

# **“UBIT-TER Sweet”**

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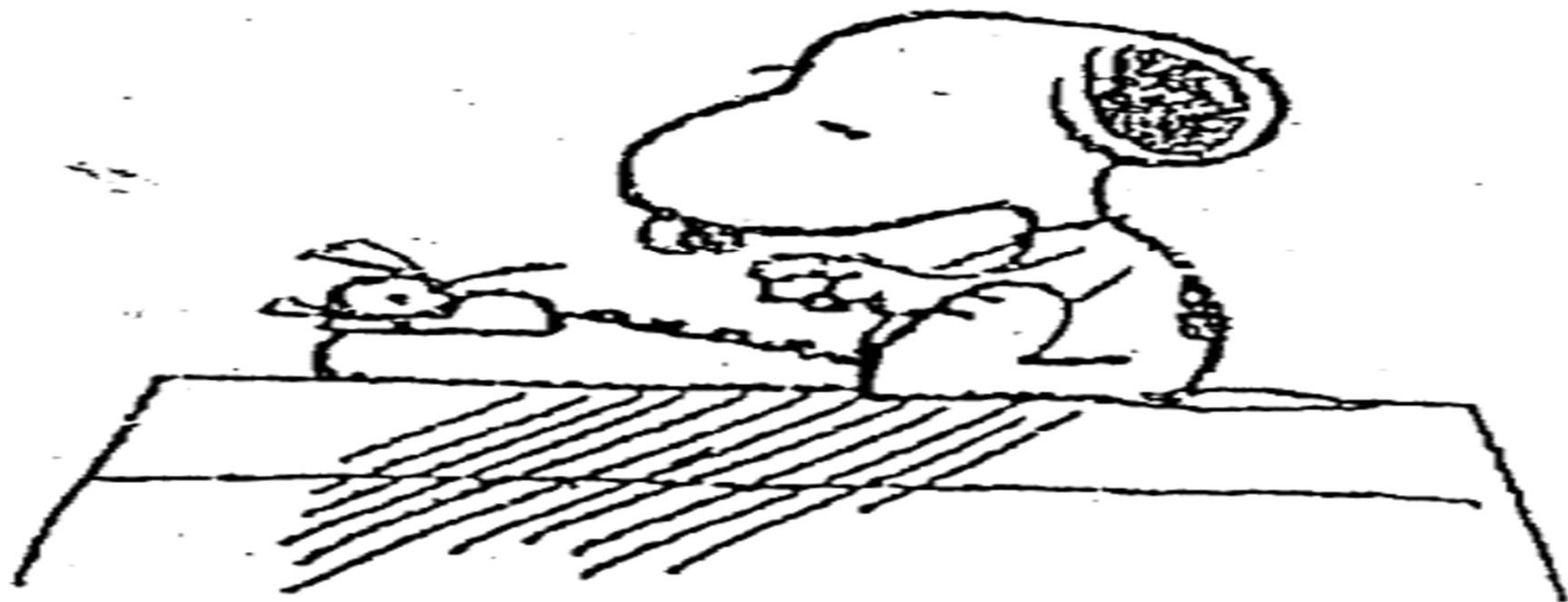
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# “UBIT-TER” Sweet - Outline

- UBIT
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    - Trade or Business
    - Regularly Carried On
    - Not Substantially Related
  - Exceptions
  - Exclusions
- College & University Compliance Project
  - Compliance Questionnaires
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    - Sponsorship Arrangements
    - Facility Rental
  - Mayo Decision
  - What to Expect

# Often asked Question?

“Isn’t the University exempt from tax?”

*“It depends.”*

# UBIT Background

- Destination of Income Rule
  - *Trinidad v. Sagrada Orden de Predicadores*, 263 US 578, T.D. 3548, III-1 C.B. 270 (1924).
- 1947 - New York University purchased a macaroni factory and dedicated the profits to NYU.
  - *C.F. Mueller Co. vs. Comm’r.* 14 T.C. 922 (May 25, 1950)
  - The business community cried foul and told Congress that tax-exempt organizations would soon own all major industries.

