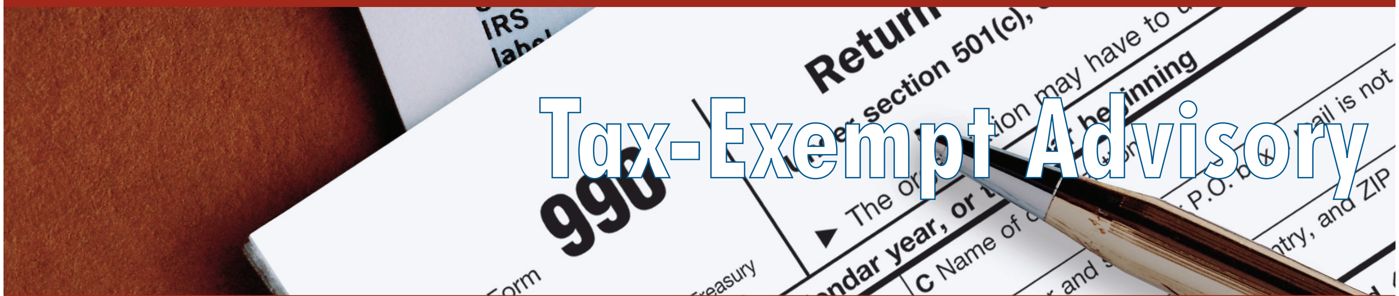
BLANK ROME LLP
COUNSELORS AT LAW



www.BlankRome.com
May 2010 No. 4

Interim Report for IRS Compliance Project for Colleges and Universities

In October 2008 we advised our clients of the IRS compliance project that would examine colleges and universities. The project is part of a larger effort by the IRS to review the largest and most complex organizations in the tax-exempt sector. The questionnaire primarily focused on 1) the conduct and reporting of exempt or other activities that may generate unrelated business taxable income (UBTI), 2) investment, management, and use of endowment funds, 3) executive compensation, and 4) governance practices.

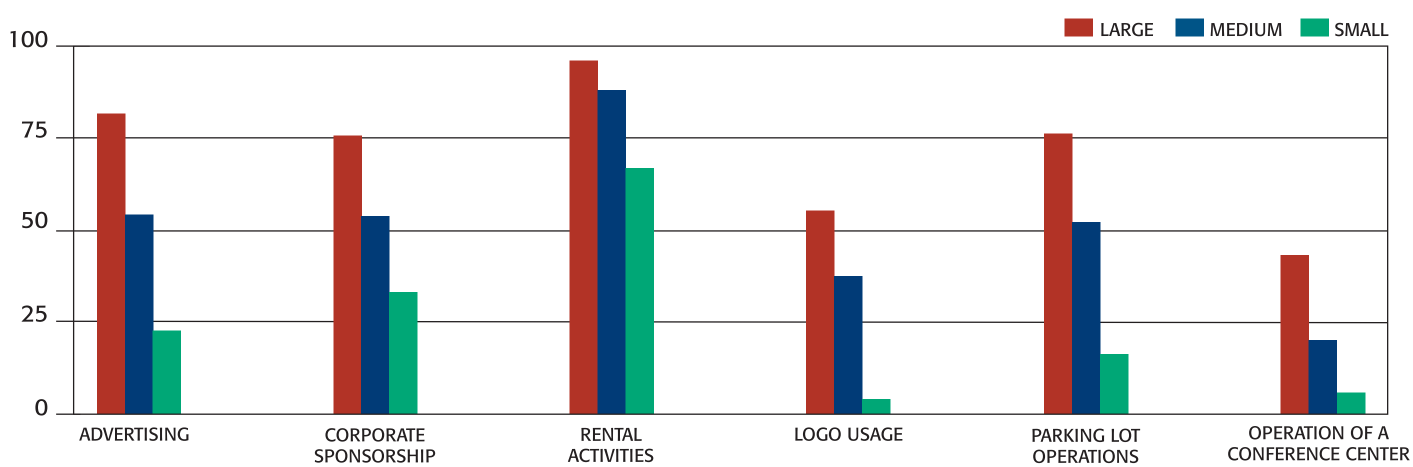
The IRS sent the questionnaire to 400 public and private nonprofit colleges and universities. The overall response rate was 97%. From the responses, the IRS opened examinations of more than 30 colleges and universities, focusing on UBTI, executive compensation, and controlled entities.

