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BLOG POST

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Lots of Colleges and Universities Have Lots of Unrelated Business Taxable Income — What About You?

Yesterday, the IRS released its final report on its compliance project on colleges and universities. (For those who don't remember, this started in 2008 with questionnaires sent to 400 randomly-selected exempt colleges and universities, followed by 34 not-at-all-randomly-selected audits.) While there were other interesting findings, I'd like to focus on the widespread and substantial underreporting of (and corresponding underpayment of taxes on) unrelated business taxable income: you can see the error rates and dollars involved in the final report.

While the study was limited to institutions of higher learning, there is a cautionary tale here for much of the charitable sector. The major problems cited by the IRS in the unrelated business area were:

- improperly claiming expenses to offset taxable income where expenses related to activities were not conducted with a profit motive. You can't get business expense deductions if you're not running a business for profit, and the IRS decided you can't be running a business for profit if you consistently lack profits.
- improperly allocating costs associated with assets that are used for both exempt purposes and in unrelated business activities. You can't over-allocate the expense of dual-use assets to offset your taxable income.
- errors in calculating net operating losses, and unsubstantiated net operating losses.
- misclassifying unrelated business activities as related to and substantially furthering exempt purposes, and therefore not subject to tax.

Activities conducted by colleges and universities most often associated with unrelated business reporting problems were fitness centers and sports camps, advertising, facilities rentals, arenas, and golf. While very few charities have a golf course, income from advertising and facilities rentals is common. The unrelated business income tax has been described, only half jokingly, as an "optional" tax in light of the many exceptions and avoidance techniques available, but the results of this compliance project may be a warning that could be changing. Concerned charities may want to get ahead of the IRS by conducting their own internal unrelated business income tax compliance audit. The new report tells them what to look for.

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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