The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations

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Upcoming Venable Nonprofit Legal Events

November 14, 2013 – Donor Intent, Restricted Funds, and Gift Acceptance Policies: What Every Nonprofit Needs to Know to Effectively Accept and Utilize Contributions

December 5, 2013 – Work & Family: What Nonprofit Employers Should Know about Family-Oriented Employment Laws

Overview

- IRS Enforcement
- Compliance Projects
- The Colleges and Universities Compliance Project
  - Timeline
  - Final Report
- Lessons to Be Learned from the Final Report
  - Tax-Exempt Colleges and Universities
  - All Tax-Exempt Organizations

Compliance Projects

Compliance Projects

- What is a Compliance Project?
  - New method of conducting examinations where the IRS reviews the largest and most complex tax-exempt organizations.
  - Through a compliance project, the IRS will:
    - Consider the tax compliance issues that are unique to an entire industry;
    - Learn about the industry and identify common areas of potential noncompliance within the industry; and
    - Develop a methodology for training IRS agents to identify and develop facts related to the identified issues.

Compliance Projects (cont'd.)

- Compliance projects can focus on either:
  - Single industry
    - Hospitals
    - Credit counseling organizations
  - A single issue common amongst a significant portion of all tax-exempt organizations:
    - Officer compensation
    - Self-certification of tax-exempt status
    - Political intervention

Compliance Projects (cont'd.)

- Advantages of Compliance Projects
  - IRS develops an understanding of an entire industry, including practices unique to the industry.
  - The IRS may identify industry-wide issues that require additional guidance.
- Disadvantages of Compliance Projects
  - A knowledgeable IRS may result in a more thorough examination.
  - A few bad actors within an industry may taint the IRS' view of the entire industry.
  - Any published guidance may be too late.

Phases of Compliance Projects

- Each compliance project typically follows the same order of events:
  - Phase 1: Internal review and research
  - Phase 2: Questionnaire
    - All contact is done via mail
    - Merely informational
    - Cannot lead to revocation, but can lead to an examination
  - Phase 3: Examinations
    - Very intrusive — an IRS agent will be on-site
    - Can result in revocation

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Phase 1: IRS Internal Review and Research

- The IRS will research the industry or issue that it intends to examine through the Compliance Project.
  - Form 990;
  - Media;
  - Internal discussions with various IRS divisions; and
  - Statistical information developed by economists.
- Based on the information reviewed, the IRS will develop a questionnaire and identify the organizations to obtain information from:
  - Identification of the parameters of an industry;
  - Determine appropriate sample size for project; and
  - Identify specific organizations to examine based on: size, location, information reported on the Form 990, or the organization's name.

Phase 2: Questionnaire

- IRS will send a questionnaire to the organizations identified:
  - College and University Compliance Project: 30-page questionnaire
  - Self-Certification Compliance Project: nine-page questionnaire
- Upon receiving responses to the questionnaire, the IRS will analyze the responses to gain an understanding of industry practices and common areas of noncompliance and identify particular organizations that are noncompliant.

Phase 2: Questionnaire (cont'd.)

- From this information, the IRS will lay the foundation for the examination phase of the compliance project by:
  - Identifying issues on which to focus examinations,
  - Developing training programs based on the issues identified, and
  - Identifying the organizations to examine.

Phase 2: Questionnaire (cont'd.)

- Important considerations:
  - If selected as part of a compliance check project, the compliance check is not itself an IRS examination. A compliance check will not result in:
    - Revocation,
    - Assessment of taxes, or
    - A change in foundation status.
  - An organization is not legally required to complete or return a compliance check questionnaire.
  - It is strongly recommended that every organization that receives a compliance check questionnaire fully complete and return the questionnaire.

Phase 2: Questionnaire (cont'd.)

- Who gets examined?
  - If there is extremely widespread noncompliance, the entire industry—the IRS examined approximately 80% of the credit counseling industry.
  - If noncompliance is prevalent but not extreme, then a significant portion of the industry may be examined—approximately 20% of the hospitals were examined.
  - Only 8.5% of the colleges and universities in the compliance project were examined. However, every organization that failed to complete the compliance check questionnaire was examined by the IRS.

Phase 3: Examinations

- This phase is where the IRS will show up at your office and start asking questions and reviewing documents.
- Based on the responses to the questionnaires, the IRS will then decide the issues and organizations that will be the focus of examinations.
- Examinations will generally affect few organizations, but the impact is much greater:
  - Can take several months to several years; and
  - Can result in the assessment of additional tax or even revocation of an organization's tax-exempt status.

