Client Alert

Latham & Watkins
Tax Department

IRS Interim Report on Tax-Exempt Colleges and Universities Compliance Project

The Internal Revenue Service (IRS) released an interim report on May 7, 2010 summarizing the responses to compliance questionnaires sent to nonprofit colleges and universities in October 2008. The Colleges and Universities Compliance Project is part of an IRS effort to review the largest and most complex tax-exempt organizations. Colleges and universities were used in the study because they represent one of the largest nonprofit segments in terms of revenue and asset size.[1]

"The Colleges and Universities Compliance Project is part of a larger effort by the IRS to review tax-exempt organizations, and all tax-exempt organizations might find the report helpful."

The focus of the compliance project is on (1) the conduct and reporting of activities that may generate unrelated business taxable income; (2) executive compensation practices; (3) the investment, management, and use of endowment funds; and (4) governance issues. As part of the project, the IRS has opened examinations of more that 30 colleges and universities, focusing primarily on unrelated business income and executive compensation issues.

The interim report presents preliminary information regarding each of the items listed above. This *Client Alert* summarizes certain key aspects of the interim report. We note, however, that the final report is expected to include a more detailed analysis of the questionnaire responses, along with a summary of findings and information derived from the examinations.

The IRS anticipates that the final report will identify issues and areas that warrant additional guidance and further scrutiny. After reviewing the information in the interim report, tax-exempt organizations may find advisable a careful review of the nature and adequacy of their corporate policies and procedures, including governance, executive compensation, unrelated business activities, and endowment oversight, spending and investment.

Background

In October, 2008 the IRS distributed 400 compliance questionnaires generally requesting information relating to organizations' taxable year ending in 2006.[2] Respondents are divided into three groups based on the size of their student populations: small (fewer than 5,000 students), medium (5,000 to 14,999 students), and large (15,000 or more students). The respondents were also divided into public and private universities — respectively, those exempt from federal income tax pursuant to Section 115 of the Internal Revenue Code of 1986, as amended (the IRC), and those exempt under IRC Section 501(c)(3).

The interim report both summarizes the data collected and reflects the review by the IRS to date of the 344 responses received. Additional valuable information is expected to be provided in the final report including (1) the use of and relationship with controlled entities and related organizations; (2) differences in treatment by organizations of various activities as exempt or unrelated and of cost allocations made across activities and related organizations; (3) the reporting of losses; (4) the use of comparability data and compensation practices and procedures to establish compensation of executives and other highly paid employees; (5) the impact of the initial contract exception (described below) on the setting of compensation; (6) the use of the rebuttable presumption procedure (described below); and (7) the governance policies and practices of organizations with respect to activities with potential unrelated business income implications, related organizations and controlled entities.

Unrelated Business Taxable Income

The questionnaire listed 47 activities in four categories (advertising, corporate sponsorship, rentals and "other") that the IRS believes may result in unrelated business taxable income. Included in such "other" activities were catalog sales, internet sales, mailing list rentals, logo usage, commercial research, and the operation of hotels, conference centers, restaurants, parking lots, bookstores and golf courses. The most frequently reported unrelated business activities were advertising and facility rentals. Just under half of small colleges and universities reported never having filed a Form 990-T (the Exempt Organization Business Income Tax Return), compared with 29 percent of medium and only 4 percent of large colleges and universities.

The interim report indicates that in most cases, "the percentage of colleges and universities that indicated engaging in an activity was much higher that the percentage of organizations that reported including that activity on their Form 990-T." For example, a quarter of large organizations reported conducting commercial research, while only 5 percent included related revenue on their Form 990-T. Organizations reporting advertising activity ranged from 23 percent for small organizations to 82 percent for large organizations, while only 6 percent of small organizations and 53 percent of large organizations reported that they included advertising income on their Form 990-T. While such discrepancies may appropriately exist where, for example, the activity is conducted exclusively for exempt purposes or meets an exception under the unrelated business taxable income rules, the IRS described this as an area for further study.

