IRS Audits: What Could They Mean for Unrelated Business Income?

An IRS audit could happen when you least expect it.

By Laura Kalick

Most exempt organizations are well aware that the IRS conducts random audits. But it's important to realize that, in light of its limited resources, particularly for the Exempt Organizations Division, the IRS is increasingly focusing its examinations on areas it believes will yield a high return for its efforts.

When it comes to exempt organizations, the area that comes to mind is unrelated business income (UBI). For a recent example, look no further than the IRS College and University Compliance Project, in which the IRS examined approximately 40 colleges and universities and disallowed more than $170 million in losses and net operating losses (NOLs) due to errors in computation or substantiation of NOLs, lack of profit motive, improper expense allocations, and unrelated activities that were classified as exempt or excluded. Nonprofits engaging in unrelated activities risk facing an IRS audit and having past NOLs disallowed, which can result in a substantial retroactive tax burden.

With that in mind, in order to mitigate your risks, you should consider the following precautions when allocating expenses and using NOLs from unrelated business activity.

Defining Unrelated Business Income

The IRS has established certain analytic metrics to identify where there may be issues. The first page of the Form 990 reveals how much gross unrelated business income an organization has and the net amount of unrelated business taxable income reported on Form 990-T. To note, when organizations have had substantial gross UBI but no taxable income for three years, they may have a greater chance of being selected for an IRS examination. The biggest concerns are whether expenses being used to offset unrelated business income are properly allocated to that income, and whether the activity generating the expenses even fits the definition of a trade or business, which depends on whether there was a profit motive when conducting the activity.

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With regard to the allocation of expenses, page 9 of Form 990 provides a road map for the allocation of expenses, helping organizations characterize revenue as related, unrelated, or excluded. To claim unrelated trade or business income, the activity generating the income must pass a three-part test:

1. **The activity must not be substantially related** to the exempt purpose of the organization;
2. **The activity must be a trade** or business; and
3. **The activity must be carried on** regularly.

If a single activity is listed in both the related and unrelated columns, the IRS assesses whether the corresponding expenses are being allocated on a reasonable basis. Expenses related to an organization's mission cannot be used to offset unrelated business income. If personnel or facilities are used for both related and unrelated activities, a reasonable allocation must be made. Historically, this case-by-case assessment process has proved troublesome, and the IRS has begun work to smooth out issues and promote consistency. In fact, in its Priority Guidance Plan, the IRS indicates it plans to work on methods of allocating expenses relating to dual use facilities.

Where's the Profit Motive?

Profit motive is a key piece in defining an unrelated activity as a trade or business and determining whether net expenses from that activity are available to offset income from another unrelated trade or business. When considering an activity that generates losses year after year with no net income, the IRS and the courts have historically asserted that such activity is being conducted without motive to generate profit, and therefore can't be considered a trade or business. Consequently, an organization can't use the losses from such activities to offset the income from a profitable unrelated trade or business.

If such activities are determined to be without a profit motive, the IRS can disallow or "throw out" the losses, requiring an organization to pay up. In fact, it's a typical tactic for the IRS to disallow expense deductions from an unprofitable activity, even though the net operating losses may have been generated years ago. Such a verdict could pose significant unanticipated tax costs to an organization, and nonprofits should take steps to minimize the possibility of disallowed expense deductions. Note that the rule for NOLs is that they can be carried back to the two prior tax years to offset income from those years. Or, they can be carried forward for 20 years.

Document, Document, Document!

When undergoing an audit, an organization must provide sufficient documentation proving the profit motive of the activity in question. While the IRS's general rule is to assess only the open tax years, when assessing whether an NOL is legitimate, the IRS can review taxes back to the year the loss was generated, even if this means going back 20 years.

To prepare for the possibility of an IRS audit, you should carefully track and document losses and expenses from all UBI activities. Specifically, you should keep and file old tax returns and all related calculations, as well as allocations, memos, and agreements.

Recently, Congress has weighed in on the issue of using net operating losses from one activity to offset income from another activity. In fact, a provision of the Draft Tax Reform Act of 2014 would not allow losses from one UBI activity to offset the gains of another UBI activity.

Does your nonprofit conduct any unrelated business activity? If so, be sure to put practices in place to prepare for a potential IRS audit.

Laura Kalick , JD, LLM in Tax (lkalick@bdo.com), is National Nonprofit Tax Consulting director and writes for the Nonprofit Standard blog (Nonprofitblog.bdo.com), from which this article is adapted.

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