Why Build a Tax Strategy?

By Steve Hoffman

I'd like to give you the results of a report from the IRS on its college and university compliance project and what it really means to you, the internal auditor. First, some background: The IRS sent 400 questionnaires to colleges and universities in 2008. From that sample, 34 audits have been completed. Here's what the IRS found.

UNDERREPORTING OF UNRELATED BUSINESS INCOME TAX

The result of this underreporting was increases by the IRS to unrelated business income tax of about $90 million. That's right, *$90 million*. Further, there were 180 changes to the amount of unrelated business income tax reported by colleges and universities on Form 990T.

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DISALLOWANCE OF LOSSES

There were disallowances of more than $170 million in net operating losses, which is estimated to result in an additional $60 million in assessed taxes. The IRS also threw out expenses claimed by the universities that they determined 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, which means no net operating losses can be claimed. The IRS requires a profit motive in order for the unrelated business activity to be reported on the tax return. Another IRS determination showed improper expense allocations – reporting of expenses against income that the IRS found to be incorrect.
2. The IRS also found that there were errors in computation and substantiation of net operating losses and because of these errors, the IRS disallowed $19 million in losses.

Additionally, with 40 percent of the colleges and universities examined, the IRS reclassified some of the claimed exempt activities from being unrelated to being taxable. That is, the IRS disagreed with the university on what was reported on their tax return. Thus, nearly $4 million in income was 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 reduced to five major groups. Does your school have any of these? Are you reporting them correctly? Are you looking at these activities for potential tax risks?

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 that you do not know the answers to these questions.

The focus of this article is on the report by the IRS and how to defend your school in an audit. The IRS report also included information on compensation and comparability data and employment tax issues (which resulted in wage adjustments of $36 million that resulted in tax

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in penalties of over $7 million). These two other areas, compensation and employment tax, will be discussed in future articles.

Interestingly enough, the IRS report concluded that the IRS plans to look at unrelated business income reporting more broadly. No kidding! With the amount of tax assessed shown in the report from only 34 completed audits, the IRS found the pot of gold at the end of the rainbow. Are you ready for an audit?

ARE YOU READY FOR AN AUDIT?

I firmly believe you cannot get ready for an audit, you have to stay ready. And to stay ready, you have to get ready. In my book, "Taxation for Universities and Colleges: Six Steps to a Successful Tax Compliance Program," I outline the six steps you should take to build your audit defense – to get ready and stay ready. Briefly, these 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 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 taxes affecting your campus, I suggest you build a list, whether a simple spreadsheet or a 'tax calendar' (sample available from the author by email). Then, determine who is responsible for completing each of the tasks and when they are due. This will help you monitor and control your tax risk.

2. Identification

Does your university have a tax gap? There are various methods for seeking out taxes on your campus. There are questionnaires and surveys, automated queries within your financial systems and more. I learned, after 12 years as a tax manager at three different universities, that unidentified tax gaps will not come knocking on your door. It is necessary to seek them out. This cannot be done within your office. It is a campus-wide effort. Are you involved in meetings on a regular basis where tax issues are discussed?

3. Compliance

Compliance with tax law does not just happen. It's a concentrated effort led by a CFO or VP of Business and Finance or a controller and the internal auditors. A tax compliance program is a collaborative approach to developing a strategic path forward that will drive even more compliance with tax laws. I have a saying, "Compliance breeds compliance," and it's true: 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.

Another way to look at it: In the event of a large audit assessment of tax, it may be the Chief Internal Auditor who must address the questions, "How did this happen? And why did this happen?" The truthful answer is, "We didn't get ready or stay ready."

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4. Reporting

Simply stated, reporting is the fulfilling of your school's requirements 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. Penalties for filing incorrect information returns with the IRS were just increased. But don't worry; they very kindly capped the penalties at $1.5 million. Did you know that the University of Michigan files more forms with the IRS than General Motors? Your school also files more forms with the IRS than you can imagine. This brings us to the next step.

5. Monitoring

Monitoring of internal controls is a continual activity and obligation of the Chief Internal Auditor for the entire campus. Monitoring is the reviewing and managing of the control system that begins at the top. I believe every university should have tax policies in place – before an audit. (Get Ready, Stay Ready.)

6. Audit defense

Preparation for an audit has to begin now, and continue tomorrow and everyday – not the day when the auditors arrive. A single person does not accomplish an audit defense. However, it is led by a single person with the help of others on campus.

These six steps are not a "speed dating" approach to tax compliance. Implementation will take some time, but it begins with the first step and follows through step number six. I was the first-ever tax manager at the largest land-grant college in the United States. At times, I felt I was trying to change the course of the Titanic with only one oar in the water. The result of a tax compliance strategy I created and implemented was the lowest ever audit assessment made against the university – only $4,000. And that was after eight months of having three auditors in my office. Compare that to prior audits of the same university where the IRS left with checks totaling $3 million and $1.5 million for the two prior audits. Following the six steps will save you money and time.

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I have found in many smaller schools there is no designated tax person. Tax responsibilities are decentralized and are often an "other duty as assigned." These tax duties are often only done once a year and 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. Internal auditors need training in assessing tax risk at their university.

I have also found through informal surveys by speaking at many universities across the country that an amount equal to approximately 15 percent of the total budget goes out the door every year to taxing authorities, yet there is no strategy, no tax team and very few controls, none of which are monitored. Many auditors are not aware of who signs the tax returns for the university, when the tax is due, if deposits have been made timely and sometimes not even the various penalties that have been assessed against the university. Chief Internal Auditors generally have a strategy for large undertakings or an audit plan for the year. Is tax risk included in your audit plan? There may be a fraud strategy, an audit strategy, but no strategy for tax compliance. ■