NACUANOTES
National Association of College and University Attorneys
August 21, 2013
Vol. 11 No. 16

TOPIC:

FOREWARNED IS FOREARMED: FREQUENT ISSUES IN COLLEGE AND UNIVERSITY AUDITS

AUTHOR:

Howard Weinman, Partner, Crowell & Moring LLP (admitted to practice only in the District of Columbia and before the Internal Revenue Service; practice limited to matters before the Internal Revenue Service.)

NACUA MEMBER CONTACT:

Laurel Pyke Malson, Partner, Crowell & Moring LLP

INTRODUCTION:

Although both public and private non-profit colleges and universities are generally exempt from federal income tax, there are still numerous areas of potential friction with the IRS. In April of this year, the IRS released the final report of its Colleges and Universities Compliance Project ("CUCP"). [1] The report details the most frequent types of audit adjustments made by the IRS with respect to colleges and universities. As a result, it should help colleges and universities in reviewing their areas of highest tax compliance risk and taking appropriate steps to mitigate that risk.

DISCUSSION:

I. Major Areas of Interest in Federal Taxation of Colleges and Universities

Private non-profit colleges and universities are generally exempt from federal income tax as educational institutions under Internal Revenue Code of 1986 ("IRC") section 501(c)(3). Public colleges and universities derive their tax-exempt status from IRC section 115, exempting income of states and municipalities. However, both public and private colleges and universities are subject to tax on their unrelated business taxable income ("UBTI"). [2] This is generally the net income derived from activities that do not relate to their exempt purposes. [3] Although the rules are complex, often the most important factor is the degree to which the activity relates to the exempt purposes of the college or university. For example, the IRS ruled that, where a school maintained a ski facility, fees from use by its students for recreational purposes were related and not taxable, but fees from use by the general public were unrelated and UBTI. [4]

Another area of interest is high compensation paid to insiders. IRC section 501(c)(3) has long prohibited private inurement. However, where the IRS deemed pay to "insiders" (generally, officers and executives) to be excessive, the only remedy formerly was to revoke the exempt status of the organization, which usually was deemed to be unduly harsh. In 1996, Congress enacted IRC section 4958, commonly known as the excess benefit or intermediate sanction rules. In certain cases of excessive pay or other one-sided transactions, this section imposes a 25% excise tax on the recipient of the excess benefit. [5] Management of the exempt organization is also subject to a 10% tax on the excess benefit, not exceeding $20,000 for any one transaction. [6] Both the recipient of the benefit and the institution's managers may create a rebuttable presumption against these taxes, however, if certain steps are followed. These are (i) approval of the arrangement in advance by an authorized body (e.g., a committee of the board), no member of which has a conflict of interest; (ii) reliance on appropriate data as to comparability when making the determination; and (iii) adequate and concurrent documentation of the basis of the arrangement. [7] The excess benefit rules apply to private colleges and universities but not to public institutions.

II. Background of the Colleges and Universities Compliance Project

The IRS Exempt Organizations and Government Entities Division began the CUCP in 2008 as part of a series of projects to examine tax compliance in the most important parts of the tax-exempt sector. [8] A stratified, random sample of 400 small, medium, and large educational institutions, both public and private, was selected. These institutions were sent questionnaires concerning various possible compliance issues. From these, the IRS obtained 344 usable responses. [9]

The IRS published interim results of the CUCP in 2010, generally based on data from 2006. [10] While some data (such as average amounts of executive compensation) may be dated by this point, other data are not. The interim report stated that:

- More than 80% of institutions surveyed had conflict of interest policies for top management, increasing to nearly 100% for large institutions. [11]

- More than 60% of institutions surveyed did not rely on outside advice on UBTI issues. [12]

- About half of large institutions had written policies to assure arm's-length transactions with related organizations not exempt under section 501(c)(3); this dropped off substantially for medium and small institutions (which had fewer such related organizations, and therefore less of a need). [13]

- Many institutions reported engaging in activities that might produce UBTI, but far fewer actually reported the income on IRS Form 990-T. [14] For example, 41% of large institutions reported income from patents, but less than 3% included the income on Form 990-T. This would indicate that many such institutions considered the income to be related to their exempt purposes, treated it as otherwise exempt (e.g., as qualifying passive income) from UBTI classification, or simply failed to report.

