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The IRS Is Scrutinizing Hospitals' Net Operating Losses: Is Your Hospital Ready?

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The IRS has put hospitals with loss-generating businesses in its crosshairs. The IRS's TE/GE Fiscal Year 2020 Program Letter lists ''Hospital organizations with unrelated business income (UBI)'' as a new ''compliance strategy'' for the IRS, with a ''focus on unrelated business taxable income (UBTI) reported on Form 990-T, *Exempt Organization Business Income Tax Return*, where expenses materially exceed gross income.''[1] In other words, the IRS is looking for hospitals reporting significant UBTI losses and examining them. The IRS has not yet released any data regarding the number of hospital UBTI exams they have opened and closed in the last three years, but, speaking from anecdotal experience, these exams appear to have increased significantly.

As with the IRS's exams of the UBTI of colleges and universities a decade earlier, the IRS is typically taking one of two positions (or sometimes both, with one as an alternative) in challenging hospitals' reported UBTI losses: (1) disallowing expenses based on allegedly improper allocations between related and unrelated business activities; and/or (2) disallowing net operating losses (NOLs) based on the hospital's alleged lack of a profit motive in carrying out the loss-generating activity.[2] The former approach can turn a UBTI loss from a particular activity into UBTI, while the latter approach can deny a deduction that could be used to offset UBTI. Either way, the end result can be more tax for hospitals.

Hospitals with unrelated business activities that have generated significant losses need to be prepared for both lines of attack. The purpose of this article is to help prepare hospitals for these potential IRS challenges.

ALLOCATION BETWEEN RELATED AND UNRELATED BUSINESS ACTIVITIES

The most confounding question regarding the IRS's challenges of expense allocation methods is why the IRS is currently engaging in these challenges at all, given it is in the process of preparing guidance on this issue and has publicly stated that it will not litigate the issue until this guidance is released. Before getting to this question, however, a brief review of the relevant authorities and the IRS enforcement history on the issue is in order.

Background

Section 512 defines UBTI as gross income derived from unrelated business activities less deductions ''directly connected with'' such activities.[3] In the context of facilities and personnel used in both related and un-

[1] TE/GE Fiscal Year 2020 Program Letter, at p. 3. TE/GE has subsequently said that in ''fiscal year 2021, we'll continue to pursue our compliance program described in our FY 2020 Program Letter,'' suggesting that IRS examinations of hospitals' UBTI losses are continuing this year. *See* TE/GE, ''Compliance Program and Priorities.''

[2] *See* IRS Colleges and Universities Compliance Project Final Report, IR-2013-44 (Apr. 25, 2013), p. 13. As part of its multi-year compliance project on tax-exempt colleges and universities, the IRS selected 34 colleges and universities for exam, with expense deductions being disallowed on more than 60% of the Forms 990-T examined due to improper allocations between exempt and unrelated business activities and losses and NOLs being disallowed for lack of profit motive at 70% of colleges and universities examined.

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

related activities, the regulations under §512 elaborate on the definition of ''directly connected with'' as follows:

> Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses *on a reasonable basis*. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses *on a reasonable basis*. The portion of any such items so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167 or other relevant provisions of the Code.[4]

The vague ''reasonable basis'' standard set forth in Reg. §1.512(a)-1(c) has not left the IRS in an especially strong position when it has tried to argue that a tax-exempt organization should have used one allocation method over another. (As the IRS put it in recent proposed regulations ''permitting allocation methods based solely on reasonableness is difficult for the IRS to administer.'')[5] Accordingly, in the one court case where the IRS attempted to assert an alternative allocation method, it lost. Specifically, in *Rensselaer Polytechnic Institute v. Commissioner*, the IRS argued that a university should have allocated the depreciation and other overhead expenses associated with a facility that it used for both related and unrelated activities based on the total hours in the day and year (with all ''idle time'' allocated to the related activity) rather than based on the total actual usage of the facility.[6] The court rejected the IRS's argument, noting that, under the regulation, ''the critical question is whether the method of allocation adopted by [the taxpayer] was 'reasonable' '' and concluding that the taxpayer's method of allocation based on actual use met this standard.[7]

