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The Unrelated Business Income Tax and Its Consequences for the University of Colorado

By Alex Loyd, Research Associate Attorney, UC Boulder

This article describes the basic framework of the Unrelated Business Income Tax ("UBIT") and its compliance obligations for the University of Colorado ("University").

A. Introduction to UBIT

The University is tax-exempt as an educational entity under Internal Revenue Code ("IRC") Section 501(c)(3). As such, the University generally enjoys the advantages of avoiding tax on its net income, in addition to other tax-related benefits and exemptions. The University, however, may be exposed to adverse tax consequences -- specifically, taxation at regular corporate rates -- for activities not substantially related to the University's exempt purposes or functions under IRC provisions called the Unrelated Business Income Tax ("UBIT"). Under UBIT, the University may not use its exempt status and resources to compete with for-profit, tax-paying entities.

In October 2008, the Internal Revenue Service ("IRS") began a survey of colleges and universities regarding compliance with UBIT.¹ In 2010, the IRS opened compliance examinations of more than 30 higher education institutions based on data gathered from the survey. Accordingly, it is beneficial for the University community to understand UBIT and the types of activities that may trigger higher tax rates or IRS audits.

B. Important Definitions under UBIT

While IRC Section 501(c)(3) provides an exemption to colleges and universities, Sections 511-513 define the activities subject to UBIT. Under Section 512(a), "unrelated business taxable income" is defined as the "gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions ... directly connected with the carrying on of such trade or business." Section 513 defines "unrelated trade or business" to include any trade or business "the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501."

1. Three-part Test to Determine when UBIT is Triggered

Under IRC Section 512(a), unrelated business taxable income occurs where an exempt entity:

- (1) engages in a trade or business,
- (2) which is regularly carried on, and
- (3) which is not substantially related to the entity's exempt purpose.

a. Definition of a "Trade or Business"

¹ See <http://www.irs.gov/charities/article/0,,id=186865,00.html>.

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A trade or business includes any activity which is carried on for the production of income from the sale of goods or the performance of services. Courts have developed the "profit motive" test, which states that an activity constitutes a trade or business for purposes of UBIT when it "was entered into with the dominant hope and intent of realizing a profit."² For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy is considered a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose.³ Similarly, soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose.⁴

b. Definition of "Regularly Carried On"

To determine whether an activity is "regularly carried on," the IRS considers "the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued."⁵ The first step is to consider the normal time span of the particular activity, and then determine whether the length of time alone suggests that the activity is regularly carried on, or only intermittently carried on.⁶ If the activity is "of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such [activity] by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business."⁷ By way of example, United States Department of Treasury Regulations describe a hospital auxiliary's operation of a sandwich stand for only two weeks at a state fair.⁸ In contrast, the regulations deem the operation of a commercial parking lot every Saturday as a regularly-carried-on activity.⁹

If the activity is "of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business."¹⁰ The regulations note that the operation of a horse racing track several weeks a year is an example of a regularly-conducted seasonal business, because such tracks are open only -- but regularly -- during a particular season.¹¹

c. Definition of Substantially Related Activities

To avoid UBIT, an activity must have a substantial causal relationship to the achievement of a tax-exempt organization's fundamental exempt purpose.¹² In other words, the production or distribution of goods or the performance of services from which gross revenue is derived must contribute to the accomplishment of the exempt purpose of the tax exempt entity. Ancillary activities, such as research, are generally considered to include an exempt purpose because such activities advance education or science and are considered unique services that can contribute importantly to a tax-exempt organization's mission.¹³

Treasury regulations provide guidance for determining whether the activity is substantially related for exempt purposes:

Where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of the exempt functions constitutes gross income from the conduct of unrelated trade or business.¹⁴

² *United States v. American Bar Endowment*, 477 U.S. 105, 110, note 1 (1986).

³ See IRS Publication 598, available at <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

⁴ *Id.*

⁵ *Nat'l Collegiate Athletic Ass'n v. C.I.R.*, 914 F.2d 1417, 1421-22 (10th Cir. 1990) (citing Treas.Reg. § 1.513-1(c)(1)).