# UBIT Background, continued

- Congress repealed the Destination of Income Rule in the Revenue Act of 1950.
- Beginning January 1, 1951 most tax exempt organizations, including private colleges and universities, were now subject to tax on unrelated business activities.
- Private colleges cried foul too, however, and in the Revenue Act of 1951 state colleges and universities became subject to this tax.
  - currently IRC Section 511(a)(2)(B)

# General UBIT Rule

Unrelated Business Income Tax (“UBIT”) is imposed on:

- A trade or business
- Regularly carried on
- Not substantially related

## Planning Point

- With a for-profit entity all revenue is presumed taxable.
- Whereas a tax-exempt organizations is in the enviable position of determining what revenue is taxable and creating favorable facts to get a desired outcome.

# General UBIT Rule - Trade or Business?

- Whether a “**trade or business**” exist is a question of fact.
- A “**trade or business**” generally includes any activity carried on to make money from selling goods or services.
- Recurring annual losses by an activity may preclude a finding of a “**trade or business**” for *lack of profit motive*.
- **Fragmentation Rule** - If several activities are conducted as a large group, each activity must be analyzed separately as its own “**trade or business**”.



# General UBIT Rule - Regularly Carried On?

- Whether or not an activity is “**regularly carried on**” is a question of fact.
- Generally, if an activity shows **frequency and continuity** and is conducted the same way that a **taxable entity would run a similar business**, it is regularly carried on.
- Year round activities are regularly carried on even if they are conducted only one day a week.
- Seasonal activities operated similar to a taxable entity are considered regularly carried on, even though they are conducted only for a short period each year.
  - operating a ski resort
  - But not selling holiday Christmas cards

# General UBIT Rule - Regularly Carried On? *continued*

An activity is likely “*regularly carried on*” unless it is conducted:

- On an *infrequent* basis;
- For a *short period* of time during the year; or
- Without competitive and *promotional efforts*.

# General UBIT Rule - Substantially Related ?

- Whether an activity is “*substantially related*” is a question of fact.
- An activity is **substantially related** when it *contributes importantly* to the organizations exempt purpose.
- Planning Point :
  - The IRS does not decide on the scope of a State College & University’s exempt purpose.
  - Who gets to decide what contributes importantly to a State College or University’s exempt purpose?
    - The IRS?
    - The State Legislature?
    - What if a state law allows the a Board of Regents to conduct an activity upon finding a public purpose is served?
  - E.g. providing a gym memberships in accordance with Interagency Cooperation Act of the Government Code.

# General UBIT Rule - Substantially Related

## *Examples*

- University of Houston Hilton Hotel and Conference Center – facility is the “contemporary learning laboratory right here on campus” for students seeking hospitality degree from the U of H’s Conrad N. Hilton College.
- The University of Texas M.D. Anderson Cancer Center’s Jesse H. Jones Rotary House International - providing guest rooms and conference facility for patients and their families is related.
- University of Texas at Austin’s AT&T Executive Education and Conference Center – providing conference facilities and guest rooms for weekend executive MBA students is related.

# General UBIT Rule - *Exploitation of Exempt Purpose*

- ***Exploitation of Exempt Purpose*** - conducting an activity on a scale larger than ***reasonably necessary*** to perform the exempt function.
- Income from an activity to extent exploited is UBIT.
- Caps the extent of substantially related activities.
- Examples
  - catering campus events vs. catering to for-profit entities in the central business district
  - Providing hotel rooms for a patients family vs. the general public

# General UBIT Rule - Review

If an activity...

- is a **trade or business**
- **regularly carried on**
- **not substantially related** to an exempt purpose,

then it is subject to **UBIT**, *unless...*

the activity meets an *exception* or *exclusion*.

