These are challenging times for the Internal Revenue Service (“IRS”), and even more so for its Exempt Organizations Division (“EO”). A divisive Congress and poor relations between the President and Congress have resulted in insufficient funding and demoralizing attacks on the IRS. In a recent speech, IRS Commissioner John Koskinen spoke to the devastating impact of budget cuts on the IRS workforce, noting, among other things, that the IRS budget for Fiscal Year 2015 is $1.2 billion less than five years ago, an approximately 10 percent reduction without adjusting for inflation. Articles in April 2015 in the Washington Post note that the decline in the IRS workforce has resulted in the IRS being unable to respond to most requests for taxpayer assistance prior to the April 15 filing date; and although the IRS collects about 93 percent of the revenue that keeps the federal government going, the IRS does not have the resources to pursue appropriately delinquent taxpayers, even those who owe significant amounts and have the means to pay. As with many other issues that suffer currently because of the dysfunction at the Federal level, this does not seem to serve the long-term interests of our country. The payment and collection of taxes is critical to the well being of the United States. While certainly less critical, ensuring that tax-exempt organizations meet the requirements for exemption, properly complete and file Form 990, and, when required, file Form 990-T and properly report the unrelated

business income tax ("UBIT") due is important to public confidence in, and the long-term success of, our vital charitable sector.

A report released by the General Accounting Office ("GAO") in December of 2014 ("2014 GAO Report"), spoke to the importance of the tax-exempt sector, representing over 1.6 million entities and an estimated five percent of the gross domestic product, with a concentration in healthcare and education. In assessing IRS oversight, the GAO found as the IRS budget has declined over the past several years, "the number of full-time equivalents (FTEs) within its Exempt Organizations (EO) division has fallen, leading to a steady decrease in the number of charitable organizations examined. In 2011, the examination rate was 0.81 percent; in 2013, it fell to 0.71 percent. This rate is lower than the exam rate for other types of taxpayers, such as individuals (1.0 percent) and corporations (1.4 percent)." Among the oversight challenges noted is that EO does not have quantitative measures of compliance, and therefore cannot set quantitative, results-oriented goals for increasing compliance or assess to what extent its actions are affecting compliance; and the e-filing rate for tax-exempt organizations is significantly lower than for other taxpayers, which means less digitized data available for data analytics and higher labor costs, impacting the IRS having timely accurate and complete data.4

Given the state of the country, it is with great humility that I offer some small suggestions for improving the Form 990-T that I believe could better assure that charities are more knowledgeable about, and better comply with, their UBIT reporting and tax obligations. These proposed changes may be realizable, as they that can be implemented without congressional approval; although they would require resources within EO and the IRS that may not be available. A number of other changes that would be highly desirable, but require Congress, or at least Treasury, leadership, seem highly unlikely for the foreseeable future for political reasons. And, of course, it is possible that even a redesign of the Form 990-T could become so embroiled in politics that substantial change is not possible.

4 See UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, TAX-EXEMPT ORGANIZATIONS: BETTER COMPLIANCE INDICATORS AND DATA, AND MORE COLLABORATION WITH STATE REGULATORS WOULD STRENGTHEN OVERSIGHT OF CHARITABLE ORGANIZATIONS (2014), available at http://www.gao.gov/products/GAO-15-164 [hereinafter “2014 GAO Report]. The GAO made three recommendations: the IRS should 1) develop compliance goals and additional performance measures that can be used to assess the impact of enforcement activities on compliance and 2) clearly communicate with state charity regulators how they are allowed to use IRS information related to examinations of charitable organizations. GAO also recommends that Congress consider expanding the mandate for 501(c)(3) organizations to electronically file their tax returns to cover a greater share of filed returns.” GAO advised that: “In written comments, IRS agreed with GAO’s recommendations. Id. at Highlights. The GAO findings suggest the desirability of a Form 990-T that facilitates both data-driven, computer-based determinations and public oversight. See also UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, INTERNAL REVENUE SERVICE: OBSERVATIONS ON IRS’S OPERATIONS, PLANNING, AND RESOURCES (2015), available at http://www.gao.gov/products/GAO-15-420R.
A redesigned Form 990-T could meet four goals related to improving the UBIT and enhancing compliance: (1) better assisting taxpayers in properly reporting their UBIT; (2) increasing the ability of the IRS to determine the organizations and issues to examine based solely on information provided in the filed forms; (3) making the public oversight envisioned by Congress more effective; and (4) improving the data available to Treasury and Congress to facilitate a more thoughtful consideration of possible changes to the UBIT. The first three goals also should result in an increase in tax collection. However, it is unclear the extent to which there are significant dollars at issue. The most recent IRS Statistics of Income (“SOI”) on UBIT (tax year 2011)\(^5\) shows that over 43,000 tax exempt organizations filed a Form 990-T with the IRS, reporting about $11.4 billion in gross unrelated business income and $11.2 in deductions, resulting in over $350 million in tax. The SOI found that over half of all organizations that were required to file Form 990-T did not report any UBIT liability after subtracting deductions from gross unrelated business income; Section 501(c)(3) organizations were the most common filers, filing approximately 35 percent of the returns, and they accounted for 65 percent of all unrelated business income, 67 percent of all deductions, and 58 percent of all unrelated business income tax liability.

Finally, I note that the focus of this paper is limited to the filing of Form 990-T by organizations described in Section 501(c)(3) of the Internal Revenue Code\(^6\) and by governmental colleges and universities with respect to their reporting of unrelated business income. The Form 990-T is filed by a variety of other exempt organizations that have gross income from an unrelated trade or business, including organizations described in Section 501(a), applicable reinsurance entities under the Affordable Care Act of 2010,\(^7\) qualified tuition programs under Section 529, individual retirement accounts (traditional IRAs, Roth IRAs, simplified employee pension plans, and saving incentive match plans for employees of small employers) under Section 408, Coverdell education savings accounts under Section 530(b), Archer medical savings accounts under Section 220(d), and health savings accounts under Section 223(d). Form 990-T also provides the mechanism for proxy tax liability to be reported, for regulated investment companies and real estate investment trusts to claim an income tax refund on undistributed long-term capital gain, and for credits to be requested for certain federal excise taxes or small employer health insurance premiums paid.\(^8\)

I. Overview of Unrelated Business Taxable Income and the Form 990-T

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6. Hereinafter all references to a “Section” or a “Subsection” means a section or subsection of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.


An organization that qualifies for exemption under Section 501(c)(3) is not taxable on its income resulting from activities that are substantially related to its charitable or other purposes that form the basis for its exemption. With modifications and special rules, however, an exempt organization is taxable on income resulting from income that is not substantially related to its exempt purposes.

Exempt organizations that have gross unrelated business income from an unrelated trade or business of $1,000 or more are required to file Form 990-T, “Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))”. While the obligation to file a return is based on gross income from any unrelated trade or business, tax is paid only on the net income calculated under applicable rules. Section 6104(d)(1)(A)(ii), enacted in 2006, requires Section 501(c)(3) organizations that file a Form 990-T because they exceed the gross income threshold to make their returns, including amended returns, available for public inspection for a period of three years from the date the form is required to be filed, including extensions.

The initial UBIT provisions were promulgated in the Revenue Act of 1950, and today are codified in Sections 511-515. The legislative history and Treasury Regulations

10 A Section 501(c)(3) organization that files Form 990-T for the sole purpose of requesting a credit for certain federal excise taxes paid under Section 6033(e) does not have make the Form 990-T available for public inspection; and only schedules, attachments, and supporting documents that relate to the imposition of UBIT must be made available for public inspection. See Form 990-T Instructions, supra note 8, at 7.
11 Sections 511-513 and Section 502, relating to the taxation of “feeder organizations” were enacted as part of the Revenue Act of 1950, Pub. L. No. 81-814, § 301, 64 Stat. 906 (1950); Sections 514 and 515 were added in Act Aug. 16, 1954, ch. 736, 68A Stat. 172 and 176 (1954).

Prior to enactment of the Revenue Act of 1950 (which added IRC provisions now numbered 502 and 511 through 514), the Service made numerous attempts to deny exemption to organizations which engaged in transparently profit-making activities on the ground that these organizations were not organized and operated exclusively for their stated exempt purpose. The courts almost always ruled against the Government in these proceedings, however. The principal stumbling block was the “destination of income” test laid down by the United States Supreme Court in Trinidad v. Sagrada Orden de Predicadores, 263 US 578, T. D. 3548, III-1 C.B. 270 (1924), holding, at least in common understanding, that the destination and not the source of the income was the ultimate test of the right of exemption.

