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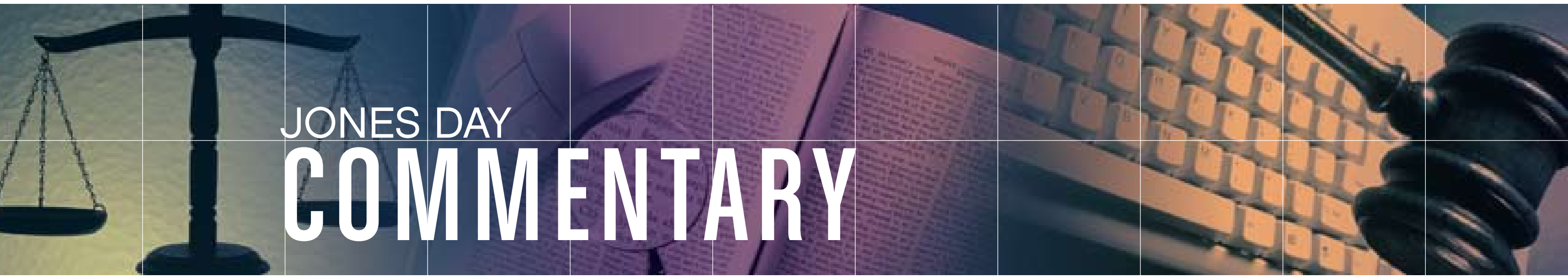

IRS LAUNCHES COLLEGE AND UNIVERSITY COMPLIANCE PROJECT; DISTRIBUTES COMPLIANCE QUESTIONNAIRES

Last month, we prepared a *Jones Day Commentary* noting that the IRS was on the verge of distributing a compliance questionnaire to 400 colleges and universities nationally. (To view a copy of the prior *Commentary*, please visit http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S5467.) Now the IRS has followed through, and the questionnaires have been sent. (To access a sample copy of the form questionnaire in PDF format, please visit the IRS web site at http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf) This IRS compliance project will be a matter of potential concern for not only colleges and universities themselves, but also potentially for affiliated organizations, such as academic medical centers, faculty practice plans, and foundations.

The questionnaire (Form 14018) is framed as a compliance questionnaire. It is not an audit, but it can lead to one. Institutions receiving the questionnaire that are not already under audit still have an opportunity to correct potential problems discovered in responding to the questionnaire.

SCOPE OF COMPLIANCE QUESTIONNAIRE

The questionnaire itself is 33 pages in length, accompanied by another nine pages of instructions and a four-page cover letter. It contains 74 questions applicable to all institutions and an additional 20 questions applicable only to private institutions.

The format, approach, and much of the substance of the questionnaire are reminiscent of what the hospital community faced with the IRS hospital project questionnaires issued a couple of years ago. As expected, the questionnaire seeks detailed organization information and information relating to activities potentially giving rise to unrelated business income ("UBI"), endowment funds, and executive compensation—all generally for the 2006 tax year with some exceptions.

ORGANIZATION INFORMATION

Part I of the questionnaire contains 22 questions seeking a variety of statistical information from institutions and information relating to their operational issues, financial status, organizational policies, highest paid employees, and highest gross revenue generating affiliates.

Statistical Information. Statistical information requested includes information on students, faculty, and employees of the institution. Information is also requested relating to tuition rates and discounts.

Operational Issues. Information on organizational transparency is sought, in that the IRS asks whether the organization makes its audited financial statements available to the public (such as through posting on the institution's web site). Questions also target the institution's involvement in distance learning activities and educational programs and operations outside the United States.

Financial Status. The questionnaire seeks to take a financial "snapshot" of the institution by ascertaining its gross assets, net assets, gross revenue, and total expenses.

Organizational Policies. The IRS has stressed the importance of an organizational conflict of interest policy for many years. To that end, the questionnaire asks whether the institution has a written policy (or equivalent state statute for public institutions) that applies to conflicts of interest involving the governing board, management, and full-time faculty. In an effort to learn more about the relationships between colleges and universities and non-501(c)(3)-related organizations, the questionnaire asks whether the institution has a written policy (or equivalent state statute) designed to ensure that transactions with such entities are made at arm's length. Finally, the IRS seeks information relating to whether the institution has a written policy (or equivalent state statute) that establishes arm's-length assurances when the institution receives certain types of income from affiliates, including interest, rent, royalties and management fees, and other items and services provided to affiliates. Institutions are asked to describe how they determine pricing in their dealings with related organizations and to indicate how many entities they control.