III. CUCP Final Report

At about the time that it issued the interim report in 2010, the IRS began audits of 34 responding institutions that the IRS believed presented the highest potential for noncompliance. Perhaps by coincidence, this was about 10% of the number of useful responses to the IRS questionnaire. Because these institutions were selected for their high audit potential, they are not representative taxpayers, and the extent of noncompliance found by the IRS should not be extrapolated. The IRS explained in detail the types of audit adjustments that it made in its final report ("Final Report"), issued April 25, 2013. [15]

A. UBTI

The IRS increased UBTI beyond the amount reported for 90% of the 34 institutions it examined for the Final Report, based primarily on the following: [16]

- Institutions reported activities that suffered chronic losses as unrelated. An evident benefit from doing so was that the losses from these activities could offset UBTI from other, profitable unrelated activities. However, the IRS takes the position that an activity that incurs chronic losses cannot be treated as a "trade or business," because it observably lacks a profit motive. Therefore losses from such activities cannot reduce UBTI.

- On over 60% of the examined Forms 990-T, institutions had improperly allocated costs to unrelated (rather than exempt) activities, resulting in a reduction of the amount of UBTI.

- On over a third of examined Forms 990-T, there were errors in computation or a failure of substantiation with regard to net operating losses [17] (losses that cannot be used in the current year because there is not enough income for them to offset, but are carried over to offset UBTI in another year).

- Nearly 40% of examined institutions had misclassified certain activities as not reportable on Form 990-T. Over 80% of these activities were profitable.
  Note: The IRS audit adjustments show a pattern here by the audited institutions: try to classify unprofitable activities as unrelated, try to classify profitable activities as related, and try to allocate costs to the unrelated activities, all with the goal of reducing UBTI.
- A majority of the audit adjustments came from the following activities: fitness, recreation centers and sports camps; advertising; facility rentals; arenas; and golf courses.

B. EXECUTIVE COMPENSATION

The IRS Final Report noted that most private colleges and universities attempted to avoid imposition of excess benefit excise taxes by following the procedures to create a rebuttable presumption in their favor. However, about 20% of the institutions that attempted to follow the procedures failed because of issues with their comparability studies. [18] Specifically, the studies:

- Relied on institutions that were not similar, taking into consideration type (e.g., public or private, liberal arts, research university), location, endowment size, tuition and cost to attend, revenues, total net assets, number of students and faculty, age of the institution, and selectivity;

- Did not document the selection criteria for the schools included nor an explanation of why they were deemed comparable;

- Were off-the-shelf studies used without regard to whether other schools included were in fact comparable; and

- Did not specify whether amounts reported included only salary or also other types of compensation.
  Note: These criticisms by the IRS provide a roadmap for institutions when designing future comparability studies to assure that at least these points are addressed. Although some institutions failed to qualify for the safe harbor, the Final Report does not include any indication that the IRS actually proposed excess benefit excise taxes in those cases, possibly because the IRS concluded that the compensation was reasonable in any event.

After either accepting the comparability group used by the institution or making appropriate adjustments, the IRS determined where, in the range of comparable institutions, the examined institution set compensation. The IRS found that compensation for most positions at the 34 audited colleges and universities was in the range of the 75th percentile. [19]

Note: It appears that several institutions were trying to pay as much as they could, and may have selected "comparables" that would help to support that result. In many cases, the IRS examiners disagreed, with the result that the compensation paid moved into a substantially higher percentile than was indicated by the original study.

C. OTHER COMPENSATION ISSUES

The IRS found several deficiencies with respect to employment taxes, [20] resulting from:

- Failure to include the value of personal use of cars, housing, social club memberships, and travel;

- Misclassification of employees as independent contractors;

- Failure to withhold taxes for wages paid to non-resident aliens; and

- Failure to include the value of certain graduate tuition waivers.

IV. Practical Steps Colleges and Universities Can Take

The IRS stated that it would be pursuing UBTI and executive compensation issues in the future. [21] Educational institutions are forewarned! There are several steps they can take.

A. UBTI

With respect to UBTI issues, colleges and universities may want to make more extensive use of outside advisers, both to develop more defensible positions (including avoidance of outright mistakes) and to protect against penalties. As previously mentioned, the IRS found in its interim report that over 60% of responding institutions did not rely on outside advice in determining UBTI. Furthermore, among the 34 institutions examined, about 80% did not seek outside advice about specific activities. [22]

Even where the examined institutions did seek outside advice, however, the IRS disagreed with the conclusions reached by the advisor about 40% of the time. Nevertheless, outside advice can serve several purposes. It can help the institution to take more reasonable positions and to better substantiate those positions. If well articulated, it may persuade the IRS not to make an adjustment. Even if the IRS disagrees and an adjustment is sustained, reliance on a qualified outside adviser may protect the institution from accuracy-related penalties, which if imposed are typically 20% of the increase in tax. [23]

With regard to penalty protection, the U.S. Tax Court has rejected reliance on the opinion of an inside adviser, no matter how well qualified, [24] as well as an opinion by an outside adviser who participated in structuring the transaction at issue. [25] Obviously, budgetary considerations will require careful selection of situations in which an outside adviser is used.