Also, prior to 1951, certain organizations popularly called “feeder” organizations were held exempt from Federal income tax under the predecessor to IRC 501(c)(3), even though their sole activity was engaging in commercial business, and the only basis for exemption was the fact their profits were payable to specified exempt organizations. See Roche’s Beach, Inc. v. Commissioner, 96 F.2d 776 (1938); Willingham v. Home Oil Mill, 181 F.2d 9 (1950); C.F. Mueller Company v. Commissioner, 190 F.2d 120 (1951). The courts held that the exclusive purpose
reflect that the primary purpose for the enactment was to address a source of “unfair competition” with for-profit businesses. Section 511 imposes the tax on “unrelated business taxable income” (“UBTI”), as defined in Section 512, of specified organizations otherwise exempt from Federal income tax. It provides that the tax rate is at corporate rates under Section 11 for most organizations described in Sections 501(c), but that charitable trusts described in Section 501(a), stock bonus, pension and profit-sharing plans under Section 401(a), supplemental unemployment benefit trusts described in Section 501(c)(17), and pension plans described in Section 501(c)(18), regardless of form, are subject to tax at the individual rates under Section 1(d), but without the deduction for personal exemption. Section 511(a)(2)(B) provides that colleges and universities that are governmental entities, and their wholly-owned corporations, also are subject to tax on the same basis as organizations described in Section 501(c).

Section 512 defines UBTI. The general rule set forth in Subsection (a) is: “Except as otherwise provided in this subsection, the term ‘unrelated business taxable income’ means the gross income derived from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).” The modifications in subsection (b) include, among others, the well-known exclusions for most: dividends; interest; payments with respect to securities loans; royalties; rents for real property; and the sale, exchange, or other disposition of property other than inventory and other property held primarily for sale in the ordinary course of business; as well as certain research. It also includes the special rules for certain amounts received from controlled entities (Section 512(b)(13)). Section 512(b)(6) generally permits organizations to utilize the net operating loss deductions (“NOLs”) provided in Section 172.

Section 513 defines “unrelated trade or business.” The general rule set forth in Subsection (a) is: “The term ‘unrelated trade or business’ means, in the case of any organization subject to the tax imposed by section 511, any trade or business the

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13 See, e.g., S. REP. NO. 2375 (1950); H. REP. NO. 2319 (1950); Treas. Reg. § 1.513-1(b).
14 For an outstanding paper on Section 512(b), see James K. Hasson, Jr. & Suzanne Ross McDowell, Unrelated Business Income Tax (UBIT): Pushing the Boundaries of Section 512(b), AM. BAR ASS’N-AM. LAW INSTIT. TAX EXEMPT ORGANIZATIONS: AN ADVANCED COURSE (Oct. 14, 2011), available at Westlaw at https://a.next.westlaw.com/Document/I9e7d6df5e1a11e08b05df15589d8ef8?navigatio nPath=Search%2Fv3%2Fsearch%2Fresults%2Fnavigation%2Fi0ad604070000014cba543e13a5482e90%3D%3DANALYTICAL%26fragmentIdentifier%3D1D9e7d6df5e1a11e08b05df15589d8ef8%26startType%3D1%26contextData%3D%2528sc.Search%2529%26transitionType%3DSearchItem&listSource=Search&listPageSource=69365897485499651e6df6603c0bb508&list=ANALYTICAL&rank=2&grading=na&s essionScopeld=5a5f463f6d0b8a71f144b511ca94f855b&orignationContext=Search%20Result&transitionType=SearchItem&contextData=%28sc.Search%29.
conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function described in section 501....” Treasury Regulations provide that a trade or business is "substantially related" to exempt purposes only where the activity of the trade or business itself contributes importantly to the accomplishment of those purposes; and, in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve.15

Section 513 then excepts any trade or business “(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation;” “(2) which is carried on” by an organization described in Section 501 or a governmental college or university “primarily for the convenience of its members, students, patients, officers, or employees;” or “(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.” Other Subsections relate to specific activities, including qualified public entertainment activities such as trade shows and state fairs, bingo games, distributions of low cost articles, and certain sponsorship payments.

Subsection (c), enacted as part of the Tax Reform Act of 1969,16 makes it clear that an activity does not lose its identity as a trade or business merely because it is conducted within a larger group of activities that may or may not be related to an organization's exempt purposes. It provides:

**(c) Advertising, etc., activities**

For purposes of this section, the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

This provision, discussed in greater detail below, is commonly known as the “fragmentation” rule.

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15 See Treas. Reg. § 1.513-1(d).
Section 514 sets forth special rules for calculating UBTI where unrelated trade or business activities involve debt-financed property. Section 515 provides for a tax credit in calculating UBTI for certain taxes imposed by foreign countries and possessions of the United States.

While a detailed discussion of UBTI is beyond the scope of this paper, greater consideration of several issues is important to considering the efficacy of changes that might be made to the Form 990-T and these are discussed in Part IV.

II. IRS College and University Study

In October of 2008, the IRS sent extensive questionnaires to 400 randomly-selected colleges and universities requesting information for their tax years ending in 2006. Based on the responses, the IRS selected 34 colleges and universities for examination “because their questionnaire responses and Form 990 reporting indicated potential noncompliance in the areas of unrelated business income and executive compensation.”

On May 7, 2010, IRS Exempt Organizations issued Colleges and Universities Compliance Project Interim Report (“Interim Report”), which presented an overview of responses to the compliance questionnaires by 344 colleges and universities, representing 177 private and 167 public institutions. The Interim Report sets forth information about organizational structures, demographics, exempt and unrelated business activities, endowment funds, executive compensation, and governance practices, classified into three groups based on the size of the school’s student population.

On April 25, 2013, with more than 90 percent of the examinations completed, the IRS issued Colleges and Universities Compliance Project Final Report (“Final Report”). The Final Report focuses on UBI and executive compensation, although it also reported on additional issues, including some supplementary data analysis with respect to the responses to the compliance questionnaires. The Final Report recognizes that the 34 colleges and universities that were examined were not randomly selected and therefore assumptions cannot be drawn about other colleges and universities based on the examinations. With regard to the questionnaire data analysis and unrelated business activities, the Final Report found:

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19 See Final Report, supra note 17.
20 See Final Report, supra note 17, at 10.
"II. Unrelated Business Activities"

- About 60 percent of all colleges and universities had, at some point, filed a Form 990-T, with public institutions more likely than private to have filed.

- The activities most frequently reported on Form 990-T were Facility Rental (14 percent), Advertising (11 percent) and Recreation Center Usage (9 percent).

- All colleges and universities engaged in activities that they did not report on Form 990-T. Of the three most frequently reported activities (whether or not reported on Form 990-T):
  - 63 percent of colleges and universities engaged in Facility Rental with 14 percent reporting it on Form 990-T;
  - 54 percent engaged in Bookstore with 7 percent reporting it; and
  - 48 percent engaged in Food Service with 2 percent reporting it.

- The following shows by activity, the percentage of public and private colleges and universities engaged in that activity compared to the percentage reporting that activity on Form 990-T:
  - Public
    - Facility rental, 82 percent engaged with 53 percent reporting.
    - Food services, 64 percent engaged with 5 percent reporting.
    - Bookstore, 60 percent engaged with 12 percent reporting.
  - Private
    - Facility rental, 57 percent engaged with 11 percent reporting.
    - Bookstore, 52 percent engaged with 5 percent reporting.
    - Food services, 42 percent engaged with 1 percent reporting.

With respect to the examined colleges and universities, the Final Report provided the following UBIT highlights:

“Examinations have resulted in:

- Increases to UBTI for 90% of colleges and universities examined totaling about $90 million;

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\(^{22}\) See Final Report, supra note 17, Executive Summary at 2-3.
• Over 180 changes to the amounts of UBTI reported by colleges and universities on Form 990-T; and
• Disallowance of more than $170 million in losses and Net Operating Losses (NOLs, i.e., losses reported in one year that are used to offset profits in other years), which could amount to more than $60 million in assessed taxes.

