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Factors Indicating a Profit Motive

An unrelated business activity that is conducted with the intent to make a profit does not cease to be a business activity merely because it is not profitable for a particular year [IRC Sec. 513(c)]. However, no intent to make a profit may indicate an activity is not a trade or business. The term *trade or business* has the same meaning here as in IRC Sec. 162, which allows the deduction of ordinary and necessary expenses incurred in carrying on a trade or business [Reg. 1.513-1(b)]. The term includes any activity carried on with a profit motive from the sale of goods or the performance of services.

The IRS has rejected the position that a tax-exempt organization may exclude unrelated activities from unrelated business taxable income based on the organization's assertion of a lack of intention to make a profit. According to the Supreme Court, a profit motive is generally established by earning a profit (*Portland Golf Club*). Therefore, unless the objective facts demonstrate a factual lack of profit motive, profit motive is generally presumed. Various courts have continued to allow exempt organizations to rely on the nine factors to analyze profit motive. To demonstrate profit motive without profitability, the organization must show that its intent to profit was thwarted by circumstances.

One case, *WP Realty, LP* (TC Memo 2019-120), provides an explanation of factors reviewed to determine if a profit motive exists.

WP Realty, LP Case

The facts of the WP Realty, LP (WPR) case are complicated. Whispering Pines was first developed as an overnight camp for inner-city youth. The organization morphed into two separate entities after compromising with the IRS on the ownership and operation of the golf course assets. After compromise, Whispering Pines became (1) a tax-exempt entity (SGA) fostering amateur competition and supporting and developing amateur athletes; and (2) a for-profit limited partnership, WP Realty, LP (WPR), that developed the golf course(s) and improvements. SGA would have access to the golf course and facilities by entering in a lease agreement.

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The decision to develop the golf course into a for-profit endeavor involved a long, deliberate process due to its remote location. It was further complicated by a significant downturn in the economy and an oversupply of golf courses. The IRS disallowed deductions for losses of approximately $14 million from a trade or business for tax years 2011–2014, determining a lack of profit motive. The taxpayer subsequently petitioned the tax court.

The Nine Factors

The relevant factors in determining whether an activity is engaged in for a profit as well as the findings on each factor in the WPR case are discussed in the following paragraphs.

Manner in which the activity is carried on. Adopting a business-like manner with proper accounting procedures, conducting it similarly to a commercial business, and changing operating methods to improve profitability indicate an intent to make a profit. WPR kept complete and accurate books, produced profit and loss statements, department budgets, and used the books and records as well as their business plan(s) to make informed business decisions. Attention was focused on creating value and building a reputation for the golf course so that it could become a destination golf course. In addition, Robertson (LP), the original property owner, billed WPR for personal expenses incurred on his behalf.

Another 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. WPR made improvements to reduce expenses and generate income during a period in which the golf industry faced significant economic difficulties. Throughout the years in issue, revenue was raised from green fees, food and beverage sales, golf merchandise, and rental income from cottages. WPR devised a business plan to increase revenue and make the course more marketable, which included having the course become a top-ranked course and hosting tournaments outside their exempt purpose tournament. (*Favored WPR*.)

Expertise of taxpayer and advisors. Studying and using accepted business and economic practices, and consulting with professionals tend to indicate an intent to make a profit. WPR's LP had prior experience with real estate and golf course development and consulted with experts in golf to create the golf course and improvements. In addition, WPR's employees had extensive experience in the golf industry. (*Favored WPR*.)

Time and effort expended. Devoting considerable personal time, particularly if the activity does not involve substantial personal or recreational aspects, withdrawing from other activities, and hiring qualified employees can indicate a profit motive. WPR employed qualified persons including an experienced manager to oversee course operations, a renowned golf professional to assist guests, and a top chef to prepare meals. Weekly operational meetings were conducted that included a discussion of revenues and expenses. (*Favored WPR*.)

Expectation that activity assets will 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. WPR produced no evidence that showed anticipated appreciation of Whispering Pines' assets would be sufficient to overcome its losses. (*Favored IRS*.)

Successful experience in carrying on the activity. 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. A taxpayer's success in other, unrelated activities may also indicate a profit objective. The LP succeeded in developing two other projects similar to Whispering Pines that involved developing a golf course. In particular, LP learned how to structure a golf course for real estate development and how the number of members affected the operations of a golf course. In addition, previous experiences taught LP the benefits of not using debt financing. From this experience, LP also understood the importance of being patient because it may take time before a project is profitable. (*Favored WPR slightly*.)