In the wake of its defeat in *Rensselaer*, the IRS issued an ''action on decision'' (AOD) stating that it continued to believe that the ''proper method of allocation of the fixed expenses should be to allocate between exempt and unrelated use on the basis of a 24-hour-a-day, 12-month-a-year period'' (that is based on total hours) but that ''this issue should not be litigated until the allocation rules of section 1.512(a)-1(c) of the Income Tax Regulations are amended.''[8] ''As long as the language permits an allocation between exempt and unrelated uses on a 'reasonable' basis,'' the IRS concluded, ''it may be difficult for the Service to prevail on this issue in another circuit.''

While ''this issue'' in the AOD could reasonably be interpreted to refer to the specific issue of requiring allocation by total hours versus actual usage, the IRS generally refrained from litigating any cases challenging a taxpayer's allocation method in the decades that followed. And, notwithstanding the AOD's call for the relevant regulations to be amended to strengthen the IRS's litigating position, the IRS failed to issue such regulations, as decade after decade passed.

Guidance on Allocation Finally Emerges — But is Also Still Pending

Finally, in 2014, Treasury and the IRS placed ''[g]uidance under §512 regarding methods of allocating expenses relating to dual use facilities'' on their Priority Guidance Plan, and this description remained on the list of prioritized guidance items through October 2019. The most recent Priority Guidance Plan lists ''allocation of certain expenses by exempt organizations with more than one unrelated trade or business'' as part of the guidance to be released under §512(a)(6), a recently-enacted provision that requires UBTI to be computed separately for each trade or business.[9] Moreover, in the preamble to the final regulations under §512(a)(6), published in December 2020, Treasury and the IRS made clear that they ''continue to consider and expect to publish in a separate notice of proposed rulemaking'' guidance on the reasonableness of various UBTI allocation methods.[10] In other words, while additional guidance on UBTI expense allocation remains an IRS priority and might be released in the near future, it has yet to be released in even proposed (must less final) form.

The final regulations under §512(a)(6) are important to the issue of UBTI expense allocation in two other respects. First, for the first time in the history of UBTI, Treasury and the IRS amended the regulations to go beyond the ''reasonable basis'' standard and rule on the reasonableness of a specific allocation method. Namely, the final regulations amended Reg. §1.512(a)-1(c) to provide that the use of revenue to al-

[4] Reg. §1.512(a)-1(c) (emphasis added).

[5] REG-106864-18, 85 Fed. Reg 23,172, 23,177 (Apr. 14. 2020).

[6] 732 F.2d 1058 (2d Cir. 1984).

[7] 732 F.2d 1058, 1061.

[8] AOD 1987-14 (June 18, 1987).

[9] 2020-21 Priority Guidance Plan, at p. 5.

[10] T.D. 9933, 85 Fed. Reg. 77,952, 77,957 (Dec. 2, 2020).

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locate costs is not a reasonable allocation method if the taxpayer ''fails to equalize price differences between related activities and unrelated trade or business activities'' — a method that the preamble refers to as the ''unadjusted gross-to-gross method.''[11] The new language in Reg. §1.512(a)-1(c) reads as follows:

> [A]llocation of expenses, depreciation, and similar items is not reasonable if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities. For example, if a social club described in section 501(c)(7) charges nonmembers a higher price than it charges members for the same good or service but does not adjust the price of the good or service provided to members for purposes of allocating expenses, depreciation, and similar items attributable to the provision of that good or service, the allocation method is not reasonable.

Among the methods that the IRS could have selected as its first example of a per se unreasonable approach, the unadjusted gross-to-gross method is especially low hanging fruit, as the IRS had long indicated its disapproval of this method (albeit not in formal guidance) and the method is usually difficult to justify as reasonable.[12] That said, the fact that the IRS took at least one baby step in providing concrete guidance on the expense allocation question is significant, given the decades of inaction.

