



FLORIDA
INTERNATIONAL
UNIVERSITY

MEMORANDUM

TO: DEPARTMENT HEADS & BUDGET MANAGERS

FROM: EDGAR SALAZAR – ASSOCIATE CONTROLLER

SUBJECT: OVERVIEW OF THE UNRELATED BUSINESS INCOME TAX AT FIU

DATE : SEPTEMBER 1, 2017

Unrelated Business Income Tax

I. Federal Income Tax Exemption

Florida International University (“FIU”) is exempt from federal income tax under §115 of the Internal Revenue Code (“IRC”). The IRC provides that the exempt purposes of state universities include all purposes and functions described in IRC §501(c)(3): charitable, scientific, testing for public safety, literary, educational, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. However, FIU is not exempt from tax imposed by IRC §§511 to 514 on activities which are unrelated to those exempt purposes, e.g., unrelated business income (“UBI”).

II. Unrelated Business Income Defined

For an activity to be considered an unrelated trade or business, all of the following criteria must be satisfied:

1. The activity must be a “trade or business;”
2. The activity must be “regularly carried on;” and
3. The activity must not be substantially related to any IRC §501(c)(3) exempt purpose.

Federal income tax is imposed on FIU’s unrelated business income. This tax is referred to as unrelated business income tax (“UBIT”). Activities that are determined to produce unrelated business income will be included in FIU’s Exempt Organization Business Income Tax Return (Form 990-T), which is prepared annually by the Tax Compliance Department of the Controller’s Office for submission to the Internal Revenue Service (“IRS”). A questionnaire is sent to all departments each year to assist in identifying potential unrelated trade or business activities.

A. Trade or Business: The term “trade or business” generally includes any activity carried on for the production of income from the sale of goods or from the performance of services. A trade or business activity is one in which a profit is expected to be made. However, where an activity that is carried on for profit constitutes an unrelated trade or business, no part of such trade or business is excluded from the “for-profit” classification merely because it does not result in a profit in a particular year.

B. Regularly Carried On: Business activities ordinarily are considered regularly carried on if such activities show a frequency and continuity and are pursued in a manner similar to comparable commercial activities of nonexempt organizations. An activity should not be considered regularly carried on if it is (1) on a very infrequent basis; (2) for a short period of time during the year; or (3) without competitive and promotional efforts. Activities over a period of only a few weeks are not "regular" for an exempt organization if the activities are of a kind normally conducted by a nonexempt business on a year-round basis. Intermittent, casual or sporadic activities are generally not regular. However, year round activities are regular even if they are conducted only one day a week. Further, seasonal activities may be regularly carried on even though they are conducted only for a short period each year.

C. Not Substantially Related to Exempt Purposes: To be considered exempt (nontaxable) income, there must be a substantial causal relationship between the activity that generates revenue and the exempt purpose of the organization (i.e., the activity must contribute importantly to the accomplishment of the exempt purpose other than the need to produce income). The mere fact that an activity generates a source of funds that are then used for exempt purposes does not mean that the activity is related to the exempt purposes. In looking at an activity, particular emphasis is placed on the size and extent of the activity. If an activity is conducted on a scale larger than reasonably necessary to carry out the exempt purpose, it is more likely to be treated as unrelated.

III. Statutory Exceptions and Modifications

Even if an activity is characterized as an unrelated trade or business based on the above three criteria, there are statutory exceptions for certain activities and modifications to the rules for certain types of income.

A. Statutory Exceptions: IRC §513 and Treas. Reg. §1.513-1 excludes the following activities from the definition of unrelated trade or business:

1. Convenience Exception.

Any trade or business which is carried on primarily for the convenience of the organization's members is not an unrelated trade or business. The convenience exception is applicable only for sales to members of FIU (e.g., students, faculty and staff). Any sales to non-members (e.g., the general public) are taxable. The convenience exception normally applies to the operation of on-campus vending machines, the sale of sundry items by campus bookstores and the laundering of dormitory linens and student clothing. The IRS takes the position that the convenience exception does not apply to items with useful lives of more than one (1) year. In addition, revenue from alumni is not related and therefore the income from alumni related activities is taxable.

