NEW SCRUTINY OF COLLEGE AND UNIVERSITY EXECUTIVE COMPENSATION AND UNRELATED BUSINESS ACTIVITY

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I. INCREASING CONGRESSIONAL AND IRS FOCUS ON COLLEGES AND UNIVERSITIES

A. Climate of Heightened Scrutiny and Greater Enforcement

Today colleges and universities are subject to close scrutiny by the United States Congress and the Internal Revenue Service (the "IRS"). Investigations of excessive executive compensation and private benefits have led to the dismissal and resignation of college and university officers.[1] The downturn in the U.S. economy has prompted Congress and the public to question why seemingly large endowment funds are not being used to provide assistance to needy students, particularly in the face of escalating tuition costs. Press reports regarding businesses operated by educational institutions have raised concerns in the for-profit sector. Suggested reforms in the tax treatment of charitable organizations, originally issued in 2004 by the United States Senate Finance Committee, have resulted in certain legislative changes as well as an increased focus on compliance and enforcement initiatives. Senator Charles E. Grassley (R-Iowa) continues to address the need for additional charitable reforms and has focused on hospitals, colleges and universities, and other large charities, questioning whether these organizations should be subject to the same rules as local soup kitchens and homeless shelters. His principal concern is that funds raised by § 501(c)(3) organizations should be used for "charitable" purposes, particularly in the education sector.[2]

Senator Grassley more recently has turned his attention to colleges and universities. He has questioned why wealthy colleges and universities are not spending more endowment money on student aid, and he has sought more information on how colleges and universities "are maximizing their tax-exempt status to fulfill their charitable mission of educating students."[3] Senator Grassley has also indicated the possibility of legislation that would require an annual payout equal to five percent of an educational institution's endowment. In November 2009, following the release of a survey in the Chronicle of Higher Education on annual executive compensation, Senator Grassley continued to express concerns by stating that "[t]he executive suite shouldn't be insulated from belt-tightening."[4]

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1. For example, see *NCSU Fires Mary Easley, Chancellor Quits Amid Turmoil*, NEWS 14 CAROLINA (June 9, 2009), http://charlotte.news14.com/content/top_stories/610366/ncsu-fires-mary-easley--chancellor-quits-amid-turmoil/; Statement from the American University Board of Trustees, Thomas Gottschalk (Oct. 24, 2005), http://www.american.edu/trustees/statements/10242005.html.

2. Charles E. Grassley, *Salaries for College Presidents Go Up*, http://grassley.senate.gov/about/Salaries-for-college-presidents-go-up.cfm (last visited Nov. 18, 2010).

3. Charles E. Grassley, *Wealthy Colleges Must Make Themselves More Affordable*, CHRON. HIGHER EDUC., May 30, 2008, at A36.

4. Press Release, U.S. Senate Committee on Finance, Private College Salaries

At an American Bar Association Section of Taxation meeting in September 2009, Emily Lam, an attorney-advisor in the Office of Tax Policy, indicated that exempt organizations are in a climate of enforcement and disclosure rather than leniency, and that the trend is toward disclosure and transparency (noting "the price to get to exemption is sunshine").[5] She also noted that within the IRS there has been an increased focus on compliance and enforcement "with a lot more looking at what charities are doing."[6]

The IRS's increased focus on compliance and enforcement is evidenced by a number of new initiatives (many of which are directed towards colleges and universities), including the following:

- The IRS 2008 fiscal-year work plan for the Exempt Organization Division announced a renewed focus on IRS examinations of tax-exempt colleges and universities, especially college and university endowments and their use (or lack thereof) in the context of the rising cost of higher education.[7]
- The release of a dramatically revised Form 990 that not only serves as a roadmap for areas of IRS concern, but also gathers significant amounts of information to assist the IRS in its compliance and enforcement efforts.
- The IRS issuance in late 2008 of a compliance questionnaire to over 400 colleges and universities, focusing on endowments and investments, unrelated business taxable income, governance, and executive compensation.[8]
- Continued focus on executive compensation and the application of the excess benefit transaction rules in a number of exempt organization sectors, including colleges and universities.[9]
- Continued focus on governance practices of exempt organizations, including questions on the revised Form 990 and the issuance of a governance checksheet and guidesheet for use by IRS agents in examinations.[10]

Soar as Tuition Goes Up (Nov. 2, 2009), http://finance.senate.gov//newsroom/ranking/release/index.cfm?id=8e69a8a4-7e4a-422f-9739-29e80a2be490.

5. Alison Bennett, *Treasury Official Lam Stresses Charities Face Climate of Enforcement, Transparency*, Daily Tax Rep. (BNA), Sept. 25, 2009, at G-8 .

6. *Id.*

7. *See* FY 2008 EO Implementing Guidelines, Section III.A.2, *available at* http://www.irs.gov/pub/irs-tege/fy08_implementing_guidelines.pdf.

8. A copy of the questionnaire is available at http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf.

9. *See* INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS: FY 2009 WORK PLAN 17 (2008), *available at* http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf.

10. *See* Internal Revenue Service, Governance and Tax-Exempt Organizations—

- An announcement that more than 30 colleges and universities are currently under audit as a result of responses to the college and university compliance questionnaire.[11]
- The issuance of a Congressional Budget Office report on April 30, 2010 on indirect tax arbitrage achieved by colleges and universities through the use of tax-exempt bond financing, which may indicate an additional area of future IRS inquiry.[12]

These initiatives reflect the growing significance of the nonprofit sector in the U.S. economy. And with increasing pressure on national, state, and local governments to raise revenues, nonprofits are likely to continue to find themselves in the crosshairs. In 2005, assets held by § 501(c)(3) organizations exceeded $2.2 trillion, and these organizations generated over $1.25 trillion in revenue. Colleges and universities held more than $400 billion in endowment assets in 2008, the most recent year for which national data is available.[13] In addition, compensation for private college presidents continues to rise. A recent survey found that the presidents of 30 private colleges had annual compensation in 2008 of over $1 million, and that the average annual compensation for the top three most-highly paid presidents exceeded $3 million.[14]

There is also heightened scrutiny by the public of the manner in which exempt organizations compensate their managers. For example, a self-professed public watchdog group recently petitioned the IRS, the Senate Finance Committee, and the Pennsylvania Department of Banking to review alleged excessive compensation paid by the Milton Hershey School and the Milton Hershey School Trust.[15] The petition challenges the

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Examination Materials (2009), *available at* http://www.irs.gov/charities/article/0,,id=216068,00.html.

11. *See* INTERNAL REVENUE SERVICE, IRS EXEMPT ORGANIZATIONS: COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT: INTERIM REPORT at 5 (2010), *available at* http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf [hereinafter *Interim Report*].

12. *See* CONG. BUDGET OFF., TAX ARBITRAGE BY COLLEGES AND UNIVERSITIES (2010), *available at* http://www.cbo.gov/ftpdocs/112xx/doc11226/04-30-TaxArbitrage.pdf\. The Joint Committee on Taxation estimated the cost of this tax advantage, measured in terms of lost revenues had the institutions used taxable debt, at $5.5 billion in 2010. The CBO study focuses on approaches to measuring the amount of tax arbitrage practiced by colleges and universities and the effect of expanding the definition of tax arbitrage and thereby eliminating some of the benefits of tax-exempt financing. This report may lead the IRS to raise questions relating to such indirect tax arbitrage of any colleges and universities under audit.

13. U.S. GOV'T ACCOUNTABILITY OFF., POSTSECONDARY EDUCATION: COLLEGE AND UNIVERSITY ENDOWMENTS HAVE SHOWN LONG-TERM GROWTH, WHILE SIZE, RESTRICTIONS, AND DISTRIBUTIONS VARY (2010), *available at* http://www.gao.gov/new.items/d10393.pdf.

14. Andrea Fuller, *Compensation of 30 Private-College Presidents Topped $1-Million in 2008*, CHRON. HIGHER EDUC., Nov. 19, 2010, at A1.

15. A copy of the letter requesting review is available at

reasonableness of compensation paid to certain board members and also alleges certain conflicts of interest.