In May 2010, the IRS issued an interim report, which presents the feedback from 344 organizations—177 private and 167 public colleges and universities.[1] It presents the responses in accordance with the size of the organizations. The three categories of colleges and universities are: 1) small, with fewer than 5,000 students, 2) medium, with between 5,000 and 14,999 students, and 3) large, with more than 15,000 students. This is a brief overview of the IRS interim report.

Activities That May Generate Unrelated Business Taxable Income

When a tax-exempt organization engages in activity that is not sufficiently related to its tax-exempt purpose, it generates unrelated business income, which is subject to tax. The tax is reported on Form 990-T. Generally, UBTI has three characteristics: 1) it is a trade or business; 2) it is regularly carried on; and 3) it is not substantially related to furthering the exempt purpose of the organization. In its interim report, the IRS categorized four areas of activities, which could potentially generate UBTI: 1) advertising, 2) corporate sponsorship, 3) rentals, and 4) other activities, such as logo usage, bookstores, and commercial research. We note that such activities, in many cases, if structured correctly, will not result in UBTI.

Overall, large organizations reported conducting UBTI activities more often than medium and small organizations. The disparities between the reported activities among the organizations were considerable. The following chart indicates the proportions in which each size of organization reported engaging in an activity that could generate UBTI.



In most cases, the percentage of colleges and universities that reported engaging in an activity was much higher than the percentage that reported including that activity on their Form 990-T. For instance, although 82% of large organizations reported they engaged in advertising activity, only 53% of large organizations reported including advertising income on their Form 990-T. This may be explained because certain of the potential UBTI activities may not actually generate tax. The IRS plans to study this area further.

Endowment Funds

All of the colleges and universities reported, at high rates, that they maintained endowment funds. Nearly all organizations reported having an endowment fund investment policy, and external party managers were the most commonly used type of fund manager for each organization size. Most of the organizations reported having investment committees to oversee endowment fund assets. 85% of small organizations, 93% of medium organizations, and 94% of large organizations used investment committees, ranging in average size from 7 to 12 members.

The average size of endowment assets per full-time student varied. In small organizations, the average was $56,000 and the median was $14,000. In medium colleges and universities, the average was $34,000 and the median was $5,000. In large organizations, the average was $66,000 and the median was $7,000.

Disbursements of endowment funds also differed according to organization size. Although nearly all of the organizations reported disbursements for scholarships, awards, grants, or loans, 88% of large organizations reported disbursements for general education support and libraries while only 58% of small organizations did the same. In addition, large colleges and universities reported, at a rate of 64%, using endowment funds for research, as opposed to only 14% by small organizations.

Executive Compensation

Executive compensation also varied in accordance to the size of the college or university. It is not surprising that the reported compensation of the highest paid officer, director, trustee, or key employee was greatest at the large organizations with an average of $428,000 and median of $361,000. The average and median compensation was the lowest at small colleges and universities, $202,000 and $174,000, respectively. In most cases, the highest paid employee in this category was the chancellor or president.

Highest paid employees other than officers, directors, trustees, or key employees generally reflected the previous trends. At large colleges and universities, the average salary was $798,000 and the median was $352,000. The highest paid employee was a sports coach at 43% of organizations and a faculty member at 34% of organizations. At small colleges and universities, the average salary was $145,000 and the median was $98,000. At more than half of the small organizations, the highest paid employee was a faculty member.

The majority of colleges and universities also reported that none of their six highest paid officers, directors, trustees, or key employees was a disqualified person immediately before entering into compensation arrangements with the organization. However, few organizations reported making fixed payments under the initial contract exception to any of these six highest paid employees–17% at small organizations and 15% at medium organizations. The initial contract exception allows organizations to avoid penalties, under the regulations applicable to excess benefit transactions, if the organization has a binding contract with the person and he was not a "disqualified person" before entering into the contract.

Governance Practices

During the course of the questionnaire, the IRS requested information related to the governance of colleges and universities. These questions touched upon conflict of interest policies, setting of compensation, endowment policies, unrelated business activities, transactions with related parties, and other similar practices.