The second interesting aspect of the final regulations under §512(a)(6) is what the preamble says about litigating the reasonableness of expense allocation. For one, Treasury and the IRS said that, since the release of the AOD on *Rensselaer*, the IRS's position has been that it ''would not litigate the reasonableness of an allocation method 'until the allocation rules of [Reg. §1.512(a)-1(c)] are amended.' ''[13] Here, Treasury and the IRS appear to be broadly interpreting the *Rensselaer* AOD to mean that the IRS would not litigate the reasonableness of *any* expense allocation method — not just the ''actual use'' method considered in *Rensselear*. The preamble then goes on to say that, now that the regulations have been amended to deem the unadjusted gross-to-gross method unreasonable, the IRS is rescinding this ''no litigation'' position in tax years beginning in 2021 (when the final regulations became effective) ''to the limited extent of any allocation method that fails to equalize price differences between related activities and unrelated trade or business activities.'' This language suggests that in tax years beginning *before* 2021 — which are all of the tax years that the IRS is currently examining under its compliance strategy involving hospitals with UBTI losses — the IRS will not litigate the reasonableness of any allocation method, even the facially unreasonable unadjusted gross-to-gross method. Finally, Treasury and the IRS state that the IRS ''will continue to refrain from litigating the reasonableness of other allocation methods pending the publication of further guidance.''[14] Accordingly, in tax years beginning in and after 2021, the IRS has said it will not litigate any allocation method other than the unadjusted gross-to-gross method until guidance on expense allocation is issued.

What Hospitals Can Say to IRS Exam Agents Who Challenge Their Allocation Methods

The salient question that this preamble language raises is, why are IRS exam agents wasting the time of hospitals in challenging the reasonableness of their allocation methods if the IRS Office of Chief Counsel is on record stating that it will not litigate this issue? Admittedly, many of the exams under the relevant compliance strategy began before Treasury and the IRS published the final regulations under §512(a)(6) in December 2020, so perhaps it has just been a matter of the right hand of the IRS (IRS exam) not knowing what the left hand (IRS Office of Chief Counsel) is doing. Regardless, now that the final regulations have been released, IRS Exam should discontinue its challenges of hospitals' expense allocation for any tax years beginning before 2021. If an IRS Exam agent does not discontinue a challenge of a hospital's expense allocations, the hospital should ask the agent to check with the IRS Office of Counsel (Division Counsel) as to whether they will litigate the allocation method under examination and hopefully, if Chief Counsel says ''no,'' the agent will drop the issue.

As for tax years beginning in 2021 (none of which would be under exam as of this writing), the IRS has so far said it will litigate only the unadjusted gross-to-gross method of expense allocation. As a technical matter, most hospitals are unlikely to be using an un-

[11] T.D. 9933, 85 Fed. Reg. 77,952, 77,957.

[12] *See, e.g.*, Clifford Gannett and Charles Barrett, *Unrelated Business Income Allocations*, 1992 EO CPE Text, at p 12. (providing an example where members paid $1.50 for a meal and nonmembers $2.50 per meal).

[13] T.D. 9933, 85 Fed. Reg. 77,952, 77,957.

[14] T.D. 9933, 85 Fed. Reg. 77,952, 77,957.

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adjusted gross-to-gross method. For hospitals, the determining factor in whether many business activities (such as diagnostic lab testing and the sale of pharmaceuticals) is related or unrelated is often whether the activity relates to a patient (related) or a non-patient (unrelated).[15] If the price charged with respect to a non-patient for a particular lab test or a drug is consistently higher than the price charged to a patient, and the hospital allocated expenses based on revenue without adjusting for the price differences, then the hospital would, indeed, be using an unadjusted gross-to-gross method that the IRS could challenge. However, typically, a hospital charges the same ''gross charge'' (the full established price for lab tests and drugs, before contractual allowances with payors and discounts have been applied) to both patients and non-patients. Accordingly, an expense allocation based on such uniform gross charges would not be an unadjusted gross-to-gross method.