The primary reasons for increases to UBTI in the completed exams were:

• *Disallowing expenses that were not connected to unrelated business activities:* The IRS found that examined colleges and universities were reporting certain losses as connected to unrelated business activities when they were not. The misreporting occurred in two ways:
  
  o *Lack of profit motive:* The IRS found that organizations were claiming losses from activities that did not qualify as a trade or business. Nearly 70 percent of examined colleges and universities reported losses from activities for which expenses had consistently exceeded UBI for many years. UBI must be generated by a “trade or business.” An activity qualifies as a “trade or business” only if, among other things, the taxpayer engaged in the activity with the intent to make a profit. A pattern of recurring losses indicates a lack of profit motive. The IRS disallowed reporting of activities for which the taxpayer failed to show a profit motive. Those losses no longer offset profits from other activities in the current year or in future years, with more than $150 million of NOLs disallowed.

  o *Improper expense allocation:* The IRS also found that on nearly 60% of the Form 990-Ts we examined, colleges and universities had misallocated expenses to offset UBI for specific activities. Organizations may allocate expenses that are used to carry on both exempt and unrelated business activities, but they must do so on a reasonable basis and the expenses offsetting UBI must be directly connected to the UBI activities. In many cases, the IRS found that claimed expenses, which generated losses, were not connected to the unrelated business activity.

• *Errors in computation or substantiation:* The IRS checked the calculations for all NOLs reported on returns under exam and found that NOLs were either improperly calculated or unsubstantiated on more than a third of returns. As a result, the IRS disallowed nearly $19 million in NOLs.
• **Reclassifying exempt activities as unrelated**: The IRS determined that nearly 40 percent of colleges and universities examined had misclassified certain activities as exempt or otherwise not reportable on Form 990-T. Fewer than 20 percent of these activities generated a loss. The examinations resulted in the reclassification of nearly $4 million in income as unrelated, subjecting those activities to tax.

Examinations resulted in more than 180 changes to UBTI reported for specific activities by colleges and universities. More than 30 different activities were connected to the changes. The majority of these adjustments came from the following activities:

• Fitness, recreation centers and sports camps
• Advertising
• Facility rentals
• Arenas, and
• Golf

The Final Report\(^{23}\) states that these activities, in order of frequency, were connected to more than half of the adjustments and that advertising and facility rentals resulted in changes in UBTI for nearly half of colleges and universities examined, while fitness, recreation centers, and sports camps, arenas, and golf course resulted in UBTI adjustments for about a third of the schools examined.

Focusing on dollars, the IRS made approximately $260 million in adjustments, comprised of about $90 million in additional UBTI and more than $170 million in disallowed losses. Of those amounts, more than $150 million – almost 58 percent of all adjustments and almost 90 percent of disallowed losses – related to a lack of profit motive, that is non-qualifying activities generating losses that were or could become available to offset gains in unrelated trade or businesses. While the examined colleges and universities certainly did not constitute a representative sample, the amount at issue coupled with the fact that this was the most common adjustment, with disallowances affecting 70 percent of the organizations, suggests that more should be done to address the issue.

The Executive Summary of the Final Report concludes with “Next Steps”:\(^{24}\)

> “The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly, especially at recurring losses and the allocation of expenses, and

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\(^{23}\) See Final Report, *supra* note 17, at 11-12.

\(^{24}\) See Final Report, *supra* note 17, Executive Summary at 6.
to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation.”


The Exempt Organizations portion of the ACT Report in 2014, Analysis and Recommendations Regarding Unrelated Business Income Tax Compliance of Colleges and Universities (“ACT Report”), focused on UBIT compliance by colleges and universities in light of the IRS’s colleges and universities study, and chose the topic because of the IRS’s stated intention to increase its focus on UBTI reporting (as announced in the “Next Steps” portion of the Final Report). The ACT Report provided an overview of UBIT, starting with the history of UBIT, discussed: the application of UBIT rules to colleges and universities; the IRS study of colleges and universities compliance recommendations; customer education and outreach by the Exempt Organizations Division of the IRS; and, more briefly, the current Form 990-T. It then concluded with five recommendations. The ACT Report also included five appendices, including a draft redesigned Form 990T.

The five recommendations are:26

(1) The IRS Exempt Organizations Division should recommend that Chief Counsel and Treasury open a regulation project so that profits from a substantial commercial activity will not preclude exemption under I.R.C. § 501(c)(3) as long as an organization’s income and its financial resources are used commensurate in scope with its charitable program.

(2) The Exempt Organizations Division should work with Chief Counsel and the Treasury Department to provide formal guidance to the field regarding proper methods for allocating indirect costs where facilities and/or personnel are used to carry on exempt activities and to conduct unrelated trade or business.

(3) The Exempt Organizations Division should work with the Chief Counsel and the Treasury Department to publish a comprehensive revenue ruling on a range of UBI issues. The ruling should provide categories of activities that will be considered related and unrelated, guidance on preparatory time spent on

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26 Id. at 157-74
activities, and scenarios of situations involving the activities frequently reported on the college and university questionnaire, such as facility rentals and dual use properties.

(4) The IRS should expeditiously formalize and adopt a new Form 990-T based upon the proposed format enumerated in this report. The new form will be web-based and have as its centerpiece activity-by-activity reporting on "Checklist A". This checklist - which would not be open to public disclosure - includes links to education and outreach materials; activity-specific worksheets that provide step-by-step processes for calculating revenues and expenses; and flow-through to a new, streamlined Form 990-T (see Appendices B and C).

(5) The IRS should continue to leverage its use of its electronic database and web based resources to improve and enhance its communication, education, and training. The IRS should continue to improve, update and enhance the public and tax professional’s access to the IRS materials and information available on its website.

The ACT Report included five appendices:

Appendix A is a proposed revenue ruling on unrelated business income. It examines the application of the law to 23 activities by private schools and colleges and universities and states whether and the extent to which the activity results in unrelated business income: four involving facility rentals of dual use property; three involving cell tower rentals; four involving hotel rentals and dormitory use; two involving catering and food services; one involving an exclusive provider arrangement; one involving website publications; two involving bookstore operations; two involving youth camps; two involving technology transfer; one involving the sale of advertising in connection with an annual five-day baseball tournament; and one involving a foreign blocker corporation.

Appendix B is a draft redesigned Form 990T.

Appendix C is a 990T Unrelated Business Activities Checklist. The ACT Report recommendation is that the Checklist not be subject to public disclosure.

Appendix D is a list of IRS Continuing Professional Education texts related to UBIT.

Appendix E is the Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V – Tax Exempt Entities.
One of the six members of the Exempt Organizations portion of the ACT, Marty Martin, wrote a *Concurring, Dissenting, And A Sixth Recommendation For An Economic, Financial, And Statistical Study of IRS Statistics Of Income ("SOI") And Related Data To Inform and Guide IRS Policy and Practices for Nonprofit's Unrelated Business Income Practices and Unrelated Business Income Tax To Include Considerations Of Alternative Tax Regimes* that is not available with the ACT Report or on the IRS website but that he advises was “hand delivered to the IRS Commissioner as written comments accompanied by a request to include these comments.” Mr. Martin agreed with Recommendation 5 (leverage electronic resources), which he stated he “substantively wrote for the report;” concurred in part with Recommendation 1 (commerciality and commensurate) “to the extent these inquiries may result in the removal or diminution of these constraints;” and dissented “from the report’s Recommendations 2 (allocations), 3 (revenue ruling), and 4 (Form 990T),” declining to “support the adoption of these recommendations in the absence of a substantive financial, economic, and statistical valid analysis of unrelated business income and unrelated business income tax;” and made the following additional recommendation: “Using IRS Statistics of Income ("SOI") and other relevant data, the IRS should engage in an economic, financial, and statistical study of IRS Statistics of Income ("SOI") to inform and guide IRS and the U.S. Department of the Treasury’s Office of Tax Policy to consider policy and practices for the nonprofit’s sectors unrelated business income practices and unrelated business income tax to include considerations of alternative tax regimes.” He notes that the IRS colleges and universities study did not utilize a representative sample from a statistically valid random stratified sample of all colleges and universities and envisioned a follow-up study that has not occurred to date; neither the IRS nor Treasury has used the SOI’s capabilities to analyze UBIT in response to the IRS reports; the IRS should engage in a significant economic, financial, and statistical valid analysis of SOI and other data to inform and guide IRS policy and practice regarding the nonprofit sector’s UBIT; and he believes that a “flat tax” or other novel approach should be considered for UBIT, which could result in a “simple three line calculation and filed electronically”: Gross UBI x Tax Rate = Taxes Owed.