B. IRS Compliance Questionnaire and Interim Report for Colleges and Universities

In October 2008, the IRS began a coordinated effort to learn more about the operations and activities of colleges and universities. Of the 2,402 public and private colleges and universities identified as offering four-year degrees or higher in the United States, the IRS selected 400, stratified by size and population, to receive a detailed compliance questionnaire. An entire portion of the questionnaire focused on activities of colleges and universities and the potential unrelated business taxable income from such activities, including expense allocation, losses, and debt-financed property issues. Substantial sections of other portions of the questionnaire related to executive compensation and supplemental benefits. On May 7, 2010, the IRS issued an Interim Report based on the responses to this questionnaire.[16] Meanwhile, more than 30 institutions are currently under IRS examination as a result of their responses to the questionnaire.

The Interim Report summarizes responses from the questionnaire based upon the responding institutions' 2006 tax years.[17] The Interim Report reports the data received from 344 responding colleges and universities—177 of them private and 167 of them public.[18] For the purposes of the Interim Report, the IRS divided the institutions into three groups based on population (small: fewer than 5,000 students; medium: 5,000-14,999 students; large: 15,000 or more students).[19] Of particular relevance to the future landscape for colleges and universities are the findings summarized in the Interim Report regarding executive compensation and unrelated business taxable income and debt-financed property.

1. Executive Compensation Findings

The Interim Report includes information provided by the responding institutions regarding compensation of their executives, as well as their general practices in setting compensation, including amounts and types of compensation, compensation provided by related organizations, executive loans and other extensions of credit, and use of the rebuttable presumption of reasonableness and initial contract exception under the excess benefit transaction rules of I.R.C. § 4958.

In most cases, the institution's highest-paid executive was its chancellor

http://www.witf.org/images/stories/Article_Images/news/PDF/Hershey_Trust_Excessive_Compensation.pdf

16. *Interim Report*, *supra* note 11, at 5.
17. *Interim Report*, *supra* note 11, at 1.
18. *Interim Report*, *supra* note 11, at 1.
19. *Interim Report*, *supra* note 11, at 2.

or president.[20] For executives (meaning officers, directors, trustees, and key employees), the compensation paid by large institutions averaged $420,000 with a median of $357,000, while small institutions paid an average of $200,000 with a median of $174,000.[21] A smaller number of institutions (seven large, five medium, and three or fewer small institutions) also paid compensation to executives through related organizations.[22] In small and medium institutions, the highest paid employee (other than executives) was most often a faculty member, but for large institutions, most often (in forty-three percent of organizations) it was an athletic coach.[23] The average compensation of the highest-paid employee (other than an executive) ranged from $727,000 for large institutions to $142,000 for small institutions, while the median compensation was $285,000 for large institutions and $98,000 for small institutions.[24] Again, a small number of institutions also reported providing compensation (approximately one-half of the total compensation paid) from related organizations (thirteen large, three medium, and five small institutions).[25]

Nearly all institutions reported compensating their executives by base salary and contributions to employee benefit plans, as well as contributions to life, disability, and long-term-care insurance.[26] Approximately one-third of all institutions offered bonuses, and over one-half of medium and large institutions provided housing or utilities as part of their compensation package.[27] Institutions also reported on the provision of institutional vehicles for personal use, personal travel for the employee or the employee's family members, expense reimbursements, personal services provided at the employee's home, health- or social-club dues, and other fringe benefits not covered by I.R.C. § 132.[28]

For the questions relating to the process used to set compensation of the highest paid executives, the IRS instructed public colleges and universities not to complete this section of the questionnaire because, as discussed below, they are not subject to the excess benefit transaction rules of I.R.C. § 4958.[29] For the private institutions, while more than half of all sizes of such institutions reported taking steps to raise the rebuttable presumption of reasonableness when setting compensation, these institutions relied on compensation comparability data less frequently than the other rebuttable

20. *Interim Report*, *supra* note 11, at 54, Fig. 63.
21. *Interim Report*, *supra* note 11, at 55, Fig. 64.
22. *Interim Report*, *supra* note 11, at 55, Fig. 64.
23. *Interim Report*, *supra* note 11, at 51, Fig. 58.
24. *Interim Report*, *supra* note 11, at 52, Fig. 59.
25. *Interim Report*, *supra* note 11, at 52, Fig. 59.
26. *Interim Report*, *supra* note 11, at 57, Fig. 67.
27. *Interim Report*, *supra* note 11, at 57, Fig. 67.
28. *Interim Report*, *supra* note 11, at 57, Fig. 67.
29. *Interim Report*, *supra* note 11, at 60.

presumption requirements (i.e., approval by an independent governing body and contemporaneous documentation).[30] A small number of private institutions reported using the initial contract exception for their six highest paid executives, even though a majority of institutions reported that none of those executives were previously disqualified persons and therefore any fixed payments for such executives would not be subject to the excess benefit transaction rules.[31] The IRS recently announced that it will begin to more closely review the information in the Interim Report to determine whether the comparability data relied upon by reporting institutions is defensible. The IRS will apparently assess whether comparisons were based on individuals within similarly-sized organizations, in similar geographic areas, and with responsibilities similar to those of the senior executives of the reporting institutions.[32]

The Interim Report also indicates that many of the responding institutions (forty-five percent of small, eighty-two percent of medium, and ninety-six percent of large organizations) have related entities, the most common type being related tax-exempt organizations. Many of these institutions also reported that they controlled one or more other organizations. As previously noted, some institutions used such related organizations to provide compensation to their highest paid executives and other employees.

2. Unrelated Business Taxable Income and Debt-Financed Property Findings

The questionnaire asked the institutions to report on the extent of their activities in forty-seven different areas and then queried whether the institutions treated the revenue derived from these activities as tax-exempt or as subject to unrelated business income tax.[33] Questions focused primarily on (1) advertising, including printed publications, internet advertising, billboards, and television or radio broadcasting; (2) corporate sponsorship, including printed materials, events, internet sponsorship, billboards, and television or radio broadcasting; (3) rental of property, including facilities, arenas, recreation centers, athletic facilities, personal property, and telecommunications; and (4) a wide range of miscellaneous activities, including internet and catalog sales, royalties, mailing lists, affinity cards, scientific research and intellectual property, hotels and conference centers, catering and food services, parking lots, bookstores, golf courses, investments in partnerships and S corporations, and controlled

30. *Interim Report*, *supra* note 11, at 63–64, Fig. 79, 81–83.
31. *Interim Report*, *supra* note 11, at 63, Fig. 80.
32. Diane Freda, *University Compensation – Setting Procedures Will Get Further Review by IRS, Lerner Says*, Daily Tax Rep. (BNA), Nov. 26, 2010, at G-3.
33. *Interim Report*, *supra* note 11, at 22.

entities.[34]

The questionnaire also asked the institutions to indicate whether they filed a Form 990-T and reported the activities and the revenue generated on the Form 990-T. The IRS notes in the Interim Report that it intends to explore further the differences between the number of institutions responding that they engaged in certain activities and the lower number of institutions responding that they reported such activities on Form 990-T.[35] The IRS acknowledges that this difference may be attributable to the fact that some business activities are substantially related to the institution's exempt purposes. It is also possible that an exception or exemption, such as the "convenience" exception, is available to shelter the income generated by business activities from the unrelated business income tax. But the IRS states that this will be an area of further study.[36]

Additional questions on the questionnaire required the institutions to report on their expense allocations and whether they relied on advice from independent accountants or counsel when determining whether an activity generated unrelated business income. More than half of the institutions in all size categories indicated that they had indirect expenses, and at least sixty percent of all responding colleges and universities responded that they did not rely on outside advice for determining the tax treatment of revenue from these activities.[37]

3. Anticipated Final Report

The IRS anticipates that it will issue a final report on the information gathered by the compliance questionnaire. The final report will also likely include information from the college and university examinations that are now underway and will allow for extrapolation of its findings to colleges and universities as a sector.[38] The IRS expects that this study will identify areas that warrant additional guidance or further scrutiny, including executive compensation.[39] It is possible that the final report will generate additional examinations of colleges and universities focused on compensation-related or other issues.