As for the revenue the hospital actually collects for a given test or drug, these amounts may vary significantly depending on the allowance the relevant insurer or payor has negotiated with the hospital and on whether the individual receiving the lab test or drug is insured or eligible for financial assistance and other discounts. However, notwithstanding the random variance in the amount collected for each given lab test or drug, unless nonpatients and their insurers consistently pay more for a given test or drug than patients and their insurers, an expense allocation method based on actual receipts would still not fall within the technical definition of an unadjusted gross-to-gross method set forth in Reg.§1.512(a)-1(c).

As noted above, if a hospital does not use an unadjusted gross-to-gross method to allocate expenses, the IRS has declared in published guidance that it will not litigate the hospital's expense allocation until further guidance is issued. That said, until it is clearer that IRS Exam agents will respect this pronouncement (by not pursuing issues that the IRS will never take to court), hospitals should be prepared to demonstrate that whatever metrics they have used to allocate costs are reasonably associated with the underlying costs.

PROFIT MOTIVE

In contrast to its history in challenging the reasonableness of allocation methods, the IRS has had some success in disallowing NOLs based on a lack of profit motive.[16] The basic argument the IRS has employed is as follows: To be an unrelated trade or business activity that generates an NOL that may be deducted against UBTI, the activity must be a ''trade or business'' for tax purposes. For an exempt organization's activity to be a trade or business for tax purposes, the exempt organization must demonstrate that it has a profit motive in carrying out the activity. Thus, losses or NOLs generated by an activity without a profit motive may not be used to offset UBTI.[17]

Perhaps because of its relative success in litigating the profit motive issue, IRS exam agents tend to rely solely on a lack of actual profitability over a number of years to demonstrate a lack of profit motive. However, the courts are clear that a taxpayer's intent to profit is not disproved simply because of a lack of actual profits. Rather, as the Sixth Circuit in the relatively recent case, *Losantiville Country Club v. Commissioner*, made clear, a ''taxpayer can hurdle the intent-to-profit requirement without showing consistent profitability'' if it can demonstrate that it ''intended'' to profit.[18] The court further held that the so-called ''hobby loss'' factors under §183 may be used to ''illuminate that intent.''[19] In another relatively recent case, *WP Realty, LP v. Commissioner*, 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.[20] Of the nine hobby-loss factors, the Tax Court found that only four weighed in favor of the taxpayer (with one factor only ''slightly'' favoring the taxpayer), three weighed in favor of the IRS, and two were neutral, and the court still ruled in favor of the taxpayer.

Accordingly, hospitals with significant NOLs generated by an activity over multiple years will want to apply each of the following hobby loss factors to the activity and carefully document those that may weigh in favor of a profit motive. This exercise may be especially worthwhile for NOLs that arose in tax years

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[15] *See* Rev. Rul. 85-110, Rev. Rul. 68-376.

[16] *See, e.g., Losantiville Country Club v. Commissioner*, 906 F.3d 468 (6th Cir. 2018); *West Virginia State Med. Ass'n v. Commissioner*, 91 T.C. 651 (1988), *aff'd*, 882 F.2d 123 (4th Cir. 1989), *cert denied*, 493 U.S. 1044 (1990); *Atlanta Athletic Club v. Commissioner*, T.C. Memo 1991-83, *rev'd on other grounds*, 980 F.2d 1409 (11th Cir. 1993).

[17] Furthermore, if an exempt organization has allocated fixed or indirect costs in a manner that generates a UBTI loss, the U.S. Supreme Court has made clear that an exempt organization must demonstrate an intent to make a profit after the allocation of such fixed or indirect costs. *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990). (In other words, an organization may not generate a UBTI loss based on the allocation of fixed costs but then argue a profit motive based only on variable costs; the organization must demonstrate a profit motive based on the method it has used to compute UBTI.).