2. Volunteer Labor Exception.

Any trade or business in which substantially all the work is performed by volunteers (without compensation) is not an unrelated trade or business. Under this exception, substantially all (approximately 85% or more) of the work of the trade or business is performed without

compensation. In assessing the contribution made by volunteers, the IRS considers such factors as the monetary value of the respective services rendered, the number of hours worked, the intrinsic importance of the volunteer work performed, and the degree of reliance placed upon volunteers.

3. Donated Merchandise Exception.

Any trade or business which consists of selling merchandise substantially all of which has been donated to the organization is not an unrelated trade or business. Under this exception, substantially all (approximately 85% or more) of the merchandise sold must have been received as gifts or contributions. In such cases, the income is exempt regardless of whether the labor to operate the activity is paid or volunteered.

4. Special Circumstances.

There are special circumstances in which an unrelated activity may be recognized as serving an exempt purpose. The IRS makes this determination on a case-by-case basis. The following are examples of special circumstances where the IRS found that the unrelated activity was exempt from taxation:

- Services or facilities otherwise unavailable in the community that fulfill an important community or medical need;
- Services, facilities or equipment that are technically advanced or unique.

B. Modifications: Under IRC §512(b) dividends, interest, annuities, royalties, and gains or losses from selling or exchanging property (other than inventory), as well as the deductions directly connected with these types of income, are excluded from the unrelated business taxable income computation. Also, rental income from real property and incidental rent from personal property is excluded from the unrelated business taxable income computation. However, IRC §514 treats dividends, interest, annuities, royalties, gains/losses, and rental income as unrelated business income if it is derived from an unrelated use of property where such property was acquired with borrowed funds.

1. Royalties.

A royalty may generally be defined as compensation paid to owners of a patent, copyright, mineral interest, or other property right for the use of it or the right to exploit it. The royalty exclusion includes overriding royalties, net profit royalties and royalty income received from licenses by FIU as the legal and beneficial owner of patents assigned to it by inventors.

(a) Licensing Agreements. The royalty exclusion is commonly used by exempt organizations to exclude licensing fees from UBIT. The IRS generally agrees with this provided that the exempt organization plays a passive role in the licensing arrangement. However, where the exempt organization's involvement is active, the IRS will not characterize the payment as a royalty and thus the payment will be subject to UBIT. An example of the latter situation is when the exempt organization is providing endorsements or services that are important to the success of the arrangement. In such cases, the IRS views the royalty payment as consideration for services rendered and not a royalty.

2. Rents.

The rules covering rents vary depending on whether the rent is derived from real property, personal property or from a mix of both real and personal property.

(a) Real Property: As a general rule, rent from real property is excluded from unrelated business income provided all of the following are true:

- Additional services are not rendered;
- Rental amount is not based on a percentage of net profits; and
- Property is not debt financed.

Rental income received by FIU does not qualify as excludable if FIU renders services for the convenience of the occupant. Services are considered rendered to the occupant if they are primarily for his or her convenience and are other than those usually rendered in connection with the rental of rooms or other space for occupancy only.

Rental income received by FIU does not qualify as excludable if the rental amount is based on a percentage of net profits. Rental income is excludable where the rental amount is for a fixed fee or based on a fixed percentage of gross receipts or sales.

The IRC contains an exception to the debt-financed property rules for the acquisition of real property by "qualified organizations" (which includes educational institutions). Basically, the debt-financed property rules do not apply to debt incurred by a qualified organization to purchase real property where the following conditions are present:

- the purchase price is a fixed amount;
- the amount of indebtedness and the time for payment of such indebtedness is not dependent on revenue, income, or profits derived from the real property;
- the real property is not leased back to the seller or a party related to the seller; and
- if the real property is held by a partnership and one or more of the partners is not a qualified organization, then allocations to the partners must be qualified allocations or must not have as a principal purpose the avoidance of income tax.

(b) Personal Property: Rental income from personal property is excluded only if there is a mixed lease and the rents attributable to the personal property are an "incidental" part of the total rents received under the lease. The following rules apply to personal property rents:

- All of the rental income is excluded if the rent attributable to the personal property is not more than 10% of the total rent under the lease;
- If the rent attributable to personal property is more than 10% but not more than 50% of the total rent, only the rent attributable to the real property is excluded; and
- If the rent attributable to the personal property is 51% or more of the total rent, then none of the rental income is excluded and the entire amount is considered taxable.

