

INVESTMENT & TAX SERVICES

January 14, 2005

Unrelated Business Income (UBI)

The University of Virginia is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code on income from activities that are substantially related to its educational and research missions, which form the basis for the University's tax exemption.

However, if the University were to carry on a trade or business activities that is not substantially related to its exempt purposes, it would be subject to tax on the net income of such a business activity, even though it may bring in funds to support the University of Virginia's exempt operations.

UBI Defined

Unrelated Business Income is the income from a trade or business activities that is are regularly carried on by an exempt organization and that is are not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this these activities. Thus, for UBI to occur, three requirements must be met: (1) a trade or business activities, (2) which is are regularly carried on, and (3) is are not substantially related to the tax-exempt purpose of the University. Each one of these requirements is briefly described below.

Trade or Business

The term "**trade or business**" generally includes any activity carried on for the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization.

Regularly Carried On

Business activities ordinarily are considered **regularly carried on** if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial organizations.

Substantially Related to Exempt Purpose

A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Whether an activity contributes importantly depends in each case on the facts involved.

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. To the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. That part in excess of what is needed to accomplish the exempt purpose would be considered an unrelated trade or business

Exclusions from Unrelated Business Income

The following types of income are generally excluded when figuring unrelated business income. However, the exclusions do not necessarily apply to income from debt-financed assets (described below):

1. All dividends, interest, annuities, payments with respect to securities, loans, and income from notional principal contracts.

2. Payments received with respect to a securities loan are excluded from unrelated business income only if the loan is made under an agreement that:
 - Provides for the return to the organization of securities identical to those loaned;
 - Requires payments of amounts equivalent to all interest, dividends and other distributions that the owner of the securities is entitled to during the period of the loan;
 - Does not reduce the organization's risk of loss or opportunity to gain on the securities;
 - Contains reasonable procedures to adequately "collateralize" the securities loan at daily fair market value, and
 - Permits the organization to terminate the loan upon notice of not more than five business days.
3. Payments with respect to securities loans include dividends and interest from the underlying securities, income from the collateral security or investment thereof, or fees based upon the period of time the securities are on loan.
4. Royalties, including overriding royalties, are excluded from unrelated business income. A royalty is a payment relating to the use of a valuable right, including trademarks, trade names or copyrights.
5. Rents from real property are generally excluded from unrelated business income. Rents from personal property are not excluded. In the event of a mix of personal and real property, the entire lease is exempt if the portion due to personal property is less than 10%. If the portion is between 10% and 50% personal property, then only the portion attributable to the real property is exempt. If the portion of personal property exceeds 50%, the entire lease is subject to tax.

The rental exclusion does not apply to leases based upon a percentage of the profit earned by the tenant. To be exempt, a lease must be either a fixed amount of rent or a percentage of sales or a combination thereof.
6. Income from research at a university is exempt, whether fundamental or applied. The term research does not include activities of the type normally carried on incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment.
7. Gains or losses from the sale, exchange or other disposition of property are exempt from unrelated business income other than:
 - Stock in trade or other property of a kind that would properly be included in inventory;
 - Property held primarily for sale to customers in the ordinary course of a trade or business, or
 - Cutting of timber that an organization has elected to consider as a sale of timber.
8. Any gain from the lapse or termination of options to buy or sell securities is excluded from unrelated business income, but only if written in the course of the organization's investment activities.

Other Sources of Unrelated Business Income

1. A university may have unrelated business income as a member of a partnership. If so, it must include its share of the taxable income of the partnership as though it had operated the business itself.
2. The share of any income of an "S" corporation will be taxable regardless of the actual source or nature of the income. A university's share of any interest or dividend income (otherwise exempt) from an "S" corporation will be subject to tax.
3. Interest, annuities, royalties and rents from a controlled taxable corporation are subject to tax, if those items reduced the tax of the controlled corporation. To be controlled, the exempt organization must own more than 50% of the stock in a corporation or more than a 50% interest in a partnership.

4. Investment income that would otherwise be excluded from tax must be included to the extent it is derived from debt-financed property. The term debt-financed property means any property held to produce income (including gain on sale) for which there is an acquisition indebtedness at any time during the tax year or during the 12-month period prior to the property's disposal. Property includes real estate, tangible personal property and corporate stock.
5. Acquisition indebtedness is the unpaid amount of debt incurred by the organization:
 - When acquiring or improving property
 - Before acquiring or improving property if the debt would not have been incurred except for the acquisition or improvement
 - After acquiring or improving property if the debt would not have been incurred except for the acquisition or was reasonably foreseeable when the property was acquired or improved.
6. Real property debts of an educational institution are generally exempt from the acquisition indebtedness rules.

If substantially all (85% or more) of the use of any property is substantially related to the organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include the generation of income.

If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property the organization uses for exempt purposes. Neighborhood property is that which is contiguous to the owned property or within one mile if it is not practical to acquire contiguous property. After 5 years, the organization must satisfy the IRS that exempt use will occur with the next 5 years