be a fragmentation of this activity from the campus services, coupled with a consolidated analysis of any other UBI activity across the organization, in preparing the IRS Form 990T. See Appendix C.

Recreation Center Cases:

Situation A

Facts & Circumstances – University A has an extensive Recreation Center (RC) on the campus operated by the Student Union (SU), an auxiliary organization. SU Articles of Incorporation, Bylaws and an Operating Agreement and Support Service Lease authorize the organization to manage the RC facility for the benefit of “students, faculty, staff and invited guests.” SU Board policy permits membership to alumni, student parents, immediate relatives of faculty/staff, and retired faculty/staff (as invited guests) for limited access to RC facilities.

RC written management practices set membership fees, including those for invited guest membership.

Issue – Is the income derived from invited guest membership fees the result of *unrelated business activity*, and therefore subject to UBI reporting requirements?

Analysis – RC facilities operated by the SU is a properly authorized Title 5 auxiliary organization function (“Student Union Programs”) and with the organization’s purpose(s) reflected in its Articles of Incorporation and Bylaws. The Operating Agreement and Support Service Lease specifically include operation of the RC, and the extension of RC services to “invited guests.”

APPENDIX A

The SU governing board has adopted a policy that limits “invited guests” to only alumni, students, parents, faculty/staff immediate relatives, and retired faculty/staff. RC facility fees for students are paid through student body fees. There is an approved membership use fee schedule set by SU management consistent with board policy and budget requirements.

RC extended services to “invited guests: may meet the 3-factor UBI rule test. It appears the services represent a *business activity* that is *regularly carried on*, and while there is arguably a substantially close relationship, as expressed in policy, between the University/SU and the defined classification of “invited guests,” and therefore these “invited guest” memberships might be viewed as *substantially related* [*business activity*] transactions, the history of IRS determinations does not favor linking “invited guests” to *related business activity*.

The IRS has long considered alumni (and their spouses), parents of students, and retirees to be “strangers to the university” when it comes to linking them to otherwise *unrelated business activity*.

Conclusion – The “invited guest” RC membership fees would likely be determined as within UBI rules and reporting requirements. But see Private Letter Ruling 9732032 (non-precedent).

[Note: The extension of campus facility services for fees charged to the general public would undoubtedly trigger the *dual use* rule and likely UBI reporting requirements on a portion of the transactions allocated as *unrelated business activity*. See monograph discussion at page 6.]

Travel Services:

Situation – University Z has a campus travel agency (TA) operating out of facilities leased from the Foundation (an auxiliary organization). The travel services are offered primarily to students, faculty and staff, but nearby community members occasionally use the TA. TA is a private, for-profit company operating on the campus through an agreement with the Foundation. The University-Foundation Operating Agreement and Support Service Lease authorizes the TA relationship as Title 5 auxiliary organization function (“Campus Program”), and the University approved the TA-Foundation sublease and service agreement. The Foundation receives a percentage of TA gross income as rent for the subleased premises.

Issue – Does the Foundation have any UBI reporting requirements and/or liability for TA service charges paid by “general public” clients for TA travel services?

Analysis – The travel agency services to students, faculty and staff provided through the Foundation on an “out-source” basis appears properly authorized through its Articles of Incorporation, Title 5, and the appropriate service agreements and leases. The extension of TA services to the general public is not mentioned in any documents, but is a practice that has gone on without objection.

The rent received by the Foundation under the TA lease and service agreement is based on volume of services rendered. UBI rules generally exclude so-called “passive income,” including certain real property rent income.

However, under the “passive rent test” the exclusion for rent does not apply if the determination of the rental amount depends in whole or in part on the net income or profits derived from the property leased (other than an amount based upon on a fixed percentage or percentages of receipts or sales).

It appears that the “passive rent test” does apply to the TA lease (calculated on gross income), hence the rental income received by the Foundation is not subject to UBI reporting requirement.

APPENDIX A

The income derived by TA from general public clients is included in its corporate tax reporting.

Conclusion – The Foundation is probably not liable for any UBI tax from the TA rental income.