History of income or losses. A history of continued losses with respect to the activity may indicate the lack of a profit motive. A record of large losses over many years is evidence that a taxpayer did not have a profit motive. However, losses beyond the initial start-up period may not indicate a lack of profit motive if attributable to customary business risk and reversals or unforeseen circumstances such as a natural disaster. In WPR, the Tax Court determined this factor to weigh in favor of the IRS. However, they were not convinced that the long history of losses negated WPR's actual and honest intent to profit from the operation of Whispering Pines. (*Neutral*.)

Amount of occasional profit earned. Deriving some profits from an otherwise money-losing venture may support the existence of a profit motive. However, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated. The court determined WPR had neither made a profit nor engaged in a highly speculative venture. (*Favored IRS*.)

Taxpayer's financial status. Substantial income from sources other than the activity may indicate that the activity is not engaged in for profit. The LP had substantial wealth not related to WPR. He contributed more than $101 million for WPR's capital. However, wealth not associated with the activity in issue is not a bar to that activity being engaged for profit.

Additionally, the receipt of a tax benefit does not alone establish that the taxpayer lacks a profit motive. Even though the losses were large, the LP had substantial income during the years at issue. The tax benefits are not comparatively substantial enough to indicate that WPR did not expect to make a profit. (*Neutral.*)

Elements of personal pleasure or recreation. 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. An activity is not classified as a hobby simply because the taxpayer finds it pleasurable. The analysis does not require that the activity be engaged in with the exclusive intent of deriving a profit or even maximizing profits.

The LP played golf at Whispering Pines only three times during the years at issue. However, a portion of the property was designated for his family's exclusive use and resulted in personal pleasure. But, a home had been moved to this area more than 20 years before Whispering Pines was developed. (*Neutral*.)

Note: No single factor is determinative, and other relevant factors may be taken into account in determining whether the activity is conducted with a profit motive.

Tax Court's conclusion. After a review of all the facts and circumstances and for the reasons stated previously, the court found that WPR was engaged in a for-profit activity for the years at issue (2011–2014). Therefore, WPR was entitled to deduct the losses (approximately $14 million) the IRS had disallowed. Even though they agreed with the IRS that Robertson (the LP) initially had the goal of creating a charitable organization, they were convinced that WPR's predominant, primary, or principal objective was to realize an economic profit independent of tax savings. Once WPR was created, they intended to make a profit. The court also noted that because SGA has now reached WPR's membership goal and the major improvements are completed, they expect that WPR will start to make a profit. However, if losses continue, WPR may again find its profit motive before the court.

Practical Consideration:

Records of businesses plans, changes in business strategy, professional consultations, and meeting minutes and decisions can be critical documentation in substantiating profit motive. A careful read of this case demonstrates the importance of documenting strategic decisions throughout an organization's life.

Late Filed Exemption Application Relief Changes

Organizations described in IRC Secs. 501(c)(3), 501(c)(9), 501(c)(17), and 501(c)(29) are generally required to apply for recognition of tax-exempt status within 27 months from the end of the month in which the organization is formed to be recognized as exempt from the date of formation. Organizations applying after the 27-month period (i.e., late applications) are generally granted tax-exempt status as of the date the application is filed. However, an organization filing a late application may request specific relief in order to be recognized and treated as tax-exempt effective as of a date earlier than the application date (Reg. 301.9100-3). This relief is sometimes referred to as *9100 relief*. The IRS's Exempt Organization Determinations group (EO Determinations) can grant 9100 relief if certain requirements are met. An organization must provide evidence that (1) it acted reasonably and in good faith in missing the 27-month deadline, and (2) the granting of relief will not prejudice the interests of the government. An organization applying for recognition under Section 501(c)(3) and requesting relief must submit Form 1023 (rather than Form 1023-EZ).

On March 17, 2021, the IRS published an internal memo (TEGE-07-0321-0005) describing updates to the Internal Revenue Manual for changes in granting 9100 relief provided by Rev. Proc. 2021-5 (2021-1 IRB 250). For applications submitted on or after January 4, 2021, the following procedures apply:

- EO Determinations will not grant relief under Reg. 301.9100-3 if granting request for relief would result in the organization's exemption being automatically revoked effective before the date of application.
- EO Determinations will not grant relief under Reg. 301.9100-3 if the period of limitations on assessment under IRC Sec. 6501(a) for any taxable year for which the organization claims exemption has expired prior to the date of application.
- EO Determinations will not consider relief for an organization that is not required to apply for recognition of exempt status in order to be tax-exempt.
- In all instances where the request for exemption is being approved but relief under Reg. 301.9100-3 is not being granted, EO Determinations will call the organization and explain why relief is not granted. In addition, the correct determination letter will be sent along with Letter 6392 (9100 Effective Date).

Alternative for Goodwill Impairment

In March 2021, the FASB issued Accounting Standards Update (ASU) 2021-03, *Intangibles-Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events*. The ASU applies to private companies and nonprofit organizations accounting for goodwill impairment under FASB ASC 350-20.

