

Client Alert

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Unrelated Business Income and Executive Compensation: Final Report on Tax-Exempt Colleges and Universities Compliance Project Provides Guidance for All Nonprofits

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The Final Report of the Colleges and Universities Compliance Project, released by the IRS on April 25, focuses primarily on the reporting of unrelated business income (UBI) and compensation paid by tax-exempt colleges and universities, but its assessments are directed at all tax-exempt organizations. In the report, the IRS announced plans to:

1. review the UBI of tax-exempt organizations more broadly, focusing on the characterization of activities as exempt or unrelated, methodologies for allocating expenses between the two, and the use of current-year losses and net operating loss carry-forwards used to reduce UBI; and
2. evaluate the comparability data relied on by nonprofits to establish executive compensation.

“The audits identified some significant compliance issues at the colleges and universities examined,” said Lois Lerner, Director, Exempt Organizations Division. “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.”

Using this client alert and the report as a helpful guide, all tax-exempt organizations may wish to undertake a careful review of their activities that could give rise to UBI and related calculation methodologies and reporting requirements, as well as the appropriateness of the peer group selected for executive compensation comparability purposes.

Background

The Compliance Project started in 2008 with the distribution of detailed questionnaires to 400 tax-exempt colleges and universities. As a result of the responses, the IRS initiated 34 examinations for potential noncompliance relating to executive compensation and unrelated business activities. The final report focuses on the results of those examinations and indicates areas that the IRS will target for a closer look in ongoing and future audits across the tax-exempt sector.

Underreporting of Unrelated Business Taxable Income

UBI is the income from a regularly carried on trade or business which is not substantially related to the tax-exempt organization's exempt purpose. Unrelated business taxable income (UBTI) is the UBI that is taxable after deducting expenses directly connected to the unrelated trade or business. In most cases, losses from one unrelated business activity can offset UBI from another. Once UBI is reduced to zero for a fiscal year, any unused net operating losses (NOLs) can be carried forward to offset UBI in future years, subject to certain limitations.

The report describes a wide variety of activities examined, some of which are common across the tax-exempt sector, including “advertising and exclusive provider arrangements, sports management agreements, facility rentals, arenas, food service, golf courses, hotels, recreation centers and programs, parking lots, commercial research, and bookstores.”

The report concludes that (i) substantially all of the 34 colleges and universities examined led to increases in UBTI, totaling about \$90 million; (ii) there were more than 180 changes to the amounts of UBTI reported on Form 990-T; and (iii) more than \$170 million in NOLs were disallowed.

Of more than 30 activities connected to the adjustments, the majority arose from:

- Fitness and recreation centers and sports camps;
- Advertising;
- Facility rentals;
- Arenas; and
- Golf.

Primarily, and as further detailed below, the increases to UBTI resulted from the disallowance of expense deductions, computation or substantiation errors, and the reclassification of activities from exempt to unrelated.

Disallowed deductions

The report finds that losses were being inappropriately used to offset UBI in the following two ways.

Lack of profit motive. The report indicates that almost 70 percent of those examined reported losses from activities with a pattern of recurring losses, which the IRS believes indicates the lack of a profit motive. Without a profit motive, the activity is not considered a “trade or business” for UBI purposes. The IRS therefore disallowed the use of expenses from those activities to reduce other UBI. The IRS disallowed more than \$150 million of NOLs.

As a result, exempt organizations may wish to reconsider their utilization of losses from lines of business with a pattern of recurring losses to offset UBI from profitable unrelated trades or businesses or be prepared to establish the requisite profit motive even if the activity is a loss activity.

Improper expense allocations. The report found that on nearly 60 percent of the Form 990-T unrelated business income tax returns examined, losses from exempt activities were used to reduce UBTI, which is inappropriate. Expenses, including for personnel, applicable to both exempt and unrelated activities must be allocated on a reasonable basis. All expenses used to reduce UBTI must be *directly connected* to unrelated trade or business activities. For example, if an officer earning \$200,000 in salary and benefits annually devotes approximately 10 percent of his or her time to an unrelated trade or business and 90 percent to exempt functions, \$20,000 could be deducted from UBI — the allocable portion of the salary and benefits.

Tax-exempt organizations may wish to confirm that expenses used to reduce UBTI are directly connected and reasonably allocable to the unrelated trade or business. For example, for any salary expense being apportioned in part to reduce UBTI, the IRS could request documentation, in the form of timesheets or other contemporaneously maintained records, evidencing the reasonableness of the percentage of the employee’s time being allocated to the unrelated trade or business.