IV. Special Rules for Certain Activities

A. Advertising: The sale of commercial advertising by FIU in publications and athletic programs may be considered unrelated business income. Generally, advertising in a university periodical is regarded as an unrelated business activity even if the publication of the editorial content of the periodical furthers FIU's exempt purposes. In situations where FIU publishes a periodical with professional staff and the periodical contains advertising, income from advertising less the costs associated with the part of the periodical containing advertising is considered unrelated business income. In situations where FIU contracts with an outside publisher to publish the periodical, the advertising portion of the publication is also unrelated business income if FIU is an active participant in the publication of the periodical.

Consumer advertising may be regarded as related to the exempt purpose if students are actively involved in the solicitation, sale and publication of the advertising under the supervision and instruction of FIU. For example, a campus newspaper operated by students publishes paid advertising. Although the services rendered to the advertisers are of a commercial character, the advertising business contributes importantly to FIU's educational program through the training and participation of students involved.

However, just because students are involved, the activity is not automatically considered exempt from taxable income. The deciding factor lies with the overall purpose of the program. For example, a university acquires a radio station that serves as a laboratory for training students in the radio industry. The radio station also provides a source of income to the school, serves as a medium for advertising FIU and serves as a medium for adult education. If the greatest portion of time is devoted to the activities conducted by regularly constituted commercial radio stations and not student training, the advertising activity will be deemed taxable.

1. Sponsorship Payments.

Unrelated business income does not include the activity of soliciting and receiving "qualified sponsorship payments." A qualified sponsorship payment is any payment to a tax-exempt organization by a person engaged in a trade or business where there is no arrangement or expectation of any substantial return benefit (other than the use or acknowledgement of that person's name, logo, or product lines in connection with the activities of the tax-exempt organization). The term "use or acknowledgement" includes logos and slogans that do not contain qualitative or comparative descriptions of the payor's product-line or services, a list of the payor's locations, telephone numbers, or internet address, and the payor's brand or trade names and product or service listings. For example, "FIU is proud to have XXX as our sponsor" is a statement of recognition; whereas, "FIU suggests that you buy from XXX" is advertising. The display or sale of the sponsor's product by the sponsor at a sponsored event is not considered an inducement to buy, sell or use the sponsor's product and does not affect the determination of whether a payment is a qualified sponsorship payment. Acknowledgement of an exclusive sponsorship of FIU's activity generally does not, by itself, result in a substantial return benefit. However if FIU agrees to perform substantial services in connection with an exclusive provider arrangement, income received by FIU may be included in unrelated business income. Examples of substantial services include guaranteeing that coaches make promotional appearances on behalf of the company (for example, to attend photo shoots, to film commercials and to appear at retail stores), assisting the company in developing marketing plans, and participating in joint promotional opportunities. These activities are unlikely to be substantially related to FIU's exempt purposes and are likely to constitute a regularly carried on trade or business. The term "qualified sponsorship payment" does not include a payment which is contingent upon the level of attendance, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity.

2. Broadcasting Rights.

An athletic program is considered an integral part of a university's educational aspect. The educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights contributes importantly to the accomplishment of the organization's exempt purpose, and the sale of the exclusive broadcasting rights is not an unrelated trade or business.

B. Artistic, Entertainment and Theatrical Events: Presentation of performing arts, such as acting, singing, and dancing by students even where FIU derives gross income from admission charges for the performances, is not an unrelated activity. 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 FIU's exempt purposes, it does not constitute gross income from unrelated trade or business activities.

When FIU sponsors the appearance of professional theater companies and symphony orchestras, which present drama and musical performances for students, faculty members, and the general public, such activities may also be related. Although FIU derives gross income from the conduct of such performances, the presentation of the performances makes use of an intangible generated by FIU's exempt educational purposes. The presence of the student body and faculty and the presentation of such drama and music events contribute importantly to FIU's overall educational and cultural purposes. Therefore, the income which FIU receives does not constitute gross income from the conduct of an unrelated trade or business activity.

The IRS determines whether the income derived from professional entertainment events is considered unrelated business income by looking at how the event was conducted, not the content of the event. The IRS does not look at the cultural nature of the event, but looks at each entertainment event separately and makes its determination as to whether the activity is related or unrelated based on the extent to which it is operated in substantially the same manner as a commercial operation. The IRS's decision of whether income derived from professional entertainment events is considered unrelated business income is based upon the facts and circumstances of each situation. Therefore, each event needs to be reviewed separately to determine several variables, including, but not limited to, the involvement of students/faculty, if the event was conducted in a commercial manner, and if the event contributes importantly to FIU's missions.

