# Healthcare tax checkups

## Podcast transcripts

Episode 6: IRS exams of tax-exempt hospital UBTI losses

**Announcer**

Hello, and welcome to Healthcare Tax Checkups, a KPMG podcast series, featuring KPMG tax leaders on emerging and perennial tax issues impacting the healthcare industry.

**Announcer**

Today's episode explores recent IRS scrutiny around UBTI losses for tax-exempt hospital systems, and recommendations hospitals who begin to get questions from the IRS about their allocation of expenses between related and unrelated business activities, or their profit motive in carrying out the unrelated activities.

**Lori Robbins**

Hello, everyone, and thank you for tuning into this podcast episode. I'm Lori Robbins, Deputy Tax Industry Leader of KPMG's Healthcare Tax Practice.

**Lori Robbins**

With me is Preston Quesenberry. Preston is a Managing Director in KPMG's Washington National Tax-Exempt Organizations Group. He has more than 15 years of experience in the nonprofit and tax-exempt space, providing advice on a wide variety of legal, tax, and strategic issues in the private sector, and previously serving in multiple capacities at the IRS.

**Lori Robbins**

Preston advises clients on a wide variety of tax issues, including qualification for tax-exempt status, public charity status, unrelated business income tax, joint ventures, lobbying, and political activities, and executive compensation.

**Lori Robbins**

While at the IRS, Preston helped issue Treasury regulations and other published guidance affecting the exempt healthcare sector, including regulations and other guidance regarding requirements for charitable hospitals, supporting organizations, accountable care organizations, and other exempt organization issues.

**Lori Robbins**

So Preston, thank you for joining us.

**Preston Quesenberry**

Happy to be here.

**Lori Robbins**

You recently wrote a Bloomberg tax article on how the IRS is undertaking a compliance strategy for hospitals with unrelated business income.

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What can you tell me about what the IRS is doing, and why the IRS has increased scrutiny of hospital net operating losses?

Well, first for those listeners who may not be familiar with the unrelated business income tax, I think it might be helpful to just start with a few basics.

While tax exempts are generally exempt from tax, they are taxed on net income that they earn from carrying on business activities that aren't related to their charitable or exempt missions. Then, if the expense of is attributable to those unrelated businesses are more than the income from those businesses, such that there's a loss rather than a profit, that loss can be carried over as a net operating loss or NOL and deducted against, or potentially deducted against, unrelated business taxable income, or UBTI, in future years.

That's what we're looking at here are these losses and NOLs generated from unrelated business activities, and TEGE Division, that stands for Tax-Exempt Governmental Entities, that division of the IRS is responsible for enforcing the unrelated business taxable income or UBTI regime. Every year, the TEGE Division puts out a list of its compliance program initiatives, and on its list for the fiscal year ending in 2020, the IRS included as a compliance strategy, one that was focused on tax-exempt hospitals reporting significant UBTI losses on their tax returns.

Around the same time as I saw this appear in the TEGE Division list, I noticed significant uptick in IRS exams of tax-exempt hospitals, focusing on these UBTI losses. From what I've seen, the IRS playbook on these exams is to take one of two positions, or sometimes both, with one as an alternative position.

The first position involves disallowing expense deductions, based on allegedly unreasonable allocations between related activities on the one hand, and unrelated business activities on the other hand. It's often the case that when you have an unrelated business activity, you have personnel or assets that are used both in a related and unrelated function, and that necessitates some kind of allocation. What the IRS is doing is saying, "We don't think that allocation is reasonable, and therefore, we're going to challenge your expense deductions."

The second or alternative position involves disallowing NOLs, or net operating losses, based on the hospital's alleged lack of a profit motive in carrying out the loss generating activity. In either, whichever approach the IRS takes, it can result in more UBTI for the hospital, and therefore, more tax.

As for why the IRS decided to focus on hospital UBTI losses, as a compliance strategy at this moment, I can really only speculate. One thing to note is that about a decade ago, the IRS did conduct many UBTI exams of colleges and universities, where they also went after UBTI losses, so made to the IRS just figured that it's the hospital's turn since they're the other major category of exempt organizations that would have significant UBTI losses.

Another thing to note is that Congress did significantly change the UBTI regime with respect to losses and NOLs in the Tax Cuts and Jobs Act of 2017. Under this new regime, NOLs that are generated in taxable years beginning after 2017, can only be taken against the specific trader business that generated them.

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**Preston Quesenberry**

And by contrast, NOLs that are generated in taxable years beginning before 2018, can be taken against total UBTI, regardless of which trader business it came from, and therefore, those pre-2018 NLS are a lot more valuable. So, given how relatively valuable those pre-2018 NOLs are, maybe the IRS just decided that now was a good time to start scrutinizing them most closely and to see if they're legitimate.