Highest Paid Employees. For each of its five highest paid employees (other than officers, directors, trustees, and key employees), institutions are asked to list the individual's name, position, compensation from the institution and related organization, and any NCAA athletically related income. Institutions must indicate whether their athletic coaches are employed by another organization.

Highest Gross Revenue Generating Affiliates. For each of its five highest gross revenue generating organizations in four stated categories (disregarded entities, tax-exempt organizations, organizations taxable as a partnership, and organizations taxable as a corporation or trust), institutions are asked to disclose the activities of each organization, control and ownership percentage and other identifying information.

For purposes of the questionnaire, the term "related organizations" is significantly broader than the typical parent-subsidiary and brother-sister relationship. The instructions indicate that other examples of related organizations include an organization that uses a common paymaster, an organization that pays part of the compensation that the responding institution would otherwise be contractually obligated to pay, and an organization that conducts joint programs or shares facilities or employees with the responding institution. Likewise, the term "control" is broadly defined and includes, for example, indirect control and control by virtue of possessing a group ruling for exemption.

UNRELATED BUSINESS INCOME

Part II of the questionnaire contains nine comprehensive and detailed questions that essentially place all of an institution's potentially UBI-generating activities under a microscope.

The section begins with a question listing 47 activities that the IRS views as potential sources of UBI, including advertising, facility rental, recreation and athletic facilities, catalog and internet sales, food service, credit card promotions, power generation, parking, and golf courses. For each activity in which an institution was directly engaged (regardless of whether the activity was reported on Form 990-T), the institution must disclose how it treated the income from the activity, provide an explanation for treatment of all or part of the activity as non-UBI, disclose whether the activity was managed or operated by an unrelated third party, indicate whether the institution incurred a loss from the activity in at least three out of the five previous years, indicate whether expenditures to non-501(c)(3)-related organizations (taxable or exempt) exceeded $50,000 during any single loss year, provide a reason for any losses, and indicate whether the institution has future plans for making a profit from the activity. Institutions must then list the five largest activities by gross revenue from the preceding list that were not treated as unrelated business activities.

Joint venture activities are scrutinized for potential UBI issues, in that institutions are asked to indicate whether they participated in any joint ventures, any of the income from which was not subject to tax on UBI, listing the five largest activities by gross revenue.

The IRS is also interested in knowing whether institutions relied on independent accountants or counsel to provide advice on determining whether activities were unrelated or exempt, allocating expenses between unrelated and exempt activities, or pricing between the institution and its related organizations for expenses incurred in unrelated activities.

The remaining questions in the section recap how each of 32 of the activities that the IRS views as potential sources of UBI were disclosed on previously filed Forms 990-T.

ENDOWMENT FUNDS

Part III of the questionnaire contains 28 questions relating to endowment funds. If an institution held endowment funds, or if such funds were held on the institution's behalf by an institutional foundation (which is a common arrangement for colleges and universities), the institution is required to answer the questions in Part III.

The IRS is interested in such endowment oversight matters as whether the institution had an investment policy for the endowment funds, who managed the investments in the endowment funds (a related party, an external party, or in-house investment managers), and whether an investment committee oversaw investment of the endowment assets. To the extent that an institution has an investment committee in place, the IRS wants to know the size of the committee, whether the committee approved the selection of external parties used to manage the investments, and whether the committee approved investment guidance recommendations made by outside consultants.

A series of questions in the endowment section deals with whether internal or external investment managers provided investment guidance for investment of the endowment funds. The compensation arrangements of the investment managers, and the approval process therefor, are also scrutinized in this section.

Perhaps headed down a path analogous to that taken by the IRS when it sought to ensure that hospitals were providing sufficient community benefit in exchange for the tax benefits they enjoy, the IRS asks the amount of an institution's endowment assets per full-time equivalent student.

The IRS seeks to quantify the amount of an institution's "quasi endowments" (principal that can be spent at the discretion of the institution's trustees), "term endowments" (principal that can be spent after its defined "term" has passed), and "true endowments" (principal that cannot be spent). An institution must also report what percent of its endowment comprised charitable gift annuities, charitable remainder trusts, and pooled income funds.

