# Compensation and Unrelated Business Income are Focus of IRS Colleges and Universities Report

Just a few weeks before many tax-exempt organizations file their annual Form 990, the IRS yesterday released its final report on the Colleges and Universities Compliance Project, which it had initiated in 2008 by sending questionnaires to 400 colleges and universities. The final report highlights two key compliance issues that emerged from 34 audits the IRS conducted as a result of its review of responses to the questionnaires: compensation and unrelated business income. In a release issued in conjunction with the report, IRS Exempt Organizations Director Lois Lerner noted that the compliance issues the IRS identified "may well be present elsewhere across the tax-exempt sector," suggesting that the IRS may be planning particular compliance efforts with respect to compensation and unrelated business income.

## Compensation

The 34 audits focused on compliance with the "intermediate sanctions" rules that penalize the payment of excessive compensation to a tax-exempt organization's insiders. The report indicated that most of the schools under audit attempted to comply with a safe harbor procedure contained in Treasury regulations which creates a rebuttable presumption that the organization paid reasonable compensation. However, the IRS concluded that a number of schools did not meet the precise requirements of the safe harbor procedure, generally because of problems with one aspect of the procedure: reliance upon appropriate comparability data. The report noted that typical missteps included failure to specify in the comparability data whether it included all elements of an individual's compensation (e.g., not simply cash compensation) and reliance on comparability data from organizations that were not similarly situated (e.g., differing net assets, student numbers, or endowment size).

The report also notes that approximately one-third of the audits examined employment tax returns. Each of those audits resulted in adjustments to reported wages, the assessment of additional unemployment taxes and in some cases penalties. Wages were adjusted upward for a variety of reasons, such as personal use of automobiles, housing and club memberships, and personal travel. With regard to nonqualified deferred compensation, the IRS required adjustments where deferred amounts should have been included in income currently because they were not subject to a substantial risk of forfeiture.

## Unrelated Business Income

The report noted significant compliance issues among the audited schools with the reporting of unrelated business taxable income (UBTI). Ninety percent of those examined had increased UBTI as a result of the audits. One of the key reasons for increased UBTI was the disallowance of losses, including net operating losses carried forward from prior years. The most common reason the IRS disallowed losses was based on a conclusion that the activity giving rise to the losses was not a "trade or business" at all because the college or university lacked a profit motive. It is clear from the report that if an activity shows a pattern of recurring losses, the IRS is likely to assert that no profit motive exists and to seek the disallowance of losses from that activity that would otherwise reduce total UBTI. The IRS also highlighted the misreporting of expenses not properly attributable to unrelated business activities as a reason for UBTI adjustments. The report notes that approximately 60 percent of the audited schools allocated expenses improperly between related and unrelated business activities, such that too great a deduction was taken against unrelated business income. Furthermore, the report also singled out the following specific activities as giving rise to over half of all UBTI adjustments: fitness and recreation centers and sports camps, advertising, facility rentals, arenas, and golf courses.

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The IRS report is based on audits of a relatively small group of colleges and universities specifically targeted by the IRS for potential noncompliance issues, and the report makes clear that assumptions about other colleges and universities should not be drawn based on the report. However, the focus of the report on compensation and unrelated business income suggests that all tax-exempt organizations, especially colleges and universities, should expect the IRS to be paying particular attention to these areas.

For additional information, please feel free to contact Lorry Spitzer, Kendi Ozmon, Morey Ward or your usual Ropes & Gray attorney.

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