Colleges and universities may want to keep the UBTI rules in mind as they structure, describe, and advertise activities that they may want to be related or unrelated. This would require proactive involvement by the institution's tax function. Resource constraints may make this difficult, but the resources involved may pale compared to those that would have to be devoted to a subsequent controversy with the IRS that might have been avoided.

Another generic UBTI issue was IRS resistance to allowing unrelated activities that suffered losses to offset income from profitable unrelated activities. In a different area (so-called hobby losses), many factors are considered in determining whether a taxpayer has a profit motive that permits deduction of losses, such as whether the activity is carried on in a businesslike manner, the taxpayer's expertise, and the expectation that assets used in the activity may appreciate in value. [26] Institutions treating activities that produce chronic losses as unrelated may be able to improve their position by appropriately documenting their business plans and ways in which they expect the activities to be able to turn a profit in the future.

Substantiation was also a UBTI issue. Taxpayers are required to maintain books and records adequate to substantiate tax liability. [27] Institutions should consider whether their accounting systems, which may not be focused on UBTI, are adequate for UBTI substantiation purposes. (For example, did the school ski facility in Rev. Rul. 78-98 [28] maintain records that distinguished between fees from students and fees from outsiders?) Record retention policies may also be an issue for activities that generate losses that cannot be used immediately but are carried over and used to offset UBTI many years (up to 20) in the future. By the time the loss is used and must be substantiated, the supporting records may be long gone unless the education institution takes steps to protect them (which, unfortunately, may be inconsistent with the institution's other documentation retention policies).

B. EXECUTIVE COMPENSATION AND EMPLOYMENT TAXES

When setting executive compensation, private institutions and their executives need to be wary of pushing the envelope too far and failing to qualify for the safe harbor presumption of reasonability, particularly with regard to comparability studies. It is evident that they may not simply sit back and accept the advice of a compensation consultant, but rather must carefully consider whether the "comparable" positions and institutions surveyed really qualify as such. [29]

Rules regarding the taxation of employee fringe benefits are complex, and inclusion of the value may be resisted by the (sometimes very senior) employees. However, compliance is essential. The "employee vs. independent contractor" issue is one with which both taxable and exempt organizations struggle, because the differentiating criteria are nebulous. There is a temptation to classify individuals as independent contractors where possible, since this may avoid payroll taxes and eligibility for benefits. This is an issue that has bedeviled taxable corporations for years. Careful consideration of the terms of the arrangement, including the actual terms of any contract as well as how the arrangement works out in practice, is essential. Several rules, both statutory and administrative, can provide varying degrees of relief from back employment taxes where individuals are classified as independent contractors erroneously but in good faith. [30] These rules do not address consequences of misclassification other than federal taxes. To benefit from some of them, the institution may be required to treat the individuals as employees going forward.

C. ADOPTION OF POLICIES

It is clearly a best practice at this point for an educational institution to have a conflicts of interest policy in place for senior personnel. Such a policy helps the institution to focus on transactions that could lead to improper insider dealings and thus helps to avoid the transactions in the first place. The IRS has emphasized this and asks specifically about the policies in the institution's annual Form 990.

For the same reason, policies relating to transactions between the educational institution and related organizations that are not qualified under section 501(c)(3) can help to avoid situations in which the institution's resources are improperly diverted to the related organization. In an extreme case, this can endanger exempt status. In a lesser case, it may sour relations with the IRS examination team and lead to other adjustments that might otherwise have been overlooked.

D. DISAGREEING WITH THE IRS

Although the IRS made numerous adjustments to this group of colleges and universities on audit, that does not mean that the IRS positions were correct and that the adjustments will ultimately be sustained. IRS examination teams generally propose adjustments as to any issue where there is a reasonable chance that the IRS could prevail; they are not allowed to consider hazards of litigation. After these issues are raised, the institution has the opportunity to file a protest and go to the IRS Appeals Office, which is expressly permitted to consider litigation hazards and whose mission is to settle cases fairly and without litigation. [31] Many adjustments are eliminated or substantially reduced in the IRS Appeals process, and of course taxpayers generally have the right to litigate any remaining disputes.

As is the case in any dispute resolution, the parties have the opportunity to settle on a different basis than a court would be required to reach. For example, in the case of an activity that is on the edge between related and unrelated, a court would have to decide that it either does produce UBTI or not. A settlement, however, could be on a 50-50 basis. Other issues are inherently factual and may be settled with the IRS audit team, even though the team cannot consider legal hazards. For example, the extent (if any) to which compensation is excessive, or the methodology used to allocate costs between related and unrelated activities, is subject to negotiation.