4. Resulting College and University Audits

As a result of responses to the college and university questionnaire, the IRS now has more than thirty colleges and universities under audit. It is unknown what responses triggered these examinations, although it is likely that the use of tax-exempt financing, unreasonable executive compensation,

34. *Interim Report, supra* note 11, at 23–26.
35. *Interim Report, supra* note 11, at 29.
36. *Interim Report, supra* note 11, at 31.
37. *Interim Report, supra* note 11, at 31–33.
38. *Interim Report, supra* note 11, at 5.
39. *Interim Report, supra* note 11, at 1.

and unrelated business activities are the primary areas of focus overall. The IRS has not commented on the reasons for the audits, but it previously indicated that it intends to be "exceptionally active" in reviewing the executive compensation paid in tax-exempt organizations.[40] One concern expressed has been that the use of comparables from third-party organizations that set their executive salaries using the initial contract exception under the excess benefit transaction rules may result in inappropriate skewing of the comparables relied upon when determining the reasonableness of executive compensation.[41] The IRS will also have at its disposal additional information about compensation levels and practices based upon filings on the redesigned Form 990 beginning with the 2008 tax year. Other areas of focus may also include employer-provided housing, below-market or interest-free loans, deferred compensation, and miscellaneous items of income such as tax gross-ups, spousal travel expenses, and similar benefits.[42]

The selection of more than thirty colleges and universities for further examination following receipt of the responses to the questionnaire clearly indicates that the IRS is serious about pursuing compliance issues arising from the data and information gathered. Colleges and universities need to be prepared not only to deal with an examination and to explain their positions in the event the IRS implements an examination, but they also should take steps to avoid further scrutiny or adverse findings should an examination occur. This will require colleges and universities to review their executive-compensation practices as well as their reporting positions with respect to business activities.

II. EXECUTIVE COMPENSATION AND I. R. C. § 4958

A. History of "Intermediate Sanctions"

Until the excess benefit transaction rules of I.R.C. § 4958 were enacted in July 1996, the IRS had only one enforcement tool it could use when a person had abused his position within a charitable or educational organization by using his position or influence within the organization to

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40. Tom Gilroy, *IRS Plans to Stay Focused on EO Executive Compensation, Miller Says*, Daily Tax Rep. (BNA), Nov. 21, 2008, at G-6.

41. Diane Freda, *IRS Exploring Initial Contract Exception's Impact on Exempts' Executive Compensation*, Daily Tax Rep. (BNA), July 2, 2009, at G-2.

42. The IRS appears to have a particular interest in exempt organization deferred compensation. This is likely influenced by the requirements of I.R.C. § 409A that were enacted in 2004. The IRS has announced its intent to coordinate the deferred-compensation rules for tax-exempt organization plans in I.R.C. § 457 with the § 409A requirements. *See* I.R.S. Notice 2007-62, 2007-32 I.R.B. 331 (announcing the intent to issue new guidance regarding (1) the exemption under § 457(e)(11) for bona fide severance-pay plans and (2) the definition of "substantial risk of forfeiture" in § 457(f)(3)(B)).

obtain unwarranted benefits for himself or related parties.[43] The only sanction available to the IRS was revocation of the organization's tax-exempt status, which could have a devastating effect on a charity, especially if it relied on either deductible charitable contributions or tax-exempt financing for funding. Revocation is often a disproportionate and misdirected sanction that inappropriately punishes the charity, its employees, and, most importantly, the community that it serves, while allowing the insiders who benefited from the abusive transaction to retain the benefit of their misconduct. These shortcomings highlighted the need for an enforcement tool that could directly penalize those who engaged in the improper behavior without affecting innocent parties.

In 1976, and again in 1987, Congress enacted a form of intermediate sanctions for public charities that engage in lobbying or political activities in violation of I.R.C. § 501(c)(3).[44] But Congress did not develop intermediate sanctions for violations of the prohibition on private inurement until the early 1990s, after a few highly publicized cases of such wrongdoing. The IRS's inability to address these potentially abusive transactions without revoking the charitable organization's tax-exempt status led to a renewed call for a form of intermediate sanction for improper transactions involving public charities.

The Clinton Administration shared Congress's concern that existing tax law did not adequately curtail abusive transactions. The administration's views were first expressed by IRS Commissioner Margaret Richardson testifying at a hearing of the House Ways and Means Oversight Committee investigating specific cases of perceived abuses.[45] Commissioner Richardson stressed that the absence of any sanctions, short of revocation of exempt status, for a public charity's violations of the private inurement and private benefit rules was creating serious enforcement problems for the IRS. Commissioner Richardson noted that the consequences of revocation are often highly disproportionate to the violation, and often punish the wrong parties by threatening the continued existence of the public charity and its ability to perform needed services for its community while allowing those abusing the charity to retain the benefits of their misconduct.

Not long after the Commissioner's testimony, the administration proposed the enactment of intermediate sanctions for public charities in

43. Treas. Reg. §§ 53.4958-1 to 53.4958-7 (as amended in 2002).

44. In 1976, Congress incorporated a form of intermediate sanctions in the I.R.C. § 501(h) rules governing lobbying by public charities, I.R.C. § 501(h) (West 2010), and in 1987, adopted a two-tier, foundation-type penalty-tax scheme in I.R.C. § 4955 for public charity violations of the prohibition on intervention in political campaigns. I.R.C. § 4955 (West 2010).

45. *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways & Means*, 103d Cong. 8 (1993) (statement of Margaret M. Richardson, Comm'r, IRS).

violation of the inurement prohibition. The Department of Treasury, in consultation with the IRS, forwarded to Congress a detailed proposal for legislation intended to provide the government with effective targeted sanctions. The general approach was to adopt a series of graduated levels of penalty taxes on "disqualified persons" and "organization managers" that engage in "excess benefit transactions" for their own private benefit with "applicable tax-exempt organizations."

Congress agreed that it needed to cure this serious weakness in the tax law and, with broad support from the charitable sector, enacted I.R.C. § 4958 on July 30, 1996. Section 4958 was enacted as a "narrowly tailored" intermediate sanction scheme based on the Treasury proposal, taxing excess benefit transactions and unreasonable compensation agreements between public charities (and § 501(c)(4) civic leagues and social welfare organizations) and certain "disqualified persons."[46]

Colleges and universities must be keenly aware of the potential application of the excess benefit transaction rules to compensation arrangements and other transactions common to colleges and universities. For example, excessive or unreasonable compensation, not only for the chief administrative officers of a school, but also for influential academic officers, athletic coaches, and board members, can potentially subject these persons to excise taxes under § 4958. These transactions can be complicated by the detailed requirements of the regulations under the law.

B. Overview of Excess Benefit Transaction Rules Under § 4958

The excess benefit transaction rules of § 4958 impose an excise tax on certain "disqualified persons" (basically traditional corporate insiders, their families, and related organizations) that engage in an "excess benefit transaction" with an "applicable tax-exempt organization."[47] This tax is paid by the disqualified person and initially is equal to twenty-five percent of the amount of the excess benefit.[48] The public charity is never subject to any tax under § 4958. If more than one disqualified person benefitted from a single transaction, all such disqualified persons are jointly and severally liable for the excise tax.[49]

Section 4958(b) imposes a second-tier tax on the disqualified person of 200% of the amount of the excess benefit if the violation is not corrected within the applicable taxable period, as discussed below.[50] If part of the transaction is corrected, the second-tier tax is imposed only on that part

46. For a detailed discussion of the history of I.R.C. § 4958 and an analysis of its provisions, see Milton Cerny & Catherine Livingston, *IRS Intermediate Sanctions: How They Will Impact Colleges and Universities*, 25 J.C. & U.L. 865 (1999).

47. I.R.C. § 4958(a)(1) (2006); Treas. Reg. § 53.4958-1(a).

48. I.R.C. § 4958(a)(1) (2006).

49. Treas. Reg. § 53.4958-1(c)(1).

50. *See infra* Part II.H.

which is not corrected.[51] An excise tax may also be imposed on "organization managers" who participate in an excess benefit transaction. Any organization manager (i.e., a director, trustee, or officer) who participates in the transaction knowing that it is an excess benefit transaction is also liable for an excise tax of ten percent of the amount of the excess benefit unless such participation is not willful and is due to reasonable cause.[52] The maximum aggregate tax that can be imposed on all of the organization managers for any single excess benefit transaction is $20,000.[53] The organization managers are jointly and severally liable for such tax.[54]

An organization manager "participates" in an excess benefit transaction not only where he takes affirmative action with respect to the transaction (such as voting to approve an unreasonable compensation arrangement), but also when he is silent or fails to take action when under a duty to speak or act.[55] Where an organization manager opposes a proposed transaction in a manner consistent with his obligation to the organization, he is not considered to have "participated" in the transaction.

