Education Alert

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Lessons From the IRS Colleges and Universities Compliance Project

by Gary M. Harden and Breanne M. Democko

Background

The IRS recently completed a five-year study known as the Nonprofit Colleges and Universities Compliance Project ("the Project"). Its final report ("Final Report") on the Project summarizes the lessons IRS learned from the years of research and analysis. The IRS began the study by sending a 33-page questionnaire to 400 randomly selected colleges and universities. Following review of the responses and the Forms 990 and 990-T, the IRS selected 34 schools for audit. The audits were limited to two specific areas for review: (1) unrelated business income tax (UBTI) and (2) executive compensation.

Although the Project focused on nonprofit colleges and universities, the concerns raised in the Final Report are applicable to all tax-exempt organizations as the issues discussed likely are to be present elsewhere across the tax-exempt sector.

Lesson #1: Colleges and Universities Underreport Their Taxable Income (UBTI)

The IRS found that **90%** of the colleges and universities examined were underreporting their UBTI in an amount nearly equaling $90 million. The IRS disallowed more than $170 million in losses and net operating losses. UBTI arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to its tax-exempt purpose. The IRS found that the majority of the activities for which adjustments occurred related to: fitness and recreation centers, sports camps, advertising, facility rentals, arenas and golf activities.

The IRS noted the underreporting of UBTI stemmed primarily from the following four practices:

- Schools claimed losses from activities that did not qualify as a trade or business activity due to lack of a profit motive and evidenced by years of sustained losses from the activity;
- 60% of the schools misallocated expenses to offset UBTI;

Offices

Toledo Office:
One Seagate, 24th Floor
P.O. Box 10032
Toledo, Ohio 43699
Phone: 419-241-6000
Fax: 419-247-1777

Columbus Office:
100 East Broad St.
Ste. 2100
Columbus, Ohio 43215
Phone: 614-564-1445
Fax: 614-280-1777

Findlay Office:
510 South Main St.
Findlay, Ohio 45840
Phone: 419-424-5847
Fax: 419-424-9860

Novi Office:
28175 Haggerty Rd.
Novi, Michigan 48377
Phone: 248-994-7757
Fax: 248-994-7758

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- Many schools incorrectly treated income producing activities as not subject to UBTI, and thus there was significant improper expense allocation to the UBTI activity; and

- More than one-third of the schools erroneously calculated or understated its net operating losses.

There are several important lessons that stem from the IRS's findings in the Final Report. First, the Final Report stresses the importance of properly classifying income. Nonprofit colleges and universities should be mindful when classifying the income related to activities, especially those identified in the Final Report such as fitness and recreation centers, advertising and facility rentals. Second, the Final Report demonstrates the importance of documenting the intended profit motive of business activities, especially when those activities produce unrelated business losses for several successive years. Third, all nonprofit organizations should analyze and consider whether some aspects of their income-producing activities may have an unrelated component. Lastly, the Final Report highlights the importance of maintaining detailed records to substantiate the allocation of expenses between related and unrelated activities as well as to document the underlying detail supporting net operating losses that occurred long before the filing year.

Lesson #2:
Benchmarking – Compensation Practices Fall Short of the Mark

The Final Report also includes an analysis of executive compensation issues, focusing on certain procedural shortcomings relating to reasonable compensation requirements under IRC 4958 and the proper reporting of all items of compensation and benefits.

Along with other 501(c)(3) organizations, nonprofit colleges and universities are subject to the prohibition on "private inurement." This means that an organization may only pay its directors, officers, trustees and key employees a "reasonable compensation." Compensation is considered "reasonable" if the amount would reasonably be paid by a similarly situated organization for comparable services. If an organization paid an amount in excess of what is considered reasonable compensation, then the organization is deemed to have made payments or engaged in activities that improperly inure to the benefit of its "insiders." As a result, the IRS could seek to revoke the tax-exempt status of the organization or alternatively, the IRS may impose penalties on the insiders receiving undue benefit from their tax-exempt organization, as well as a parallel excise on the organization's directors or managers that knowingly approved any "excess benefit transaction."

Organizations may establish a rebuttable presumption that compensation paid by the organization to its directors, officers, trustees and key employees is reasonable by the following:

1. appoint an independent body to review and determine the amount of compensation;
2. the independent body must rely on appropriate comparability data to set the compensation amount; and
3. the independent body must contemporaneously document its decisions in setting compensation.

In its Final Report, the IRS learned **20% of the colleges and universities examined were exposed to sanctions, including potential loss of their tax exempt statuses,** having not successfully established this rebuttable presumption. Some common shortcomings included (1) the organization's use of comparability data that was derived, at least in part, from organizations that were not "similarly situated" to the organization in question (based on factors such as location, endowment size, revenues, total net assets, number of students, selectivity in admissions and age of the institution); and (2) the organization's reliance on compensation studies that did not document adequately how and/or why certain comparability data was selected, and/or did not specify whether the amounts reported included salary only or also reflected other types of taxable and non-taxable compensation.

Although not the focus of the audit, the IRS examined employment tax returns and retirement plan reporting as well. The IRS examined the employment tax returns of about one-third of the colleges and universities, all of which resulted in wage adjustments and assessments of tax and, in some cases, penalties. These adjustments emphasize the importance of reporting the compensation of employees, including taxable fringe benefits, on an accurate, complete and consistent basis. The IRS also looked at retirement plan reporting of about one-quarter of the colleges and universities. Of those colleges and universities examined, the **IRS found problems with about 50%.**

IRS Action Plan

As a result of the findings in the Final Report, the IRS noted the significant amount of UBTI and compensation issues identified in the Final Report "may well be present elsewhere across the tax-exempt sector." Accordingly, the IRS plans to pay particular attention to both matters going forward.

With regard to UBTI, the IRS plans to look at UBTI reporting more broadly and will focus on recurring losses and expense allocation. When completing Forms 990 and 990-T and determining an organization's UBTI liability, organizations should consult with legal counsel in order to ensure that expenses are accurately allocated, and that losses and net operating losses bear the requisite relationship to the activity giving rise to UBTI. If an organization takes the position that an activity is related, rather than unrelated, to its tax-exempt purposes, the organization should document the basis for that determination based on all pertinent facts and circumstances.

With regard to executive compensation, the IRS plans to ensure tax-exempt organizations are aware of the importance of using appropriate comparability data in setting compensation. Organizations exempt under Sections 501 (c)(3) or 501(c)(4) should review closely their methods for setting executive compensation and their use of comparability data.

All tax-exempt organizations should review carefully the Final Report and allow adequate time to consult with legal counsel and/or accountants in order to ensure tax reporting compliance. If you have any questions about this or any other tax issue, please contact Gary M. Harden or Breanne M. Democko or visit our website at www.eastmansmith.com.

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