On many levels, the Final Report is an outstanding undertaking and a great resource. I agree with the first three recommendations (issuance of regulations to the effect that substantial commercial activity should not preclude exemption under Section 501(c)(3) as long as the organization’s income and its financial resources are used commensurate in scope with its charitable program; issuance of formal guidance regarding proper methods for allocating indirect costs where facilities and/or personnel

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are used to carry on exempt activities and to conduct unrelated trade or business; and issuance of a comprehensive revenue ruling on a range of UBI issues), although I think it is highly unlikely that any will move forward in this environment; but this is not to suggest that they are not wholly appropriate ACT recommendations. I also agree with the fifth recommendation (the IRS should continue to leverage its use of its electronic database and web based resources to improve and enhance its communication, education, and training, and continue to improve, update and enhance the public and tax professional’s access to the IRS materials and information available on its website) and think progress in that area is possible currently, subject to resource issues.

The fourth recommendation (the IRS should expeditiously formalize and adopt a new Form 990-T) is the topic of this paper. The ACT vision is four-fold: heighten education and outreach in the UBIT area; simplify the Form 990-T for those organizations required to file; minimize the size of the return if possible; and provide “yes/no” responses to IRS questions seeking overall UBIT data. The recommendation that the form be web-based is, of course, unassailable; although that is a resource and priorities issue for the IRS. Without electronic filing, the IRS must input data manually to be able to conduct data analytics and to make computer-based determinations, and, as a practical matter, Forms 990-T are much less available to the public and press. The recommendation includes that the centerpiece be an activity-by-activity reporting based on a draft Checklist that was provided – which would not be open to public disclosure – and which includes links to education and outreach materials and to specific worksheets. A goal is to provide step-by-step processes through worksheets that acts as a “flow-chart” or “decision tree” and walks the organization through the process of recognizing (e.g., trade or business? regularly carried on? not related to exempt purpose?) and reporting UBI, all in plainly-worded narratives, practical examples, and step-by-step worksheets that calculated revenues and expenses and then flowing through to the new streamlined Form 990.

There are a number of excellent ideas in the ACT Report, as well as suggestions that can be developed. Big picture, I have three major concerns about the approach recommended in the ACT Report. First, the ACT does not focus on the desirability of creating a new Form 990-T that facilitates IRS examinations – presumably in many cases beginning with compliance checks or “desk” examinations – by allowing for data-driven, computer-based determinations of which organizations are most likely to be non-compliant and therefore should be examined. The IRS has recently announced that it will utilize a more data-driven approach to identifying exempt organizations to examine based on computer scans of Forms 990.30 It seems unlikely that such an approach

30 See, e.g., Diane Freda, IRS Exempt Chief: Sharper, Faster Tool Available in Data-Driven Exams, BLOOMBERG BNA DAILY TAX REPORT (March 20, 2015) (Comments of Tamera Ripperda, Director of Exempt Organizations, Tax-Exempt and Government Entities Division, Internal Revenue Service, at the Washington Non-Profit Legal and Tax Conference); Paul C. Barton, Minding the P’s and Q’s on Form 990, EOs Warned, TAX ANALYSTS’ TAX NOTES TODAY (March 20, 2015)(Comments of Elaine Leichter, Tax
would be effective with the current Form 990-T. Thus, while the draft revised “streamlined” Form 990-T is an improvement over the current form on a number of levels, it suffers from what I view as one of the failings of the current form – on its face, there simply is insufficient information for the IRS to be able to provide effective oversight.

Second, the ACT seems to have not considered, or at least to have rejected without mention, the desirability of creating a form that allows for better public oversight. Congress made the decision in 2006 that the Form 990-T of Section 501(c)(3) organizations should be made public, presumably to enhance public oversight. While there was controversy within the exempt organizations community about the wisdom and fairness of the decision (tax returns, as opposed to information returns, historically are confidential), Congress had the right to – and did – make the call. The Form 990-T has not been revised significantly since Congress acted in 2006. It strikes me that a public Form 990-T that provides insufficient information for public oversight makes no sense, wholly failing to achieve congressional intent. Moreover, given the limited resources of the IRS generally, and the Exempt Organizations Division specifically, which is acknowledged in the ACT Report, allowing for public oversight would seem to be an important factor in promoting compliance both because charities are likely to be impacted directly when they know that their returns are subject to public oversight and because the public, the press, competitors, and those involved with the charity can in fact challenge the charity.31

Interestingly, the 2014 GAO Report32 reported that of the 4,495 examinations of charitable organizations in 2013, 41 percent related to the IRS National Research Project on employment taxes (which contributed to an unusually high number of exams during that year) and similar initiatives, 22 percent resulted from Form 990 data analytics, and 14 percent resulted from referrals from external and internal sources, including news items, alleging noncompliance. Other categories were: 10 percent document matching, 4 percent review of operations, 3 percent refund or abatement claims, and 6 percent compliance checks. The GAO reported that of the 6,940 total referrals in 2013, the two most common sources for tax-exempt entities were the general public – with 81 percent – and other IRS functional areas – with 12 percent. Thus, the 2014 GAO Report supports the importance of a Form 990-T that allows for IRS analytics and referrals from the public.

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31 Section 7623 provides for awards up to 30 percent of collected proceeds (including, tax, interest, and penalties) to whistleblowers who report underpayments of tax. Because the disputed amounts must be at least $2 million to qualify as of right for such awards, it seems unlikely that Section 7623 provides much additional incentive for reporting UBTI underpayments. See, e.g., Internal Revenue Service, Internal Revenue Manual, at Part 25 (Special Topics), Ch. 2 (Information and Whistleblower Awards), Section 2 (Whistleblower Awards) (2010), available at http://www.irs.gov/irm/part25/irm_25-002-002.html.

To the contrary, the ACT Report recommends that the draft proposed 990T Unrelated Business Activities Checklist (Appendix C) not be subject to public disclosure. The worksheet referenced as a model in the ACT Report is the Social Security Benefits Worksheet (“SSB Worksheet”) associated with Form 1040, U.S. Individual Income Tax Return. The SSB Worksheet is designed to assist taxpayers in computing taxable Social Security benefits, but it is not mandatory to use the SSB Worksheet and the SSB Worksheet is not required to be filed with the Form 1040; the Worksheet explicitly states “Keep for Your Records.” While the IRS has the benefit of the Checklist proposed by the ACT, and any “yes/no” responses to IRS questions seeking overall UBIT data that may be developed, there is no suggestion in the ACT Report that the worksheets are part of the filing or that consideration was given to ease of IRS oversight of filed Forms 990-T or to the collection of meaningful data that could inform the development of examination guidelines, policy, or legislation.

Third, while I was concerned that limiting my Form 990-T focus to organizations described in Section 501(c)(3) and governmental colleges and universities with respect to their reporting of unrelated business income was too limited and could result in recommendations that make the form unworkable for other types of filers, the ACT Report recommendations are limited to a much narrower class – colleges and universities. Thus, for example, while the recommendation of providing step-by-step processes through worksheets that acts as a “flow-chart” or “decision tree” and walks the organization through the process of recognizing and reporting UBI seems like a splendid idea in theory, it would seem a formidable task once expanded to the universe of all organizations filing Form 990-T. Similarly, the Checklist, which has significant merit and could be developed to have additional merit, especially if publicly available, might become an unrealistic document if broadened to cover the breadth of applicable exempt organizations that file Form 990-T. Of course, there could be varying checklists for different types of organizations, or at least those with significant UBIT potential in a large array of activities.

A final comment relates to the merits of a short Form 990-T. The Form 990-T needs to be less complex and ambiguous so that organizations can complete it more accurately. In my opinion, at the same time, the form also needs to facilitate IRS examinations and meaningful data collection and allow for public oversight. Those goals do not necessarily support a shorter form. In fact, the basis for the ACT recommending a shorter form is not at all clear, as at the same time it also is recommending the creation of substantial paperwork (checklists, worksheets, etc.) that support the Form 990.