# General UBIT Rule - Exceptions

An activity that otherwise satisfies the General Rule will not be subject to UBIT, if:

- performed by a ***volunteer*** workforce,
- provided for the ***convenience*** of members, students, patients, employees or officers, or
- selling donated merchandise (***thrift store exception***)

# General UBIT Rule - Exclusions

The following are exclusions from UBIT:

- Passive investment Income
  - Interest
  - Dividends
  - Annuities
  - Payments with respect to securities loans, and
  - Any other incomes from routine investments, including notional principal contracts
- Rental Income
- Royalty payments
- 513(i) Safe Harbor - Qualified Sponsorship Payments



# The College and University Compliance Project

- In late 2008, the IRS sent compliance questionnaires (Form 14018) to about 400 colleges and universities.
- This compliance questionnaire focused on:
  - Organization – Officers – Related Entities
  - Endowment Funds
  - Executive compensation
  - UBIT (Unrelated Business Income Tax)
    - Advertising - Corporate Sponsorship - Rental
    - Classification of exempt or taxable activities
    - Allocation of revenues and expenses for taxable activities
    - Calculation of income or losses on the Form 990-T

# Why Audit Colleges and Universities?

- TEGE (Tax Exempt & Governmental Entities ) organizations control \$8.2 trillion in assets.
- TEGE organizations pay more than \$220 billion in employment and income tax withholding.
- TEGE has approximately three million taxpayers, including:
  - small community organizations,
  - cities and municipalities,
  - colleges and universities,
  - pension funds,
  - state governments,
  - issuers of tax favored bonds.
- TEGE has three divisions
  - EP (Employee Plans) - private and public retirement plans with \$4 trillion in assets.
  - EO (Exempt Organizations) - 1.6 million exempt entities with \$2.4 trillion in assets.
  - GE (Government Entities) – 88,000 federal, state, and local entities, and over 550 federally recognized Indian tribes with \$2 trillion in assets and 1.8 trillion in outstanding tax-favored bonds.

# The C&U Audits

- In 2009, about 30 colleges and universities were selected for audit under C&U compliance project.
- Reportedly, various size of both public and private colleges and universities were selected.
- At least 3 universities in Texas were selected.
- Scope was similar to CEP Audits from the 1980s.

# College & University Audit

- The IRS asked questions regarding:
  - Endowments
  - Related entities – IRC 512(b)(13) - repatriation of taxable income to exempt community tax free
  - Executive Compensation
- The answers, however, did not reveal any glaring tax problems.
- So it became apparent, the focus of the audit for a Texas public college or university was going to be UBIT.

# College & University Audit - Focus

- Loss Carry-forward Activity
  - Hobby Loss Rules – 3 of 5 years
- Sponsorship
  - Beverage pouring rights - exclusive provider arrangements
  - Multimedia rights
  - Naming of buildings – charitable contributions
  - Athletic Equipment Agreements
- Rental Income
  - Real property
  - Mixed real & personal property
  - Providing personal services

# Sponsorship

- **Qualified Sponsorship** is a payment of money, property or services where the **Sponsor (i.e. person engaged in business)** has no expectation of receiving any **Substantial Return Benefit**
  - Section 513(i) is a **Safe Harbor** not subject to UBTI
  - distinguish taxable advertising and mere sponsor acknowledgement
  - Sponsor does not include natural person or tax-exempt entity.
    - Michael Dell
    - Dell Computer Corporation
    - The Michael and Susan Dell Foundation
- **Substantial Return Benefit** means any benefit *other than*:
  - “Use or Acknowledgment” of sponsor’s name or logo in connection with the exempt organization’s activities, including exclusive sponsorship arrangements
  - Receipt of goods, services, or other benefits of “Insubstantial Value” (i.e. FMV not more than 2% of Sponsor’s payment)

# Sponsorship – Acknowledgement

Sponsorship Acknowledgment may include:

- Exclusive sponsorship arrangements;
- Logos and slogans that do not contain qualitative or comparative descriptions of the Sponsor's products, services, facilities or company unless qualitative or comparative descriptions are an established part of a Sponsor's identity, logo or slogan;
- List of the Sponsor 's locations, telephone numbers, or Internet address;
- Value-neutral descriptions, including displays or visual depictions, of the Sponsor 's product-line or services;
- Sponsor 's brand or trade names and product or service listings; and
- Display or distribution, whether for free or remuneration, of a Sponsor's product at a sponsored event.