[18] *Losantiville,* 906 F.3d at 473.

[19] *Losantiville*, 906 F.3d at 473.

[20] T.C. Memo 2019-120.

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beginning before January 1, 2018,[21] as these NOLs may be used to offset total UBTI (as opposed to only UBTI derived from the trade or business from which the NOLs arose)[22] and are not subject to an 80% limitation.[23]

Manner in Which the Activity is Conducted

Carrying on an activity in a businesslike manner, such as by maintaining complete and accurate books and records, conducting the activity in a manner similar to other activities of the same nature that are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods, is one factor that may indicate a profit objective.[24] Businesslike conduct is characterized by a careful and thorough investigation of the profitability of a proposed venture, monitoring a venture's progress, and attention to problems that arise over time.[25] Perhaps the most important indication of whether an activity is being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income.[26]

To demonstrate that it has carried on an unrelated business activity in a businesslike manner, a hospital will ideally be able to show not only that it has kept complete and accurate books and records regarding the activity but also that these books and records provide the hospital with information to make informed business decisions. The establishment and monitoring of performance targets could be one way to show this. Even more helpful will be any steps the hospital can document that it has taken over the years to improve the profitability of the particular activity — for example, new methods, approaches, or processes; capital improvements designed to increase efficiencies or revenue; marketing campaigns or other strategies to increase customers; adjustments in pricing; and new hires designed to improve performance. A contemporaneous written business plan outlining such steps could be especially persuasive, but business plans may also be evidenced by actions.[27] Also potentially persuasive would be evidence that the steps taken have succeeded in reducing losses (even if they haven't yet resulted in actual profits). Finally, to the extent the steps have not succeeded in reducing losses, any evidence the hospital can document regarding unanticipated economic difficulties in the relevant industry that may have thwarted best-laid plans could help demonstrate an intent to profit.

Expertise of the Taxpayer or Her/His Advisers

The taxpayer's expertise, research, and study of an activity, as well as its consultation with experts, may be indicative of a profit motive.[28] Accordingly, a hospital's documented efforts to hire and consult with experts in relevant fields will help demonstrate an intent to engage in business for profit.

Taxpayer's Time and Effort Devoted to the Activity

The taxpayer's devotion of much of their personal time and effort to carrying on an activity may indicate a profit motive, particularly if the activity does not involve substantial personal or recreational aspects. A profit motive may also be indicated if the taxpayer ''employs competent and qualified persons to carry on such activity.''[29] Accordingly, a hospital's documented employment of ''competent and qualified'' people to carry on a loss-generating activity may indicate a profit motive.

Expectation that the Activity's Assets May Appreciate

An expectation that assets used in the activity will appreciate may indicate a profit motive even if the taxpayer derives no profit from current operations.[30] ''The term 'profit' encompasses appreciation in the value of assets . . . used in the activity.''[31] A taxpayer's willingness to sustain continued operating losses because of its subjective expectation that the assets used in the activity will increase in value is indicative

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[21] Pursuant to the statutory provision that enacted §512(a)(6) at the end of 2017, NOLs arising in tax years beginning before January 1, 2018, may be deducted against total UBTI, while NOLs arising in tax years beginning after December 31, 2017, may be deducted only against UBI from the business from which the NOLs arose. *See* Pub. L. No. 115-97, §13702 (Dec. 22, 2017).

[22] *See* Reg. §1.512(a)-6(g)(1).

[23] *See* §172(a)(2).

[24] Reg. §1.183-2(b)(1).

[25] *WP Realty v. Commissioner*, T.C. Memo 2019-120. *WP Realty* contains a detailed review of much of the case law on this topic. This article will primarily cite to *WP Realty* rather than each individual case cited therein, but readers who want to examine other authorities may consult *WP Realty* for other case names.