IV. Specific UBTI Issues

34 Even within the category of colleges and universities, the recommendations do not consider those that are medical in nature or that are universities that include medical schools or hospitals.
As previously noted, while a detailed discussion of UBTI is beyond the scope of this paper, greater consideration of several issues related to allowable deductions in determining UBTI and to the use of losses is important to considering changes that might be made to the Form 990-T to increase compliance.

A. Allowable Deductions in Calculating UBTI: Direct and Sole Use, Dual Use, and Exploitation of Exempt Functions

The regulations under Section 512 speak in greater detail about allowable deductions in computing UBTI. They provide that such deductions “not only must qualify as deductions allowed by chapter 1 of the Code but also must be directly connected with the carrying on of unrelated trade or business.” This in turn requires a “proximate and primary relationship to the carrying on of that business.”

To the extent that expenses, depreciation, and similar items are attributable solely to unrelated business activities, they “are proximately and primarily related … and therefore qualify for deduction to the extent that they meet the requirements of section 162, 16, or other relevant provisions of the Code.”

Dual Use Expenses. With respect to “dual use” expenses, incurred in connection with both exempt activities and unrelated trade or business activities, an allocation is required. The Final Report states that expense deductions were disallowed on more than 60 percent of the Form 990-Ts that were examined based on improper allocations between exempt unrelated activities. Treasury Regulations are, to understate the issue, not very helpful. They provide that “expenses, depreciation and similar items attributable to such facilities (as, for example, overhead) and personnel (as, for example, items of salary)” must be allocated on “a reasonable basis.” An example in those regulations allocates the president’s salary based on the time he spent in the unrelated trade or business activities. In the absence of direct accounting information, the Second Circuit in the Disabled American Veterans case affirmed a Court of Claims determination that expenses related to fundraising constituting both an exempt activity and an unrelated business activity (because of the premiums provided in return for contributions) should be allocated based on the gross receipts of each.

Potential allocable expenses can be considered in three buckets: direct expenses that are wholly attributable to the non-exempt activity; variable expenses that vary in

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35 See Treas. Reg. § 1.512(a)-1(a).
36 See Treas. Reg. § 1.512(a)-1(b).
37 See, e.g., Disabled American Veterans v. U.S., 704 F.2d 1570 (2d Cir. 1983)(rejecting the taxpayer’s argument that certain expenses benefitting both related and unrelated activities should be attributed entirely to the taxable unrelated activities).
38 See Final Report, supra note 17, at 13.
39 See Treas. Reg. § 1.512(a)-1(c).
proportion to the exempt and non-exempt activities; and fixed or indirect expenses. In the *Rensselaer Polytechnic Institute* case, the Second Circuit considered the issue of fixed or indirect expenses, such as depreciation. The court found that the indirect expenses were "by definition 'proximately and primarily related' to the business," rejecting the IRS's position that no part of such expenses should be allocable to the unrelated activities without the taxpayer first showing that such expenses would not have been incurred in the absence of the business activity. The court further found "reasonable" the university's method of allocation based on actual use – the time the fieldhouse was used for non-exempt purposes divided by the total time the fieldhouse was used – and rejected the IRS position that to be "reasonable" and "directly connected with" the allocation to non-exempt use should be based on total availability – the time the fieldhouse was used for non-exempt purposes divided by the total time the fieldhouse was available for use (i.e., idle time allocated entirely to the exempt use). In an Action on Decision ("AOD") that may still represent the view of the IRS and Chief Counsel, the IRS continued to take the position that fixed expenses should not be allocated on the basis of actual usage, and that the proper method of allocation should be based on hours used for unrelated activities compared to a "24-hour-a-day, 12-month a-year" period. However, the AOD recommend that the matter not be litigated until the "reasonable basis" language in Treas. Reg. 1.512(a)-1(c) is amended. Of course, the regulations have never been amended.

In the *Portland Golf Club* case, the Supreme Court found the "gross-to-gross method" of allocation was a reasonable method to allocate fixed expenses in connection with member (exempt) and non-member (non-exempt) sales of a social club, however, the IRS had in the case stipulated that the method was reasonable (presumably focusing only on the issues as to whether losses on sales to nonmembers could offset investment income if the nonmember sales were not motivated by an intent to profit and the methodology for determining an intent to profit.) In a footnote, the Court noted the stipulation and commented that the "method of allocation appears generous to Portland Golf. The club charges nonmembers higher prices for food and drink than members are

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42 See Rensselaer Polytechnic Institute v. Comm'r, supra note 41.
43 Id. at 15.
44 See AOD 1987-014 (June 18, 1987). The Rensselaer Polytechnic Institute decision was a two-one decision, with Judge Mansfield dissenting. The AOD relies heavily on his analysis. In GCM 39863 (June 3, 1991), 1991 WL 776309, FSA 1192 WL1355067 (Apr. 1, 1992), and FSA 1998 WL 1757809 (Nov. 20, 1998), the IRS maintained that the AOD remained its position on the issue of fixed expenses in dual use activities, but declined to litigate or assert the position as the regulations have not been amended.
45 See Portland Golf Club v. Comm'r, 497 U.S. (1990). The Court noted that the “Commissioner has taken no firm position as to the precise manner in which Portland Golf’s fixed costs are to be allocated between member and nonmember sales. Indeed the Commissioner does not even insist that any portion of petitioner’s fixed cost must be attributed to nonmember activities in determining intent to profit.” Id. at 18 (footnote omitted).
charged, even though nonmembers’ meals presumably cost no more to prepare and serve. It therefore seems likely that the gross-to-gross method overstates the percentage of fixed costs properly attributable to nonmember sales. In the Disabled American Veterans case, the taxpayer had sought to allocate in the context of periodicals related to its exempt function except for advertising – an exploitation activity discussed immediately below. Treasury Regulation 1.512(a)-1(f)(6) states: “Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.” Thus the IRS may challenge the “gross-to-gross” method outside of the social club context or where the method is unfair as, for example, where non-members are charged more than members.

No doubt the “flexibility” permitted in the Treasury Regulations has contributed greatly both to the confusion in computing UTBI and to the availability of calculating UBTI to the detriment of the fisc. There would seem to be great merit in regulations utilizing a standard based on the “best” or “most appropriate” method, with examples, and of expressly requiring a “consistent approach.” However, amending the regulations seems highly unlikely for the foreseeable future.

Exploitation Activities. Where an unrelated trade or business activity “exploits” the exempt function of the organization, the general rule is that “expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income … [because] they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity.” An illustration of such an exploitation activity in the regulations is the sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of the organization’s exempt purpose. A special rule allows for expenses attributable to the exempt activity to qualify as directly connected with the carrying on of the unrelated trade or business activity to the extent they exceed any income “derived from or attributable to the performance” of the exempt activity if the unrelated trade or business activity is of a type “normally conducted by taxable organizations in pursuance of such business;” however, the allocation may not result in a loss carryover or carryback with respect to that trade or business activity or be taken into account when computing UBTI “attributable to any unrelated trade or business activity not exploiting the same exempt activity.”

46 Id. at note 4.
47 See supra note 37.
48 See Gannett & Barrett, supra note 41.
49 See Treas. Reg. § 1.512(a)-1(d)(1).
50 See Treas. Reg. § 1.512(a)-1(d).
An example in the Treasury Regulations\textsuperscript{51} involves a business league that mails advertising to its members for a fee. The expenses attributable solely to the conduct of the advertising activity (e.g., the costs of the mailings and of staff devoted solely to the advertising activity) and the allocable portion of dual use expenses (e.g., staff engaged in both the advertising activity and exempt activities) are deductible, but the costs of developing the organization’s membership and carrying on exempt activities are not deductible as they are “incurred primarily in connection with” the organization’s “fundamental purpose as an exempt organization” and therefore “do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it. A second example in the Treasury Regulations\textsuperscript{52} involves a photography exhibition with an exhibition catalog that includes advertising. The example distinguishes (i) direct advertising costs, which are deductible and, to the extent the activity generates a net loss, that net loss can be used to offset other UBTI and are subject to carryover and carryback, (ii) exploitation costs related to the publication of the exhibition catalog (excluding the direct costs of the advertising in the catalog), which can be used to offset any net advertising income (advertising income less direct expenses) to the extent the exploitation expenses exceed the income from the sale of the catalog, but the exploitation costs cannot offset other UBTI and are not subject to carryover and carryback, and (iii) expenses directly connected with the exhibition, which may not be utilized to offset advertising income because the exhibition is not an activity normally conducted by taxable entities engaged in publication and the sale of advertising and therefore is not “directly connected” and does not have a “proximate and primary relationship” to the unrelated advertising activity. Treasury Regulations include detailed rules related to the sale of advertising in exempt organization periodicals, including the allocation of membership receipts to the cost of a periodical, deductions attributable to such periodicals, determining if a periodical is published for the production of income, and allowing for the consolidation of income and expenses of multiple periodicals published for the production of income, provided that once adopted, consolidation must be used consistently.\textsuperscript{53} With respect to dual use deductions, the regulations\textsuperscript{54} relating to exploitation advertising activities provide:

“Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be made on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of the item, but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Thus, for example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity; occupancy costs such as rent, heat and electricity may be allocated on the basis of the portion of space devoted to each activity; and

\textsuperscript{51} See Treas. Reg. § 1.512(a)-1(e), Example 1.
\textsuperscript{52} See Treas. Reg. § 1.512(a)-1(e), Example 2.
\textsuperscript{53} See Treas. Reg. § 1.512(a)-1(f).
\textsuperscript{54} See Treas. Reg. § 1.512(a)-1(f)(6)(i).
depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations."