⁶ *Id.* (citing § 1.513-1(c)(2)(i)).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Treas. Reg. § 1.513-1(d)(2).

¹³ See IRC § 513(a).

¹⁴ Treas. Reg. § 1.513-1(d)(2).

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The IRS, therefore, requires a case-by-case identification of the exempt purpose, an analysis of how the activity contributes to that purpose, and an examination of the scale on which the activity is conducted.

2. Common University Activities that could Trigger UBIT

A large variety of university activities can generate unrelated business income. As discussed, providing goods or services to the public (including alumni) is a taxable activity. Examples of activities that may generate UBIT are:

- Most forms of advertising that generate revenue for the University
- Rental or sales of mailing lists
- Routine analytical or testing services to non-university users
- Travel tours for alumni where tour purpose is not educational activity¹⁵
- Renting equipment to non-university personnel
- Leasing a University stadium to private interests for a fixed fee¹⁶
- Online stores linked to University web sites
- Printing or audio visual sales and services to non-university users
- Parking revenues generated from general public attendance at a non-university sponsored event

In addition to the activity itself, the location of the activity may entail UBIT consequences. If unrelated business activities take place on property financed with tax-exempt bonds, the bond financing could lose tax exempt status.¹⁷

Note that UBIT provisions specifically exclude several types of activities that may apply to the university, including: 1) Volunteer Labor - any trade or business is excluded in which substantially all the work is performed for the organization without compensation. Some fund-raising activities, such as volunteer-operated bake sales, may meet this exception; 2) Convenience of Members - Any trade or business is excluded that is carried on by an organization described in Section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees, such as a school cafeteria; 3) Selling Donated Merchandise - Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions.

C. University UBIT Websites and Contacts

Please contact the Office of University Counsel or your campus' finance offices to make a final determination as to whether income is taxable under UBIT or to discuss any of the issues raised in this article.

The Boulder Campus UBIT questionnaire is available at: http://abs.colorado.edu/ABS_WEB/Forms/ubit.pdf.

The Denver Campus UBIT policy is available at:

http://staging.ucdenver.edu/faculty_staff/employees/policies/Policies%20Library/Fiscal/UBIT_policy_080108.pdf.

¹⁵ See IRS Publication 598, available at <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

¹⁶ See IRS Publication 598, available at <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

¹⁷ *Id.*

***Christian Legal Society v. Martinez*: The Supreme Court upholds non-discrimination policy applied to student organizations**

By Maggie Wilensky, Assistant University Counsel, System

Last summer, the Supreme Court announced a decision in *Christian Legal Society v. Martinez*, 130 S. Ct. 2971 (2010). The case raised the question – which had previously resulted in split decisions among the federal courts – whether a public law school may condition student organization recognition and funding on adherence to a nondiscrimination policy.

The facts

Hastings College of the Law (Hastings) is a public law school in California. Hastings requires registered student organizations (RSOs) to adhere to a non-discrimination policy in order to achieve RSO status, which makes a group eligible to apply for student activity fee funding and to use school meeting space. Hastings' non-discrimination policy prohibits discrimination on the basis of several protected class categories, as well as sexual orientation. Hastings interprets the policy to require RSOs to "accept all comers."

The local Christian Legal Society (CLS) chapter was affiliated with the national CLS organization, which requires members to sign a statement of faith prohibiting homosexual conduct and excluding members who hold divergent religious views. Therefore, CLS was unable to abide by Hastings' nondiscrimination policy, as its membership requirements would exclude members on the basis of sexual orientation and religious belief. In seeking to become an RSO at Hastings, CLS requested an exemption from Hastings' non-discrimination policy. Hastings informed CLS that it would not grant an exemption to the nondiscrimination policy but that CLS could use school facilities to hold and announce meetings.

The lawsuit

CLS sued Hastings, arguing that the nondiscrimination policy violated its First Amendment rights of expression and associational freedom. In technical legal terms, CLS contended that the policy was a non-viewpoint-neutral restriction on access to a public forum and violated its rights of "expressive association."