[Note: The informal extension of travel services by TA should be brought into compliance with Title 5, or the University and Foundation should develop a policy statement that reconciles this practice and reflects it in the TA sublease and service agreement.]

Sports & Event Facilities:

Situation A

Facts & Circumstances: University T, serving a major urban area, has several campus facilities for intercollegiate athletic/recreational sports events, and for conferencing and meetings. The Associated Students (AS) – an auxiliary organization – built and operates the facilities. The AS Articles of Incorporation and its operating agreement and related leases with the University contemplate these facilities/operations, designed primarily for University-related events and activities. Many of the events in these facilities are attended by the general public and typically an AS ticket or participation fee is paid, or “rent” the facilities for purposes unrelated to either the University or the AS.

Issue – Is the income derived by the AS from the use of these campus facilities by individuals, groups or entities not associated with the University or AS the result of *unrelated business activity*, and therefore subject to UBI reporting requirements?

Analysis – The AS operates the facilities consistent with Title 5 auxiliary organization functions (“Campus Programs”), and in accordance with its operating agreement and related leases. These operations comport with the AS exempt purposes set out in its Articles of Incorporation. The facility lease terms stipulate that the operations shall be primarily for the use of students, faculty and staff, and for University-hosted activities, but acknowledges that uses unrelated to the University/AS may be authorized consistent with the primary purpose.

The AS governing board prescribes facility use fee/charge rates.

Conclusions – “Rents” paid AS by unrelated facility users are not exempt from UBI rules since this income is from the right to use, rather than right to occupy real property – not within the “passive income” rule.

Ticket sales to persons unrelated to the University/AS for events/meetings in these facilities (other than transactions for third-party licensed events/meetings) would also be subject to inclusion in the reporting of unrelated business income.

[Note: These facilities would require application of the *dual use* methodology in calculating UBTI.]

Situation B

Facts & Circumstances – University S serves a large region of the state, but is located in a rural community with limited public or group meeting/conference facilities. The campus student union (owned by the CSU) is operated by a student body organization (recognized auxiliary organization) under an operating agreement and support service lease for the facility.

The operating agreement/lease identifies the functions limited by Title 5 for this type of auxiliary organization-operated facility, but does not specify whether or not off-campus organizations are

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permitted to license unused space for meeting or conferences on a priority, scheduled basis. The University has long been aware of this practice, and in many instances has actively sponsored or encouraged the student body organization to allow such uses. A student union facility-use policy has been adopted by the governing body that includes provisions permitting such off-campus use within specified criteria, including type of user, nature of program (relationship to University mission, etc.), availability (priority given to students, faculty or staff), internal costs, and the like. The policy also includes a user fee schedule.

Issue – To what extent is the student body organization engaged in *unrelated business activity* for permitting off-campus individuals, groups or organizations to use student union facilities for meetings/conferences?

Analysis – It is important that the auxiliary organization’s facility-use policy distinguish among potential off-campus users who:

- have an affiliation with, are sponsored by, or are otherwise related to an instructional or service-support program of the University;
- are public or community-support organizations within the area served by the University; or
- are otherwise engaged in business or personal purposes unrelated to the above.

The license (use) agreement with users should categorize the nature of the use in order to properly fragment the activity between *related* and *unrelated* purposes.

Depending on the extent of such off-campus users, and how the fee rates are structured against fragmented facility expenses, the auxiliary organization may have an argument that such use activity is not a trade or business under the UBIT rules. The IRS has considered so-called “lonely outpost” institutions in the context of merchandise sold on a campus, but the issue of services offered is more difficult to argue without clearer evidence that the community really has no other facilities to turn to.

Conclusion – The auxiliary organization should analyze, compute, and report UBI and resulting tax stemming from users “otherwise engaged in business or personal purposes” unrelated to the University’s educational or community support mission, where it is shown that the activity meets the “trade or business” definition. As with Situation A above, such user income is probably not within the “passive income” rule. Each facility-user transaction falling arguably within the relatedness category should have supporting documentation.