The organization manager must have actual knowledge of facts that would support treating the transaction as an excess benefit transaction.[56] In addition, the manager must be aware that there are limits on excess benefit transactions.[57] Finally, the manager must negligently fail to make reasonable attempts to ascertain whether the transaction was an excess benefit transaction.[58]

An organization manager's participation will be due to reasonable cause, and therefore will not give rise to excise tax exposure, if the manager exercised ordinary business care and prudence in relation to the transaction. The regulations under § 4958 offer a safe harbor for organization managers who rely on professional advice. An organization manager will not be subject to tax if the manager fully discloses the factual situation to an appropriate professional and then relies on the reasoned written opinion of the professional with respect to elements of the transaction within the professional's expertise.[59] Appropriate professionals include legal counsel, certified public accountants or accounting firms with expertise regarding

51. Treas. Reg. § 53.4958-1(c)(2).
52. I.R.C. § 4958(a)(2).
53. As amended by the Pension Protection Act of 2006, the maximum limit of $20,000 per excess benefit transaction applies to taxable years beginning after August 17, 2006. For prior years, the maximum limit was $10,000. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212, 120 Stat. 780, 1074 (codified as amended at I.R.C. § 4958(d)(2)).
54. Treas. Reg. § 53.4958-1(d)(8).
55. *Id.* § 53.4958-1(d)(3).
56. *Id.* § 53.4958-1(d)(4)(i)(A).
57. *Id.* § 53.4958-1(d)(4)(i)(B).
58. *Id.* § 53.4958-1(d)(4)(i)(C).
59. *Id.* § 53.4958-1(d)(4)(iii).

the relevant tax laws, and independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the property or services involved, and include in the written opinion a certification that they meet these requirements.[60] Also, a manager's participation will not ordinarily be considered "knowing" if the requirements for raising the rebuttable presumption of reasonableness (discussed below) are met.[61]

C. Applicable Tax-Exempt Organizations and Application of Excess Benefit Transaction Rules to Colleges and Universities

Section 4958 only applies to "applicable tax-exempt organizations," which are defined to be those organizations that would be exempt from federal income tax pursuant to I.R.C. §§ 501(c)(3) or 501(c)(4). A special "lookback" rule deems an organization an applicable tax-exempt organization for the five-year period ending on the date of an excess benefit transaction.[62] In addition, although private foundations are § 501(c)(3) organizations, they are excluded from the definition of "applicable tax-exempt organizations" because they are otherwise subject to the self-dealing rules under I.R.C. § 4941.[63]

Most nonprofit private colleges and universities draw their federal income tax exemption from § 501(c)(3). They are classified as public charities under I.R.C. § 509(a)(1) because they are educational institutions within the meaning of I.R.C. § 170(b)(1)(A)(ii). On the other hand, public colleges and universities generally rely on exemption from federal income tax as an arm of a state or a political subdivision under I.R.C. § 115, and are therefore not subject to the excess benefit transaction rules.[64] Those public institutions that otherwise would qualify for exemption under § 501(c)(3) and that may have obtained their own determination letter recognizing them as exempt under § 501(c)(3) (typically as a convenience for their donors) are specifically excepted from the excess benefit transaction rules if they are governmental units.[65]

D. Disqualified Persons

The definition of "disqualified person" is a key part of § 4958. Only transactions with disqualified persons come within the scope of § 4958. In general, a disqualified person is any person who, at any time during the five-year period ending on the date of the transaction, was in a position to

60. Treas. Reg. § 53.4958-1(d)(4)(iii).
61. *Id.* § 53.4958-1(d)(4)(iv). *See infra* Part II.G.
62. I.R.C. § 4958(e) (2006); Treas. Reg. § 53.4958-2(a) (as amended in 2008).
63. Treas. Reg. § 53.4958-2(a)(2)(i).
64. *Id.* § 53.4958-2(a)(2)(ii).
65. *Id.*; Rev. Proc. 95-48, 1995-2 C.B. 418.

exercise substantial influence over the affairs of the organization.[66] Certain persons are presumed to be disqualified persons under § 4958, while others may be disqualified persons depending upon the facts and circumstances.[67]

1. Definite Categories of Disqualified Persons

The following persons are presumed, by virtue of their positions, to exercise substantial influence over the affairs of the charitable organization and thus to be disqualified persons:

> *Voting Members of Governing Body*. Any individual serving on the governing body who is entitled to vote on any matter over which the governing body has responsibility.[68]
>
> *President, Chief Executive Officer, or Chief Operating Officer*. Any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the administration, management, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise.[69]
>
> *Treasurer or Chief Financial Officer*. Any person who has ultimate responsibility for managing the finances of the organization. A person who serves as treasurer or chief financial officer has this ultimate responsibility unless the person demonstrates otherwise.[70]

In addition, family members of the persons described above are disqualified persons.[71] Family members include the person's spouse, siblings (whether by whole or half blood), ancestors, children, grandchildren, great-grandchildren, and the spouses of siblings, children, grandchildren, and great-grandchildren.[72] Also, entities that are thirty-five percent or more controlled by the persons described above and their family members are disqualified persons. In the case of a corporation, control is based on owning thirty-five percent or more of the total combined voting

66. Treas. Reg. § 53.4958-3(c).
67. *Id.* § 53.4958-3(a)(1).
68. *Id.* § 53.4958-3(c)(1).
69. *Id.* § 53.4958-3(c)(2).
70. *Id.* § 53.4958-3(c)(3).
71. *Id.* § 53.4958-3(b)(1).
72. Treas. Reg. § 53.4958-3(b)(1).

power of the corporation.[73]

2. Facts and Circumstances Test

If a person does not fall into one of the definite categories of disqualified persons, the person may still be a disqualified person. The determination of whether a person has substantial influence over the affairs of the organization such that he is a disqualified person is based on all relevant facts and circumstances.[74] The Treasury Regulations indicate that the following facts and circumstances "tend to show" that a person has substantial influence over the affairs of an organization such that the person is a disqualified person:

- The person founded the organization;
- The person is a substantial contributor to the organization during the current year and has been for the four preceding years;
- The person's compensation is based primarily on revenues derived from activities of the organization that the person controls;
- The person has authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization as compared to the organization as a whole; or
- The person owns a controlling interest in a corporation, partnership, or trust that is a disqualified person.[75]

The IRS takes the position that it is not necessary for a person to actually exercise substantial authority over the affairs of the organization to be a disqualified person under the "facts and circumstances" test. A person who is merely in a position to do so apparently can be a disqualified person.[76]

Conversely, the following facts and circumstances tend to show the

73. *Id.* § 53.4958-3(b)(2)(i), (ii).

74. *Id.* § 53.4958-3(e)(1).

75. *Id.* § 53.4958-3(e)(2).

76. *See* Lawrence M. Brauer & Leonard J. Henzke, Jr., *Intermediate Sanctions (IRC 4958) Update*, EXEMPT ORGS. CONTINUING PROF. EDUC. TECHNICAL INSTRUCTION PROGRAM 9, *available at* http://www.irs.gov/pub/irs-tege/eotopice03.pdf. ("In considering all the relevant facts and circumstances to determine whether a person is a disqualified person as to an applicable tax-exempt organization, it is *not* required that a person *actually exercised* substantial influence over the affairs of an organization, only that the person was in a *position* to exercise substantial influence. . . . Thus, although a person may not have actually exercised substantial influence over the affairs of the organization, if the person was in a *position* to do so at any time during the Lookback Period, this person is a disqualified person as to the organization.").

person does not have substantial influence over the affairs of an organization:

- The person has taken a bona fide vow of poverty as an employee, agent, or on behalf of, a religious organization;
- The person is an independent contractor, such as an attorney, accountant, or investment manager, whose sole relationship with the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the independent contractor will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);
- The direct supervisor of the person is not a disqualified person; or
- The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization.[77]

In addition, employees (either full-time or part-time) who receive total economic benefits below the dollar threshold for determining "highly compensated employee" status under I.R.C. § 414(q) are not disqualified persons, provided that they are not otherwise a disqualified person by virtue of their position and are not a substantial contributor. In applying this exception, all economic benefits directly or indirectly received by the employee from the organization must be taken into account, not just compensation.[78]

3. Disqualified Persons at a College or University

Persons holding certain positions at a college or university fall within the definite categories of disqualified persons. These include presidents, chancellors, and rectors because of their ultimate authority for management and supervision of the institution, as well as chief financial officers, treasurers, and vice presidents of finance because of their ultimate responsibility for managing the institution's finances. Similarly, voting members of the institution's board of trustees or board of directors are disqualified persons. And individuals who held any of these positions during the five-year "lookback" period continue to be disqualified persons with respect to the college or university.

