



IRS TO SEND QUESTIONNAIRES TO 400 COLLEGES AND UNIVERSITIES NATIONWIDE

As part of its 2008 Work Plan, the IRS announced that its Exempt Organizations Compliance Unit would send compliance questionnaires to about 400 colleges and universities. IRS officials recently stated that the questionnaires will be sent within the coming weeks.

The IRS seeks to gather information from a sampling of small, medium, and large colleges and universities that represent a cross-section of public and private schools. The IRS particularly will be looking at executive compensation, investment and use of endowment funds (including the demographics of the student populations served, especially in institutions with large endowments), and unrelated business income (“UBI”) including Form 990-T reporting. The compliance questionnaires are expected to be quite extensive, and colleges and universities may be given up to 90 days to respond, with the possibility of extensions.

While the questionnaires will not constitute an IRS “audit,” they can certainly lead to one. Prior IRS “voluntary” compliance checks have resulted in follow-

up contacts with organizations that did not respond. Importantly, colleges and universities receiving the compliance questionnaire who are not already under audit still have an opportunity to correct potential problems discovered in responding to the questionnaire.

Distribution of the college and university compliance questionnaire will be similar to the hospital compliance project undertaken by the IRS in 2006, when compliance questionnaires were sent to approximately 600 hospitals. These questionnaires were quite extensive and contained three parts and a total of 72 questions. Topics included compensation practices, community benefit (including patient demographics), and a broad array of activities related to hospital operations.

EXECUTIVE COMPENSATION

Executive compensation has been—and continues to be—a high-priority item in IRS exempt organization enforcement initiatives. In March 2007, the IRS issued a

report on an Executive Compensation Initiative it launched in 2004. The report reminded exempt organizations of the need to review their compensation policies, maintain an appropriate degree of board oversight, as well as ensure that compensation decisions are based on adequate market data on comparability and are thoroughly documented.

Executive compensation issues in the college and university arena have not escaped public scrutiny. A fairly recent example of such scrutiny involves the investigation by Senator Charles E. Grassley (former Chairman of the Senate Finance Committee) of the compensation and severance arrangements of former American University President Benjamin Ladner in 2005.

It is anticipated that the college and university compliance questionnaires will contain inquiries relating to compensation practices that mirror the inquiries hospitals faced as part of the hospital compliance project in 2006. Thus, the momentum that the IRS has built over the years in its scrutiny of executive compensation matters is expected to be carried through to the college and university compliance questionnaire.

As with the hospital compliance questionnaire, one challenge that colleges and universities are expected to face in responding to their questionnaire is making a determination of who is and is not a “disqualified person.” While the term includes voting board members and certain officers, under the facts and circumstances approach of the applicable regulations, it is potentially much broader. This determination will be important if (as in the hospital compliance questionnaire) the IRS requires that compensation questions be answered as they pertain to employees in the institution who are disqualified persons.

If the college and university compliance questionnaire mirrors the hospital questionnaire, colleges and universities will be asked, among other things, to provide salary and other compensation information (including contributions to employee benefit plans and deferred compensation plans, and expense allowances from nonaccountable plans), to provide information regarding how compensation amounts were determined, to indicate what factors were included in comparability data used in establishing compensation, to indicate whether actual compensation was set within the range of comparability data, and to provide information regarding

business relationships between the institution and any of its disqualified persons.

ENDOWMENTS

Senator Grassley is leading the charge on maximizing the use of endowment funds of colleges and universities and has explored the impact of legislation requiring a mandatory payment from such funds. Earlier this year, Senators Max Baucus and Chuck Grassley wrote to 136 colleges and universities with endowments of \$500 million or more asking a series of questions about endowment growth and spending on student aid. They asked each of the institutions a series of questions about their endowment funds, tuition costs, and financial aid in light of a study that showed explosive college endowment growth.

On September 8, 2008, Senator Grassley chaired a roundtable discussion entitled, “Maximizing the Use of Endowment Funds and Making Higher Education More Affordable.” He reviewed the many tax benefits enjoyed by (or because of) the tax-exempt status of colleges and universities—that the institutions do not pay taxes on their net operating income or on the investment income earned within their endowment funds; that the institutions are able to raise monies by issuing tax-exempt bonds and by soliciting tax-exempt contributions; and that students attending the institutions, and their families, are eligible for deductions and various tax credits against their income tax liabilities. He also noted the ability of such institutions to receive federal grants. He then went on to state, “Given the impressive investment returns of college endowment funds, even in years of economic downturn and as tuition has steadily increased, Congress would be remiss if it didn’t question what benefits tax-exempt colleges and universities provide in return for all of the federal benefits they receive.”

According to Senator Grassley, large endowments held by colleges and universities are comparable to private foundations—the primary difference being that private foundations have a mandatory annual payout of 5 percent of investment assets, while colleges and universities have no such requirement. The public policy argument is essentially that charitable contributions to an endowment result in an immediate tax benefit to the donor but, absent a payout requirement, may not result in an immediate benefit to the public. According to a report by

the Joint Committee on Taxation (JCX-49-06), “At some point, accumulations of income by a public charity may become unreasonable and antithetical to the requirement that a public charity be operated exclusively for exempt purposes.”

