

IRS Announces Plans to Look into UBTI Reporting on a Broader Scale

May 16, 2013

On May 8, 2013, the House Ways and Means Subcommittee on the Oversight of Tax-Exempt Organizations held a hearing on the College and University Compliance Project Final Report ("Final Report") issued by the IRS on April 25, 2013. The purpose of the hearing was to examine the causes for the "widespread noncompliance" found by the IRS with respect to unrelated business taxable income (UBTI).

In his Opening Statement, Congressman Charles W. Boustany (R-La), chairman of the Subcommittee, stated that the: "IRS found almost universal noncompliance by some of the most sophisticated organizations in the tax-exempt sector. Noncompliance included widespread calculation errors and misreporting. Ninety percent of the 34 institutions [examined] had their UBTI calculations adjusted upward for a total increase of around \$90 million. . . While UBTI rules, like many tax rules, may involve some uncertainty, these finding may suggest deeper problems with the classification of for-profit activities by colleges and universities."

The IRS began the Colleges and Universities Compliance Project in 2008 with the distribution of questionnaires to 400 randomly selected colleges and universities that are exempt from tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). The questionnaire covered organizational and demographic information, along with exempt and unrelated business activities, executive compensation, endowment funds and governance practices. The IRS followed up the questionnaire with an examination of 34 colleges and universities, which were divided equally between private and public institutions and approximately two-thirds of which were large organizations with 15,000 or more students. On April 25, 2013, with more than ninety percent of the examinations completed, the IRS issued its Final Report.

As a result of the examinations, the IRS made approximately 180 adjustments, increasing UBTI for 90 percent of the colleges and universities examined by an aggregate amount of \$90 million and disallowing more than \$170 million in losses and net operating losses (NOLs). The IRS identified the following activities as triggering the greatest number of adjustments:

- advertising
- facility rentals
- fitness, recreation centers, and sports camps
- arenas, and
- golf courses.

The most common reason that the IRS adjusted the UBTI of the examined institutions was the incorrect classification by the college or university of certain activities as a “trade or business” and the deduction of losses associated with those activities. As the IRS noted, an organization is only considered to be engaged in a “trade or business” if, among other things, it has a profit motive. Where there is a pattern of recurring losses, the IRS concludes that the taxpayer is not engaged in the activity with the intent to make a profit. Accordingly, losses from those activities are not deductible. The validity of losses is an important issue for the IRS because losses from one unrelated activity can be used to offset income from another unrelated activity in the current year or carried forward or back to offset unrelated income in future or past years. In connection with its examination, the IRS disallowed \$150 million of losses from activities in which it found no profit motive. Thus, those losses were no longer available to offset income from other activities in the current year or to be carried forward or back to offset income in future or past years.

In addition, the IRS found that 60 percent of the organizations examined had misallocated losses to offset income from unrelated business activities. In general, tax-exempt organizations are permitted to offset their UBTI with ordinary and necessary expenses incurred in connection with the unrelated activity. While expenses incurred for both exempt and unrelated activities may be allocated between the two, the allocation must be reasonable and the expenses used to offset UBTI must be directly connected to the unrelated activity. The Final Report indicates that “in many cases . . . the claimed expenses were not connected to any unrelated business activity.”

Additional adjustments resulted from the misclassification of certain activities as exempt or otherwise non-reportable rather than as unrelated. The examinations resulted in more than \$4 million of income treated by colleges and universities as exempt being reclassified as unrelated, and thus, taxable, income.

The IRS also disallowed \$19 million of net operating losses because such losses were either unsubstantiated or improperly calculated. These mistakes were found on more than one-third of all of the returns examined.

Lois G. Lerner, Director of Exempt Organizations Division, testified at the May 8th hearing. She reiterated that the 34 colleges and universities selected for examination were not representative of all colleges and universities (because they were selected on the basis of a risk of noncompliance). However, she noted that the IRS’s next step is to look into the issue of UBTI reporting on a broader scale, particularly recurring losses and the allocation of expenses between exempt and unrelated activities.

We will continue to monitor the IRS’ activities in the area of UBTI and will keep our clients updated as additional guidance on UBTI reporting is issued.

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