Furthermore, at least 61 percent of the colleges and universities responding indicated that they did not rely on outside counsel or accountants when determining whether activities are unrelated or exempt, as to the allocation of expenses between unrelated and exempt activities, and pricing between the organization and its related organizations for expenses incurred in unrelated activities.

Executive Compensation

The highest paid employee other than "executives" (officers, directors, trustees and key employees (those with management and administrative positions akin to officers)) was a faculty member for 55 percent of small and 49 percent of medium colleges and universities. For large colleges and universities, that person was a sports coach among 43 percent of the respondents. Average and median total compensation amounts are provided in the interim report for the highest paid employee (other than executives). The average compensation for such highest paid employee was $145,000, $241,000 and $798,000, for small, medium and large colleges and universities, respectively. By contrast, the average compensations of the highest paid executive was $202,000, $318,000 and $428,000, respectively.

The questionnaire asked about specific types of compensation, and the interim report provides the percentages of respondents reporting, for example, incentive compensation, severance or other change of control payments, personal use of vehicles, personal travel for the person or family members, housing and utilities, personal services, health/social club dues and first-class travel. A small number of organizations in each size category reported providing loans to at least one of its six highest paid executives. Some indicated that loans or forgiven loans considered to be compensation for services were not reported on either Form W-2 or Form 1099.

Rebuttable Presumption of Reasonable Compensation

The Treasury regulations under IRC Section 4948 (the intermediate sanctions on excess benefit transactions) provide a process to establish a rebuttable presumption that compensation is reasonable (*i.e.,* not an excess benefit). However, 45 percent of small, 29 percent of medium, and 38 percent of large organizations reported not using the rebuttable presumption procedures for any of their six highest paid officers, directors, trustees and key employees. Public colleges and universities are not subject to the excess benefit transaction rules. These entities were instructed not to respond to related questions, and any responses received were not included in the interim report's results.

Establishing the rebuttable presumption of reasonableness generally requires an independent governing body to review and establish the amount of compensation in advance, use of appropriate data as to comparability, and adequate and contemporaneous documentation of the basis for the determination. The majority of respondents reported documenting the basis for compensation determinations prior to payment for at least one of their six highest paid executives. Almost all of the respondents reported requiring approval by an independent governing body and recusal of interested persons from compensation discussions and voting. Fifty-four percent of small organizations, 79 percent of medium organizations and 63 percent of large organizations reported use of an independent comparability survey. Eleven percent of small organizations reported setting compensation outside the range of comparability survey data, while 100 percent of the medium and large organizations set compensation within the range.

The interim report shows the types of data used for comparisons. Of note, 15 percent of small and 19 percent of medium organizations reported using compensation levels paid by similar taxable organizations. None of the large organizations did so. The interim report also shows the various reported sources of comparability data, including published surveys and internet research of compensation at similar institutions, outside experts specifically hired to provide comparable data, and Forms 990 filed by other colleges and universities.

The Treasury regulations provide that fixed amounts paid under a binding written initial contract between an organization and a person who was not a disqualified person immediately before entering into the contract are not excess benefit transactions (the "initial contract" exception). For 87 percent of small, 79 percent of medium, and 63 percent of large organizations, none of their six highest paid executives were prior disqualified persons. As a result, fixed payments made pursuant to an initial contract would not be subject to the excess benefit transaction rules. Nonetheless, relatively few organizations reported making fixed payments pursuant to the initial contract exception to any of their six highest paid executives.

Endowment Funds

In the majority of cases (ranging from 60 percent of small organizations to 84 percent of large organizations), an outside consultant was engaged for investment guidance. Of those using outside consultants, a vast majority of respondents indicated that the organization's investment committee approved the selection of outside investment managers and the recommendations made thereby. The vast majority of compensation arrangements for outside investment managers were reviewed and approved by the investment committee or the full board.

