

## Nonprofit Opportunity for Free Distance Learning: *IRS Releases Interim Report on College and University Compliance Project*

Several weeks ago the IRS released an interim report on the College and Universities Compliance Project (“Project”), which it launched a year and half ago. The Project focuses on college and university compliance in several areas: (1) unrelated business taxable income; (2) investment, management, and use of endowment funds; and (3) executive compensation practices. Additionally, the Project evaluates governing board oversight of these issues.

This IRS compliance check began with the mailing of questionnaires to 400 public and private colleges and universities requesting information for each institution’s tax year 2006. According to the IRS interim report, the 400 questionnaires generated 344 usable responses.<sup>1</sup> The survey summaries from the interim report are instructive, providing alert and proactive colleges and universities, as well as other nonprofits that have unrelated business activities or pay relatively high compensation, the opportunity to conduct a self-audit.

**1. Unrelated Business Taxable Income (“UBTI”).** The IRS questionnaire asked if schools were directly involved in 47 different activities (categorized broadly as advertising, corporate sponsorship, rentals, and other) that may generate unrelated business taxable income. The highest overall participation rate was in rental activity (small 67%; medium 88%; large 96%). Yet the UBTI reporting rate was low, with almost half of smaller institutions responding that they had never filed a Form 990-T (small 48%; medium 29%; large 4%).

Sadly, more than 60% of the schools (small 64%; medium 68%; large 61%) reported they did not rely on advice from independent accountants or legal counsel for determining UBTI liability. Those that solicited advice did so primarily to determine whether an activity was related or unrelated to exempt purposes. The IRS is pinpointing this apparent underreporting of UBTI, along with the lack of professional counsel, as a target for further examination.

**2. Rebuttable Presumption Procedure in Compensation Decisions.** As provided in the Intermediate Sanctions legislation, a rebuttable presumption that compensation decisions do not result in prohibited excess benefit may be established if three steps are followed: 1) use of comparability data; 2) approval by an independent body; and, 3) contemporaneous documentation. Just over half (55%) of the small schools used the rebuttable presumption procedure (71% medium; 62% large). Most conspicuously lacking was the use of comparability data by schools in setting salaries. Given the protection provided by creating a rebuttable presumption of reasonableness and that the procedure is much easier than capping a deepwater oil spill, it is surprising that a relatively large number of colleges and universities have not established this practice.

**3. Management and Investment of Endowment Funds.** Unsurprisingly, a greater percentage of large institutions indicate they maintain endowment funds (small 52%; medium 73%; large 85%). It is noteworthy that nearly all the schools, regardless of size, had an investment policy for these funds (small 94%; medium 94%; large 95%). Most schools indicated they used an investment committee to oversee endowment fund assets (small 85%; medium 93%; large 94%) and used outside consultants for investment guidance (small 60%; medium 74%; large 84%). The

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<sup>1</sup> This extraordinary high response rate to a government survey confirms that the IRS still carries considerable clout, a position reaffirmed when the thirteen schools that did not respond were referred to the IRS Exempt Organizations office for examination. The 344 usable respondents included 177 private and 167 public institutions of various sizes: 159 small colleges (<5,000 students), 94 medium-sized (5,000 to 14,999 students), and 91 large colleges and universities (>15,000 students).

reporting schools had target spending rates of approximately 5%, regardless of size. Engaging outside guidance, using a written Board-adopted endowment policy, and appointing a specialized oversight committee are best practices for any exempt organization with an endowment.

**4. Governance and Written Policies.** The IRS questionnaire also sought to elicit whether schools had in place current written policies addressing a number of key compliance areas, including compensation, loans, conflicts of interest, endowments, and transactions with related entities. The vast majority of schools reported having a conflict of interest policy and an endowment policy. But the number of schools that utilized a formal written policy governing compensation of insiders, sharing of employees between organizations, or lending money was low.

The IRS has opened more than 30 examinations of colleges and universities pursuant to this Project, focusing on unrelated business taxable income and executive compensation issues. Nonprofit pundits are predicting that this Project will likely serve as a template for future compliance projects with other types of exempt organizations. Prudent nonprofits are well advised to study the good lessons from this interim report and the forthcoming final report, which are particularly well suited for distance learning.

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