Provosts, chief academic officers, and others with significant managerial authority may be disqualified persons under the "facts and circumstances" test. Deans of professional schools and chairs of academic departments that represent a substantial portion of the institution's overall activities,

77. Treas. Reg. § 53.4958-3(e)(3).
78. *See id.* § 53.4958-3(d)(3). The dollar threshold for 2010 is $110,000.

assets, income, or expenses may also be disqualified persons depending on the underlying facts and circumstances.[79]

In addition, there are certain other positions that, because of their increasing stature in recent years, require close examination under the facts and circumstances test to determine whether persons holding those positions are disqualified.

Athletic Coaches. Concerns about the status of athletic coaches have existed for some time. During hearings on the proposed regulations under § 4958, commentators expressed concerns that the facts and circumstances test could include a broader group of persons than the statute was intended to cover. One commentator specifically asked the IRS to modify the regulations to clarify that college or university athletic coaches were not disqualified persons because they do not have sufficient influence over the affairs of the school as a whole.[80] The final regulations do not contain any specific guidance regarding athletic coaches but the following was added to the list of factors tending to show an absence of substantial influence over the affairs of the organization:

> The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.[81]

This factor can provide a basis for not treating many athletic coaches as disqualified persons, absent other factors that would indicate substantial influence over the organization or falling within one of the definite categories. For example, a coach of an athletic program that does not represent a substantial portion of the activities, assets, income, or expenses of the college or university, as compared to the college or university as a whole, generally would not be a disqualified person absent some other factor.[82] However, the head coach of a sport that generates a substantial

79. *Id.* § 53.4958-3(g), Ex. 8. This example addresses the status of a law-school dean at a large university. The example concludes that she is a disqualified person because of her role in hiring faculty, her control over the capital expenditures and budget of the law school, and the fact that the law school represents a substantial portion of the income of the university.

80. *Regulations to Implement New Intermediate Sanctions Statute: Public Hearings on Proposed Regulations Under Section 4958 Before the IRS Oversight Board* (testimony of Dorothy Robinson, Vice President and Gen. Counsel, Yale Univ., on behalf of the Am. Council on Ed.), http://www.aau.edu/WorkArea/showcontent.aspx?id=2728.

81. Treas. Reg. § 53.4958-3(e)(3)(iv).

82. The Treasury Regulations include a helpful example concerning the chairman of a small academic department within the college of arts and sciences of a large

portion of the college's or university's income could be a disqualified person as a result of the management authority over that program, even if such management authority is shared with another, such as an athletic director. In addition, substantial increases in compensation levels for head coaches of large college and university athletic programs make the status of such persons under the excess benefit transaction rules highly important. For example, from 2007 to 2009, the average pay for a head coach in the NCAA's 120-school Football Bowl Subdivision rose forty-six percent to $1.4 million.[83] Similarly, the average pay for a head coach of the sixty-five schools that competed in the 2009 NCAA men's basketball tournament was nearly $1.3 million.[84]

Endowment Managers. The explosive growth of college and university endowments in recent years has been well documented. Even after the financial crisis of 2008–2009, the endowments of a number of colleges and universities are staggeringly large.[85] In light of the size of endowments, careful consideration should be given to the potential status of endowment managers as disqualified persons. If it is determined that an endowment manager is a disqualified person under § 4958, particular care should be exercised in setting the manager's compensation, particularly in light of the high compensation often paid to these managers in order to attract them from the for-profit sector. If the endowments represent a substantial portion of a college or university's assets, the endowment manager's authority over the investment (and disposition) of those assets may be sufficient to establish substantial influence under the "facts and circumstances" test.

E. Organization Managers

Organization managers who participate in an excess benefit transaction may also be subject to the excise tax under § 4958. The term "organization manager" includes, with respect to any applicable tax-exempt organization, any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or

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university. The example concludes that the dean is not a disqualified person even though he exercises various management responsibilities with respect to the department, because his department does not represent a substantial portion of the university's activities, assets, income, expenses, or operating budget. *Id.* § 53.4958-3(g), Ex. 9.

83. Steve Berkowitz, *IRS Audits of Schools Might Delve into Salaries of Coaches; Corporate Sponsorships Could be Scrutinized*, USA TODAY, May 24, 2010, at 7C.

84. *Id.*

85. *See* Goldie Blumenstyk, *Why the Endowment-Spending Debate Matters Now More Than Ever*, CHRON. HIGHER EDUC., Mar. 7, 2010, *available at* http://chronicle.com/article/Why-the-Endowment-Debate/64527/ (over fifty colleges and universities have endowments worth more than $1 billion).

trustees of the organization.[86] In general, the definition is limited to those officers, directors, or trustees of the organization with final authority or responsibility for decisions.[87] Independent contractors such as attorneys, accountants, and investment managers, or advisers acting in those capacities, are not considered organization managers.[88] Also, the term "organization manager" does not include any person who was an organization manager during the five-year "lookback" period (unlike the term "disqualified person"). The excise tax cannot be imposed on such individuals for transactions occurring after they ceased to act as organization managers.

F. Excess Benefit Transactions

Section 4958 applies to a broad array of transactions. The term "excess benefit transaction" means any transaction where an applicable tax-exempt organization provides an economic benefit (either directly or indirectly) to a disqualified person and the value of that economic benefit exceeds the consideration received by the applicable tax-exempt organization.[89]

Excess benefit transactions include payments of unreasonable compensation and non-fair market value transactions with the organization, such as the purchase from the organization of assets for less than fair market value or the sale of assets to the organization for greater than fair market value.[90] The following discussion focuses on compensatory transactions with disqualified persons at colleges or universities subject to § 4958 or related entities.

1. General Principles

To determine whether there has been an excess benefit transaction, generally all consideration and economic benefits exchanged either directly or indirectly between the parties will be taken into account. In a compensatory context, this means all forms of payment such as salary, fees, bonuses, severance pay, deferred compensation, and retirement benefits, as

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86. I.R.C. § 4958(f)(2) (1996).

87. Treas. Reg. § 53.4958-1(d)(2).

88. *Id.* § 53.4958-1(d)(2)(B).

89. *Id.* § 53.4958-4(a)(1).

90. While compensation arrangements commonly present potential excess benefit transaction issues, there are a number of other types of transactions that can present concerns under § 4958. For examples of other types of transactions that the IRS has asserted were excess benefit transactions, compare Caracci v. Comm'r, 118 T.C. 379 (2002) (transfers of a tax-exempt organization's assets to a for-profit organization for inadequate consideration) with Dzina v. United States, 345 F. Supp. 2d 818 (N.D. Ohio 2004) (repossession of commercial property following a tax-exempt organization's default on an installment sale contract for that property) and I.R.S. Priv. Ltr. Rul. 2002-43-057 (Oct. 25, 2002) (loans to parties related to a tax-exempt organization).

well as non-cash compensation.[91] Certain limited types of compensation are disregarded when evaluating the reasonableness of compensation paid to a disqualified person, as discussed below.[92] In addition, there must be written evidence that the parties intended to treat that compensation as consideration for the performance of services at the time compensation is paid.

Section 4958 contains certain general principles for evaluating whether a compensation payment may constitute an excess benefit transaction. The first general principle is that both current and prior services provided by a disqualified person may be considered when evaluating the reasonableness of compensation.[93] For example, if a college or university president is promised at age fifty-eight that she will receive a supplemental retirement payment at age sixty-two if she remains in continuous employment to that age, her total years of service up to and including the year she turns sixty-two could be taken into account when evaluating the reasonableness of that payment, not merely the services she performs the year she turns sixty-two.