The interim report provides detailed breakdowns of the types of investments and the relative percentages of various asset classes held, including alternative investments (hedge funds, private equity, venture capital, natural resources and others), fixed income funds, equity funds, real estate, international funds, cash and other investments. Not surprisingly, US fixed income and equity funds predominate. Most organizations reported holding foreign investments, and many used various investment entities to make foreign investments. For the most part, the target for total real returns net of investment fees was between 5 percent and 10 percent. Target spending rates were consistently reported between 4.7 percent and 5.0 percent.

Fifteen percent of the organizations indicated that the board or committee members delegated with investment oversight placed restrictions on the purchase or sale of certain securities because of particular donor restrictions or special requests.

The most common policy for distributions made from an endowment fund but not used during the fiscal year of distribution was to apply the amount not used to the following year. Some organizations returned the amount to the endowment fund, while the least common approach (3 percent of respondents) was to make the amount available for general use.

Governance

Governance issues and related organizational policies and procedures are addressed throughout the interim report, including as described above.

Fifty-eight percent of small colleges and universities reported having a conflict of interest policy governing full-time faculty (81 percent had policies governing its ruling body and top management officials), compared to 100 percent of large colleges and universities. The percentage of colleges and universities with conflicts policies with respect to various transactions with non-501(c)(3) related entities varied widely.

Nearly a quarter of small organizations do not make their audited financial statements available to the public, while 91 percent of medium and 97 percent of large organizations do so.

The questionnaire included various questions relating to the use of outside counsel and other advisors, including with respect to unrelated businesses, price allocations between unrelated and exempt activities, pricing between related organizations, investment management, and compensation data. As noted above, more than 60 percent of the organizations did not rely on outside advice as to whether business activities were related or unrelated to the organization's exempt purpose, the allocation of expenses between related and unrelated business activities, and intercompany pricing between the organization and related entities. The questionnaire also asked about the involvement in various areas of the governing board and its committees, including investment and compensation committees.

Related and Controlled Organizations

Many respondents reported having related and controlled organizations. Related tax-exempt organizations were the most common related entities, followed by taxable corporations and trusts, disregarded entities and partnerships. Of those with at least one related organization, 35 percent of small, 19 percent of medium, and 36 percent of large colleges and universities reported that they had at least one non-exempt related organization. The compliance questionnaire asked whether written policies (or statutes in the case of public organizations) were in place to ensure that various transactions with non-exempt related entities were made at arm's length. For small organizations, positive responses ranged from a low of 8 percent for shared employees to 27 percent for the provision of goods or services.

Less than half of those reporting that they had at least one controlled entity indicated that they reported income from controlled entities on their Form 990-T. The interim report provides that "[w]hile there may be cases in which organizations had no reportable income, the difference may suggest a possible reporting inconsistency that will be reviewed further."

Conclusion

The Colleges and Universities Compliance Project is part of a larger effort by the IRS to review tax-exempt organizations, and all tax-exempt organizations might find the report helpful. As indicated above, the information presented may serve as a useful guide when reviewing the nature and adequacy of tax-exempt corporate governance policies and procedures, including with respect to executive compensation, unrelated business activities, and endowment oversight, spending and investment.

Endnotes

1 In 2009, the IRS published a study on tax-exempt hospitals, their executive compensation and their provision of community benefits. Lois Lerner, IRS Director of Exempt Organizations, said that the college and university project, "like our previous one on nonprofit hospitals, gives us a lot of valuable information on activities conducted by those organizations that will help us in our enforcement and services efforts."

2 Given the subsequent downturn in the economy, reported amounts may not be representative of current financial positions or policies. Also, the interim report does not generally include responses provided in narrative form, which the IRS indicates will be addressed in the final report. The information in the interim report is not weighted and should not be seen as representative of the sector as a whole. In addition, the interim report does not include data received by 11 respondents who reported on a systemwide basis, rather than with respect to an individual campus.

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