**Lori Robbins**

So, Preston, you just mentioned that the IRS may look at disallowing some expenses, based on improper allocations between related and unrelated business activities. There's some guidance on how expenses are allocated between related and unrelated business activities when it comes to UBTI losses.

**Lori Robbins**

Now, what does that guidance provide, generally?

**Preston Quesenberry**

Well, the existing guidance really doesn't say much. For a long time, it's basically just said that exempt organizations can allocate expenses between the related and unrelated activities on a quote reasonable basis. That's a pretty wide-open and vague standard that the IRS has had trouble really doing much with, and have actually lost some cases where they try to assert that one allocation method should be used. The court has said, "Well, the regs say a reasonable methods, and we think what the taxpayer did was reasonable, so we're going to uphold their method."

**Preston Quesenberry**

The IRS did very recently in final regulations that were released less than a year ago in December of 2020, they did draw one line in the sand and say that one allocation method is per se not reasonable, and this per se unreasonable method is commonly called the adjusted gross to gross method, and it necessitates three elements being present.

**Preston Quesenberry**

The first element is that the exempt organization is selling a good or service that is both related and unrelated, depending on the circumstances, and that the cost of that good or service are substantially the same, regardless of whether it's related or unrelated.

**Preston Quesenberry**

For hospitals, this situation commonly arises when the hospital's selling a good or service such as lab tests, or filling prescriptions, that is related when it's providing to the hospital's patients, but it's considered unrelated when providing to non-patients. But oftentimes the personnel and assets used in those good or services are the same, and so you need to allocate.

**Preston Quesenberry**

The second element that needs to be present for this adjusted gross to gross method to be present, is that the price charged for the good or service in the unrelated activity is more than the price charged in the related activity.

**Preston Quesenberry**

Then the final element that needs to be present is that the tax-exempt organization has to allocate expenses between the related and unrelated activity by revenue, and not adjust the prices to equalize them. So what this means in practical terms is that, say you've got a hospital, and it has a lab test that it charges $100.00 to a non-patient and $50.00 to a patient. It's the same lab test, but as we know about hospital pricing, they can be widely divergent, depending on the circumstances, the insurer, et cetera.

**Preston Quesenberry**

What the prohibition on using the adjusted gross to gross method says, is that if you've got that situation, a $100.00 on the unrelated side, $50.00 on the related side for the same good, the hospital can't allocate by revenue without adjusting the price. If it did allocate by revenue without adjusting the price that under that example, with the 100.00 on the one hand and 50.00

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on the other hand, that would result in allocating two-thirds of the expenses on the unrelated side, and one-third of the expenses to the related side, which as you can see, that would be kind of patently unreasonable, because you've got the exact same tests that would presumably have the exact same costs involved, and yet you're allocating two-thirds of the cost to one test, just because the price is higher.

What the regulation would suggest would be, "Well, you've really got to adjust those prices, pretend that they're equal, and then maybe allocating by revenue is okay," and if you just did that, then the allocation in that example would just be 50/50 between the related and unrelated.

Saying that this unadjusted gross to gross method is unreasonable, that's the only guidance that the IRS is currently provided on allocation, beyond just saying that allocation may be done on a reasonable basis.

There's really not anything else out there, but the Treasury and the IRS have made clear that they're in the process of working on additional guidance on allocation, so we hope to see something additional soon.

More to come after those final regulations issued in December.

That's right.

Good to know.

What recommendations do you have for those hospital systems that start to get questions from the IRS about their allocation methods?

Well, interestingly, the preamble to the final regulations released back in September that I mentioned, they expressly state that the IRS will not litigate the reasonableness of allocation methods, pending the publication of that further guidance on allocation that I also just noted that the Treasury and the IRS are working on.

To me, it seems very odd that IRS exam is out there aggressively pursuing an issue that the IRS of chief counsel has expressly stated it won't litigate. That just seems like a huge waste of everyone's time for IRS exam to be pursuing those issues. So accordingly, if an IRS exam agent is challenging a hospital's allocation method, and let's just assume we're talking about a tax year beginning before 2021, the first thing I would recommend is to point out that preamble language to the agent and ask the agent to run the issue by IRS Division counsel to see if it's an issue that the IRS should be pursuing if they're not even going to litigate.

Now, I only have my personal experience, and that's a small sample size, and naturally, every case is going to be different, but so far, I've found that when Division counsel involved, that allocation issue has gotten dropped. I can't say for certain why that is, but I have to think that chief counsel has little appetite to litigate an issue, when they're actively working on a guidance project on that issue, and also have in the way of helpful precedent to point to.