Second, compensation paid both directly and indirectly by a college or university must be evaluated when determining its reasonableness. Indirect payment of compensation can arise in two circumstances. The first is when compensation is paid by an entity controlled by the college or university. The other situation is when compensation is paid through an intermediary.[94]

For purposes of these rules, a college or university is considered to control another entity when:

- In the case of a corporation, the institution owns fifty percent or more of the stock;
- In the case of a partnership, the institution owns fifty percent or more of the capital or profits interests;
- In the case of a non-stock corporation, the institution's directors, trustees, employees, or agents constitute fifty percent or more of the directors or trustees, or the institution appoints or elects fifty percent or more of the directors or trustees; or
- In the case of other entities, such as trusts, the institution owns fifty percent or more of the beneficial interests.[95]

Ownership for these purposes is determined using the constructive ownership rules of I.R.C. § 318, even for non-corporate entities, similar to the manner in which control is determined for controlled organization

91. Treas. Reg. § 53.4958-4(b)(1)(ii)(B)(*1*).
92. *See infra*, notes 105–06 and accompanying text.
93. Treas. Reg. § 53.4958-4(a)(1).
94. *Id.* § 53.4958-4(a)(2).
95. *Id.* § 53.4958-4(a)(2)(ii).

purposes under the unrelated business income tax rules.[96]

The intermediary rule applies where the college or university does not have sufficient ownership or representation on the board of a third-party payor of compensation to cause that third-party payor to be a controlled entity, or when the payment is through a person rather than an entity. For purposes of this rule, an intermediary is any individual or entity (whether tax-exempt or taxable) that indirectly participates in an excess benefit transaction on behalf of the college or university. To establish an intermediary relationship, the college or university must provide an economic benefit to the intermediary, and either (1) there is an oral or written agreement or understanding that the intermediary will provide an economic benefit to or for the use of the disqualified person, or (2) the intermediary provides an economic benefit to or for the use of the disqualified person without a business purpose or an exempt purpose of its own for providing the economic benefit.[97]

The breadth of the indirect payment rules for controlled entities and intermediaries requires that many types of third-party payment arrangements be treated as payments by the college or university. For example, payments by an affiliated foundation or supporting organization to supplement compensation that the college or university pays directly to its president or other key administrators will in many circumstances be treated as payment directly by the college or university, thereby requiring that the supplemental compensation be aggregated with compensation actually paid by the college or university when evaluating the reasonableness of compensation paid to such persons. Therefore, colleges and universities must be aware of any related-party compensation arrangements with their disqualified persons to properly evaluate whether compensation is excessive. In addition, affiliated foundations may be subject to the excess benefit transaction rules even where the institution as a public college or university may not be. In these circumstances, it is common for foundations to supplement the compensation of the president and for the president to be a trustee or director of the foundation and therefore a disqualified person with respect to the foundation. In such a case, the foundation must determine the reasonableness of the total compensation paid to the president, even when the college or university is not required to do so. The foundation should also take steps to raise the rebuttable presumption of reasonableness, discussed below, in this circumstance.

2. Reasonableness Test

The regulations under § 4958 impose a reasonableness test for evaluating whether compensation is excessive relative to the services

96. *See* I.R.C. § 318(a) (1996).
97. Treas. Reg. § 53.4958-4(a)(2)(iii).

performed by the disqualified person. This test measures the value of the services based on what would ordinarily be paid for like services by like enterprises under like circumstances.[98] The types of like enterprises that can be considered are not limited to tax-exempt organizations. Taxable enterprises may be considered to the extent they are sufficiently similar to the applicable tax-exempt organization paying the compensation.[99]

IRS challenges as to the reasonableness of compensation are generally based on factors similar to those that the IRS considers in challenging compensation deductions under I.R.C. § 162. In fact, the regulations under § 4958 incorporate the standards of § 162 for determining reasonableness of compensation for purposes of § 4958.[100] The factors under § 162 include whether the compensation was the subject of true arm's-length bargaining, the size and complexity of the organization, the nature of the duties and responsibilities of the disqualified person, the disqualified person's qualifications and prior compensation, the disqualified person's performance, how the disqualified person's compensation compares with that of other similarly situated employees of the organization, and whether an outside investor would be likely to approve the compensation.[101]

The time at which the reasonableness of compensation is measured depends upon whether the compensation is a "fixed payment." A fixed payment is either a specific amount or an amount that is determined under a fixed non-discretionary formula.[102] That amount or formula must be specified in a binding written contract (such as an employment agreement).[103] The reasonableness of a fixed payment is generally evaluated based on facts and circumstances at the time the contract was entered into by the parties, not when the compensation is paid.[104] Therefore, the IRS generally cannot challenge the reasonableness of a fixed payment that occurs several years after the date of the contract. Instead, the reasonableness of the payment may only be challenged based on circumstances existing at the time the parties entered into the contract. Consequently, fixed-payment arrangements allow colleges and universities to establish reasonableness at the outset of entering into a written compensation arrangement, such as through reliance on then-current compensation comparability data, and can eliminate the need for the

98. *Id.* § 53.4958-4(b)(1)(ii)(A).

99. *Id*.

100. *Id*.

101. These factors are described in the notice of deficiency that the IRS issued in the first intermediate sanctions case that it brought concerning unreasonable compensation. *See* Bruce Hopkins, *First Intermediate Sanction Excess Compensation Case Arrives in U.S. Tax Court; Penalties Total $6.4 Million*, THE NONPROFIT COUNSEL, Vol. XVII, No. 12 (Dec. 2000).

102. Treas. Reg. § 53.4958-4(a)(3)(ii).

103. *Id.* § 53.4958-4(a)(3)(iii).

104. *Id.* § 53.4958-4(b)(2)(i).

frequent compensation surveys and studies associated with non-fixed or discretionary payments under a contract.

A different timing rule applies for payments that are not fixed payments or that are fixed payments but are paid despite substantial non-performance under the contract (such as a payment made despite the disqualified person's failure to complete the full term of an employment agreement). In these circumstances, the reasonableness of the payment is evaluated at the time the payment is actually made. Changes in compensation comparability data from the time the compensation arrangement was entered into to the time when the compensation is actually paid are potentially relevant to the reasonableness determination. This typically should not pose a problem in an environment of escalating or stable pay levels. However, changes in economic circumstances that reduce comparable pay or changes in pay practices may cause a non-fixed payment (or a fixed payment without substantial performance by the disqualified person) to fail to meet the reasonableness test when actually paid.[105]

3. Included Compensation

The reasonableness standards described above must be applied to the total compensation received by the disqualified person. Compensation includes all forms of cash and non-cash payments, and includes such items as salary, fees, bonuses, severance pay, deferred compensation, qualified retirement plan benefits (such as contributions to a § 403(b) plan), non-qualified deferred compensation, and compensatory transfers of property.[106]

Other types of compensation and benefits must be similarly included in the evaluation, even if they are not included in the disqualified person's taxable income. Examples include payments to welfare-benefit plans (e.g., medical, dental, life insurance), severance pay, disability benefits, fringe benefits (other than fringe benefits described in I.R.C. § 132), expense allowances or reimbursements (unless paid under an accountable plan), and the economic benefit of below-market loans. In addition, premiums paid

105. In addition to these timing rules, the regulations also have special timing standards for determining when an excess benefit transaction occurs. As a general matter, an excess benefit transaction occurs when unreasonable compensation is paid (or on the last day of the taxable year for multiple compensation payments paid in one year under a single contractual arrangement, such as an employment agreement). Excess benefit transactions involving qualified retirement-plan benefits or compensatory transfers of property under I.R.C. § 83 are treated as occurring when the benefits or property become vested. Treas. Reg. § 53.4958-1(e). In the case of a compensatory transfer of property, the transaction occurs when the property is no longer subject to a substantial risk of forfeiture unless the disqualified person has made an election under I.R.C. § 83(b), in which case the general timing rule applies. *Id.* § 53.4958-1(e)(2).