Auditors will review contracts with performance artists to determine if they were consummated for related educational purposes. The IRS is specifically looking for events that are produced by the institutions that are not distinguishable from those efforts of a commercial promoter and arena.

C. Bookstore and Other Retail Merchandise Operations: In general, bookstore operations are related activities and not subject to UBIT. The IRS will typically fragment sales into three major categories:

- directly educational materials (nontaxable);
- non-educational, convenience exception (nontaxable); and
- other merchandise sales (taxable).

Items that are directly related to FIU's educational purposes are exempt when sold to students, faculty and other employees. This includes books and general school supplies.

Sales of non-educational items that are low in cost and in recurrent demand are exempt as sales for the “convenience” of FIU’s members. Examples of merchandise that may be exempt under this convenience exception include toiletry articles (such as toothpaste), wearing apparel or novelty items bearing FIU's insignia, and other items such as candy, newspapers, magazines, greeting cards, etc.

In the absence of clearly established special circumstances, items not directly related to FIU's exempt purposes that have an ordinary useful life of more than one year are not encompassed by the convenience exception. Where bookstores are open for sales to the general public, sales to the general public clearly do not fall within the convenience exception. Each item sold by a retail merchandise operation must be considered individually along with identifying the purchaser to determine which sales are includible as unrelated business income.

D. Childcare Centers: If purchasers of the service are students, faculty, and staff, and the childcare facility is provided for their convenience, the income is not subject to UBIT. However, if the service is available to the general public as well, the portion attributable to general public usage may be subject to UBIT depending upon other factors such as educational training and college credit given for student participation.

E. Food and Catering Activities: Food service activities open to the general public are not related to FIU's exempt purposes and are generally considered unrelated business activities.

However, there are exceptions based on where the activity takes place and other activities being carried on at the same time and place. Food service at a FIU exempt activity where the food is generally only available to ticket holders is exempt. However, if non-FIU events take place at those locations, the food services are considered unrelated business activities. Food services at facilities that are only accessible from some closed or restricted areas (for example, a restaurant located within a museum), but not directly accessible from the street are considered related to the other areas it serves and the exempt activities carried on in those facilities. Patronage of the eating facility by the general public is neither directly or indirectly solicited nor is the facility contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the location (for example, the museum). Use by students, faculty, and staff is exempt from unrelated business income as a “convenience” to them. Casual and intermittent use by members of the general public does not constitute a business activity regularly carried on in a commercial manner; therefore, this activity is not considered unrelated business income.

In situations where FIU has excess capacity in its food service program and the food service unit provides catering services to both FIU and non-FIU users, catering services provided to FIU student, faculty, and staff is related and not considered unrelated business income. However, catering services to non-FIU customers constitute unrelated business income.

F. Joint Ventures: Generally, income from a joint venture will not be taxable if it contributes importantly to an exempt purpose or if it is carried on for the “convenience” of FIU members. However, joint venture relationships have been scrutinized by the IRS to ensure that a tax-exempt organization is not serving the private purpose of the for-profit entity.

G. Parking Spaces/Lots: With respect to parking facilities, FIU owned parking facilities used by faculty, staff and students are not subject to unrelated business income tax. However, if FIU operates a parking facility that is used by members of the general public, parking fees are taxable, as this activity is not substantially related to FIU’s exempt purpose and parking fees are not treated as rent from real property. If FIU enters into a lease with a third party who operates FIU’s parking facility and pays rent to FIU, such

payments are not considered unrelated business income as these payments constitute rent from real property.

H. Recreational and Athletic Facility Membership Fees: In most cases the use of athletic or recreational facilities by students, faculty, and staff is considered to be for the “convenience” of the member of the tax-exempt organization and, therefore, not subject to UBIT. On the other hand, if membership fee income is collected from spouses, dependents, alumni, guests, or the general public then that income may be subject to UBIT. However, where FIU does more than merely open up the facilities and, for instance, provides lessons as well, the activity may be considered educational and related to FIU’s exempt purposes. For example, the operation of a summer sports camp provides instruction to individuals in a sports skill. The instruction of individuals, of any age, in a sport develops that person’s capabilities and is, therefore, educational. Since the operation of a summer sports camp in this situation is an educational activity, it is substantially related to FIU’s exempt purposes.

