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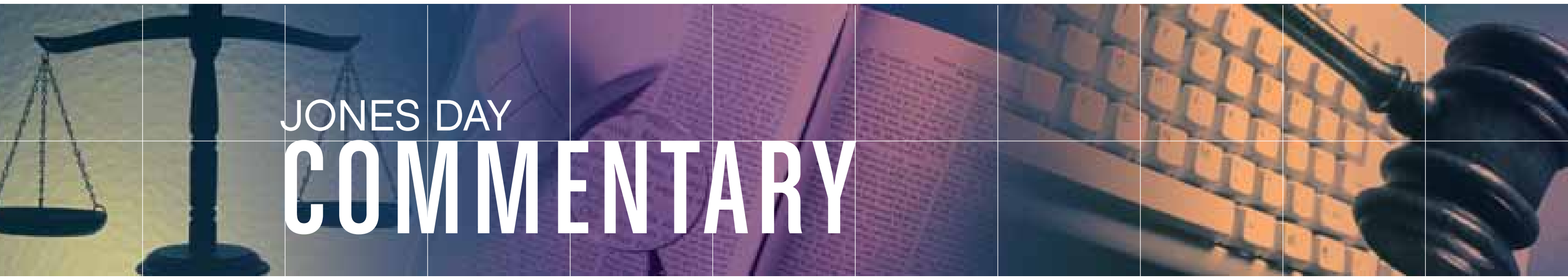

JONES DAY
COMMENTARY

IRS TO AUDIT COLLEGES AND UNIVERSITIES– A "LESSON PLAN" ON PREPARING FOR THE IRS

Last fall, the IRS distributed a compliance questionnaire to approximately 400 colleges and universities nationally. As a follow-up to those questionnaires, the IRS is now prepared to undertake examinations (audits) of several institutions based on the responses submitted. *Whether or not your institution received a questionnaire or is selected for a follow-up exam, the focus of the upcoming exams can serve as a "lesson plan" to prepare your institution for increased IRS scrutiny across the higher education sector.*

IRS INTEREST IN COLLEGES AND UNIVERSITIES

The college and university compliance project is following the same general path as the previous hospital compliance project. Higher education, like health care, garners much interest from the IRS because of the significant dollars represented in the sector.

Now that the college and university project questionnaires have been completed and substantially returned by those who received them, the next steps involve the commencement of IRS examinations based on the responses received and the release by the IRS of an interim report. The interim report, which IRS officials anticipate will be released by the end of 2009, is expected to mirror the hospital project interim report, in that the content will consist primarily of raw data rather than substantive analysis.

TWO ANTICIPATED FOCAL POINTS OF FOLLOW-UP EXAMS–EXECUTIVE COMPENSATION AND UBI

On June 11, 2009, at the AICPA National Not-for-Profit Industry Conference, Ronald J. Schultz, Senior Technical Advisor, Tax Exempt and Government Entities Division of the IRS, and Nikole C. Flax, Senior Tax Law Specialist at the IRS, discussed the upcoming college and university exams. Specifically, they discussed two anticipated focal points of the follow-up exams—executive compensation and unrelated business income ("UBI").

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Executive Compensation. The compliance questionnaire sought detailed information from colleges and universities on their six highest paid officers, directors, trustees, and key employees. Some questions focused solely on loans and extensions of credit to the institution's top executives. Private institutions were required to disclose significant detail regarding their compensation review and approval process, including whether they have a formal written compensation policy for setting executive compensation; whether they retained the services of an outside executive compensation consultant to provide comparable compensation data, and, if so, whether the consultant provided other services to the institution; and what factors were included in compensation analyses.

The compliance questionnaire also asked institutions to report whether they used the rebuttable presumption procedure to determine the compensation of their top executives, and whether any fixed payments to those persons were made pursuant to the initial contract exception.

At the AICPA conference, Ms. Flax noted that the IRS will be looking closely at comparability data used in setting executive compensation, as well as usage of the initial contract exception to the intermediate sanctions rules for "excess benefit transactions" under section 4958 of the Internal Revenue Code (the "Code").