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The Colleges and Universities Compliance Project

Colleges and Universities Project

Timeline

- **October 2008:** The IRS announces the Project and sends out questionnaires to over 400 tax-exempt colleges and universities.
- **May 2010:** The IRS releases an Interim Report reporting on responses to the questionnaires and announcing that it has selected 34 colleges and universities for further examination, including both public and private colleges.
- **April 2013:** On April 25, 2013, the IRS announces it has completed 90% of the examinations and releases its Final Report on the Project.

Colleges and Universities Project

Final Report

- Discussed conclusions that were based on findings of information obtained through the compliance questionnaires and on-site examinations.
- Described common areas of noncompliance and areas of IRS enforcement during examinations, including:
  - Unrelated business income; and
  - Compensation.
- Explained the results of the examinations opened under this program.

Unrelated Business Income

- Tax-exempt organizations are not required to pay federal income taxes on income derived from activities that are substantially related to their exempt purposes. However, a tax-exempt organization may be subject to the federal corporate income tax on income derived from unrelated trade or business activities (“UBI”).
- UBI:
  - 1) The activity must be a trade or business;
  - 2) The trade or business must be regularly carried on; and
  - 3) The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from income tax.

Unrelated Business Income (cont'd.)

- **Trade or business**: The activity must be carried on for <u>the production of income</u> from the sale of goods or the performance of services.
- **Regularly carried on**: The activity is conducted often and continuously. The IRS will compare the activity with the same or similar activities conducted by non-exempt organizations.
- **Substantially related**: The activity must contribute significantly to the accomplishment of one or more of the organization's exempt purposes
- **Consequences:** UBIT imposed at the regular corporate rates; may also lead to loss of exempt status.

Examples of UBI

- UBI is a common issue for all types of exempt organizations.
- Examples:
  - Sports camps
  - Christmas cards sold by a veterans’ organization
  - Museum shops— item-specific
  - Advertising in magazines and other publications

Unrelated Business Income: Losses

- **Net Operating Losses ("NOLs")**: These are losses that are reported in one year and used to offset gains in past or future years.
- Tax law permits deductions for NOLs and for expenses that are "directly connected" with the carrying on of the unrelated trade or business.
  – For an organization to utilize losses to reduce its UBIT liability, those losses must relate to the activity or activities giving rise to UBI.

UBI: Final Report Findings

- **90% of the schools examined misreported UBI.**
- UBI arose in connection with common categories of activities: advertising; arena use; facility rentals; and the operation of fitness and recreation centers, sports camps, and golf courses.
- The IRS determined that at least 60% of the schools' losses used to offset UBI were not sufficiently connected to unrelated business activities.
  – Over $170 million in disallowed claims of losses and NOLs against the UBIT liability of the schools examined, which could result in $60 million in taxes.
  – The IRS disallowed over $150 million in NOLs alone during the course of the examinations.

UBI: Final Report Findings (cont'd.)

- **A Particular Focus on Losses**
  - If an activity consistently resulted in losses over the course of several years, the IRS concluded that such activities lacked the necessary "profit motive" that characterizes a trade or business.
  - 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."
  - Other issues included errors in computation of NOLs and the substantiation of such amounts and misclassification of activities as related to the institution's exempt purposes.

Compensation

- **Issues related to compensation can result in two types of IRS enforcement:**
  - Enforcement against the organization that provides the compensation, which could result in the revocation of the organization's tax-exempt status stemming from:
    - The provision of an impermissible private benefit; or
    - The inurement of an organization's assets to certain individuals.
  - Enforcement against the individuals who receive excessive compensation through the provision of excise taxes on such individuals.

Private Benefit and Private Inurement

- **Private Benefit**: Generally, organizations exempt under Section 501(c) must be organized and operated for the benefit of the public, rather than for private, interests.
  - Quantitative test
  - Qualitative test
- **Private Inurement**: Charitable organizations are also prohibited from allowing any part of their net earnings to inure to the benefit of any private individual or shareholder.
  - Only applicable to transactions between a tax-exempt organization and an “insider”

Intermediate Sanctions

- IRC Section 4958 allows the IRS to impose excise taxes on "disqualified persons" who receive "excess benefits."
- An "excess benefit" is any benefit that exceeds the FMV of the consideration received, including:
  - Compensation that exceeds FMV;
  - The purchase of an asset for an amount that exceeds the FMV of the asset; and
  - The sale of an asset for substantially less than FMV.