I. Research. Income from certain research grants or contracts may be exempt from the unrelated business income tax depending on the type of research: The following types of research are exempt:

- Scientific research carried on in the public interest. Scientific research is considered in the public interest even though an individual may retain the exclusive right to the use of a patent, copyright, process or formula if the granting of such exclusive right is the only practical manner in which the patent, copyright, process or formula can be utilized to benefit the public, and only if it is carried on for a charitable purpose such as aiding in the scientific education of college or university students;
- Research performed for the United States, its agencies, or any State or political subdivision of a state;
- Research performed “for any person” by a college, university, or hospital; and
- Research performed “for any person” by an organization operated primarily for the purpose of carrying on fundamental research. Such research may be performed “for any person,” but the results must be made freely available to the general public. Whether an organization is operated primarily for the purpose of carrying on fundamental, as opposed to applied, research is a question of fact to be determined based on all the facts and circumstances. A determination that the research is conducted in the public interest and research results made available to the general public includes an analysis of how, when and on what terms research results are published.

The term “research” does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment or buildings. The IRS has defined testing as those activities where “a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive and the procedure is merely a matter of quality control.” There is a presumption that a project is “ordinary testing” if the work is performed to satisfy a federal or state regulation requiring such an evaluation before a product may be marketed. Therefore, any income from such sources would constitute unrelated business income, if regularly carried on and not related to exempt purposes.

(a) Sale of By-Products.

The sale of products resulting from research activities may or may not be exempt from UBIT. If the product is sold in substantially the same state it is in on completion of the research, the sale

does not constitute unrelated business income. However, if further manufacture or processing of the product occurs, the gross income is considered unrelated business income.

An example of this distinction is as follows: An experimental dairy herd maintained for scientific purposes by a research organization produces milk and cream in the ordinary course of operation of the project. The sale of the milk and cream would not be gross income from conduct of unrelated trade or business. On the other hand, if the research organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless:

- the manufacturing activities themselves contribute importantly to the accomplishment of the exempt purpose of the organization (i.e. education of students); or
- the research produces more raw milk than can be sold as milk in its normal period of shelf life. This causes further processing to be done of the excess raw milk to obtain products that have a longer shelf life to avoid spoilage.

J. Service Centers: Service department's primary users should be internal FIU departments. Use by private organizations should be secondary or incidental to the operation of the service department. Service departments should not compete with established community businesses for private customers or users. If sales of goods and/or services to individuals or non-FIU entities occur, the activities should be reviewed for UBIT considerations.

K. Summer Dormitory Rentals: The IRS has held that income from the rental of dormitory space is exempt income since a university's mission is not necessarily limited to its own students, but could encompass students of another organization that utilized its facilities. However, the IRS is beginning to challenge the educational mission of some summer conferences and camps. The greater the participation of FIU in such camps (i.e., university used its own personnel to conduct the camp), the stronger the link to the educational mission of FIU. When FIU merely contracts with an outside individual or organization to operate the camp, a closer look is needed at the specific agreement to determine taxability.

L. Travel Tours: On many occasions, the IRS has held that income derived from universities and their related alumni associations from the sale of travel tours to alumni are considered UBIT if no formal education programs are conducted in connection with the tours.

V. Allowable Deductions

Only expenses which are directly related and for the primary purpose of carrying on the unrelated trade or business are allowed as deductions in computing unrelated business taxable income. Expenses, depreciation, and similar items attributable solely to the conduct of the unrelated business may qualify for deduction. When facilities or personnel are used both to carry on exempt activities and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is then allowable as a deduction in computing unrelated business taxable income, if the expense is otherwise an allowable income tax deduction.

VI. Filing Requirements

FIU annually files Form 990-T, Exempt Organization Business Income Tax Return to report unrelated business income generated by FIU activities. FIU's fiscal year-end is June 30 and as such, FIU's Form 990-T is due by November 15 of the following calendar year. If the regular due date falls on a Saturday, Sunday,

or legal holiday, the return must be filed on the next business day. FIU may request an automatic six (6) month extension of time to file Form 990-T. This extension of time to file the Form 990-T is not an extension of time to pay any tax that may be due.

VII. Additional Resources

If you have any questions or need more information, please contact the Office of Tax Compliance. Additional information is also available in IRS Publication 598 and Form 990-T instructions.