B. Fragmentation, Aggregation, and Activities that are Not Profit Making

Fragmentation. While “integrated aggregates of assets, activities and good will … comprise businesses for the purposes of certain other provisions of the Internal Revenue Code,” for UBIT purposes, “[a]ctivities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.”55 This “fragmentation” rule requires that each revenue stream be reviewed to determine whether it constitutes an unrelated trade or business. Treasury Regulations provide two examples: a hospital pharmacy that makes regular sale of pharmaceutical supplies to the general public, as well as the hospital and its patients; and an exempt organization soliciting, selling, and publishing commercial advertising in a periodical otherwise related to its exempt purposes.56

Aggregation and Profit Motive. Although fragmentation results in viewing income streams as separate activities for purposes of determining whether any results from an unrelated trade or business, as a general rule, the UBTI of an organization is calculated by aggregating the income and deductions related to all of its unrelated trades or businesses.57 This allows for a loss in one activity to offset the gains in another. However, where an activity does not have a profit motive (e.g., there is a pattern of sustained losses or there is a loss in an activity that seems unlikely to generate profits going forward), the IRS takes the position that the loss may not be used to offset gains from other activities.

The precise basis for this position is not always consistently presented, although the requirement that there be a profit motive seems firmly rooted today. The IRS considers profit motive to be a necessary component of a “trade or business” for purposes of Section 513.58 Treasury Regulations59 analyze the issue as follows: the “primary objective” for adopting the UBIT was “to eliminate a source of unfair competition” by

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55 See Treas. Reg. § 1.513-1(b).
56 Id.
57 See Treas. Reg. § 1.512(a)-1(a).
59 See Treas. Reg. § 1.513-1(b).
taxing certain unrelated business activities "upon the same basis as the nonexempt business endeavors with which they compete;" "where an activity does not possess the characteristics of a trade or business within the meaning of section 162," UBIT "does not apply since the organization is not in competition with taxable organizations;" but in general, an activity "carried on for the production of income" and "which otherwise possesses the characteristics required to constitute trade or business within the meaning of section 162--and which, in addition, is not substantially related to the performance of exempt functions--presents sufficient likelihood of unfair competition to be within the policy of the tax" and, accordingly, constitutes a trade or business.

Thus, the regulations on their face suggest four closely related and in some regards non-severable bases for requiring a profit motive: (1) an activity must be carried on for the production of income, which requires a profit motive, to be subject to UBIT (this requires "income" meaning "net" or "taxable" income); (2) profit motive is inherent in the requirement of a "trade or business;" (3) an activity must possess the characteristics required to constitute a "trade or business" within the meaning of Section 162, which requires a profit motive, to implicate the UBIT provisions; and (4) there is no unfair competition without a profit motive and therefore no "trade or business" as envisioned by the UBIT provisions. In the Final Report, the IRS states that a "trade or business" can generate UBI and that an activity qualifies as such only if, among other things, the taxpayer "engaged in the activity with the intention of making a profit."61

The references to Section 162 in the regulations quoted above relate only to the definition of "trade or business;" they are not seeking to define deductible expenses. This is a critical distinction as not all deductions are pursuant to Section 162 and other deduction provisions do not necessarily have a "trade or business" requirement.62 The

60 The use of the term "income" is ambiguous. On the one hand, the statutory scheme frequently uses the term "unrelated business taxable income" to differentiate net from gross income and the obligation to file a Form 990-T is based on having at least $1,000 in "unrelated business income," which is gross income. On the other hand, Section 513(c) provides: Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit." This can be read to suggest that a profit motive is required but, where in place, losses can be applied.

61 See Final Report, supra note 17, at 12. See also note 58 and related text, supra.

62 See, e.g., BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶5.03(1) (7th ed. 2000), which states: "Sections 162(a) and 167 explicitly permit taxpayers, including corporations, to deduct business expenses or depreciation only if incurred in a trade or business or in connection with property held to produce income. No such requirements explicitly apply to other deductions that are allowed to corporations, although individuals generally are allowed such deductions only if the deductions have a business or profit connection…. The reason for this difference is not that the Code authorizes corporations to deduct items that have no business rationale; to the contrary, it seems that all corporate deductions require a business connection. But the Code, in effect, presumes that all corporate transactions arise in the corporation's trade or business, with the important exception of transactions serving the interests of the corporation's shareholders, rather than its own interests. Another way of putting the point is that transactions not serving the corporation's business purpose are, ipso facto, not 'true' corporate transactions…. Furthermore, § 165(a) provides that any loss sustained during the taxable year, if not compensated for by insurance or otherwise, may be deducted. In the case of an
analysis in some situations is confusing because a court or the IRS may be relying on Section 162 in finding no profit motive and seem to suggest that losses cannot be used to offset gains from other unrelated activities because the Section 162 deductions are not permissible. This, interestingly, seems to be what the Supreme Court did in the seminal case on the issue.

In the *Portland Golf Club* case, the Supreme Court ruled that an activity must demonstrate an intent to make an economic profit in order to use losses from that activity (in the case, nonmember income) to offset other gains (in the case, investment income); and in determining whether nonmember sales were motivated by an intent to profit, the same methodology utilized by the taxpayer to allocate fixed expenses to compute profit or loss needed to be employed. The Court looked to the special provisions applicable to social clubs in Section 512, which defines UBTI as “the gross income (excluding any exempt function income), less the deductions *allowed by this chapter* which re directly connection with the production of the gross income (excluding exempt function income)” [emphasis in original]. The Court pointed out that “the deductions claimed in this case—expenses for food, payroll, and overhead in excess of gross receipts from nonmember sales—are allowable, if at all, only under §162 of the Code.” The Court then found that while Section 162 “does not expressly require that a ‘trade or business’ must be carried on with an intent to profit, this Court has ruled that a taxpayer’s activities fall within the scope of §162 only if an intent to profit has been shown. See Commissioner v. Groetzinger, 480 U.S. 23, 35, 107 S.Ct. 980, 987, 94 L.Ed.2d 25 (1987)(“[T]o be engaged in a §162 trade or business, . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”).” The Court upheld the requirement that the taxpayer needed a profit motive based on the fact that the specific losses claimed required an intent to profit. The Court also held that because the taxpayer allocated fixed expenses in determining its losses using the

individual, however, § 165(c) goes on to restrict the breadth of § 165(a) by allowing the deduction only if the loss was incurred in a trade or business, a transaction entered into for profit, or a casualty. These restrictions are not applicable to corporations, presumably on the theory that all corporate losses arise in trade or business. Likewise, in the case of bad debts, § 166(d) confines a taxpayer other than a corporation to a capital loss on nonbusiness debts. A corporation, however, may deduct wholly or partially worthless debts under § 166(a) against ordinary income, presumably on the theory that a corporation will have no nonbusiness bad debts. The exclusion of nonbusiness deductions of taxpayers other than corporations from net operating losses seems to be based on the same assumption…. Furthermore, the same regime exists with respect to investment expenses. Section 212 was enacted in 1942 to permit the deduction of nonbusiness expenses paid or incurred for the production of income or for the management, conservation, or maintenance of property held for the production of income, and was enlarged in 1954 to embrace expenses incurred in the determination, collection, or refund of taxes. Section 212 is restricted to individuals, however, presumably on the theory that § 162(a) covers the same ground for corporations that §§ 162(a) and 212 in combination cover for other taxpayers. Thus, if a corporation engaged in manufacturing holds some securities as an incidental investment, the cost of a safe-deposit box, investment advice, bookkeeping, and so forth incurred with respect to the securities would be deductible under § 162(a) as trade or business expenses, even though an individual proprietor holding such securities would have to resort to § 212 as authority for deducting such expenses.”