Comparability Data. According to Ms. Flax, the IRS is interested in the comparability data percentile that was used by institutions to establish compensation, and the usage of percentile ranges generally by the institution (for example, whether every executive compensation arrangement is based on the 95th percentile); what comparability data was used and whether it was truly comparable; and whether comparability data from the for-profit sector was used, and, if so, the impact of that data on establishing a compensation amount (for example, the impact of using equity-based compensation among the comparables).

The IRS is interested in practices and trends related to the quality of comparability data used by exempt organizations because reliance on appropriate comparability data is a necessary step in establishing a "rebuttable presumption" that compensation paid by the organization is reasonable. Specifically, section 4958 of the Code establishes a procedure by which certain tax-exempt organizations may establish a "rebuttable presumption" that any benefit the organization provides (including compensation) to a disqualified person is reasonable. Disqualified persons are generally those individuals who, any time in the last five years, were in a position to exercise substantial influence over the affairs of the organization, such as directors, officers, or other individuals who supervise the management, administration, operation, or finances of the organization or its activities.

Three elements are necessary to trigger the rebuttable presumption. First, providing the benefit to the disqualified person must have been approved by an authorized body composed entirely of individuals who do not have a conflict of interest with respect to the transaction. Second, prior to making its determination, the authorized body must have obtained and relied upon appropriate data to determine that providing the benefit was reasonable in exchange for the disqualified person's services. Third, the authorized body must have adequately and timely documented the basis for its determination concurrently with making that determination. If the conditions for the presumption are satisfied, the burden of proof shifts to the IRS to demonstrate that the amounts paid were unreasonable.

Initial Contract Exception. Also, the IRS may look at what percentage of executive compensation arrangements in an institution were subject to the initial contract exception under the intermediate sanctions rules. By way of background, section 4958 of the Code does not apply to any fixed payments made by an organization to a disqualified person pursuant to an "initial contract." An initial contract is a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately before entering into the contract. It may be, but is not necessarily, the first contract with the institution. In some institutions, even though the initial contract exception may apply, the institution may (for transparency and fiduciary duty reasons) still choose to follow the rebuttable presumption process set forth in the intermediate sanctions rules—that is, having compensation reviewed by an authorized body, using appropriate comparability data, and documenting the decision-making process.

UNRELATED BUSINESS INCOME

The compliance questionnaire contained various questions relating to an institution's potentially UBI-generating activities. At the AICPA Conference, Mr. Schultz highlighted potential areas of interest for the IRS in the upcoming college and university exams in connection with UBI—controlled entity issues, transfer pricing methods under section 482, and expense allocations.

Controlled Entity and Transfer Pricing Issues. By way of background, controlled entity issues arise under section 512(b)(13) of the Code, which generally treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a controlled subsidiary (direct or indirect ownership of more than 50 percent). Before 2010, however, this general rule applies only to the portion of payments received or accrued in a tax year that exceeds the amount of the payment that would have been paid or accrued if the payment had been determined under section 482 (which generally allows the IRS to allocate income and deductions among controlled entities—or "reprice" arrangements—if the terms of an arrangement are other than arm's length). The purpose of this rule is to prevent a tax-exempt organization from inappropriately sharing the benefits of its tax-exempt status with taxable entities.[1]

The IRS had asked four questions of colleges and universities on the compliance questionnaire related to transactions with controlled entities—(1) to identify any arrangements for which the institution had a written policy designed to ensure that transactions with non-501(c)(3) related organizations (whether taxable or tax-exempt) are made at arm's length; (2) to identify any items of income for which the institution had a written policy that established arm's length assurances when such amounts were paid or accrued to the institution from a controlled entity; (3) to describe how the institution determined pricing in its dealings with related organizations; and (4) to identify the number of entities controlled by the institution within the meaning of section 512(b)(13).

Undoubtedly, the responses to the above questions will provide insight to the IRS into this important aspect of unrelated business income for purposes of the upcoming follow-up exams.