UBI TRANSACTION-ANALYSIS

CRITICAL FACTORS CHECKLIST

User/membership service fee transactions through an auxiliary organization can be analyzed for *unrelated business activity* (and potential UBI reporting requirements) using the following checklist. **Identify potential UBI transactions by answering the questions through the following factors-analysis test sets.** Conclusions should be demonstrated with contemporaneous evidence and brought to the attention of appropriate legal counsel and accounting/audit advisors for closure. Italicized terms are defined and discussed in the monograph.

Set 1 – Authorized Function Tests:

- Is the *transaction* an essential part of a *business activity*? If yes, continue with checklist. If no, the transaction is categorically excluded from UBI consideration [Typical example: payment of membership or user fee for services provided or to be provided.]
- Does the *business activity* fit within the organization’s purpose(s) statement expressed in the Articles of Incorporation and Bylaws? If yes, continue with test. If no, then the activity is an *unrelated business*, and it should be discontinued until the Articles are amended, or the activity brought within an alternative business structure.
- Does the *business activity* fit within one or more of the authorized auxiliary organization functions listed in Title 5, Section 42500(a)? If yes, continue. If no, then the activity is an *unrelated business*, and an improper activity for an auxiliary organization in good standing.
- Is the authorized function clearly identified in the operating agreement of the auxiliary organization? If yes or no, continue. If only no, either the *business activity* should cease, or the operating agreement amended to include the function.
- Has the university and/or organization adopted written policy with regard to whom (students, faculty, staff and relatives, alumni, general public) the service can be offered and a user/ membership fee charged? If yes, continue with checklist, and judge from the checklist-analysis whether the policy statement needs refinement. If no, continue, but carefully consider adopting such a policy, including written practices discerning the extent to which the organization ought to extend specific services to individuals with little or no direct relation to the institution – and why.

Set 2 – Trade or Business Tests:

- Is the *business activity* represented by the *transaction* engaged in with the intent to produce income (without regard to any resulting profit or loss)? If yes, continue. If not, the *business activity* is excluded from UBI consideration.
- Is there a *profit motive* present intended through such a *transaction*? If yes, this factor only aids in the analysis that the *trade or business* factor has been met, not whether the *business activity* is related or not. The absence of a *profit motive*, when coupled with the other tests in this checklist set, may establish that the *transaction* at issue is not a *trade or business*. Continue with checklist.
- Does the *business activity* – and particularly the *transaction* at issue – compete with a for-profit endeavor? Even if not, the total absence of such competition has little or no bearing on whether the *business activity* is related or unrelated, but may aid in the analysis that the *transaction* at issue does not constitute a *trade or business*. [Note: the *commerciality* of the activity is being employed not only to determine tax-exempt status, but more recently as a rationale that a *business activity* is unrelated.] Continue with checklist.
- Is the income received from *transaction* fees charged for the *business activity* used for the exempt purpose(s) of the organization? If yes, this fact aids the analysis that the *business activity* is related. [Note: rendering a service without charge is not a prerequisite to tax-exempt status.] Continue with checklist.
- Is the *transaction* at issue a distinct part of a cluster of *business activities* performed by the organization? If yes, and the 3-part factors are met over such *transactions*, the *fragmentation rule* should be applied to identify the UBI component(s) subject to reporting requirements. If not, this rule will not be applicable. Continue with checklist.

Set 3 – Business Regularly Carried On Test:

- Is the *trade or business* regularly carried on a basis (frequency and continuity) comparable to similar commercial endeavors by for-profits? If yes, continue. If not, the *trade or business* does not meet the three-factors required for application of UBI rules. [Note: factor in any preparatory time/effort that might be used in a *regularly carried on* test-analysis.]

Set 4 – Substantially Related Tests:

- By engaging in the *business or trade* through the *transaction* at issue, is the primary purpose of the organization substantially furthered? If yes with certainty, the *transaction* income is not subject to UBI rules. If not, then it is likely the income

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from this *transaction* is subject to UBI reporting requirements. If there is uncertainty, continue the tests and checklist, noting possible *unrelated business activity*. [Note: Whether transactions producing gross income contribute importantly to the accomplishment of an organization's exempt purpose is very case-specific. The mere fact that the *transaction* income is needed or used for the exempt purpose does not make a *transaction* a *related activity*.] Continue with checklist.