Intermediate Sanctions

- Disqualified persons include:
  - ODTKEs— officers, directors, trustees, and key employees.
  - Others in a position to influence an organization.
- Penalties
  - Individual recipient must return the excessive portion of the benefit to the organization, and 25% excise tax on the excessive value of the benefit.
  - Excise tax of up to 200% (of the excess benefit amount) on the individual recipient.
  - Excise tax of 10% on every ODTKE that approved the transaction.
- Revocation of exempt status is also a potential consequence.

Rebuttable Presumption

- Section 4958 and the accompanying Treasury Regulations provide a “safe harbor” that results in a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable.
- To establish the rebuttable presumption, before paying any amount under the transaction:
  - The organization must appoint an “independent body” to review and determine the amount of compensation;
  - The independent body must rely on appropriate comparability data to set the compensation amount from comparable organizations; and
  - The independent body must contemporaneously document its decisions in setting compensation.

Compensation

Final Report Findings

- Compensation of ODTKEs at **94% of schools** examined was set following procedures intended to satisfy the requirements for the rebuttable presumption.
- **50% of schools** used compensation consultants.
- However, the IRS concluded that **20% of the institutions** examined did **not** satisfy the standards established by the Treasury Regulations.
  - Comparability data derived, at least in part, from organizations that were not "similarly situated."
  - Compensation studies did not document how and/or why certain data was used or did not specify whether the amounts reported included salary only or also included benefits.

Compensation

Final Report Findings (cont'd.)

- **Non-ODTKE Compensation:** Heads of departments, faculty, coaches, and administrative and managerial employees were among other highly compensated non-ODTKEs at the schools examined.
- Non-ODTKEs generally do not fall within the categories of individuals that are per se treated as "disqualified persons" for purposes of the intermediate sanctions rules but may ultimately be deemed a "disqualified person" based on facts and circumstances.
  - May also be deemed to have received a prohibited private benefit.

Lessons to Be Learned from the Final Report

Lessons for Tax-Exempt Colleges and Universities

- **This report provides:**
  - Information on common areas of noncompliance within colleges and universities;
  - Insight into areas of IRS focus during future examinations of colleges and universities and other exempt organizations; and
  - A very specific guide for college and university compliance with all requirements for tax-exempt status.

Lessons for All Tax-Exempt Organizations

- **Complete IRS Questionnaires:** If an organization receives a compliance check questionnaire as part of an IRS initiative, the organization should complete it and file it with the IRS.
  - In this Project, 13 colleges and universities received, but did not complete, the questionnaire, and the IRS opened examinations of all 13 schools.

Lessons for All Tax-Exempt Organizations (cont'd.)

- **Prepare for UBI and Executive Compensation to Be a Focus:** During the course of the Project, the IRS went to great lengths to educate its revenue agents about these issues and their consequences.
  - In testimony before the House Ways and Means Committee in May 2013, EO Director Lois Lerner stated that the IRS is currently planning a more expansive project, to begin in 2014, which will investigate whether issues identified in the Final Report are present across a greater portion of the tax-exempt sector.

Lessons for All Tax-Exempt Organizations (cont'd.)

- **Review Methods and Policies for Compensation:** 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.
  - Having a formal compensation policy can assist an organization in establishing the rebuttable presumption of reasonable compensation.
- **Review Procedures for Selecting Comparability Data:** Organizations that do not use compensation consultants should review their own procedures for selecting comparability data to ensure that such data reflects the practices of similarly situated entities, particularly the types of surveys used.

Lessons for All Tax-Exempt Organizations (cont'd.)

- **Seek and Use Outside Advice:** When completing tax forms and determining an organization's UBIT liability, organizations should allow adequate time to consult with their tax counsel in order to ensure that expenses are accurately allocated, and that losses and NOLs bear the requisite relationship to the activity.
- When using an **outside consultant** for compensation data, organizations should **ask questions** about the origins of the data and ascertain whether the data reflects the practices of organizations that are truly similarly situated.

Lessons for All Tax-Exempt Organizations (cont'd.)

- **Consider Trade Associations:** Smaller organizations may not be able to hire outside experts to assist with UBI and executive compensation issues, but they can receive substantial benefits from membership in a trade association of similar entities that can pool their resources and, collectively, hire appropriate experts.
- **Consider Subsidiaries:** If a tax-exempt organization is contemplating substantial engagement in an unrelated business activity, a taxable, wholly owned subsidiary may be a helpful option to house the activity and protect the organization's tax-exempt status.

Questions?

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