Unexpected Sources of UBIT

Tax-exempt organizations, such as public colleges and universities, are obligated to pay income tax on unrelated business income. Unrelated business income generally consists of income from a trade or business regularly carried on by an exempt organization that is not substantially related to the performance of the organization's exempt purpose or function. Certain trade or business activities, such as income from research grants or contracts in the case of a college or university, are not considered as an unrelated trade or business.

Until recently, most colleges and universities would likely have assumed that if they charged for services provided to another tax-exempt organization in support of its exempt functions, such as another college or university, the fees received would not be subject to unrelated business income tax. This assumption no longer appears valid in light of Private Letter Ruling 200832077 (the "PLR"). This PLR was issued in response to a letter dated April 24, 2000, in which a community foundation organized under §501(c)(3) of the Internal Revenue Code (the "Code") requested a ruling from the Internal Revenue Service (IRS) regarding whether fees generated by the foundation's providing a range of nine categories of services to other tax-exempt community groups would be considered as unrelated business income and subject to payment of taxes on it.

In the PLR, the IRS began its analysis by noting that the purpose of the unrelated business income tax was to eliminate unfair competition between exempt organizations and non-exempt business endeavors. It then found that the services which the foundation proposed to sell to other exempt organizations were nearly identical to those available commercially, with the result that the foundation was indirect competition with the for-profit foundation management industry. However, the bare fact of the presence of such competition was not determinative.

The ultimate test was found to be whether the production or distribution of the goods or the performance of the services (from which the income is derived) contributes importantly to the accomplishment of the organization's exempt purpose. The IRS then categorized the services to be provided in this case into grant-making services, which it concluded contributed importantly to the grant activities of the exempt organization and were not subject to unrelated business income tax, and administrative/clerical services, which did not contribute importantly to grant-making activities and were therefore subject to that tax.