The Supreme Court decided the case in Hastings' favor. Because the Court viewed Hastings' nondiscrimination, accept-all-comers policy as being applied neutrally as a precondition to the benefits that come with RSO recognition, the Court held that the policy did not violate CLS's First Amendment rights. Because the Court treated the case as one arising under the "limited public forum" doctrine, the case turned on whether the restriction on student group recognition was reasonable in light of the circumstances and was "viewpoint neutral," or made without regard for the viewpoint of prospective RSOs. The Court first considered the policy's reasonableness, accepting Hastings justification that the policy ensured that no student would be required to subsidize groups with which he disagreed. The Court cited several additional justifications, including that the law school used the "accept all comers" policy to communicate the unacceptability of discrimination, as expressed in both California state law and school policy.

As to the policy's "viewpoint-neutrality," the Court observed that it was hard to imagine a policy more viewpoint neutral than one which required acceptance of all individuals by all groups. The Court also noted that, in addition to enforcing a viewpoint-neutral policy, the school had offered substantial alternative channels for CLS to communicate its message, permitting CLS to post announcements on school boards and to use school facilities for meetings.

While Hastings prevailed on most points, the Supreme Court left open the possibility that CLS could press one remaining claim in the lower courts, namely that Hastings' policy exists as a pretext for religious discrimination and is selectively enforced against religious groups.

Impact on public university student organization programs

CLS v. Martinez is significant in that it clarifies confusing and contradictory caselaw from the lower federal courts on whether a public university may require student organizations to adhere to an open-acceptance policy in order to obtain RSO status. However, the case addressed only one particular kind of non-discrimination policy that a public university might apply to prospective RSOs: a non-discrimination policy that requires the RSO to accept all interested students without regard to characteristics such as sexual orientation. Because the Supreme Court limited its holding to that particular kind of policy, the constitutionality of other forms of non-discrimination policies that public universities might apply to RSOs will likely be litigated in the future.

OUC News

Congratulations to Katie, Annalissa & Karyn!

Katie Goodwin was recently promoted from her position as Research Associate to Assistant Counsel at the Denver Campus Office of University Counsel. Katie was hired by the University in 2008. A native of Houston, Texas, she received a B.A. in Political Science and Spanish from Trinity University in San Antonio, TX. Following college, she moved to Los Angeles, CA where she worked in fund raising at Occidental College. Katie returned to Texas, graduating from South Texas College of Law in 2007 after spending her final semester as a visiting student at the University of Denver, Sturm College of Law. While in law school, Katie successfully competed in several appellate advocacy tournaments and clerked in one of Harris County's civil district courts.

Annalissa Philbin was recently promoted to serve as Senior Research Associate in the Denver Campus Office of University Counsel. Ms. Philbin joined the University as a Research Associate Attorney in 2006. Before coming to the Denver Campus Office of University Counsel, Ms. Philbin served for four-and-a-half years as the patent administrator for the University of Colorado Technology Transfer Office, where she worked with outside attorneys and other TTO staff to patent University-owned inventions. She graduated from the University of Colorado School of Law in 2000 and is admitted to the Colorado Bar. She is a member of the Denver and Colorado Bar Associations. She obtained her BA from Boston University in 1997.

Karyn Hardy was recently promoted to Research Associate in the Denver Campus Office of University Counsel. Ms. Hardy joined the University in 2004, serving as a Special Assistant in the Denver Campus and Litigation Offices, where she reviewed contracts and clinical training affiliation agreements, conducted legal research, and assisted in personnel cases as well as administrative hearings. Prior to joining the Office of University Counsel, Ms. Hardy worked in the Colorado Attorney General's Office Consumer Protection Unit and as a data analyst for IBM. She graduated from the University of Colorado School of Law and is admitted to the Colorado Bar. Ms. Hardy obtained her BA from Ohio Wesleyan University.

Best wishes for continued success in your new positions!



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- ◆ UCB: (303) 492-7481
- ◆ UCCS: (719) 262-3820
- ◆ UCD: (303) 315-6617
- ◆ SYSTEM: (303) 860-5686

Edited by Emilia Negrini, System Counsel Office