



The Tax Translator

What does Macaroni have to do with UBIT?

Muellers Macaroni – and a New York University. This university found that it had acquired the Macaroni company and it was producing lots of net profit. An enterprising IRS employee noticed the profit and was of the thought that this profit was not really related to the core mission of the university – that is either, educational, scientific, medical or research related and it was in competition with other commercial enterprises that made macaroni. Thus, we have the beginnings of the Unrelated Business Income Tax.

UBIT is applicable to both state institutions and independent schools. With more and more schools facing budget cuts the mantra has been to become more entrepreneurial. The difficulty with stating this is that the mantra needs to add a refrain to this song – but check with your tax department first. For independent schools there is a requirement to disclose the UBIT tax return (Form 990T) as well as the Form 990. State schools only need to comply with a copy of the 990T on request. Some schools are looking at cemeteries on campus; others are looking at leasing the gas and oil rights on their property.

There is nothing wrong with having unrelated business income – in fact, it's great to have. I have always said I'd love to have to pay a million dollars in tax because that meant I was making 4 million dollars in income. Profit is not a dirty work in higher education. I have seen documentation of departments when considering an activity that stated their goal was to break even and for this reason, the loss from that activity was removed from the tax return by the IRS as it did not meet one of the requirements for including it ON the return.

The IRS has taken an interest in UBIT returns – a deep look at UBIT by the IRS. They issued a special questionnaire about UBIT just for colleges and universities. These were sent out to 400 lucky schools and resulted in 40 UBIT audits of schools. The IRS intends to do more with UBIT as they don't understand why so many UBIT tax returns show losses and are concerned with the way schools are interpreting what is subject to UBIT. They have promised more actions on UBIT with the Director of the Exempt Organization Department saying with the information they have collected, the IRS will now move from project to process on UBIT exams – that means more exams. The IRS is still analyzing what data they have collected and then will set a course of action that will have great impact on colleges and universities. Now is the time to prepare for a UBIT exam by the IRS. Why? As a representative to the IRS during a UBIT audit (or any audit for that matter) I could not change history. The IRS can audit back three years, plus the current year. Events that took place years ago now are under scrutiny and could not be changed. This is the purpose of a tax compliance program that is on-going everyday on your campus.

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So what is UBIT? – I’ll give you the standard tests that according to the IRS create UBIT. In more common language, UBIT is an attempt to level the playing ground between the activities the university does and the rest of the world. Why the level ground? Well, for one thing, the university does not have to pay real estate tax on property and a business does – therefore, the reasoning is colleges have an unfair advantage in pricing. Or it’s like Mueller’s macaroni above – the university was receiving income from an activity that was not related to its purpose of the tax exemption.

Three Tests for what UBIT is (in modified IRS language) If you don’t have these present, you don’t have UBIT

The three out of five years must show a profit rule – I disagree with the IRS on this as the basis for this rule is from individual taxation. It started with the dog show in England where owners were required to have the dog in England for three months before the show in quarantine – and of course the dog owners had to go with them. The dog owners were, in effect, writing off the expenses of staying in England for three months – a practice the IRS did not seem to like. Because of the expense of staying so long in a foreign country the ‘business’ of showing a dog never showed a profit and the loss was able to be used to offset other income. The IRS really didn’t like this, so now we have the “Hobby Loss rule.

Advertising is always subject to UBIT. Have a University Press that sells advertising in its journals? Have advertising in your Athletic programs? Have TV screens on the walls in some of your buildings that show some advertising content? Is your Student Affairs having an event and receiving advertising dollars from some company? A bizarre example, but true - at one university there was a daily email that went out to all 30,000 employees – a very creative person in this department decided it was an opportunity for restaurants, shops and stores on ‘High St’ to advertise and offer specials to the readers of this daily email. Good idea, it generated revenue but it was subject to UBIT and I let them know that when I saw the very first email offering me a discount at a local restaurant.

Things you generally don’t have to worry about for UBIT – common exceptions to UBIT

In the back of this manual is an excellent resource that will show you several real live examples of campus activities that can generate Unrelated Business Income Tax.

Don’t be fooled by some of the responses you may receive from departments. One that I like was ‘But all of the money we make goes to a scholarship fund’. The IRS really doesn’t care about the use of the funds, only about how it was generated.

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Practical Tip: Require a UBIT survey be completed annually by the finance directors in each department. . The finance directors will not really like to do this, but they are in the best position to know the activities that are happening within their departments. There are several examples of UBIT Surveys in the back of this manual – take a look at them and require your tax manager to send out a survey at the end of each calendar year.

The completion of UBIT surveys each year is a great audit defense. I was able to present to the IRS agent three years' worth of surveys which demonstrated to him that we had a method to identify new activities on campus that might be subject to UBIT. It's necessary to DO something with the completed surveys though. They must be looked at, analyzed and followed up upon if there is some suggestion the activity could be subject to UBIT. I took it one step further. I created a template document where I documented each activity as being either subject to UBIT or not along with my reasoning. The IRS agents jaw dropped when he saw these in addition to the surveys.

I took it another step even further. Whenever a department requested the creation of a new revenue account in the GL they saw a 'splash screen' on their computer monitor (the request for creation of a new revenue account was done online). This splash screen directed them to a web page. I put my UBIT survey questions online and when all the questions were answered the department individual clicked on Submit. This sent all of their responses to me in an email where I was able to review them and follow up with them if I had more questions and it also allowed me to complete the UBIT template justifying why the activity was not subject to UBIT.

Practice Tip: Want another way to ferret out UBIT on your campus?

Most colleges will permit a department to have a credit card swipe machine to accept credit card payments. I obtained a list of departments that were assigned a credit card swipe machine and asked them what they were selling. In many cases there were activities going on that were subject to UBIT. It was an even better way to do compliance for Sales Tax liability. See the Sales Tax Chapter later in this manual.