ASU 2021-03 gives private companies and nonprofit organizations the option to perform the goodwill impairment assessment at their annual reporting date, rather than having to do the assessment as events occur during the year. Under GAAP, an organization must test goodwill for impairment when there is a triggering event that indicates that it is more likely than not that the fair value of a reporting unit is less than its carrying value (including goodwill). Triggering events can occur in interim periods, which would require organizations to perform an evaluation and measure impairment throughout the year even if they don't prepare financial statements other than on an annual basis.

The alternative in ASU 2021-03 was one way the FASB attempted to provide nonprofit organizations more flexibility in financial reporting during the COVID-19 pandemic. The uncertainties about the pandemic and related economic downturn created negative effects on revenues and cash flows for many organizations and made projections and valuations related to goodwill impairments much more challenging. Upon adoption of the guidance in ASU 2021-03, an organization can wait to perform the impairment assessment at the end of the reporting period instead of each time a triggering event occurs throughout the period.

How to Implement

The amendments in the ASU are effective on a prospective basis for fiscal years beginning after December 15, 2019. An organization can early adopt the ASU amendments for interim or annual financial statements that have not yet been issued or made available for issuance as of March 30, 2021. An organization can also apply an unconditional one-time option to adopt the accounting alternative prospectively after the ASU's effective date without assessing whether the alternative is a preferable treatment as defined under FASB ASC 250, *Accounting Changes and Error Corrections*.

There are no additional disclosures required because of the amendments. However, the organization must continue to provide the existing disclosures under FASB ASC 350-20.

What's Next?

There is another separate, broader project underway at the FASB on the subsequent accounting for goodwill and certain identifiable intangible assets, including potential straight-line amortization of goodwill over ten years, that applies to all entities. FASB staff is continuing research and outreach related to this project.

Update on Single Audit Reporting Deadlines and COVID-19 Guidance

The governmental landscape and single audit requirements continue to be shaped by the COVID-19 pandemic. The Office of Management and Budget (OMB) released the 2020 Compliance Supplement Addendum in December 2020, to address new COVID-19-related programs and modified compliance requirements that are relevant to COVID-19 for existing programs. However, since the Addendum was issued, two significant pieces of legislation have been signed into law, providing additional COVID-19 federal funding through new and existing programs. Due to the rapidly changing environment, challenges and uncertainty continue to arise surrounding several key areas that will impact single audits for recipients of COVID-19-related federal funding. This article provides updates on the following:

- New, and broader, extension of single audit reporting package filing requirements.
- The new American Rescue Plan Act.
- Updated guidance on the HEERF II program.
- Updated information on the Provider Relief Fund and reporting portal.
- Information on a new resource from the AICPA on the schedule of expenditures of federal awards.

Practical Consideration:

The March 2021 issue of *The PPC Nonprofit Update* highlights key content in the 2020 Compliance Supplement Addendum.

Single Audit Reporting Package Extension

On March 29, 2021, the OMB released Memorandum 21-20, *Promoting Public Trust in the Federal Government* *through Effective Implementation of the American Rescue Plan Act and Stewardship of the Taxpayer Resources,* which directs federal agencies to provide a blanket six-month extension for single audit reporting to the Federal Audit Clearinghouse. The extension applies to all recipients and subrecipients that have fiscal year ends through June 30, 2021, by extending the reporting package deadline six months beyond the normal due date. For example, entities with fiscal years ending June 30, 2021, that have not yet completed their single audits, will have until September 30, 2022, to complete and file their single audits with the Federal Audit Clearinghouse (six months beyond the normal deadline of March 31, 2022). No approval is needed to use the extension; however, the reason for the delayed submission should be documented. Unlike the previous single audit reporting package extensions in response to COVID-19, there is no specification from the OMB that the new six-month extension only apply to recipients of COVID-19-related funding; instead, it applies to all entities that meet the single audit requirements.

Practical Consideration:

Entities that take advantage of the six-month extension may still qualify as a low-risk auditee.

American Rescue Plan Act

The American Rescue Plan Act (ARPA) was passed and signed into law in March 2021. Similar to the previous CARES Act legislation, the ARPA provides a significant level of funding to governmental and nonprofit entities and includes a wide range of programs, including but not limited to, nutrition, schools, higher education, childcare, disaster recovery, COVID-19 testing and treatment, mental health, housing assistance, healthcare, and transportation.

The ARPA provides significant funding for existing federal programs that may be subject to single audit requirements. The Act also creates new federal programs; most significantly, the Coronavirus State and Local Fiscal Recovery Fund, which provides over $350 million to states, tribal entities, U.S. territories, and local governments. At the time of this publication, it has not been determined whether that program will be subject to the single audit. Auditors should be alert for further communications from the OMB regarding this issue. Identifying new COVID-19 programs and determining whether they are subject to the single audit is critical in determining the amount of federal expenditures to properly assess the single audit threshold and to effectively determine major programs.

