



The IRS report on colleges and universities and what it means to a business officer

By:

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In 2008, the IRS sent 400 questionnaires to colleges and universities. From that sample, 40 were selected to be audited and 34 of those audits have been completed. Here's what the IRS found and what it means to you.

Under-reporting of unrelated business income tax. This under-reporting resulted in increases by the IRS to unrelated business income tax of about \$90 million. There also were 180 changes to the amount of unrelated business income tax reported by colleges and universities on their form 990Ts.

Disallowance of losses. There was a disallowance of more than \$170 million in net operating losses, which is estimated to result in \$60 million in assessed taxes—and from just 34 audits. The IRS also threw out several expenses claimed by the universities, as they were not connected to the actual activity.

This misreporting of income and expenses occurred in two ways:

1. The IRS determined that there was a lack of a profit motive, with more than \$170 million of net operating losses disallowed. No profit motive means no net operating losses can be claimed. The IRS requires a profit motive for the unrelated business activity to be reported on the tax return. Another IRS determination showed improper expense allocations—in other words, reporting of incorrect expenses against income.
2. Also found were errors in computation and substantiation of the net operating losses; because of these errors, the IRS disallowed \$19 million in losses.

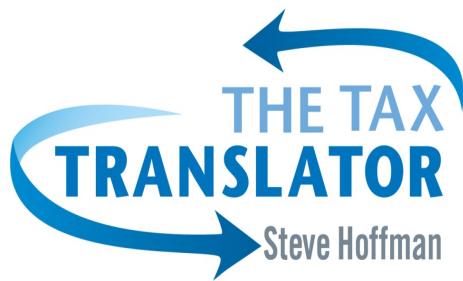
Additionally, for 40 percent of the colleges and universities that had completed audit results, some of the claimed exempt activities were reclassified from being 'unrelated' to being 'taxable'. This disagreement by the IRS means that nearly \$4 million in income that was previously not taxable (from the 34 schools that were audited) is now subject to tax. Are you keeping track of the dollars assessed so far?

What specific activities were re-classified among the 180 changes that were made? There were more than 30 different activities that were reclassified, but they can be

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reduced to five major groups. Does your school have any of these? Are you reporting them correctly?

1. Fitness, recreation centers, and sports camps
2. Advertising
3. Facility rentals
4. Arenas
5. Golf courses

Unless you are intimately involved in the preparation of the tax return, chances are you do not know the answers to these questions.

A strategy for compliance

There are six steps to get and stay ready for an audit. These steps have been developed and published in my book, "Taxation for Universities and Colleges: Six Steps to a Successful Tax Compliance Program" (Wiley 2013). Briefly, the six steps are:

1. Awareness

There are many different kinds of taxes you need to be aware of at your school. Besides unrelated business income tax, there is sales tax, excise tax, employment tax, nonresident alien tax for your foreign students and scholars, independent contractor tax liability, possible severance taxes, and even taxes in foreign countries, among others.

All these taxes have different filing and reporting requirements and different deposit dates.

Once you are more aware of the various kinds of taxes affecting your campus, I suggest you build a simple spreadsheet or 'tax calendar' You can download a sample here [\[URL\]](#). Then, determine their due date and who is responsible for completing each task. This will help you monitor and control your tax risk.

2. Identification

Does your university have a tax gap? There are various methods for finding them on your campus, including questionnaires and surveys, automated queries within your financial systems, and more. After 12 years as a tax manager at three different universities, I learned that unidentified tax gaps will not come knocking on your door. It is necessary to seek them out, and this cannot be done just within your office. It must be a campuswide effort. Do you have meetings on a regular basis where tax issues are discussed? If not, you should start having them immediately.

3. Compliance

Complying with tax law does not just happen. It's a concentrated effort led by a CFO, controller or VP of business and finance. A tax compliance program is a collaborative

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approach to developing a strategic path forward that will drive even more compliance with tax laws. I have a saying, 'compliance breeds compliance'. It means that, once you set the goal, compliance can and will happen willfully. Tax compliance requires a tax team. Build one now and include the various people who have knowledge of campus activities.

4. Reporting

Simply stated, reporting is the fulfilling of your school's requirement to provide the correct information on a timely basis to the federal, state, and local taxing authorities. Reporting and filing the forms at year-end is the culmination of the work done throughout the year, not only at year-end. The University of Michigan files more forms with the IRS than General Motors does. So does your school.

5. Monitoring

Monitoring internal controls is a continual activity and obligation of the chief business officer at both the campus level and the department level. Reviewing and managing the control system begins at the top. I've created a list of 15 tax policies I believe every university should have in place before an audit. You can access that list here [[URL](#)].

6. Audit defense

Preparation for an audit has to begin now, and continue every day, not the day the auditors arrive. And a single person does not accomplish an audit defense. It is led by a single person with the help of others in the Business and Finance department.

These six steps are not a 'speed dating' approach to tax compliance. Implementation will take some time.

Chief business officers generally have a strategy for such large undertakings. There may be a building strategy, a bond strategy, or a strategy to save money on utilities, but seldom is there a strategy for tax compliance. I have also found in many smaller schools that there is no designated tax person. There is very little if any training provided to the people with tax responsibilities. Attending a tax conference once a year for a day and a half is insufficient training on all of the taxes faced by a university. Tax laws, rules, and regulations change quite frequently.

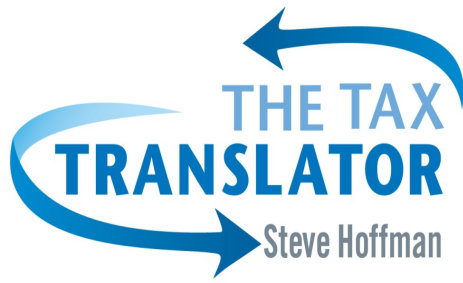
With the amount of tax discrepancies uncovered after only 34 completed exams, the IRS found its pot of gold at the end of the tax rainbow and will be conducting more of these exams in the future. Are you ready for a tax audit?

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