

## Non-profits face IRS scrutiny of unrelated business income

**A**re colleges and universities systematically cheating on their taxes?

The IRS seems to think so. In a report issued last month, it found underreporting in more than 90 percent of the university returns it examined in a compliance project, totaling hundreds of millions dollars.

The audit suggests that the IRS is stepping up its enforcement efforts for exempt organizations and that all non-profits—not just universities—should be more careful in reporting income from business activities.

While many people think of charitable and educational organizations as exempt from tax, this is not always the case.

“Tax-exempt” organizations do not have to pay tax on donations they receive or income from activities that contribute importantly to their mission.

However, this exemption from taxation does not extend to income from business activities that are conducted on a regular basis and are not substantially related to the exempt organization’s purposes. This income is known as unrelated business income, or “UBI.”

The tax on unrelated business income applies to these activities even if they help support the charitable organization’s mission. If a church, for example, were to open a hotel to raise funds, income from the hotel would be taxable.

Importantly, however, this same activity could be exempt if mission-related. For example, if a university were to open a hotel as part of its hospitality school, income from the hotel would probably not be taxable, because the business relates to the college’s exempt functions.

The different treatment in these examples makes sense, because the purpose of these rules is to protect for-profit businesses from unfair competition. With tax rates as high as they are, charities would have



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a major advantage if they did not have to pay taxes on such income.

Because the rules on unrelated business income arise out of concern about unfair competition with private business, they include exceptions for circumstances when competition is not a concern. Most importantly, non-profits are generally not subject to tax on their income from investment activities, such as investments in the stock market.

Given the complexity of the UBI tax rules, it is no surprise that the IRS compliance program found reporting issues. However, the scope of the problems that the IRS reported finding is staggering. The 34 entities that the IRS audited (selected after a questionnaire was sent to 400 organizations) had underreported income of \$90 million and improperly claimed losses of \$170 million. The numbers were so large that a House subcommittee held hearings this month to review the findings.

The IRS found many issues, but the principal ones were these:

- Universities misclassified activities as mission-related that the IRS viewed as unrelated, so they did not pay tax on income from the activities.

- Universities improperly took costs incurred for mission-related activities and charged them against their unrelated business income.

- Universities did not properly apply the many exceptions and modifications in

the rules on unrelated business income.

- Universities did not properly calculate the losses they were entitled to carry over from year to year.

This last concern may involve the most important legal issue arising from this project.

The IRS’s position, the report indicates, is that when a non-profit does not make money from an activity for many years, it is no longer conducted for profit, so losses from the activity cannot be used to offset other business income.

One question this raises is whether operating losses from the activity that the organization has accumulated in the past can be “carried forward” and used against future income from other business activities.

Many non-profits take the position that these losses can be carried forward. However, the report indicates that in the IRS’s view they cannot. Instead, the IRS believes that if an unrelated business does not generate a profit for a number of years (the report does not say how many), “loss carryforwards” from the business disappear. Applying this rule to the colleges examined, the IRS found improperly claimed carryforwards of \$150 million.

This is a new position, and to my knowledge there is no case law that supports it. However, the IRS seems to be aggressively applying it as part of its audit program.

Though the new report concerns colleges, the net operating loss issue and the other issues it describes apply to all exempt organizations. In light of the IRS focus on unrelated business income, exempt organizations should carefully examine their unrelated business activities to ensure that they are reported correctly and consistently. It is better to do this now than after the IRS comes knocking.

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