The AICPA's Government Audit Quality Center (GAQC) continues to maintain their nonauthoritative summary document that includes many COVID-19-related programs, with guidance as to which are subject to Uniform Guidance single audit requirements. The summary also includes links directly to the awarding agency websites and information to support the conclusion as to whether the award is subject to single audit for each program, as well as to other relevant information.

Practical Consideration:

The GAQC summary document, which will continue to be updated as additional information becomes available, can be found at **www.aicpa.org/content/dam/aicpa/interestareas/governmentalauditquality/resources/singleaudit/uniformguidanceforfederalrewards/downloadabledocuments/gaqc-summary-of-applicability-for-new-coronavirus-related-fed-programs-20200616.pdf**. Refer to the date at the top of the summary to be sure it is the most recent version.

HEERF II Guidance

The Higher Education Emergency Relief Fund (HEERF) grant program, which was established as part of the Education Stabilization Fund (ESF), by the CARES Act in March 2020, received a second round of funding as part of the Coronavirus Response and Relief Supplemental Appropriations Act, 2021 (CRRSAA) in December 2020 (referred to as "HEERF II"). Under previous guidance, only expenditures incurred after December 27, 2020, were eligible to be recovered with HEERF II funds. However, on March 19, 2021, the Department of Education released an updated guidance document to grant flexibility to recipients to allow them to charge costs and lost revenue to HEERF II dating back to March 13, 2020, which was the date that the national emergency related to COVID-19 was declared. The Department of Education simultaneously issued a FAQ document on how institutions of higher education with HEERF II funding are to calculate lost revenues for HEERF eligibility, along with several illustrations.

In addition to the guidance issued on the eligible start date to incur HEERF expenditures and the calculation of lost revenue, the Department of Education also released clarified information about audit requirements to HEERF grantees indicating that ESF has not been designated as an automatic high-risk program for single audit major program determination. Instead, auditors should treat ESF as a new program that has not previously been audited when performing risk assessment for major program determination.

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Practical Consideration:

The HEERF II guidance documents, along with background information, and latest news, are available on the Department of Education HEERF II Guidance website at **www2.ed.gov/about/offices/list/ope/crrsaa.html**. Direct links to the documents are as follows: (a) Updated guidance document: **www2.ed.gov/about/offices/list/ope/g5updateletter31921.pdf**, (b) FAQ document on lost revenues: **www2.ed.gov/about/offices/list/ope/heerflostrevenuefaqs.pdf**, and (c) Letter to HEERF grantees on audit requirements: **www2.ed.gov/about/offices/list/ope/heerfauditletter.pdf**

Provider Relief Fund

The 2020 Compliance Supplement Addendum indicated that healthcare entities who received and expended (or replaced lost revenue) with the U.S. Department of Health and Human Services (HHS) Provider Relief Fund (PRF) (CFDA/Assistance Listing No. 93.498) will NOT include those amounts on the SEFA until December 31, 2020, year ends. The reason for this unusual and inconsistent treatment between entities receiving PRF funding with varying year ends, is so that SEFA reporting will link to calendar year reporting for HHS. For entities with fiscal years ending December 31, 2020, and later, PRF expenditures, including lost revenues, must be reported on the SEFA. However, at the time of this publication, HHS has not opened its PRF Reporting Portal for anything other than recipient registration, meaning that auditors are unable to test HHS reporting, as required by the 2020 Compliance Supplement Addendum. Therefore, entities with years ending on or after December 31, 2020, that are recipients of PRF funding, are not able to complete their single audits at this time. Auditors should continue to monitor for communications from HHS at **www.hhs.gov/coronavirus/cares-act-provider-relief-fund/reporting-auditing/index.html**.

Practical Consideration:

Access HHS's updated FAQ document on PRF at **www.hhs.gov/sites/default/files/provider-relief-fund-general-distribution-faqs.pdf**.

AICPA SEFA Scenarios Practice Aid

The GAQC has released a nonauthoritative practice aid to assist recipients and auditors determine the appropriate presentation of federal expenditures on an accrual-basis SEFA due to the complexities of reporting many of the new COVID-19-related federal program funding. The practice aid addresses both the amount of award and the timing of when awards should appear on the SEFA and can be accessed at **www.aicpa.org/content/dam/aicpa/interestareas/governmentalauditquality/resources/singleaudit/downloadabledocuments/aicpa-gaqc-nonauthoritative-covid-19-scenarios.pdf**.

Practical Consideration:

The GAQC SEFA practice aid does not apply to single audits of PRF funding because those SEFA reporting requirements were explicitly addressed in the 2020 Compliance Supplement Addendum.