□ Is the *transaction* at issue in keeping with the scale and extent of the intended exempt-purpose *business activity*? If yes, be certain there is formal policy in place that states this fact – and explains that relationship. If not, the absence or uncertainty of that relationship should alert the organization to potential *unrelated business activity*. Continue with checklist.

□ Does the *transaction* at issue result from the *dual use* of organization facilities or assets? [Note: *related business activity* of a facility/asset will not mask the application of UBI rules for any *unrelated business activity*]. If no, this test is not applicable to the analysis. If yes, such *dual use* should be subject to further analysis to separate the *unrelated business transactions* (resulting income). See the checkpoint on the *fragmentation test* under the above **Trade or Business Set 2**.

Set 5 – Exempt Activities

- Even if the *transaction* at issue appears to be subject to the UBI reporting requirements as *unrelated business activity*, do any exceptions apply?
- Convenience Business Exemption. Is the service a *business activity* provided primarily as a convenience for individuals or an organization having a direct relationship or affiliation with the organization?
 - Volunteer-Conducted Business Exemption. Is the service a *business activity* in which substantially all of the work in providing the service is performed for the organization without compensation (volunteers)?
 - Donated Goods Exemption. [This exemption deals with *business activity* involving merchandise sales, substantially all of which has been donated to the organization. Its application to user/membership fee transaction is remote.]

* * *

Any transactions determined to constitute *unrelated business activity* should be calculated in accordance with UBI reporting requirements. See monograph discussion.

FACTORS IN COMPUTING UBIT LIABILITY

Gross Income and Profit

Total income derived from the business activity prior to subtracting *costs of goods sold* is *gross income*. *Gross profit* is *gross income* less *cost of goods sold* (but before any *deductions*).

Cost of Goods Sold

The *cost of goods sold* includes the inventory cost of the article sold plus delivery costs, warehousing costs, etc. The *cost of goods sold* is subtracted from the *gross income* to determine the *gross profit*.

Deductions

Deductions are subtracted from the *gross profit* to determine the *unrelated business taxable income*. The three types of *deductions* are:

- *direct expenses* (charged to the business activity accounts);
- *allocated direct expenses* (charged to other departmental accounts);
- *indirect expenses*.

Direct Expenses

Direct expenses fall into two categories:

- ***Deductible direct expenses charged to the business activity account***

These include ordinary and necessary business expenses such as:

- *salaries, wages, and applicable organization benefit rates*;
- *supplies and materials*;
- *subcontracts and outside services*;
- *external interest paid*;
- *facilities expense* (rental, utilities, maintenance, and custodial cost) paid by the business activity for the occupied space;
- *equipment lease or rental*;
- *other expenses* associated with the activity (e.g., travel, communications);

Caution: Federal unallowable expenses (i.e., not eligible for reimbursement from the federal government) are deductible for tax purposes if they are ordinary and necessary business expenses of the activity (although some of these expenses may otherwise be subject to limitations in the Internal Revenue Code). Some examples of costs that are unallowable for federal purposes but deductible for tax purposes are: entertainment; bad debt; advertising; public relations; alcoholic beverages; donations. Note, however, that if the product is paid for by a federal grant or contract, the rate charged to the federal award must recover only federal allowable costs.

- ***Deductible direct expenses charged to departmental accounts other than the business activity account***

These include ordinary and necessary business expenses that can be specifically identified with the business activity. These are the same types of expenses as listed above. The only difference is that the expenses were not recorded directly into the business activity accounts. [A tax advisor may help identify and allocate these costs, based on information that must be supplied to them.] Some of the typical expenses that fall into this category are:

- *salaries* of people within the department who work on the business activity, but are charged to accounts other than those of the business activity (e.g., receptionists who cover multiple areas, managers responsible for multiple areas, etc.). For these expenses, document percentage of time spent on the business activity;
- *supplies* used in the business activity, but charged to a central departmental account;
- *facilities expense* (utilities, maintenance, and custodial cost) paid by the department for the occupied space.