106. *Id.* § 53.4958-4(b)(1)(ii)(B)(*1*).

for liability insurance covering liability under § 4958 and certain fiduciary liabilities are also included, as are reimbursements for such expenses if they are not covered by insurance, unless such amounts are excluded from the disqualified person's income under § 132(a)(4) as de minimis fringe benefits.[107]

There are a limited number of pay items that can be excluded from the reasonableness determination. Excluded items include fringe benefits that are not included in income under I.R.C. § 132 (other than certain liability insurance premiums, payments, or reimbursements), and expense reimbursements received under an accountable plan.[108] There are some other categories of excluded benefits, but they generally are not relevant to standard compensation arrangements.[109]

4. Compensatory Intent Requirement

One of the more problematic aspects of the excess benefit transaction rules, and a proverbial "trap for the unwary," is the requirement that the payments to a disqualified person be specifically intended as compensation for services provided by the disqualified person. The organization must clearly indicate its intent to treat the benefit as compensation when the benefit is paid.[110] Failure to establish contemporaneous compensatory intent generally will result in an "automatic" excess benefit transaction (i.e., the compensation is automatically an excess benefit because it is treated as having been paid without any exchange of consideration from the disqualified person).

To establish compensatory intent, contemporaneous substantiation of such intent is required. There are two primary means of establishing contemporaneous substantiation.

Contemporaneous Tax Reporting. The primary method for establishing contemporaneous compensatory intent is to show that the compensation was properly reported for federal tax purposes. This can be accomplished by showing that the compensation was reported by the college or university (or other payor when the compensation was paid indirectly) on Form W-2 or Form 1099, as appropriate. Even if the college or university did not properly report the compensation, contemporaneous substantiation is shown if the disqualified person reported the compensation on his or her

107. *Id.* § 53.4958-4(b)(1)(ii)(B)(*3*).

108. *Id.* § 53.4958-4(a)(4)(i)–(ii) (accountable plan is an expense reimbursement arrangement that meets the requirements of Treas. Reg. § 1.62-2(c)).

109. These other exclusions include (1) economic benefits provided to volunteers (so long as the benefit is provided to the general public in return for a membership fee or an annual contribution of $75 or less) and (2) economic benefits provided to members or donors solely on account of the payment of membership fees or charitable contributions (provided that certain conditions are met). *Id.* § 53.4958-4(c)(1).

110. Treas. Reg. § 53.4958-4(c)(1).

individual income tax return. If compensation is not reported on the originally filed report or return, reporting it on an amended report or return is sufficient to establish contemporaneous substantiation of compensatory intent provided that the amended return or report is filed before the initiation of an IRS examination of the college or university or of the disqualified person who received the compensation. In addition, an institution's failure to report compensation will not prevent the establishment of compensatory intent if the reporting failure was due to reasonable cause. The conditions to establish reasonable cause in this context, however, are relatively narrow.[111]

Contemporaneous Written Documentation. A college or university may also establish compensatory intent through other written evidence. This may include, but is not limited to, an approved employment contract that was executed by the parties before the compensation or benefit was paid or provided.[112] Similarly, documents which indicate that the college or university followed the required steps for establishing a rebuttable presumption of reasonableness can be relied upon to establish compensatory intent.[113]

The requirement to show compensatory intent does not apply to compensation that is excludable from the disqualified person's income.[114] This exception covers employer-provided health plans, contributions to and benefits under tax-advantaged retirement plans (such as § 401(a) and § 403(b) plans) and certain fringe benefits. However, even though establishment of compensatory intent is not required for such compensation, the compensation generally must be taken into account in evaluating the reasonableness of the total compensation payable to the disqualified person (except for the limited exclusions discussed above).[115]

IRS National Office training materials provide useful insight into how the IRS applies this requirement.[116] The training materials identify specific

111. *See id.* § 53.4958-4(c)(3)(i). Reasonable cause is only available if the college or university can show "significant mitigating factors" for the reporting failure or that the event arose from events beyond its control. In either case, the college or university must also show that it acted in a reasonable manner both before and after the reporting failure occurred. *See also Id.* § 301.6724-1(b)–(d) (as amended in 2004).

112. *Id.* § 53.4958-4(c)(3)(ii)(A).

113. The procedures for establishing a rebuttable presumption of reasonableness are discussed below. *See infra* Part II.G. It is important to note that those procedures require approval of the compensation before it may be paid. Therefore, similar to the rule for approved employment contracts, other written evidence of compensatory intent must be in place before the compensation is paid.

114. Treas. Reg. § 53.4958-4(c)(2).

115. *See supra* Part II.F.3.

116. *See* Lawrence Brauer & Leonard Henzke, Jr., *"Automatic" Excess Benefit Transactions Under IRC 4958* (2004), *available at* http://www.irs.ustreas.gov/pub/irs-

types of compensation arrangements that examining agents should review in evaluating whether the requirement is met. The materials indicate that failure to meet the requirement will typically result in an automatic excess benefit transaction, even where the compensation would otherwise be reasonable, either on its own or when aggregated with other compensation for which contemporaneous substantiation is established.[117]

5. Initial Contract Exception

An important exception from the excess benefit transaction rules is available for some forms of compensation paid under an employment agreement or other binding written contract between a college or university and a person who was not a disqualified person immediately before entering into the contract.[118] This initial contract exception is most commonly available when a college or university plans to hire a new employee who will be a disqualified person once he begins employment. It is also available for employment agreements and compensation arrangements that are put in place with existing employees before they experience a change in position or responsibility (or other circumstances) that cause them to become a disqualified person.

The practical usefulness of this exception is limited by the fact that it only applies to fixed payments. As discussed earlier, a fixed payment is any payment of cash or property that is either of a specific amount or which is determined under a fixed formula. The amount or the formula must be described in the written contract. The contract must also specify the services for which the compensation will be paid.[119]

A formula does not fail to be a fixed payment merely because payment is conditioned on future specified events or contingencies.[120] But the formula cannot allow any person to exercise discretion when calculating either the amount payable under the formula or whether a payment will be made.[121] For example, a fixed payment could include an annual base salary described in an employment agreement, subject to automatic adjustment in future years by reference to changes in an objective cost-of-living standard. A contract provision that allows for periodic salary adjustment at the discretion of the organization, however, would not generally qualify as a fixed payment. Similarly, a purely discretionary bonus program, or even a bonus program with objective metrics that allowed for discretionary adjustments upward or downward in the amount payable, would not qualify as a fixed payment. Nevertheless, payments to

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117. *See id.* at 14–28.

118. Treas. Reg. § 53.4958-4(a)(3).

119. *Id.* § 53.4958-4(a)(3)(ii)(A).

120. *Id*.

121. *Id*.

tax-qualified retirement plans or other tax-favored benefit plans (such as education and adoption-assistance programs) are treated as fixed payments for purposes of this exception despite an organization's discretion to vary the amount of benefits under those plans.[122]

The initial contract exception also has certain other requirements that are worthy of note. First, the exception only applies if the person substantially performs his or her obligations under the contract.[123] As a result, the person's actual services (and performance of other obligations) generally must be consistent with those required in the contract for the exemption to be available.[124] Second, if a contract provides that it is terminable or subject to cancellation by the organization (other than as a result of a lack of substantial performance by the person) without the person's consent and without substantial penalty to the organization, the contract is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective.[125] As a result, the exception will generally be lost as soon as termination or cancellation without penalty is permitted because the individual will likely be a disqualified person prior to that time and therefore not eligible for the exception.[126]

If the contract also provides for both fixed and non-fixed payments, the exception still applies to the fixed payments. The non-fixed payments, however, are subject to the general reasonableness test described above.[127] In determining the reasonableness of the non-fixed compensation, all compensation is taken into account (even compensation that qualifies as a fixed payment).[128] For example, if an initial contract with a newly hired athletic director provides for a fixed base salary and a right to an annual bonus determined at the discretion of the president of the university, the base salary will be eligible for exemption under the initial contract rule but the discretionary bonus will not. Consequently, the reasonableness of each

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122. *Id.* § 53.4958-4(a)(3)(ii)(B). The exception would appear to apply even if participation in such plans or programs is not specifically provided for in the contract. However, best practices would dictate inclusion in the contract of a reference to participation in such programs, as applicable.

123. *Id.* § 53.4958-4(a)(3)(iv).