63 See *Portland Golf Club v. Comm*r*, *supra* note 45.
“gross-to-gross method,” stipulated to be a reasonable methodology, the same methodology also needed to be considered in determining profit motive.

On the other hand, in the American Bar Endowment case, four years earlier, the Court in a conclusory fashion noted that, to be taxable, the activity must constitute a “trade or business,” quoted the regulations to the effect that “in general, any activity of [an exempt] organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute ‘trade or business’ within the meaning of section 162” is a trade or business for UBIT purposes, and in a related footnote noted that there is a “rich and voluminous jurisprudence” involving Section 162 and the standard test for determining the existence of a “trade or business” is whether the activity “was entered into with the dominant hope and intent of realizing a profit.” This seems the more common and better analysis.

With that said, there are courts that have focused more on unfair competition with non-exempt enterprises or whether the activity is conducted in a commercial manner or on the accumulation of profits.

Another issue is the potential application of the “hobby loss” rules in Section 183 in disallowing losses. Section 183(a) provides: “In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.” Section 183(d) then creates a presumption that if “the gross income from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years ...exceeds the deductions attributable to such activity” then “unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit.”

Treasury Regulation § 1.183-2(b) sets forth nine non-exclusive factors to assist in determining whether an activity is engaged in for profit for purposes of Section 183:

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64 See note 46 and accompanying text, supra.
66 See, e.g., Professional Insurance Agents of Michigan v. Comm’r, 767 F.2d 1097 (6th Cir. 1984); Carolinas Farm & Power Equipment Dealers v. U.S., 699 F.2d 167 (4th Cir. 1983); Iowa State University of Science & Tech. v. U.S., 500 F.2d 508 (Court of Claims 1974); Louisiana Credit Union League v. U.S., 693 F.2d 525 (5th Cir. 1982); Fraternal Order of Police v. Comm’r, 87 T.C. 747, 756 (T.C. 1986); U.S. v. Caffee, 833 F.2d 717 (7th Cir. 1987); West Virginia State Medical Association v. Comm’r, 882 F.2d 123 (4th Cir. 1989); American Postal Workers Union, AFL-CIO v. U.S., 925 F.2d 480 (D.C. Cir. 1991); TAM 9719002.
67 See, e.g., Hope School v. U.S., 612 F.2d 298 (7th Cir. 1980); Massachusetts Medical Society v. U.S., 514 F.2d 153 (1st Cir. 1975).
1. The manner in which the taxpayer carries on the activity.
2. The expertise of the taxpayer or his advisors.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the asset used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer's history of income or losses with respect to the activity.
7. The amount of occasional profits, if any.
8. The financial status of the taxpayer.
9. The elements of personal pleasure or recreation involved in the activity.

In my view, it does not seem unreasonable for the IRS to consider relevant Section 183 principles in connection with 513, even though they are not directly applicable because Section 183 applies only to individuals and S corporations, and not to other corporations or trusts. For example, in the Colleges and Universities Compliance Project, the Compliance Check Questionnaire required each taxpayer to complete a table focused on specified activities. One column asked with respect to each activity whether it produced a loss in three of the past five years; and if the response was affirmative, two other columns had to be completed, one where the college or university set forth the predominant reason for the losses from the “predominant reason codes” (i.e., start-up phase, actual costs significantly greater than anticipated or budgeted, competitive pressures prevented pricing to allow for full cost recovery, less demand for product or service than projected, business cycle downturn, budgeted to operate at breakeven or loss as contributed to exempt mission, winding-up phase, and other) and a second question (“yes/no”) as to whether the organization had plans for making a future profit.

First, there is support for following tax principles that are not directly applicable. In the Portland Golf case, in dicta in a footnote, the Supreme Court noted: “Section 183 of the Code permits a taxpayer to offset expenses incurred in a not-for-profit activity against income from that activity up to the amount of the income. Even before the enactment of § 183, moreover, the courts and the Commissioner had not required that revenues earned in activities showing a net loss be declared as taxable income. See 1 Bittker & Lokken, n. 6, supra, ¶ 22.5.4, p. 22-63. Although § 183 is inapplicable to a nonprofit corporation such as Portland Golf, the Commissioner has followed longstanding tax principles in permitting the deduction of expenses incurred in nonmember sales up to the amount of petitioner's receipts. See Brief for Respondent 33. At issue in this case is petitioner's right to offset losses from nonmember sales against income from unrelated investments.”

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70 See Final Report, supra note 17, at Appendix A.
71 See Portland Golf Club v. Comm'r, supra note 46, at note 15. Earlier in the opinion, the Court stated: “The general rule under the Code is that losses incurred in a profit-seeking venture may be deducted from unrelated income; expenses of a not-for-profit activity may be offset against the income from that activity, but losses may not be applied against income from other sources. See 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts &Par; 20.1.2, 22.5.4, pp. 20-6, 22-63 to 22-64 (2d ed. 1989),” Id. at 159.
Moreover, the “longstanding tax principles” in Section 183 can help to provide clarity and inform both taxpayers and the IRS in an analogous area, provided they are consistent with Section 162. The “3 of 5” presumption actually is pro-taxpayer and it results in the IRS focusing its limited resources on cases more likely to be non-compliant. Many of the factors also are useful in informing both taxpayers and the IRS. In fact, both the presumption and the factors may be more helpful in the UBIT context than the complex caselaw under Section 162. Of course, it would be best if the IRS developed factors it considers more directly relevant in the UBIT area.

V. Specific Suggestions for the Form 990-T

The ACT Report states that the Form 990-T “first appeared in 1951 and has remained substantially the same for 63 years.” This further supports the need to redesign the Form 990-T; even more so in light of the legislative mandate that Section 501(c)(3) organizations make their filings publicly available. In that regard, there can be no doubt but that the redesigned Form 990, which was first applicable to tax years beginning in 2008, has had a significant impact on the public disclosure and oversight of charities. Questions by and large are unambiguous and designed to elicit information viewed as important to compliance and oversight. Creating a Form 990-T that is less ambiguous and designed to elicit information viewed as important to compliance and oversight is in many ways a more difficult task. This is because while the Form 990 is an information return, seeking an array of information related both to qualification for exemption and more broadly to a general oversight, the Form 990-T is a tax return, whose key goal must be to assure that UBTI is properly accounted for and UBIT is properly paid. There are limits to what the Form 990-T can do. If, for example, an organization improperly fails to report an unrelated trade or business, there is no reference to that activity on the Form 990-T. The Final Report states that activities that effectively were treated as related were determined to be unrelated activities that should have been reported on the Form 990-T at more than 40 percent of the colleges and universities examined, with total adjustments of nearly $4 million; less than 20 percent of the activities generated losses.

The other challenge is the complexity and ambiguity of the law regarding UBTI. Surprisingly, the ACT Report finds that the UBIT rules are not complex, only very detailed: “Unfortunately, many tax-exempt organizations do not fully understand the rules for determining whether income is UBTI requiring the filing of a Form 990-T and the payment of UBIT. As a result, many organizations likely underreport their UBTI and underpay their UBIT. … The UBIT rules are not complex. They are, however, very detailed.”

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72 See Final Report, supra note 17, at 133.
73 Id. at 13.
74 Surprisingly, the ACT Report finds that the UBIT rules are not complex, only very detailed: “Unfortunately, many tax-exempt organizations do not fully understand the rules for determining whether income is UBTI requiring the filing of a Form 990-T and the payment of UBIT. As a result, many organizations likely underreport their UBTI and underpay their UBIT. … The UBIT rules are not complex. They are, however, very detailed.” See ACT Report, supra note 17, at 95. Compare, e.g., Louisiana Credit Union v. U.S. (“The complexity of tax legislation is so pervasive that one is tempted to observe that most of it is ghostwritten by Henry Clay. The unrelated business income tax provisions are no
provided that the positions that they take meet the legal and ethical requisites. Merely revising the Form 990-T without creating simpler and clearer tax rules can only go so far. For example, beyond complicated allocations, there are cases and, in some instances, rulings that can support aggressive positions as to whether an activity is substantially related to an exempt function or whether it is regularly carried on and there can be significant disagreements as to whether an activity constitutes a “trade or business.” These issues would be minimized with clarifying legislation or Treasury Regulations. Beyond the unlikelihood of that occurring, in the current political environment, there is the real danger that matters could be made worse.