In sum, my first piece of advice would be to try to get IRS exam to get Division counsel involved, and one thing to note there, is if Division counsel gets involved, then they're obligated to get associate chief counsel involved, because there's a guidance project going on in this issue.

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So that said, IRS exam isn't under any obligation to get Division counsel involved, and I've had revenue agents just refuse to get Division counsel involved, and they've just said, "Well, Division counsel can decide whether or not they want to litigate it, if and when the case ever gets to that stage. But in the meantime, we're just going to continue to pursue this issue," which again, seems like a big waste of time to me, but they do. That is their prerogative if that's what they want to do.

With those cases, I'm currently in appeals, and I'm trying to point out that preamble language to the appeals officer, and encourage the appeals officer to confer with Division counsel, because appeals, an officer is supposed to take litigation hazards into account. You would think that would also include taking into account is this even something that Division counsel is willing to litigate? I'm hoping that that will bear fruit, but I'm still in the process, and I'll be sure to let people know if and when I find out.

All of that said, until it's clear that IRS exam agents are going to respect the IRS Office of Chief Counsel's pronouncement. Regarding litigation, the only other thing I can recommend is that hospitals should be prepared to demonstrate that whatever metrics they've used to allocate costs, that those are reasonably associated with the underlying costs.

You could almost take a course in procedural issues with respect to some of the different parties that will be potentially involved in these disputes.

Yes.

You mentioned in your article that the IRS has had some success in challenging an organization's profit motive when trying to disallow net operating losses.

If a hospital wants to protect its NOLs from an IRS challenge by demonstrating that certain activities, lack a profit motive, and therefore, shouldn't be considered a trader business for tax purposes, what should it do?

Well, as you note, in contrast to its history and challenging the reasonableness of allocation methods, the IRS has had some success in disallowing NOLs, based on a lack of profit motive, and the basic argument they use is, "Well, if an activity isn't conducted with a profit motive, then it's not a trader business, and if it's not a trader business, it's not an unrelated trader business."

What that means is that the NOLs from the activity can't be used to offset UBTI. Perhaps because of its relative success in litigating the profit mode issue, IRS exam agents, maybe they're overly confident, but they tend to rely solely on a lack of actual profitability over a number of years to demonstrate a lack profit motive. But importantly, the courts are clear that a history of continued losses is only one of nine factors that courts would look to in determining whether a taxpayer has an intent to profit.

These nine factors are, they're commonly referred to as the hobby loss factors, and in my experience, IRS exam agents devote little effort to attempting to gather facts regarding any of the factors, other than the history of profits or losses, and that's a common mistake on the IRS's part that hospitals shouldn't let an exam agent get away with.

I don't have time on the podcast to go into each of the nine factors, but you can find them in the regulations under Section 180 that have been applied by the courts. I highly recommend looking at the 2019 tax court case WP Realty, LP, versus Commissioner, and the site for that is TCmemo2019-120.

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**Preston Quesenberry**

In that case, the Tax Court applied the hobby loss factors to find that a golf course operated with an intent to profit, despite generating significant losses throughout its 13 year history, and of the nine hobby loss factors, the Tax Court found that only four weighed in favor of the tax payer, with one factor weighing only slightly in favor of the taxpayer, three weighed in favor of the IRS, including the history of losses, and two were neutral.

**Preston Quesenberry**

Nonetheless, the court still ruled in favor of the taxpayer. This case just goes to show that hospitals shouldn't just roll over on the profit motive issue, just because they have a history of losses and that they can win, even if they only have four to five factors weighing in their favor. I would recommend the hospitals they take a look at those factors, they try to look at the facts surrounding the losses that they're taking, and document the factors that would, weigh in support of a profit motive.

**Lori Robbins**

Great, so sounds like that they still have some possible defenses, even if they go after the profit motive issue.

**Preston Quesenberry**

Right, and even if they've got, like I said in the WP Realty case, those are 13 years of losses, so even if they've got multiple years of losses, that's not a nail on coffin, that there are other ways for hospitals to defend themselves in that situation.

**Lori Robbins**

That's great. Thank you, Preston, for your insights.

**Lori Robbins**

To our podcast listeners, thank you for tuning into this episode. For more information about IRS scrutiny of hospital's net operating losses, please check out the article written by Preston, a link to which can be found on this podcast episode's webpage.

**Lori Robbins**

If you have any questions about the topics we discuss today, please reach out to Preston, me, or your local KPMG representative.

**Announcer**

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**Announcer**

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