What the Internal Revenue Service Discovered – And What You Can Do About It

By Steve Hoffman

A long-awaited final report from the Internal Revenue Service (IRS) has been released. The College and University Compliance Project, conducted by the IRS Exempt Organizations Division, was launched in 2008. Detailed questionnaires were sent to 400 randomly selected colleges and universities. The IRS then selected 34 of the 400 for examination based upon the responses. The IRS had released an interim report but now with more than 90 percent of the examinations completed, the final report has been released. The report highlights some interesting information on what was discovered in the examinations, including compensation and comparability data, employment tax issues and retirement plan issues.

The examinations were designed to focus on unrelated business income tax and executive compensation of three groups: small, medium and large colleges and universities.

THE EXAMINATION RESULTS

The examinations were designed to focus on unrelated business income tax and executive compensation of three groups: small, medium and large colleges and universities. Exams covered all returns including Forms 990 and 990-T, employee plans returns, excise tax returns and employment tax returns.

The examinations resulted in increased unrelated business taxable income totaling $90 million, with more than 180 adjustments made to the returns. More than half of the adjustments were related to the following activities, in order of frequency:

- Fitness and recreation centers and sports camps,
- Advertising,
- Facility rentals,
- Arenas and
- Golf courses.

On 75 percent of the returns examined, the IRS disallowed losses totaling approximately $170 million that could amount to more than $60 million in assessed taxes. A reason offered for the adjustments was a misclassification of activities as a trade or business. The IRS also disallowed net operating losses of more than $150 million because the losses were not connected with an activity that had a profit motive.

Expenses were disallowed on more than 60 percent of Forms 990 because the expenses were based on improper allocations between exempt and unrelated business income. Net operating losses on examined returns in the amount of $19 million were disallowed because the losses were not calculated correctly or were unsubstantiated.

At more than 40 percent of colleges examined, there were activities determined by the IRS to be unrelated and subject to tax. These adjustments totaled nearly $4 million.

Many of the returns filed had been reviewed prior to filing: 13 percent by outside counsels, 57 percent by independent accountants and 50 percent by boards of directors or board committees.

ABOUT THE AUTHOR

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COMPENSATION ISSUES

The final report produced some interesting observations on compensation of top management officials. Highest to lowest average compensation by position was in this order:

- Investment managers,
- Sports coaches,
- Heads of departments,
- Faculty,
- Other and
- Administrative/managerial.

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Adjustments to salaries or wages from the examination of employment-related returns were due to a number of reasons:

- Failure to include in income the value of personal use of automobiles, housing and social club memberships and travel;
- Misclassification of employees as independent contractors;
- Failure to withhold taxes for wages paid to nonresident aliens (foreign students, scholars); and
- Failure to include in income the value of certain graduate student tuition waivers and reimbursements.

The IRS also made adjustments for deferred compensation as a result of examinations at eight colleges and universities. Adjustments amounted to slightly over $1 million that generated over $200,000 in additional tax.

THE SETTING OF COMPENSATION

One third of colleges and universities examined did not have formal compensation policies, and about one half used outside compensation consultants to assist with setting compensation. The IRS had concerns about the comparability of outside data. The final report shows that:

- About 20 percent of institutions did not use an appropriate data set. There was no documentation of the selection criteria and no explanation of why those schools used for comparison were deemed comparable to the school relying on the data.
- Many schools relied on a compensation survey compiled by an independent firm; however, some of the data in the compensation surveys were removed or not limited to schools that were comparable.
- The compensation surveys did not indicate if the amounts included only salary or included other types of compensation.

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SOME CONCLUSIONS

The IRS has not issued clear instructions with regard to what is subject to the unrelated business income tax.

The IRS has not made clear what expenses can be deducted from unrelated business income and needs to clarify what an allocation of expenses method is and not rely on "reasonable expenses."

Better record keeping is needed to support the calculation of net operating losses, and substantiation needs to be maintained.

Reviews of tax forms before filing with the IRS have produced little value. It appears, based on the dollars generated from an examination of only 34 colleges and universities, that reviewers may have had little knowledge of the areas of assessment by the IRS.

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Many of those with responsibilities related to compensation do not have a clear understanding of the taxability of fringe benefits; the differences between an independent contractor and an employee; the tax treatment of wages paid to foreign students, scholars and researchers; and the taxability of tuition waivers and reimbursements.

There is a lack of understanding about the taxability of certain deferred compensation arrangements.

MY BELIEF AND SURVEY RESULTS

This final report reaffirms my belief in the need for dedicated tax positions within colleges and universities. The National Association of College and University Business Officers (NACUBO) 2011 tax survey revealed that only 22 percent of the 220 colleges and universities responding had positions devoted solely to tax, and most of these positions were at research institutions. Overall, 55 percent of research institutions responding had a person devoted solely to tax matters, while only two percent of other types of institutions responding did. One telling finding of the survey is that few colleges and universities had plans to create a position devoted solely to tax.

WHAT YOU CAN DO ABOUT ASSURING COMPLIANCE

Demand more accountability from your independent accountants. More than half of the returns examined had been reviewed by such accountants. The results of the IRS Compliance Project show that a more thorough review needs to be done by these firms.

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Half of the unrelated business income tax returns filed and audited by the IRS in this project were reviewed by boards of directors or board committees. More education of boards and board committees on unrelated business income tax is clearly needed.

Thoroughly review the five areas listed above as the sources of more than half of the IRS adjustments. Insure activities in these areas are appropriately monitored and reported. Universities should be conducting an unrelated business income tax survey annually on their campus. This is generally done via a readily available questionnaire. Institutions should not simply rely upon personal knowledge of activities on campus.

More than $170 million in losses were disallowed by the IRS. This indicates the people responsible for the preparation of the returns lacked a clear understanding of what constituted a business activity and what losses were allowable. A well-trained tax manager would understand these areas and be able to accurately complete the tax return for the university.

Learn what are taxable fringe benefits and adjustments to salaries and wages. The IRS opened 11 employment tax examinations for other issues at the 34 universities audited. Increases in salaries and wages of over $35 million resulted from those additional examinations – generating more that $7 million in employment taxes.

Train staff members in the decision-making process for declaring an individual an independent contractor. Determine which staff members make this decision and provide them training on a continuing basis. Training should also be required on withholding of taxes from student employees, as this was also an important issue in the IRS report.

The IRS will continue to focus on determining whether colleges and universities comply fully with tax laws. The amount of revenue generated by the 34 examinations described above should make the IRS's pursuit clear to colleges and universities. Schools can and should prepare now for such audits by implementing a tax compliance program at their institutions. Those that do not are putting themselves at financial and reputational risk. ■