Expense Allocations. The compliance questionnaire also had requested various items of information relating to expense allocations. Institutions were asked to describe their expense allocation method for each activity reported on their Form 990-T, to provide a breakdown of direct versus indirect expenses shown on Form 990-T, to identify the UBI activities that resulted in the largest losses on Form 990-T, and to provide a breakdown of intercompany expenses versus other expenses. According to Mr. Schultz, expense allocations are of interest to the IRS and are expected to be targeted on the college and university exams because the reporting of UBI losses, or zero net UBI, is common on Form 990-T. It is not unusual on audit for the IRS to assert underreporting of net UBI based on alleged lack of a profit motive due to losses (which should not be determinative alone) or misallocation of dual use expenses or overhead.

IRS SELECTION OF EXAM TARGETS

At the AICPA conference, Mr. Schultz emphasized that the upcoming exams will not be traditional exams based on regular risk assessment. In other words, it is not necessarily the amount of a potential adjustment that will guide the IRS in the audit target selection process. For example, the IRS may be more interested in learning about how a particular institution uses comparability studies to establish executive compensation than the actual amount of a potential adjustment, if any, for payment of excessive compensation by the institution. That data may in turn shape future policy decisions such as the scope of Form 990 reporting required of colleges and universities.

Also, Mr. Schultz explained that some organizations may be selected for a follow-up exam on the basis of UBI, but they

[1] On August 4, 2009, final regulations under section 482 were published (74 Fed. Reg. 38830). The regulations generally apply to tax years beginning after July 31, 2009. Among other things, the regulations address shared services arrangements. While the regulations are somewhat lengthy and complex, they generally provide, among other things, that if a taxpayer reasonably concluded that a shared services arrangement allocated costs for covered services on a basis that most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributed to the services (as evidenced by appropriate documentation as described in the regulations), then the IRS may not adjust the allocation basis. Treas. Reg. § 1.482-9(b)(7). Other provisions would protect low-margin covered services that have a median comparable markup of seven percent or less. Treas. Reg. § 1.482-9(b)(3)(ii).

will also be examined for executive compensation. Likewise, some organizations may be selected for an exam on the basis of executive compensation, but they will also be examined for UBI. (Public institutions, however, were not required to answer questions on executive compensation and will not be subject to examination on executive compensation.)

A "LESSON PLAN" ON PREPARING FOR THE IRS

As stated above, whether or not your institution received a questionnaire or is selected for a follow-up exam, the focus of the upcoming exams can serve as a "lesson plan" to prepare your institution for increased IRS scrutiny across the higher education sector. The following are some ways that you can prepare your institution:

Executive Compensation

- Analyze the comparability data that your institution uses in order to establish executive compensation. Perhaps consider modifying current compensation policies to provide such guidance as to how comparability data should be chosen and obtained, how outside consultants should be selected, how the data should be interpreted (based on what factors), how percentile ranges are to be used, and how for-profit comparability data should be considered. Taking additional time in obtaining and interpreting comparability data, and considering the impact of your policies regarding comparability data on overall executive compensation, should create a more defensible position with the IRS if the institution's executive compensation is ever brought under scrutiny.
- Ascertain the number of executive compensation contracts for which your institution has relied on the initial contract exception, and, if appropriate, consider adapting compensation policies to specifically address the handling of initial contracts.

Unrelated Business Income

- Undertake an internal audit to (1) identify all controlled entities, (2) identify all of the institution's financial arrangements with those controlled entities, and (3) assess whether the pricing methods used to establish payments from controlled entities are based on arm's length, fair market value principles.
- Review all expense allocations used in preparation of Form 990-T, with particular emphasis on the allocation of indirect expenses. For example, be sure to ascertain whether a particular method of allocating indirect expenses that perhaps has been used for many years still provides an appropriate basis for allocation.

JONES DAY'S EXPERIENCE

We routinely assist large institutions in preparing for, responding to, and following up on IRS examinations. We also routinely engage in wide-scale or targeted "mock" audits for clients that want to stay ahead of enforcement initiatives. We would be glad to talk with you regarding any of the above matters.

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