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Unrelated Business Income Tax Issues & Reporting

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Contents

I. Zero in on Risk – IRS Scrutiny

If the IRS is to be taken at its word, the substantive tax reporting of unrelated business activities on Form 990-T, "Exempt Organization Business Income Tax Return," will change dramatically-for all tax-exempt organizations. In its Colleges and Universities Compliance Project, the IRS spent years analyzing responses to detailed questionnaires that were sent to 400 colleges and universities in October 2008 and conducting examinations of 34 colleges and universities whose responses, or lack of responses, seemed most promising from an examination perspective. After completing its examinations, the IRS issued a final report in April 2013 ("Final Report").[1]

Although much has been written about the Final Report and the results of the 34 examinations, most of these articles have focused on the statistical information that was obtained, including the amount of expenses that were disallowed, how many revenue accounts were re-characterized, the total net operating loss (NOL) carryforwards that were disallowed, and so on. While interesting in its own right, more substantive information can be gathered from this IRS activity.

It is clear from the actual examinations and the information contained in the Final Report that the IRS has issues with how tax-exempt organizations characterize their exempt and non-exempt activities, with how organizations allocate expenses to unrelated business income (UBI) activities, and with how NOLs are accumulated and carried forward. It is not clear how tax-exempt organizations are supposed to respond to these concerns as they relate to the reporting of unrelated business activities on Form 990-T. Given the numerous disallowances and re-characterizations, is the IRS looking for a "silo" approach to the

1 See IRS, "Colleges and Universities Compliance Project Final Report," available at irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

reporting of UBI activities and expenses, as has been proposed by Congress?[2] Is it totally disallowing the use of any NOLs? What type of expense allocations will be allowed in view of the fact that the IRS has not provided any regulatory guidance in the past 40 years, and that a reasonable-allocation method is still part of the Service's own regulatory language with respect to allocation of expenses?

Considering this lack of formal guidance from the IRS, tax-exempt organizations seemingly are left to develop their own approaches to income tax reporting on Form 990-T. In addition, the IRS has identified tax-gap issues (including unrelated business activities) as a current examination focus area that will span industry lines rather than being confined to university- or hospital-only targets.[3] These developments should make all exempt organizations concerned about the next steps to take relative to the tracking and reporting of unrelated business activities. Now is the time to be prepared for increased IRS scrutiny of current tax reporting methodologies, by examining the compliance and reporting issues raised in the questionnaires and examinations discussed in the Final Report.

As noted previously, through examinations resulting from the Colleges and Universities Compliance Project, the IRS:

- Re-characterized exempt activities that had not been reported on Form 990-T as unrelated, but also re-characterized a number of activities that had been reported on Form 990-T that, in the view of the IRS, should not have been reported as unrelated at all.
- Determined that most tax-exempt organizations are not properly identifying the correct expenses that can be allocated to their unrelated business activities.
- Concluded that NOLs from these unrelated activities are not properly recorded, accumulated, and carried forward.

Based on its findings in the follow-up audits, the IRS re-characterized hundreds of activities from "related" to "unrelated" or from "unrelated" to "related," and reallocated millions of dollars of expenses for failing to demonstrate a "primary and proximate" connection to the unrelated business activities, ultimately resulting in increased UBI totaling approximately $90 million. Further, the IRS disallowed more than $170 million of NOLs that had been carried forward for too many years by these tax-exempt organizations. Those corrections are estimated to amount to more than $60 million in assessed taxes. Because of the aggressive approach that the IRS took with respect to UBI, tax-exempt organizations are understandably confused and uncertain about how they should report their unrelated

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2 On February 26, 2014, House Committee on Ways and Means Chairman Dave Camp (R-Mich) released a Tax Reform Act of 2014 discussion draft, and the bill was introduced, in hopes of leading the first comprehensive overhaul of the U.S. Tax Code since the Tax Reform Act of 1986. The bill proposed a "silo" approach under which tax-exempt organizations would determine UBI separately for each type of unrelated trade or business, prohibiting an organization from using a loss from one trade or business activity to offset the income from another activity. Tax Reform Act of 2014, H.R. 1, 113th Cong. section 5003 (2014), available at www.congress.gov/113/bills/hr1/BILLS-113hr1ih.pdf.

3 The "tax gap" is related to tax compliance and refers to the amount of tax liability not paid on time by taxpayers. Two large components of the tax gap in the exempt organization arena are unrelated business income tax and employment tax.