Thus, the college and university compliance questionnaire is expected to include numerous questions relating to the size, growth, oversight, operation, and use of institutional endowment funds. In addition, the questionnaire is expected to include questions requiring them to demonstrate the community benefits they provide in exchange for the tax benefits they enjoy. For example, colleges and universities may face questions relating to their tuition pricing, their financial aid policies, the outreach and assistance they provide to low-income students, and how they recruit those students. Thus, garnering student demographic information is an anticipated objective of the compliance questionnaire. The overriding theme of the endowment-related questions will likely center around what current and future benefits colleges and universities provide to the community in return for the federal tax benefits they receive. Accordingly, the questionnaire also presents an opportunity to explain to the IRS (and Congress) the long-term challenges of higher education funding, the realities of a wide array of donor restrictions that limit the use of endowments, and the significant educational benefits provided by today’s colleges and universities.

UNRELATED BUSINESS INCOME

The commercial activities of colleges and universities are subject to increasing scrutiny by the IRS. In assessing whether commercial activities generate UBI, the IRS considers the extent to which the activities are substantially related to exempt purposes (and thus not subject to the tax on UBI), and whether the activities are of a magnitude so as to jeopardize exempt status. There are numerous areas today in which the issue of commerciality arises in the college and university setting—including, among others, technology transfers and corporate sponsorship payments. All of these areas hold potential risks for UBI.

Technology Transfers. The commercialization of technology developed through university research was encouraged by the passage of the Bayh-Dole Patent and Trademark Act of 1980. Technology transfer arrangements may take various forms—

from the licensing of university-developed research to third parties in exchange for royalties, to the creation of section 509(a)(3) supporting organizations or for-profit subsidiaries to engage in licensing and other commercialization activities on behalf of the institution. In the context of ascertaining the extent of UBI, the IRS may be interested in whether any commercialization activities are consistent with the institution’s tax-exempt educational or scientific purposes, whether the activities constitute scientific research carried on in the public interest, or whether the activities are excepted from treatment as UBI under some other provision of the Tax Code.

Corporate Sponsorship Payments. One common example of a corporate sponsorship payment in the college and university setting is when a corporation pays a university to become an official sponsor of the university’s football program, and the university in turn displays the corporation’s name and logo on the university’s football stadium where it can be seen by attendees and television viewers. Corporate sponsorship payments are generally exempt from the tax on UBI under a special rule, as long as certain requirements are met. Generally, the payments must meet the requirements of a “qualified sponsorship payment” for which the donor receives no substantial return benefit other than the use or acknowledgment of the donor’s name or logo as part of a sponsored event. Because corporate sponsorship payments in the college and university setting can be quite substantial, this may be a topic of interest to the IRS in the compliance questionnaire.

Other Activities. Other commercial activities of colleges and universities of particular interest to the IRS may include publishing activities, affinity credit card arrangements and mailing list rentals, golf courses, and travel tours. Thus, it would not be surprising for the IRS to include questions about any of these types of potentially commercial activities on the compliance questionnaire.

Reporting on Form 990-T. In his testimony before the House Ways and Means Committee on the Oversight of Tax-Exempt Organizations in July 2007, Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division of the IRS, discussed IRS concerns relating to UBI and reporting losses on Form 990-T. He stated, “According to recent data, approximately 50 percent of Form 990-T filers report zero income or a loss in the conduct of their unrelated business activities.

Beginning in 2008, we will explore the treatment and allocation of income and expenses in university systems.”

Thus, questions targeted to revealing how a college or university calculates and reports its losses on Form 990-T, and how income and expenses are allocated in calculating UBI, are likely to appear in the compliance questionnaire.

FORM 990 REPORTING

Senator Grassley has asked the IRS and Treasury to develop a Form 990 schedule for colleges and universities, similar to the new Schedule H that was developed for hospitals (which asks about costs of care, community needs assessments, and financial aid to the poor through free care and reduced charges). He recently noted that while the redesigned Form 990 requests some information about endowment funds, it does not require colleges and universities to report information about their student populations or costs. Thus, it would not be surprising if the responses to the questionnaires are ultimately used by the IRS to produce a new schedule to the redesigned Form 990 analogous to Schedule H.

SCOPE AND OPPORTUNITIES

Because the IRS intends to closely scrutinize the compliance questionnaires and likely will conduct focused examinations of some of the responding organizations, the questionnaires should be carefully completed with close attention to the scope of each question. Responders must bear in mind that other interested parties may be able to obtain copies of the completed questionnaire. For example, it may be sought in discovery by state regulators or class action plaintiffs. The questionnaire, however, also presents an opportunity for colleges and universities to put their best foot forward and educate the IRS and others on the variety of ways in which they accomplish their tax-exempt mission. In addition, whether or not your institution receives one of the approximately 400 college and university compliance questionnaires, it is

important to take a close look at the items being scrutinized by the IRS in order to best prepare your institution for more stringent reporting and/or further IRS action on the issues.

JONES DAY'S EXPERIENCE

Representative projects include assisting large institutions (including academic medical centers) in (a) responding to IRS compliance check questionnaires regarding community benefit and executive compensation practices as well as related IRS audits, (b) defending state tax exemption challenges based on allegations of insufficient amounts of community benefit, and (c) counseling clients regarding the expanded public disclosures required by the IRS's proposed redesign of the Form 990, including Schedule H. Jones Day has also counseled tax-exempt health care clients responding to congressional inquiries regarding tax exemption matters, including three of the 10 large health care systems that received letters from the Senate Finance Committee regarding community benefit, charity care, joint ventures, and executive compensation.

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