The types of investments in which endowment funds are invested is the subject of another series of questions. The IRS wants to know whether an institution makes foreign investments of endowment funds through an investment entity, and what percentage of an institution's endowment assets was invested in alternative investments, real estate, fixed income funds, equity funds, international funds, cash, or other investments. The IRS also asks the institution to state its primary investment objective (total real return) for the investment portfolio for the next five-year period.

The IRS seeks information as to how endowment funds were distributed among various categories of use—such as scholarships, research, chairs, and professorships, among other categories. Responses to this question will be critical, in light of the fact that colleges and universities have been under attack for increasing tuition costs during times of strong endowment growth. Colleges and universities should take this opportunity to make a strong showing as to what public benefits they provide in return for the tax benefits they receive. This showing is analogous to how hospitals were called upon to demonstrate that the community benefits they provided justified their tax exemption.

Information on the nature of the restrictions placed on endowment funds, and on how endowment fund distributions were monitored to ensure compliance with donor restrictions, is requested on the questionnaire. Institutions are also asked to state their policy on endowment fund disbursements that were not used in the fiscal year of disbursement.

EXECUTIVE COMPENSATION

Part IV of the questionnaire contains 35 questions relating to executive compensation. This section asks for detailed information on the six highest paid officers, directors, trustees, and key employees of the institution. A chart is provided that requests each individual's name and title, as well as the amount of compensation each individual received from the institution itself and from related organizations. Then, identification of fringe benefits paid to those six individuals, based on a checklist of 34 possible fringe benefits, some of which will be lightning rods for closer scrutiny (*e.g.*, vacation home, spousal travel, and payment of personal nonbusiness expenses) is requested.

A total of 13 questions in this section focus solely on loans and extensions of credit to the institution's top executives. Among other things, the questions seek information on repayment or forgiveness terms and income tax consequences. Insider loans are already under review by the IRS for possible noncompliance among at least 250 executives in the nonprofit sector as a result of similar questions posed to hospitals.

The final 20 questions on the questionnaire relating to executive compensation matters are targeted to private institutions. Specifically, private institutions must disclose significant additional detail regarding their compensation review and approval process, including whether there is a formal written compensation policy for setting executive compensation, the approval process for executive compensation, whether the institution retained the services of an independent compensation consultant or other sources of market data, conflicts of interest in setting compensation, and whether the compensation arrangements comply with the excess benefit transaction rules that limit compensation to fair market value or rely on specific exceptions to those rules.

COMPLETING THE QUESTIONNAIRE

Although the cover letter notes that completion of the questionnaire is "voluntary," organizations that fail to respond (or whose responses show a lack of understanding of or failure to follow best practices) are likely to receive more focused follow-up contacts from the IRS, potentially including at least a limited-scope audit to examine the issues outlined in the questionnaire. The IRS previously indicated that there will be a 90-day timeframe to reply to the questionnaire. Responses are likely to shape future IRS enforcement efforts and also may affect legislative initiatives in the next Congress. In the latter regard, Sen. Grassley has already urged the IRS to complete this project quickly and expand the scope of transparency in higher education to require all tax-exempt institutions in the sector to respond to the same questions.

IMPLICATIONS OF THE QUESTIONNAIRE

From the scope of the questionnaire, it appears that two potential areas of follow-up examination, among others, include an effort to impose excise taxes on compensation under the excess benefit transaction rules, and imposition of tax on UBI. With regard to UBI, not only could the IRS effectively use many of the factual background and activities questions against the institution if not answered properly, it could also find "automatic" UBI for certain transactions with controlled entities and penalize institutions for failure to file a Form 990-T for any past UBI.

The questionnaire may be seen as both a template of what the IRS considers to be key components of a tax compliance plan for higher education and a prototype of a future schedule that all institutions will need to attach to any Form 990 they are required to file. Accordingly, even those institutions that do not receive a questionnaire from the IRS may wish to study it and update their tax policies and procedures in anticipation of future disclosure requirements. Institutions that do file a response also may want to point out to the IRS questions that they believe are unduly burdensome or do not appear to yield relevant information.

JONES DAY'S EXPERIENCE

We have assisted large institutions (including academic medical centers) in responding to IRS compliance check questionnaires regarding community benefit and executive compensation practices, as well as related IRS audits. We are also actively involved in helping a number of our clients respond to the college and university IRS compliance questionnaire. We would be glad to talk with you regarding this IRS initiative.

LAWYER CONTACTS

If we can be of assistance, please contact your principal Firm representative or either of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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