

Recent IRS Report Focuses on Unrelated Business Income and Compensation

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On April 25, 2013, the IRS released its final report summarizing the audit results of the IRS's colleges and universities study, which began in 2008. The final report describes the IRS's multi-year project on a major segment of tax-exempt organizations. The focus of the IRS's project related to compliance by colleges and universities with respect to unrelated business income ("UBI") and executive compensation.

In 2008 the IRS sent detailed questionnaires to 400 randomly-selected colleges and universities. The IRS selected 34 of the 400 colleges and universities for examination because their questionnaire responses and Form 990 reporting indicated potential noncompliance in these two areas. The IRS notes in its report that the findings from the audit of the 34 institutions are not a representative sample of all colleges and universities, and assumptions should not be made about the UBI and compensation practices of other colleges and universities based on the examination results discussed in the report.

Nevertheless, Lois Lerner, Director, Exempt Organizations division who is currently on administrative leave due to concerns over the IRS's review of certain tax exemption applications, stated after the report was released that: "The audits identified some significant compliance issues at the colleges and universities examined. Because these issues may well be present elsewhere across the tax-exempt sector, all exempt organizations need to be aware of the importance of accurately reporting unrelated business income and providing appropriate executive compensation."

In addition, the executive summary to the report states that as a result of the study, the "IRS plans to look at UBI reporting more broadly . . . and to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using comparability data when setting compensation."

The following summarizes the key findings reported by the IRS, which will likely be areas where the IRS will focus its attention over the coming years when reviewing Form 990s, Form 990-Ts, and other forms filed with the IRS by tax-exempt organizations.

Findings Related to UBI

The examinations resulted in increases in unrelated business taxable income ("UBTI") for 90 percent of the institutions examined totaling approximately \$90 million. There were also over 180 changes to the amounts



of UBTI reported by the institutions on Form 990-T and more than \$170 million in disallowed losses and net operating losses.

The primary reasons for increases to UBTI in the completed exams were as a result of:

- (i) disallowing expenses that were not connected to unrelated business activities because the activities generating the losses did not qualify as a trade or business due to a lack of profit motive;
- (ii) misallocating expenses that were not connected to the unrelated business activity;
- (iii) improperly computing or substantiating net operating losses; and
- (iv) misclassifying certain activities as exempt activities or otherwise not reportable on Form 990-T.

The majority of the adjustments came from the following activities: (i) fitness, recreation centers, and camps; (ii) advertising; (iii) facility rentals; (iv) arenas; and (v) golf.

Findings Related to Executive Compensation

The executive compensation component of the examinations focused mainly on compliance with Section 4958 of the Internal Revenue Code (the "Code"), which prevents tax-exempt organizations described in Sections 501(c)(3) and 501(c)(4) of the Code from paying more than a reasonable amount of compensation to their officers, directors, and other key employees.

Although most institutions that were examined attempted to meet the "rebuttable presumption" standard promulgated in the Regulations under Section 4958 of the Code, approximately 20 percent failed to do so because of problems with their comparability data. Issues included:

- (i) relying on data from institutions that were not similarly situated;
- (ii) compensation studies not documenting the selection criteria for the schools included nor explaining why those schools were deemed comparable to the school relying on the study; and
- (iii) surveys not specifying whether amounts reported included only salary or included other types of compensation.

Retirement plan examinations were also opened for eight institutions and compliance issues were found in "about half" of the plans. The issues that were discovered that resulted in increases in taxable income related to lack of substantial risk of forfeiture, and loans, deferrals, and additions exceeding limits specified in the Code.



Impact of the Report

It is clear that the IRS is going to be looking at UBI and executive compensation issues for tax-exempt organizations across the tax-exempt sector. Therefore, tax-exempt organizations are encouraged to review these issues as it relates to them and address any areas of concern.

If you have any questions about the information presented in this alert, please contact your Lathrop Gage attorney or one of the attorneys listed above.