Errors in computation or substantiation

Of all the returns examined that claimed NOLs, the IRS found that more than a third of the returns had NOLs that were either improperly calculated or unsubstantiated. Nearly \$19 million in NOLs were disallowed.

In an examination, exempt organizations could be asked to provide evidence of the business purpose for a claimed deductible expense. As a result, tax-exempt organizations may find it advisable to review their practices for tracking and documenting the business purposes of expenses used to offset UBI. In addition, care should be used to comply with special rules, such as those that apply to meals, entertainment and business travel expenses.

Improperly classifying unrelated activities as exempt

The IRS determined that nearly 40 percent of those examined had misclassified certain activities as exempt or otherwise not giving rise to UBI. Nearly \$4 million in income was reclassified as arising from an unrelated trade or business.

For a trade or business to be an exempt activity, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes. Otherwise, the activity is an unrelated trade or business.

A careful review of the various activities of an exempt organization may be desirable in order to ensure their proper classification as exempt or unrelated for UBTI purposes.

Executive Compensation and Comparability Data

Section 4958 of the Internal Revenue Code imposes "intermediate sanctions" taxes on excess benefit transactions. Treasury Regulations set forth a process to establish a rebuttable presumption that a transaction is reasonable and does not constitute excessive compensation. To do so, an independent body (e.g., a compensation committee) must review and determine the amount of compensation relying on appropriate comparability data, and must contemporaneously document the decision-making process. The Treasury Regulations provide that appropriate comparability data includes the compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.

Appropriate data

The report focused on whether the data utilized was appropriate — whether the peer group reviewed consisted of similarly situated organizations, and whether the specific positions referenced were functionally comparable. To evaluate the appropriateness of the comparability data, the IRS utilized staff from its Large Business and International Division "to offer expert valuation of compensation."

The report points out the obvious: "The selection of schools used for comparison determines whether total compensation appears to be high or low." As can be expected in most audits, where the IRS modified the peer group, the compensation fell into a higher percentile than that indicated by the peer group utilized by the school.

Interestingly, the report notes that the colleges and universities generally only included other colleges and universities in their peer group. For only one position, that of chief investment officer, private foundations with very large endowments were included in the peer group in some instances.

Establishing the rebuttable presumption of reasonableness

The report found that roughly 20 percent of those examined failed to establish the rebuttable presumption. The failures specified in the report indicate that the following should be taken into account by exempt organizations and their compensation committees, with their deliberations documented accordingly:

1. The following factors should be taken into account prior to the inclusion of an organization in the peer group established for comparison purposes: type, location (urban, rural, suburban, region of the U.S., etc.), tuition, endowment size, revenues, total net assets, number of students, and selectivity (SAT ranges, etc.).
2. Compensation studies should document the selection criteria for the peer group and explain why each organization was deemed comparable.
3. Compensation surveys should specify whether amounts reported included only salary and bonuses or included all other types of compensation, which the report indicates is required by section 4958.

Tally sheet — considering the full compensation package

Many exempt organizations prepare a short form “tally sheet” showing the combined value of all forms of compensation being provided to the executive whose compensation package is being reviewed for reasonableness. Compensation for purposes of determining reasonableness includes all economic benefits provided, generally including all forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, deferred and noncash compensation, qualified and nonqualified retirement plans, payments to welfare benefit plans (medical, dental, disability, etc.), and certain fringe benefits.

Some compensation consultants find that comparison data is weakened by the inclusion of noncash compensation, because such compensation is not consistently calculated and reported on Form 990s across the tax-exempt sector. However, the Treasury Regulations clearly indicate that noncash compensation is included in determining the value of compensation for purposes of determining reasonableness, and should therefore be taken into account in some fashion.

In addition, seeking to ensure that exclusions of fringe benefits and deferred compensation from current wages are proper may help to avoid wage adjustments, which can trigger a host of taxes and penalties on both employer and employee. Employment tax exams opened at 11 of the colleges and universities in the study resulted in over \$35 million in increases to taxable wages, over \$7 million in employment taxes and over \$167 million in penalties.

Conclusion

The Final Report of the Colleges and Universities Compliance Project indicates IRS plans to:

1. Review the unrelated business activities of exempt organizations more broadly, focusing on the characterization of activities as exempt or unrelated, methodologies for allocating expenses between the two, and the use of NOLs to offset UBI, and
2. More closely evaluate the comparability data relied on by nonprofits to establish executive compensation.

As Ms. Lerner indicated, "all exempt organizations need to be aware of the importance of accurately reporting unrelated business income and providing appropriate executive compensation."

If you have any questions about this alert, executive compensation or unrelated business income generally, please contact any of the Hunton & Williams lawyers listed below.

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