

# EXEMPT AND NONPROFIT ORGANIZATIONS ALERT

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## IRS Addresses Issues of Unrelated Business Taxable Income and Executive Compensation in Colleges and Universities Compliance Project Report

On April 25, 2013, the Internal Revenue Service (IRS) released its Final Report for the Colleges and Universities Compliance Project, a multiyear analysis of tax-exempt colleges and universities.<sup>1</sup> In 2008, the IRS distributed questionnaires to 400 randomly selected colleges and universities and selected 34 for examination. The Final Report focuses predominantly on two areas of concern that are equally relevant to all Section 501(c)(3) public charities: unrelated business taxable income (UBTI) and executive compensation.

### Unrelated Business Taxable Income

As a result of the study, the IRS increased UBTI for 90 percent of colleges and universities examined, making more than 180 adjustments totaling about \$90 million. Advertising and facility rentals resulted in adjustments to UBTI for almost half of colleges and universities examined; fitness and recreation centers, sports camps, arenas and golf courses resulted in UBTI adjustments for about a third of the organizations.

The most common reason the IRS adjusted a school's UBTI was that the school incorrectly claimed losses from activities that the IRS did not consider to constitute a "trade or business." An organization only generates unrelated business income from a "trade or business," and an activity only qualifies as a trade or business if the organization engaged in the activity is intending to make a profit. The IRS' view is that if a school sustains continuous losses from a single activity, this pattern is sufficient to show a lack of profit motive. Accordingly, a school cannot claim losses against UBTI from such an activity because, not being operated for profit, it cannot be a "business" activity. For this reason, the IRS disallowed losses at 70 percent of schools examined. More than \$170 million in losses were disallowed, resulting in additional tax liability of \$60 million for impacted organizations.

The validity of these losses is of particular interest to the IRS because losses from a single activity can offset gains from other trade or business activities not only in the year of the loss but also in future and past years. This allows organizations to continue to conduct an unrelated business activity operating at a loss while taking deductions from that activity against the aggregate income of other unrelated business activities.

The IRS also disallowed expense deductions on more than 60 percent of IRS Forms 990-T because they were based on incorrect allocations between exempt and unrelated business activities. Too frequently, schools took deductions on expenses related to an activity in furtherance of an exempt purpose, which may not be deducted from UBTI.

The IRS also found that almost 40 percent of colleges and universities examined had misclassified certain activities as exempt or otherwise not reportable on Form 990-T. As a result, the IRS reclassified nearly \$4 million in income as unrelated, subjecting those activities to tax.

<sup>1</sup> The IRS released on May 7, 2010, an interim report summarizing initial responses to its questionnaire.

### Executive Compensation

The Compliance Project also focused on Internal Revenue Code (the Code) Section 4958, which provides that organizations may pay no more than reasonable compensation to their disqualified persons. Section 4958, which applies to all Section 501(c)(3) public charities, imposes an excise tax on disqualified persons who received payment of unreasonable compensation and, in certain cases, on those persons who approved it. At the colleges and universities examined, the officers, directors, trustees, and key employees (ODTKEs) were disqualified persons subject to the reasonable compensation requirements of Section 4958. The burden of proving unreasonable compensation shifts to the IRS if an organization follows the three step rebuttable presumption process. To obtain the presumption, an organization must:

- use an independent body to review and determine the amount of compensation;
- rely on appropriate comparability data to set compensation; and
- contemporaneously document the process used to set the compensation amount.

While most private colleges and universities examined attempted to meet the rebuttable presumption standard, weaknesses were found in the comparability data of about 20 percent of them, including:

- using data from institutions not similarly situated to the school;
- using compensation studies that did not document the selection criteria for the schools in the surveys and did not provide an explanation as to why those schools were deemed comparable to the school relying on the study;
- relying on surveys in which the school's own compensation data was included but the survey was not limited to schools that could be considered comparable to each other. Some schools used such surveys with no adjustments while others removed schools that were not comparable; and
- using compensation surveys that did not specify whether compensation amounts provided included only salary or also other types of compensation to equal total compensation, as required by Code Section 4958.

The IRS opened employment tax exams for 11 of the colleges and universities examined, all of which resulted in adjustments. These adjustments included an increase in taxable wages of more than \$35 million generating more than \$7 million in employment taxes and almost \$170,000 in penalties. The wage adjustments were made for a variety of reasons, including the failure to include in income the value of the personal use of automobiles, housing, social club memberships and travel; the misclassification of employees as independent contractors; the failure to withhold taxes for wages paid to non-resident aliens; and the failure to include in income the value of certain graduate tuition waivers and reimbursements. The IRS opened retirement plan examinations for eight of the colleges and universities examined, resulting in deferred compensation-related wage adjustments of more than \$1.1 million generating more than \$200,000 in taxes and more than \$12,000 in penalties.

The IRS makes it clear that the 34 selected colleges and universities are not a representative sample as they were selected for examination because their returns and questionnaires indicated potential noncompliance. Still, the IRS plans to look at UBTI reporting more broadly, especially at recurring losses and the allocation of expenses, and to use educational tools and examinations to ensure that organizations understand the need to use appropriate comparability data when setting compensation. The IRS further notes that the examinations raised issues surrounding compensation and unrelated business taxable income "that may well be present elsewhere across the tax-exempt sector."

Congressman Charles W. Boustany, Jr., M.D., (R-LA), chairman of the Subcommittee on Oversight of the Committee on Ways and Means, called the Report's findings "alarming" and announced that the subcommittee will hold a hearing on the Final Report on Wednesday, May 8 to examine the causes for the "widespread noncompliance" found.

We would be happy to assist you should you have any questions regarding the impact of the IRS' findings on your organization.

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