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# irs issues final report on colleges and universities compliance project

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*MSK Client Alert*

April 29, 2013

The Internal Revenue Service launched its Colleges and Universities Compliance Project (CUCP) in 2008 when it distributed detailed questionnaires to 400 colleges and universities, requiring comprehensive reporting by those institutions on financial results of business activities such as alumni travel programs and facilities rentals not directly related to higher education. The questionnaires also required extensive information on compensation paid to administrators and faculty. As a result of information developed from these questionnaires, the government selected 34 colleges and universities for audit because their questionnaire responses (and tax returns filed) indicated potential noncompliance in the areas of unrelated business income (UBI) and executive compensation. With most of those audits now completed, the IRS has issued its final report summarizing the results of those audits. Since the government issued an interim report when these examinations were initiated, it should come as no surprise that in the final report the IRS details extensive noncompliance by the colleges and universities that were audited.

## **Under-Reporting of Unrelated Business Taxable Income (UBTI)**

UBI is income from a trade or business regularly conducted by a tax-exempt organization that is not substantially related to the exempt purpose of that organization. UBTI is the UBI that is taxable after deducting expenses directly connected to the unrelated trade or business. The CUCP final report details increases to UBTI for 90% of the colleges and universities that were audited, totaling about \$90 million – an average of almost \$3 million per institution in additional taxable income. There were three main reasons for increases to UBTI:

- Disallowance of expenses that were not connected to the unrelated business activity. Expenses deducted from UBI to arrive at UBTI were incorrectly reported in two ways, one of which will be familiar to observers of UBTI compliance and the other of which comes as something of a surprise. In the first category, the government found that on nearly 60% of the examined Forms 990-T (used to report UBTI), colleges and universities had

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misallocated expenses from exempt activities to offset UBI from non-exempt activities. In the second category, the IRS found that organizations were claiming losses from unrelated activities that did not qualify as a trade or business because those activities consistently reported expenses exceeding UBI for many years. According to the Service, UBI must be generated by a "trade or business" and an activity will qualify as a trade or business only if engaged in with the intent to make a profit. Since a pattern of recurrent losses indicates a lack of profit motive, the IRS disallowed the use of losses from activities for which the college or university failed to show a profit motive to offset UBI from more profitable activities. In addition to resulting in tax adjustments for the years under audit, disallowance of these losses also eliminated more than \$150 million of net operating losses that would otherwise be carried forward to offset UBI in future years. This section of the report is likely to capture the attention of many college and university business offices.

- Errors in computation or substantiation. The IRS found that many institutions claimed net operating losses that were either improperly calculated or unsubstantiated, resulting in the disallowance of an additional \$19 million in net operating losses.
- Reclassifying exempt activities as unrelated. This section of the report will come as no surprise to many business officers and their advisors. The government found that nearly 40% of colleges and universities examined had misclassified certain activities as related to their tax-exempt educational purposes. The auditors reclassified these activities, resulting in an additional \$4 million of UBI. The major adjustments came from operation of fitness centers, sports camps, and recreation facilities, advertising, facility rentals, arenas, and golf.

### Compensation

The executive compensation component of the examinations primarily focused on compliance with Internal Revenue Code 4958, pertaining to excess benefit transactions, which provides that organizations may pay no more than reasonable compensation to their officers, directors, trustees, and key employees, and which applies to private, but not public, colleges and universities. Section 4958 imposes an excise tax on persons in this category who receive payment of unreasonable compensation and on those persons who approved it. A tax-exempt organization may shift the burden of proving unreasonable compensation to the government by following a prescribed process to establish a rebuttal presumption. While the government acknowledges that most private colleges and universities attempted to meet the rebuttable presumption standard, about 20% failed to do so due to a variety of errors in relying on comparability data to set compensation levels.

The final report summarizes data from the examinations on compensation paid to college and university administrators, faculty members, and other key employees. In addition to college presidents, the report finds that the most highly paid individuals are sports coaches, investment managers, department heads, and medical school faculty. The government reports employment tax adjustments, under-reported income, and deficiencies in retirement plan reporting, but by far the most valuable information in this part of the report (other than the survey of who is earning what) is the reminder from the IRS on the need for organizations to comply – precisely, and in all respects – with the rebuttable presumption process when setting executive compensation. Moreover, for organizations and their advisors who think they are currently complying with the rebuttable presumption rules, the report lays out how the government interprets those rules and details steps that the IRS thinks need to



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be taken that many organizations are not currently doing. This section of the report provides helpful guidelines for compliance reviews in this area.

For serious students, the full report is available at [http://www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_050213.pdf](http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_050213.pdf). The 37-page report includes a very useful six-page executive summary.