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IRS Releases Final Report on Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations

In October 2008, the Internal Revenue Service (the "IRS") began work on the Nonprofit Colleges and Universities Compliance Project (the "Project"). The IRS sent out an initial compliance questionnaire to over 400 tax-exempt colleges and universities. Based on the responses, 34 colleges and universities – about 8.5% of the total number of institutions that originally received the questionnaire – were then selected for examination. The IRS has now completed 90% of these examinations. On April 25, 2013, the IRS released the Final Report on the Project, summarizing the findings from the completed examinations and representing the culmination of almost five years of research and analysis.

Although the Project has focused specifically on colleges and universities, the key points raised in the Final Report are applicable to all tax-exempt organizations. Lois Lerner, the Director of the IRS Exempt Organizations Division, recently stated in remarks accompanying the release of the Final Report that the issues discussed "may well be present elsewhere across the tax-exempt sector." In particular, she emphasized that "all exempt organizations need to be aware" of the Final Report's findings pertaining to unrelated business income and executive compensation.

Unrelated Business Income Findings

Unrelated business income ("UBI") arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to the tax-exempt purposes of the organization. The Internal Revenue Code (the "Code") imposes unrelated business income tax ("UBIT") on an organization's UBI, reduced by the organization's related losses and deductions. The Final Report notes that 90% of the colleges and universities examined had misreported UBI on their Forms 990 and 990-T during the years under examination, and the resulting changes in the reporting of losses and net operating losses ("NOLs") could result in over $60 million in assessed federal taxes.

Among the colleges and universities examined, the IRS found that certain activities most commonly resulted in adjustments to UBIT liability. These included advertising; arena use; facility rentals; and the operation of fitness and recreation centers, sports camps, and golf courses. The Final Report explains that the IRS disallowed more than $150 million in NOLs during the course of its Project-related examinations because the examining agents found that the institutions engaged in these types of activities failed to demonstrate the requisite connection between a trade or business and the activities generating losses.

Other common findings among the examined colleges and universities included misallocation of expenses between activities related to tax-exempt purposes and those unrelated to such purposes; errors in computation of NOLs and the substantiation of such amounts; and misclassification of activities as related to the institution's tax-exempt purposes. It is interesting to note that the IRS identified numerous instances in which examined colleges and universities had reported net losses on activities "for which expenses had consistently exceeded UBI for many years." The IRS determined that these activities were not carried on with a profit motive and, as such, disallowed the NOLs that flowed from those activities.

Executive Compensation and Other Compensation Findings

With regard to executive compensation, the Final Report focuses on certain procedural shortcomings among many colleges and universities. As organizations described in § 501(c)(3) of the Code, these colleges and universities are subject to the prohibition on "private inurement." As such, if an organization is deemed to make payments or engage in activities that improperly inure to the benefit of its "insiders," the IRS could seek to revoke the tax-exempt status of the organization. Alternatively, under Code § 4958 (also known as the "intermediate sanctions" rules), the IRS may impose punitive excise taxes on the insiders receiving undue benefit from their tax-exempt organizations, as well as a parallel excise on the organization's directors or managers that knowingly approved any "excess benefit transaction."

These penalty taxes apply only if an organization pays an amount in excess of what would reasonably be paid by a similarly situated organization for comparable services. If a § 501(c)(3) organization pays reasonable compensation to its officers, directors, trustees, and key employees ("ODTKEs"), no excess benefit transaction occurs. Section 4958 and the accompanying Treasury Regulations provide that organizations may establish a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable. In order to attain the rebuttable presumption, 1) the organization must 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 the Final Report, the IRS found that 20% of the colleges and universities examined would not have successfully established this rebuttable presumption. The key shortcomings included 1) the use of comparability data that was derived, at least in part, from organizations that were not "similarly situated" to the institution 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 reliance on compensation studies that did not adequately document how and/or why certain 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. While the Final Report reaches certain conclusions about the scale of compensation paid by colleges and universities to various ODTKEs, it does not provide the number of institutions under examination actually found to have engaged in an excess benefit transaction subject to excise taxation.

Finally, the IRS also opened employment tax examinations at 11 of the 34 colleges and universities. Each of these examinations resulted in upward adjustments to wages and assessment of additional tax, totaling over $7 million. The reasons for these wage adjustments included common problems for all exempt organizations, such as failure to properly account for the value of the personal use of automobiles, housing, and travel in the wage calculation, as well as failures to properly classify individuals as employees or independent contractors.

Conclusions

Colleges and universities, as well as other tax-exempt organizations, should carefully review the Final Report, as it provides clear insight into areas that the IRS will likely target in the future. When completing Forms 990 and 990-T and determining an organization's UBIT liability, organizations should allow adequate time to consult with their legal counsel and accountants in order to ensure that expenses are accurately allocated, and that losses and NOLs bear the requisite relationship to the activity giving rise to UBI. If an organization will take the position that an activity is related, rather than unrelated, to its tax-exempt purposes, it should document the basis for that determination based on all pertinent facts and circumstances.

Additionally, organizations exempt under Sections 501(c)(3) or 501(c)(4) should closely review their methods for setting executive compensation and their use of comparability data. The payment of unreasonable executive compensation can lead to the imposition of intermediate sanctions or to the loss of exempt status. Organizations that hire compensation consultants should monitor the comparability data in use. Alternatively, organizations that do not engage outside consultants should review their own procedures for selecting comparability data to ensure that such data reflects the practices of similarly situated entities. In all events, organizations should ideally review their internal procedures to attain the rebuttable presumption of reasonableness with regard to compensation paid to all ODTKEs.

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