[26] *WP Realty v. Commissioner*, T.C. Memo. 2019-120.

[27] *Finis R. Welch, et ux.*, T.C. Memo 2017-229.

[28] Reg. §1.183-2(b)(2).

[29] Reg. §1.183-2(b)(3)

[30] Reg. §1.183-2(b)(4).

[31] Reg. §1.183-2(b)(4).

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of a profit motive.[32] Accordingly, even if a hospital has sustained operating losses in carrying out an activity, if it can demonstrate that it intends to sell the business at a profit — or that property (such as real property) used in the trade or business will appreciate this would be indicative of a profit motive.

Taxpayer's Success in Carrying on Other Similar or Dissimilar Activities

If a taxpayer has previously engaged in similar activities and made them profitable, this success may show that the taxpayer has a profit objective, even though the current activity is presently unprofitable.[33] A taxpayer's success in other, unrelated activities may also indicate a profit objective.[34] Accordingly, if a hospital can show that it has had success in making other unrelated trades or businesses profitable — whether similar or dissimilar to the activity generating a loss — this would be indicative of a profit motive.

History of Income or Losses

A history of continued losses with respect to the activity may indicate the lack of a profit motive.[35] If the IRS is challenging a hospital's UBTI NOLs, it will presumably be because the hospital has had continued losses with respect to the activity. However, it is important to note that this is just one of nine factors. In addition, to the extent the hospital incurred the loss during the startup stage of an activity, this factor would weigh less heavily in favor of finding a lack of profit motive.

Amount of Occasional Profits

A taxpayer's derivation of some profits from an otherwise money-losing venture may support the existence of a profit motive.[36] Accordingly, to the extent a hospital can document any years in which the unrelated business activity did make a profit, it should highlight these to the IRS Exam agent.

Taxpayer's Financial Status

Substantial income from sources other than the activity may indicate that the activity is not engaged in for profit.[37] On the other hand, neither wealth unassociated with the activity at issue, nor the receipt of a tax benefit as a result of losses generated by the activity, alone, establish that the taxpayer lacks a profit objective. To the extent a hospital can show that the tax benefits it is deriving from the UBTI losses are not comparatively substantial — e.g., because the hospital has not had significant UBTI that such losses have reduced — this factor should not weigh strongly in favor of finding the hospital did not expect to make a profit.

Elements of Personal Pleasure or Enjoyment

The presence of personal motives in conducting an activity may indicate a lack of profit objective, especially if the activity involves personal or recreational elements.[38] Typically any unrelated business activity carried out by a hospital will not involve any personal or recreational elements, so this factor should be an easy one for the hospital to satisfy.

In sum, if a hospital wishes to protect its NOLs from IRS challenge, it should review the above factors and maintain complete and accurate records indicating the hospital's satisfaction of as many of them as possible.

CONCLUSION

The IRS has selected an odd time to challenge hospitals' UBTI losses. Treasury and the IRS are reportedly in the middle of promulgating guidance on the allocation of expenses between related and unrelated business activities and have publicly stated that, pending such guidance, the IRS will not litigate all but one allocation method. IRS exam agents should therefore be left relatively hamstrung when it comes to challenging most allocation methods.

The IRS is better equipped to attempt to disallow hospitals' NOLs, but, even here, hospitals have more defenses than the IRS typically acknowledges if they can document hobby loss factors that weigh in their favor. In sum, hospitals with UBTI losses under review by the IRS have a few options to assist in their defense if they develop an understanding of the history of the IRS's enforcement in this area and have complete and accurate records to support their positions.

[32] *WP Realty*, T.C. Memo 2019-120.

[33] Reg. §1.183-2(b)(5).

[34] Reg. §1.183-2(b)(5).

[35] Reg. §1.183-2(b)(6).

[36] Reg. §1.183-2(b)(7).

[37] Reg. §1.183-2(b)(8).

[38] Reg. §1.183-2(b)(9).

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