Concerning written policies, private institutions were asked about their conflict of interest policies, and public colleges and universities were referred to their applicable state statutes. The percentage of organizations that reported having a conflict of interest policy or statute in place to ensure specific transactions with related entities are made at arm's length ranged widely. Policies or statutes for the provision of goods or services to related entities ranged from 27% in small organizations to 60% in large organizations. In respect to transfer of assets, 18% of small organizations, 27% of medium organizations, and 57% of large organizations reported policies in place. Similar disparities existed in respect to policies for rental of property and transfer of assets to related entities.

Moreover, large colleges and universities reported at a much higher percentage than small organizations that they had a written policy or applicable state statute regarding transactions with controlled entities. Transactions with controlled entities, such as a parent and its subsidiary, include the payment or accrual of management fees, rents, interest, royalties, and annuities. Generally, 4-8% of small organizations reported having written policies or applicable statutes. However, 44-48% of large organizations reported having the same rules in place for transactions with controlled entities.

The existence of policies for setting compensation also differed a great deal across organization size. Approximately 1/3 of small organizations and about 2/3 of medium and large organizations reported having a formal written policy governing compensation of at least some of their officers, directors, trustees or key employees. Compensation of officers was most often set by either the Board of Directors in small and medium organizations, or a compensation committee in the case of large organizations. In all college and university size categories, more than half of the organizations reported using a process intended to satisfy the rebuttable presumption procedure. Following the procedure enables an organization to create a rebuttable presumption that the compensation paid to an officer or key employee is reasonable and does not result in an impermissible excess benefit. There are three requirements to the procedure: 1) an independent body to review and establish the amount of compensation; 2) use of appropriate comparability data to establish compensation; and 3) contemporaneous documentation.

IRS Final Report Topics

Although the interim report reflects a great deal of information, the IRS plans to include additional information and analysis in its final report.

It will analyze responses from eleven colleges and universities excluded from the interim report because they responded on a system-wide basis rather than a campus-only basis. The questionnaires were mailed to a random sample group, and therefore, system-wide reporting was expected in some cases. These campuses were permitted to report on a system-wide basis if it was consistent with their IRS filings and they used the same method for the entire questionnaire.

The IRS also plans to test the information against other sources, including filings with the IRS, as well as review the responses for inconsistencies and review the narrative answers. The final report will also include more analysis on the governance responses to identify practices and procedures relating to potential unrelated business income implications, related organizations, and controlled entities.

Most importantly, the final report will provide additional analysis in several areas. These areas will include: 1) the use of, and relationship with, controlled entities and related organizations, 2) the reported differences in treatment by organizations of various activities as exempt or unrelated and of cost allocation practices across activities and related organizations, 3) the reporting of losses from certain exempt and unrelated activities, 4) the use of comparability data and compensation practices and procedures to establish compensation of executives and other highly paid individuals, and 5) the impact the initial contract exception may have on the setting of compensation and the use of the rebuttable presumption procedure.

Please contact an attorney in our exempt organizations practice listed below if we can be of any assistance in ensuring your organization is in compliance with IRS requirements. The professionals at Blank Rome can advise you on the means to improve your policies, procedures, and operations in this time of increased scrutiny. We anticipate the IRS to issue a final report on the compliance project on colleges and universities in the next few months, and will summarize those findings when they are released. ■

1. The interim report is available on the IRS Web site at www.irs.gov/charities/charitable/article/0,,id=220698,00.html.

Tax-Exempt Organizations Practice

David M. Kuchinos, Practice Chair
215.569.5729 ▪ Kuchinos@BlankRome.com

Michael I. Sanders, Practice Chair
202.772.5808 ▪ Sanders@BlankRome.com

Lawrence J. Beaser 215.569.5510 ▪ Beaser@BlankRome.com
Megan A. Christensen 202.772.5897 ▪ Christensen@BlankRome.com
Susan A. Cobb* 202.772.5859 ▪ Cobb-S@BlankRome.com
Joseph T. Gulant 212.885.5304 ▪ jgulant@BlankRome.com
Robert E. Madden 202.772.5857 ▪ Madden@BlankRome.com
Harold N. Pappas 212.885.5370 ▪ HPappas@BlankRome.com

*Editor