Among the issues raised by the IRS in the Final Report, there are none that can categorically be described as particularly likely to be settled for a lesser amount than proposed. Depending on the facts, adjustments based on any of these issues could be perfectly legitimate or completely unwarranted. Thus, as in any controversy, careful consideration of the merits is necessary in deciding whether to attack an audit adjustment.

CONCLUSION:

The CUCP report details the most frequent types of audit adjustments made by the IRS with respect to colleges and universities. This report, and the practical suggestions outlined in this NACUANOTE, should help colleges and universities in reviewing their areas of highest tax compliance risk and taking appropriate steps to mitigate that risk.

ADDITIONAL RESOURCES:

Internal Revenue Service, Colleges and Universities Compliance Project

ENDNOTES:

1. Internal Revenue Service, Colleges and Universities Compliance Project, Final Report (April 2013).

2. *See generally* IRC §§ 511-14.

3. The enactment of these provisions appears to have been stimulated by New York University's acquisition of C.F. Mueller Co., a large noodle manufacturer. *See* Note, "The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations," 81 *Harv. L. Rev.* 1280, 1281–82 (1968). Without these rules, the university's profits from noodle manufacturing would have been tax-free.

4. Rev. Rul. 78-98, 1978-1 C.B. 167.

5. IRC § 4958(a)(1).

6. IRC §§ 4958(a)(2), (d).

7. Treas. Reg. § 53.4958-6.

8. The IRS also, for example, undertook a compliance study of tax-exempt hospitals.

9. Of the 400 institutions, 13 declined to respond, 31 were not four-year, tax-exempt institutions (the type the IRS intended to investigate), 11 responded on a system-wide basis and were held for further analysis, and one was removed to preserve the representative nature of the sample.

10. *See* Colleges and Universities Compliance Project, Interim Report.

11. *Id*. p. 12. The IRS recommends that exempt organizations adopt a conflict of interest policy to avoid improper transactions with insiders. A draft policy is included in the instructions for Form 1023 (exemption application), and questions relating to such a policy are included in both Form 1023 and Form 990 (annual return).

12. *Id*. pp. 32-33.

13. *Id*. pp. 18-19. A transaction that favors a related organization that is not exempt under section 501(c)(3) improperly diverts assets from the section 501(c)(3) organization and could lead to loss of

the section 501(c)(3) exemption. Written policies that require arm's-length pricing or pricing that favors the section 501(c)(3) organization can help to avoid these issues. Form 990, Schedule R, requires extensive information regarding these transactions.

14. *Id*. p. 30.

15. Colleges and Universities Compliance Project, Final Report.

16. Final Report, pp. 11-14.

17. *See* IRC § 172.

18. Final Report pp. 22-23.

19. *Id*. p. 23 (possibly reflecting the Lake Wobegon effect, where "all the children are above average").

20. *Id*. 19-20. In addition, the IRS made several adjustments related to section 403(b) and 457 plans.

21. Final Report p. 6.

22. Final Report p. 14. However, the overall Form 990-T was reviewed by outside counsel in 13% of the cases examined and by independent accountants in 57% of the cases examined. *Id*.

23. IRC §§ 6662, 6664; Treas. Reg. § 1.6664-4(c). If an adjustment is large enough, a penalty is automatically proposed. Generally, an accuracy-related penalty may be excused if there was reasonable cause and the taxpayer acted in good faith. Reliance on a qualified outside advisor, to whom all the relevant information was presented, often establishes reasonable cause and good faith.

24. Seven W. Enterprises v. Commissioner, 136 T.C. 539 (2011).

25. Canal Corp. v. Commissioner, 135 T.C. 199 (2010).

26. *See, e.g.*, Treas. Reg. § 1.183-2.

27. *See* Treas. Reg. §§ 1.6001-1(c), (e).

28. *See* text at note 4, above.

29. This does not mean that institutions and executives need to acquiesce in IRS audit determinations as to comparability; they may be appealed as described below. However, the maxim "pigs get fat, but hogs get slaughtered" (*e.g., Finance Inv. Co.(Bermuda) v. Geberit AG*, 165 F.3d 526, 534 (7th Cir. 1998)), may apply here.

30. *See* IRC § 3509; Revenue Act of 1978 § 530; Internal Revenue Manual § 4.23.6; Announcement 2012-45, 2012-51 I.R.B. 724.

31. Internal Revenue Manual § 8.1.1.1(1).

Permitted Uses of NACUANOTES Copyright and Disclaimer Notice

NACUANOTES Homepage| NACUANOTES Issues
Contact Us | NACUA Home Page

"To advance the effective practice of higher education attorneys for the benefit of the colleges and universities they serve."