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IRS Issues Final Report of its Colleges and Universities Compliance Project

On April 25, the Internal Revenue Service (IRS) issued a final report (Report) on its "Tax-Exempt Colleges and Universities Compliance Project." The Report includes IRS findings and conclusions drawn from responses to questionnaires distributed to 400 public and private colleges and universities, and from the results of examinations of 34 of the colleges and universities that completed a questionnaire in order to gain a better understanding of practices involving unrelated business income (UBI) and executive compensation.

The Report is the latest example of the IRS' increased emphasis on compliance matters of tax-exempt institutions and follows on the heels of the final report released in 2011 of its "Tax-Exempt Bond Compliance Questionnaire Project." Due to the IRS' demonstrated interest in 501(c)(3) compliance matters, it is important to keep in mind that the compliance issues addressed in the Report are significant not only to a college or university's tax liability, but also to matters related to the tax-exempt bonds of a college or university, including post-issuance compliance, bond audits by the IRS, and fulfillment of various bond covenants.

In the UBI context, the IRS focused its attention on how colleges and universities report their business activities, which includes, but is not limited to, how they characterize activities as exempt or unrelated, allocate expenses, address recurring losses on specific activities, calculate net operating losses, and apply exceptions and modifications. The IRS' examinations resulted in significant increases in unrelated business taxable income (UBTI) for 90% of the examined colleges and universities totaling about $90 million most commonly for activities associated with *fitness and recreation centers and sports camps*; *advertising*; *facility rentals*; *arenas*; and *golf courses*. On the flip-side of UBTI, the IRS also disallowed approximately $170 million of operating losses claimed by 75% of examined tax returns, in most cases, because the activity lacked a profit motive and did not qualify as a "business activity." The Report's treatment of issues related to UBI and UBTI and significant amount of adjustments, in terms of percentage of colleges and universities affected and total dollar amount, indicate that the IRS' interest in UBI and UBTI issues will only increase moving forward.

Regarding executive compensation, the Report focuses on the reasonableness of compensation private colleges and universities pay to their officers, directors, trustees and key employees (ODTKEs), specifically, on the quality of the comparability data they use to establish the rebuttable presumption of reasonableness established under Section 4958 of the Code. The IRS found a number of weaknesses in comparability data used by colleges and universities. In addition, the IRS made significant adjustments to the taxable wages paid by examined institutions due to such factors as the failure to include fringe benefits in income and the mischaracterization of employees as independent contractors. The key takeaways from the Report's treatment of executive compensation are (1) institutions should closely review the fringe benefits (such as personal use of autos, social club memberships, and travel) that are being provided to officers and other key employees to ensure that such fringe benefits are being properly reported and (2) comparability data for ODTKEs should reflect, as closely as possible, what institutions of similar size, with similar endowments, and in similar geographic areas are paying such ODTKEs. In future audits, IRS examiners will likely ask to see not only compliance procedures, but also evidence that they are being followed.

The Report also addresses issues related to deferred compensation and highlights a variety of compliance issues and the resulting tax adjustments made by the IRS.

Squire Sanders bond counsel and tax partners are nationally known for their expertise in compliance matters regarding tax-exempt bonds and 501(c)(3) organizations and are in frequent direct contact with the IRS on behalf of our clients. If you have any questions regarding your institution's tax-exempt status or tax-exempt bond post-issuance compliance efforts, in general or in relation to an audit, please contact a member of the Squire Sanders Public Finance Practice Group or the Squire Sanders lawyer with whom you work.