# Sponsorship – Advertising & Personal Services

**Advertising** - any **message or other programming material** which is broadcast or otherwise transmitted, published, displayed or distributed that **promotes or markets** any trade or business, or any service, facility or product and may include any one or more of the following:

- Message containing **qualitative or comparative language**, price information or other indications of savings or value,
- An **endorsement**, or
- An **inducement** to purchase, sell, or use any service, facility or product.

**Personal Services** are not acknowledgment. (E.g. Head Coach or Mascot appearance)



# Sponsorship - Royalty Income Exclusion

- Exclusive Provider Arrangements are per se Substantial Return Benefit and thus would not qualify for Qualified Sponsorship safe harbor.
  - Does this mean the exclusive provider arrangement is UBIT?
  - Depends, but so long as University does not provide services or other return benefits then such arrangement will likely qualify for Royalty Income Exclusion.
- A royalty is the money paid for the use of a ***intangible right*** like a trademark, trade name, or copyright.
- Would licensing the right to promote all multimedia events for a university qualify for royalty exclusion?
  - IMG, Learfield, ISP Sports

# Rental Exclusion

General Rule - real property rents are not subject to UBIT, however, this ***exclusion*** does not apply to:

- Rents calculated using ***net profits*** - considered joint venture.
- Providing ***personal services*** in connection with real property.
- ***Debt-financed*** real property.
- A ***license*** – party in possession does not have right to exclude others.
- ***Mixed Lease*** – provide personal property with realty

# Rental Income

## Continued – Mixed Lease

Mixed lease = (personal property) + (real property)

- If personal property rent is **10% or less** of total rent then rental exclusion applies to total rent.
- If personal property rent accounts for between **11% and 50%** of the total rent then only real property rent qualifies for rental exclusion.
- If personal property rent accounts for **more than 50%** of total rent then rental exclusion inapplicable.

# Rental Income

## Continued – Providing Services

- **Rev. Rul. 69-178** – IRS ruled that organization that rented its meeting hall and provided only utilities and janitorial services qualified for rental exclusion.
- **Rev. Rul. 80-298** – IRS ruled university that leased its football stadium to professional football team for summer camp was not rental income because the university provided security, maintenance, linen services and some other services to team.
- **Rev. Rul. 80-297** – IRS ruled school that leased its tennis facility and provided administrative services was not able to assert rental exclusion.

# Mayo Decision

- Before Mayo the IRS's authority to issue “**interpretive regulations**” under Section 7805 was perceived to be more limited than “**legislative regulations**”
- On January 11, 2011, the US Supreme Court issued an 8-0 decision in Mayo Found. for Medical Education and Research v. United States, 131 S. Ct. 704, holding both interpretive and legislative regulations are entitled to **Chevron's** two-step analysis.
  - If Congress “**directly addressed**” the precise question at issue, then an IRS regulation is invalid. Otherwise proceed to second step.
  - If the IRS' regulation is “based on any **permissible construction** of the statute”, then the regulation is valid.
  - **Permissible construction** = not “arbitrary or capricious in substance, or manifestly contrary to the statute.”
- This two-step analysis is very deferential to IRS regulation.

# What to Expect?

## FACTS

- Historically there has been little precedential guidance on which tax practitioners may rely in determining UBIT consequences. Sometimes guidance is even contradictory.
- The College and University Compliance Questionnaires provided much information about business activities being conducted by colleges and universities.
- The C&U Audits provided insight on what activity to target for correction. (Purpose of TEGE - Educate? Raise Revenue?)
- Mayo grants the IRS the ability to craft regulations that will create the outcome they desire.

**My Opinion:** IRS will issue very **detailed regulations** to remedy perceived abuses with NOL activities, facility rental and sponsorships arrangements. Then follow with **narrow scope audits**, targeting these activities. Similar to Payroll audits.

# Questions?



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