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A Note Concerning Unrelated Business Income Tax

The Internal Revenue Code lists the types of organizations that may be exempt from federal income tax¹; namely, those whose purposes are “charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals.” The Code stipulates that the organization may not attempt to influence legislation as a substantial part of its activities, may not participate in any campaign activity for or against political candidates, and none of its earnings may inure to any private shareholder or individual. An organization will be regarded by the Internal Revenue Service (IRS) as *operated exclusively* for tax-exempt purposes if its activities are limited to those that accomplish its tax-exempt purposes; an organization will not be so regarded if more than an insubstantial part of its activities do not further its tax-exempt purposes.

Even though an organization is classified as tax-exempt, it may still be required to pay federal income tax on net income related to some of its activities². In particular, a tax-exempt organization, including educational and scientific research organizations and state colleges and universities, may be liable for *unrelated business income tax* (UBIT) – the federal tax on income derived from business activities that are unrelated to its tax-exempt mission. The IRS defines *unrelated business income*³ (UBI) as “income from a trade or business, regularly carried on, that is not substantially related to the performance by the organization of its exempt purpose or function.”

UBIT was established by Congress in 1950 as a means to level the playing field for tax-paying businesses; that is, to prevent tax-exempt organizations from using their privileged status to compete unfairly with tax-paying businesses in the provision of activities unrelated to their tax-exempt purposes. Rather than specifically prohibit tax-exempt organizations from engaging in any revenue-generating business activities, Congress decided to permit certain activities, provided they are not a substantial part of the organization’s activities, and to tax the net income from these activities at the same rate as any other for-profit business.

¹ See <http://www.irs.gov/charities/> or IRS Publication 557, *Tax-Exempt Status for Your Organization* (March, 2005).

² This *Note* will only concern federal tax liability, although the tax-exempt organization may also be liable for state tax on unrelated business income.

³ See IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations* (March 2005).

The University of Massachusetts treasurer's office is responsible for all matters related to tax administration and for the tax filings, including UBIT, of all campuses of the university. A comprehensive discussion of UBIT is provided by the treasurer's office publication *Unrelated Business Income Tax*⁴. The purpose of this Note is to point out those special situations in which a researcher's proposed activities may have significant UBIT consequences for the university.

Application of UBIT

The IRS excludes from UBIT "all income derived from research for the United States, or any of its agencies or instrumentalities, or any State or political subdivision thereof," as well as "all income derived from research performed for any person." For this reason, research activities, such as those supported by sponsored program awards to the university, will usually be exempt from UBIT. However, IRS rules state that "the term *research* does not include activities of a type ordinarily carried on as an incident to commercial or industrial applications; for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."

The exact facts and circumstances pertaining to each activity that generates income must be examined to determine whether or not it is an unrelated business activity. For example, income from laboratory service activities, such as testing water samples for the public for a fee, may be subject to UBIT if the testing is regularly carried on for the production of income and in a manner that is typical of a for-profit business enterprise. This is true even if the testing activities are covered by a sponsored research agreement.

It is important to distinguish between how income is generated and how income is used. Income that is generated by an unrelated business activity is still subject to UBIT even if it is used for a purpose that is substantially related to the tax-exempt purposes of the university. For example, net income from laboratory service activities may be subject to UBIT even though the income generated is only used to provide scholarship assistance for students.

The situation occasionally arises in which a university facility, such as a research laboratory, that is used for a tax-exempt activity, such as research, is also used for a non-tax-exempt activity, such as water sample testing. In this case, the income generated from the non-exempt activity of this dual use facility may be subject to UBIT. The challenge in this situation concerns the allocation of expenses between the tax-exempt and the non-tax-exempt activities of the laboratory⁵.

⁴ Available at: <http://www.massachusetts.edu/treasurer/generaltaxissues.html>.

⁵ The IRS has also issued rules concerning cases in which a sponsored research agreement involves private business use of a university building that was constructed with tax-exempt bonds. For example, product testing activities of a commercial entity located in a bond-financed university facility have been considered by IRS as not only unrelated business activity for purposes of UBIT, but also a private business use of the facility. In this case, the tax-exempt status of the bonds may be jeopardized, something which the bondholders will certainly wish to avoid.

Determination of UBI and UBIT Liability

If a UMass Boston researcher's activity is generating income, then it is the responsibility of the staff in the researcher's department to develop and maintain a system to properly identify, characterize, track, and document the revenues, expenses, and net income, as well as the facts and circumstances pertaining to the activity. The controller's office staff will review the departmental records, consult with the tax department staff in the university treasurer's office concerning the existence of UBI, and assist the staff in the researcher's department to prepare and file the appropriate UBIT documentation.

UBIT concerns can generally be reduced if the activity can be clearly related to the university's tax-exempt purposes. For example, by incorporating the activities in a meaningful way in students' educational programs, or by adding value through the application of the researcher's observation, experimentation, or reasoning to the accumulated products of the activity.

Although unrelated business activities may be taxable, that does not mean they are illegal or improper. The university may choose to engage in a special purpose business activity that is unrelated to its tax-exempt purposes if it can be demonstrated that the activity serves a beneficial purpose that outweighs the tax liability caused by the activity. If the net income from the unrelated business activity becomes substantial or jeopardizes the university's tax-exempt status, then the university can spin off the activity into a separate but affiliated taxable subsidiary, which pays income tax on its net income but returns all after-tax profits to the university.

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September 7, 2007