Note: If any expense benefits two or more activities in proportions that can be determined without undue effort or cost, the expenditure should be allocated to the activities based on the proportional benefit. If an expense benefits two or more activities in proportions that cannot be determined because of the interrelationship of the work involved, then the expense may be allocated to the benefited activities on a reasonable basis.

Overhead Costs

Deductible expenses also include a pro rata share of expenses incurred for common or joint objectives that cannot be identified readily or specifically with any particular business activity.

These are generally organization or departmental expenses that are indirectly related to the business activity. A few examples of these types of expenses are:

- *general organization administration* (CEO/manager costs, legal, etc.);
- *equipment depreciation*;
- *building depreciation*;
- *facilities expense* (utilities, maintenance, and custodial cost) paid by the organization.

**UNRELATED BUSINESS TAX INCOME
RESOURCES & REFERENCES:**

Online Resources –

Federal UBI Taxation

IRS, *ABCs for Exempt Organizations*:

<http://www.irs.gov/charities/article/0,,id=187787,00.html>

At www.StayExempt.org, the [web-based version](#) of the IRS Exempt Organization workshops, there is a site with a virtual workshop session, titled: *Unrelated Business Income – Does your organization generate taxable income?*

IRS, *Unrelated Business Income Tax Defined (and Explained)*:

<http://www.irs.gov/charities/charitable/article/0,,id=123293,00.html>

IRS Publication 557, *Tax Exempt Status for Your Organization*:

<http://www.irs.gov/pub/irs-pdf/p557.pdf>

IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*:

<http://www.irs.gov/pub/irs-pdf/p598.pdf>

IRS Form 990-T Instructions, *Exempt Organizations Business Income Tax Return*:

<http://www.irs.gov/pub/irs-pdf/i990t.pdf>

IRS Form 990-W Instructions, *Estimated UBIT Worksheet for Exempt Organizations*:

<http://www.irs.gov/pub/irs-pdf/f990w.pdf>

California UBI Taxation

FTB FAQs on Exempt Organization filing requirements:

<http://www.ftb.ca.gov/individuals/faq/beExempt.shtml>

FTB *Instructions for Form 109, Exempt Organization Business Income Tax Return*:

http://www.ftb.ca.gov/forms/07_forms/07_109bk.pdf

FTB Form 109, *Business Income Tax Return*:

http://www.ftb.ca.gov/forms/07_forms/07_109.pdf

Business Activity Planning

SCORE, *Planning Tools & Organization*:

http://www.score.org/pdf/SCORE_NonProfBizTools.pdf

CSU, Unrelated Business Income Tax Worksheet Guide:

http://www.calstate.edu/sfo/CodedMemos/coded_memos_2007/AD07-01.pdf

References –

Internal Revenue Code Sections

Section 511 – tax on *unrelated business income*
Section 512(a) – definition of *unrelated business taxable income*
Section 512(b) – modification (exclusion) rules
Section 513(c) – definition of *unrelated trade or business*

California Revenue & Taxation Code Sections

Section 23701d – definition of nonprofit, tax-exempt organizations
Section 23731 – tax on *unrelated business income*
Section 23732 – definition of *unrelated business taxable income*

Publications

Blazek, Jody, *Tax Planning and Compliance for Tax-Exempt Organizations*, 2d Edition, Wiley & Sons. See Chapter 21, pp. 427-466.

Harding, Bertand H., *The Tax Law of Colleges and Universities*, 2d Edition (w/ 2003 Supp.), Wiley & Sons, Inc.. See Chapters 2 and 3.

Hopkins, Bruce R., *The Law of Tax-Exempt Organizations*, 9th Edition, Wiley & Sons, Inc., 2007. See Chapter 24, Unrelated Business Activities, pp 720-837.

Phelan, Marilyn, E, *Representing Nonprofit Organizations*, Tax Practice Series, Chapter 2, Section 32, Commercial Activities, pp 2-32.20-110.