

tax-exempt organizations lawflash

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IRS Issues Final Report on Colleges and Universities Compliance Project

Report offers lessons for many tax-exempt organizations on unrelated business taxable income and executive compensation.

On April 25, the Internal Revenue Service (IRS) released a final report summarizing the results of its five-year compliance project on colleges and universities.¹ The report identifies several areas of noncompliance that are relevant to many tax-exempt organizations, including executive compensation and the reporting of unrelated business taxable income (UBTI). The compliance project involved an analysis of information collected from questionnaires sent to 400 colleges and universities, as well as the results of audits of a smaller subset of respondents that were chosen for examination based on potential noncompliance. Highlights of the report and their implications for other tax-exempt organizations are summarized below.

Unrelated Business Taxable Income

The IRS identified errors that resulted in increases in UBTI for more than 90% of the colleges and universities examined. These errors included the following:

- **Misclassification as a “trade or business” due to lack of profit motive.** The IRS disallowed claimed UBTI losses from activities that lacked a profit motive, based on a track record of successive losses for a number of years.
- **Misallocation of expenses.** The IRS disallowed expenses claimed in calculating UBTI based on improper allocations between related and unrelated income-producing activities.
- **Errors in computation or substantiation of net operating losses.** The IRS disallowed the use of net operating losses to reduce UBTI on the grounds that such losses were improperly calculated or unsubstantiated.
- **Misclassification of related activities.** The IRS recharacterized income reported as related as unrelated business income. Common misclassifications included activities related to fitness, recreation centers, and sports camps; advertising; facility rentals; arenas; and golf.

There are several lessons that can be learned from the report:

- **Document business purpose.** The report highlights the importance of documenting the intended profit motive of business activities, particularly when those activities produce unrelated business losses for several successive years.
- **Document expense allocation.** The report also emphasizes the importance of maintaining 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.

1. IRS, Colleges and Universities Compliance Project Final Report (Apr. 25, 2013, revised May 3, 2013), *available at* http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

- **Identify unrelated activities.** The report reflects the importance of analyzing whether some aspects of income-producing activities may have an unrelated component.

Executive Compensation

The IRS's report also includes an analysis of executive compensation issues, which focuses on compliance with the reasonable compensation requirements under section 4958 of the Internal Revenue Code and the proper reporting of all items of compensation and benefits. With respect to section 4958 compliance, the report somewhat surprisingly noted that, even though most of the colleges and universities retained outside compensation consultants, a significant number failed to rely on comparable market data for their executive compensation decisions. While the amount of the executive compensation may have been reasonable, the failure to use comparable market data prevented those colleges and universities from asserting the "rebuttable presumption of reasonableness" under section 4958. Common problems included reliance on data from organizations not deemed to be comparable, failure to document the process for identifying comparable organizations, and failure to specify whether compensation amounts reflected only salary or total compensation.

These findings also offer lessons for 501(c)(3) and (4) organizations. In order to support the sufficiency of comparability data used in determining the reasonableness of compensation, organizations should ensure the following:

- The selection of comparable organizations is based on a full range of factors. For example, in the college and university context, the IRS relied on location, endowment size, revenues, total net assets, number of students, and selectivity.
- The selection criteria and process for identifying comparable organizations is well documented.
- The amounts reported as compensation in the comparability data should clearly specify whether they reflect only salary or total compensation.
- The board of directors maintains involvement in the assessment of comparability data, even when a compensation consultant is engaged to complete the study. The board should review the organizations selected as comparable and the justification for such selections.

The IRS's report also includes a review of the employment tax and employee plan returns of about one-third of the colleges and universities it examined, which resulted in adjustments of wages and the assessment of taxes and penalties. This review was not the focus of the report, but it emphasizes the importance of reporting the compensation (including taxable fringe benefits) of employees on an accurate, complete, and consistent basis.

The U.S. House of Representatives Ways and Means Subcommittee on Oversight will hold a hearing on the IRS's Colleges and Universities Compliance Project Final Report on May 8, 2013, at 2:00 p.m.

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