A Redesigned Form 990-T. Based on what we have learned in the Final Report, IRS guidance, personal experience and anecdotes, and with the luxury of having the hard work of the ACT Report, I propose a redesigned Form 990-T with the following characteristics:

1. **Limit the Form 990-T to Unrelated Business Income.** The Form 990-T has become the default form for a number of purposes. For example, Form 990-T provides the mechanism for proxy tax liability to be reported, for regulated investment companies and real estate investment trusts to claim an income tax refund on undistributed long-term capital gain, and for credits to be requested for certain federal excise taxes or small employer health insurance premiums paid. The form and its instructions are complicated enough with respect to UBIT and should not, in my view, be utilized for extraneous purposes.

2. **Structure of the Form 990-T.** I envision a Form 990-T comprised of three sections: (1) a summary page with all financial data flowing in from Schedules, that also may include questions of general applicability (e.g., asking the organization how it determines if it has unrelated trade or business activities and its process for determining UBTI), followed by a page similar to the second page of the current Form 990-T that has a section for Tax Computation (current Part III), a section for Tax and Payments (current Part IV), and signature lines; (2) a Checklist of Required Schedules, similar in form to Part IV of the Form 990; and (3) specific Schedules, including Activity Schedules. Activity Schedules would include the following areas, currently included in the Form 990-T (although not particularly in that order and with some tweaking): (a) Sales of Goods; (b) Rental Income from Real Property and Personal Property Leased with Real Property; (c) Unrelated Debt-Financed Income; (d) Interest, Annuities, Royalties, and Rents from Controlled Organizations; (e) Exploited Exempt Activity Income (other than Advertising); and (f) Advertising Income. There also should be Activity Schedules for (g) Provision of Personal Property and/or Services not Reported Above; (h) Passive Investment Income (from Non-Controlled Entities); and (i) exception.

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One need only read Pub. No. 598, *supra* note 58, which is quite well written, to appreciate how challenging it is to understand the UBIT rules and to complete accurately Form 990-T.
Unrelated Income from Partnerships, “S” Corporations and Other “Flow-Through” Entities (other than from Passive Investments from Non-Controlled Entities).

The key in designing each Activity Schedule is to require the information that can meet the goals of redesigning the Form 990-T. In seeking to create a form that allows for data driven, computer-based determinations and data analytics, EO should consult with SOI, Tax Forms and Publications Division, and other areas within the IRS and Federal government that can be helpful, and ultimately release a draft form for public comment as it did with the Form 990. It seems obvious that there needs to be more description of each unrelated activity and of deductions that are not directly related to it, with particular emphasis on dual use activities. In connection with dual use activities, there should be a brief description of allocation methods, and an explanation if those methods have not been used consistently in the past. To this end, with the exception of a line allowing for charitable contributions (which need not be directly connected with an unrelated trade or business) and net operating loss deductions (which are available to offset any UBTI), I would eliminate the current Part II of the Form 990-T, “Deductions Not Taken Elsewhere,” as all deductions should relate to specific activities (i.e., these overwhelmingly are fixed or indirect expenses that should be allocated to specific activities). Part V, “Statements Regarding Certain Activities and Other Information,” is duplicative where an organization files a Form 990.75 Consideration should be given as to whether these questions need to remain on the Form 990-T because there are organizations that file Form 990-T, but not Form 990 or another tax form that seeks the same information, and the questions are relevant to those taxpayers.

Where an activity generates a loss and the taxpayer seeks to use that loss to offset gains from other unrelated activities, including as an NOL, the taxpayer would need to complete a special Schedule for Activities Generating Losses, discussed immediately below. To the extent that reconciling NOLs is a serious issue, there could be a Reconciling Net Operating Loss Worksheet, described briefly below.

Of course, it is critical that the instructions be as helpful and comprehensible as possible with respect to each line of the form. This is particularly true in describing allocation issues.

3. Activities Generating a Loss. I would include a Schedule for Activities Generating Losses as part of the Form 990-T to be completed where an organization is claiming a loss on an unrelated trade or business that is or may be used in whole or part to offset gains from other unrelated trade or business activity, including as NOLS that may be carried forward up to 20 years or back up

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to two years. This Schedule would require a description of each loss activity, require disclosure of profits or losses for the activity over the prior five years, and, if the activity has had aggregate losses over the period and has not generated profits in at least three of those years, require the organization to justify the use of losses by explaining why the activity is engaged in for profit. The instructions would explain that an activity must have a profit motive for a loss to be claimed on the Form 990-T, that a pattern of repeated losses normally suggests that an activity does not have a profit motive, but that there may be an explanation for a period of losses that are not expected to continue such as business risks or reverses or substantial multi-year start-up expenses. It strikes me that such an approach should directly eliminate most of the issues identified in the Final Report with respect to the use of losses in activities without a profit motive and, in any event, facilitates examinations.

4. **Reconciling NOLs.** The Final Report states NOLs were either improperly calculated or unsubstantiated on more than a third of the Form 990-Ts that were examined, with a resulting $19 million in disallowed NOLs. If this is determined to be a significant issue, the Form 990-T could include a line showing the NOLs available at the beginning of the tax year and at the end after the tax year, the latter considering both NOLs applied during the tax year and to newly expired NOLs. A Section 172 NOL worksheet could be created that walks the exempt organization through the steps necessary to make the determinations. The worksheet should, at a minimum, be filed with the IRS; it may not be necessary to make the worksheet publicly available.

5. **Consider Special Instructions for Specific Types of Organizations.** The Unrelated Business Activities Checklist, included with the ACT Report, is intended only for colleges and universities. It does not portend to be all encompassing, but it is a good list of probably the 31 activities most likely to generate UBIT in that sector. Utilizing the Checklist for all filers of Form 990-T would make it both under and over inclusive. For example, it includes few of the most common activities as to which health care organizations are likely to generate UBIT; and it has only marginal applicability to social clubs or trade associations. The IRS might, however, consider including a table in the instructions to the Form 990-T modeled on the ACT Checklist that speaks to the most common types of unrelated business activities of colleges and universities, with similar pages for health care organizations, and other organizations viewed as needing additional assistance in ferreting out their unrelated activities. Alternatively, it might include such a form as an additional schedule in the Form 990-T, as is the case with the Form 990 schedules for schools (Schedule E) and hospitals (Schedule H)

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76 See Final Report, *supra* note 25, at Exhibit C.
6. **Consider Separate Forms 990-Ts for Specific Types of Organizations.** To simplify the completing of a Form 990-T, it may make sense to have separate forms for different types of organizations. Possibilities include special forms limited to: organizations subject to the public disclosure rules; small organizations, organizations with minimal gross unrelated business income, and/or organizations with limited types of gross unrelated business income (e.g., passive investment income from non-controlled entities); organizations at higher risk for non-compliance because of the complexity of issues (e.g., colleges and universities and healthcare organizations); and/or organizations with unique UBIT issues (e.g., social clubs described in Section 501(c)(7)). For some of these categories, the form and instructions could be quite short and simplified as the compliance and data collection issues are minimal, making it much easier for taxpayers; in other categories, a separate form and instructions specifically designed for a special category of taxpayer not only allows for a tailoring that facilitates completion, but also potentially allows provisions applicable only to such organizations to be eliminated from other versions of the form and instructions. Of course, there would be a need to determine a default form if a taxpayer falls into categories for two or more separate forms (e.g., a university with a hospital if there were separate forms for colleges and universities and for hospitals, or a Section 501(c)(3) organization subject to the public disclosure rules if it is small with limited gross unrelated trade or business income if there were separate forms for each of those categories). Once a draft revised Form 990-T is available for comments, the IRS might specifically ask if creating a special form for certain types of filing organizations would be worth the effort and, if so, why.