124. Treas. Reg. § 53.4958-4(a)(3)(vii), Ex. 11. Some practitioners have questioned the availability of the exception if severance is payable upon the person's involuntary termination of employment before substantial completion of the term of the contract. This potential concern may be addressed by requiring the individual to comply with post-termination restrictive covenants as a condition to receiving the severance pay, such as restrictions on competition or solicitation of employees. In addition, severance pay is generally a means of insuring that a "substantial penalty" is present, as required to avoid the contract being treated as a new contract.

125. *Id.* § 53.4958-4(a)(3)(v).

126. For a thoughtful discussion of the practical implications of this requirement on structuring employment agreements and offer letters, see Celia Roady, *Intermediate Sanctions*, 884 Tax Mgmt. (BNA) Estates, Gifts, and Trusts (July 20, 2009).

127. *See supra* Part II.F.2.

128. Treas. Reg. § 53.4958-4(a)(3)(vi).

annual bonus payment must be evaluated based on the total value of the annual salary and the bonus payment, as well as any other compensation paid outside of the contract.

As a general matter, material changes to a contract, including renewals or extensions, are treated as the creation of a new contract.[129] The new contract must then be analyzed to determine whether it qualifies under the initial contract exception. If the person is a disqualified person at the time of the material change creating the new contract, the initial contract exception will no longer be available. Conversely, the new contract may still qualify for the exemption if the person is not a disqualified person when the new contract is deemed to be established.

6. Special Considerations

Revenue Sharing. Section 4958 authorizes the Treasury Department to develop regulations that would make economic benefits received by a disqualified person that are "determined, in whole or in part, by the revenues of one or more activities of the organization[]" excess benefit transactions.[130] To date, the IRS has not issued final regulations on such revenue-sharing arrangements.[131]

Absent final regulations, such arrangements should be subject to the § 4958 general reasonableness standard. However, § 4958 does include the condition that the revenue sharing arrangement not result in private inurement, echoing the prohibition in I.R.C. §§ 501(c)(3) and 501(c)(4). Consequently, such arrangements should be structured in a manner that is consistent with the general standards that the IRS has considered relevant in favorable rulings on incentive compensation arrangements for employees of those tax-exempt organizations. For instance, there should be mechanisms in the arrangement to assure that actual incentive compensation payments, when combined with salary and other compensation, are reasonable in the aggregate.[132]

Enhanced Form 990 Reporting. The revisions made to Form 990 in 2008 substantially expanded the required disclosures regarding compensation of officers and other key employees. Significant changes in the new reporting regime include required disclosure of compensation paid by related organizations, expanded scope of employees for which

129. *Id.* § 53.4958-4(a)(3)(v).

130. *Id.* § 53.4958-4(a)(1).

131. *See id.* § 53.4958-5. Proposed regulations under § 4958 included provisions treating certain types of revenue-sharing arrangements as excess benefit transactions. Those provisions were dropped in the final regulations. The final regulations reserve this as an area for guidance at a future date.

132. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2006-01-030 (Jan. 6, 2006); I.R.S. Information Ltr. 2002-0021 (Jan. 9, 2002), *available at* http://www.irs.gov/pub/irs-wd/02-0021.pdf.

disclosure is required, break-out of compensation by category of pay-type, and representations as to whether the organization used comparability data in determining compensation for top management officials.

The compensation information now required to be reported on an institution's annual Form 990 will provide the IRS with additional data for purposes of evaluating potential excess benefit transactions. As a result, colleges and universities should carefully consider their responses to each of the compensation-related questions on the Form 990. This will likely require more time and resources than have traditionally been dedicated to completing the form, not only for purposes of collecting all required data, but also for purposes of evaluating its presentation on the form.

Another impact of the new reporting requirements is that an expanded and more detailed array of comparability data will now be available. These data will enhance the ability of colleges and universities to periodically evaluate the reasonableness of the compensation arrangements with their disqualified persons and to undertake the comparability analysis that is necessary if the college or university wishes to establish the rebuttable presumption of reasonableness discussed below.

G. Rebuttable Presumption of Reasonableness

1. Advantages and Limitations

The House Committee Report provided an important planning tool for protecting against the application of the excess benefit transaction excise tax, which has been incorporated into the regulations under § 4958. The charitable organization may establish a rebuttable presumption that the compensation paid to the disqualified person is reasonable.[133]

There are two primary benefits of establishing the rebuttable presumption. First, as a general rule, if the requirements for establishing the rebuttable presumption have been met, a director's participation in a transaction will not be considered "knowing."[134] Thus, the participating directors cannot be subjected to the ten-percent excise tax imposed on organization managers under § 4958.[135] Second, meeting the requirements for the rebuttable presumption shifts the burden of proof to the IRS.[136] The IRS will then have the burden of rebutting the presumption by challenging the validity or independence of comparables or by proving that the comparables do not reflect functionally similar positions.

The rebuttable presumption, however, has recently been questioned by Senator Grassley of the Senate Finance Committee. In September 2009, Senator Grassley proposed an amendment to the provisions of the Senate

133. Treas. Reg. § 53.4958-6.
134. *Id.* § 53.4958-1(d)(4)(iv).
135. *See supra* Part II.B.
136. Treas. Reg. § 53.4958-6(b).

Finance Committee's markup of America's Healthy Future Act of 2009 that would have eliminated the rebuttable presumption of reasonableness for determining the compensation of officers and directors under the excess benefit transaction rules and would have required organizations to disclose a summary of the comparability data used to determine reasonableness.[137] Senator Grassley ultimately pulled the amendment before it was voted upon by the Committee.[138]

2. Fixed vs. Non-Fixed Payments

In the case of a contract providing for a fixed payment, the rebuttable presumption arises, if the required elements are met, at the time the parties enter into the contract.[139] The same rule applies for retirement benefits. If the contract involves a non-fixed payment (except in the case of certain payments subject to a cap), the rebuttable presumption can arise only after discretion is exercised, the exact amount of the payment is determined or the formula is fixed, and the three requirements for the rebuttable presumption are met.[140]

3. Requirements to Establish the Presumption

The rebuttable presumption of reasonableness may be established only if three separate conditions are met: (1) the compensation arrangement must be approved in advance by the organization's governing body or by a committee; (2) the approval must be made in reliance upon appropriate compensation comparability data; and (3) the basis for the determination must be adequately and concurrently documented.[141]

Advance Approval by Authorized Body. The authorized body or committee of the charitable organization that approves the compensation must be composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement.[142] An authorized body is the board of directors, a committee of the board of directors composed of individuals permitted under state law to serve on such committee and act on behalf of the board of directors, or, to the extent permitted under state law, other parties authorized by the board of directors

137. America's Healthy Future Act of 2009, S. 1796, Grassley Amendment #4-8 (2009) (unenacted).

138. *See Results of Executive Session America's Healthy Future Act of 2009, available at* http://finance.senate.gov/imo/media/doc/102009%20America%27s%20Healthy%20Future%20Act%20Markup%20Results.pdf.

139. Treas. Reg. §§ 53.4958-4(b)(2)(i), 53.4958-6(a)(1).

140. *Id.* § 53.4958-6(d)(1).

141. *Id.* § 53.4958-6(a).

142. *Id.* § 53.4958-6(a)(1).

to act on its behalf by following procedures specified by the board of directors in approving compensation arrangements.[143] For purposes of determining whether an individual has a conflict of interest, a member of the authorized body does not have a conflict of interest with respect to a compensation arrangement only if the member:

- Is not a disqualified person participating in or economically benefiting from the compensation arrangement and is not a member of the family of any such disqualified person;
- Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement;
- Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement;
- Has no material financial interest affected by the compensation arrangement; and
- Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement, who in turn has approved or will approve a transaction providing economic benefits to the member.[144]

Many colleges and universities will establish a small independent compensation committee consisting of non-employee members of the board of directors or trustees to serve as the authorized body in all compensation matters associated with disqualified persons.

Appropriate Comparability Data. The authorized body must obtain and rely upon appropriate data as to comparability before making its determination.[145] An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine if the compensation is reasonable.[146] In the case of a compensation arrangement, relevant information includes:

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.
- The availability of similar services in the geographic area.
- Current compensation surveys compiled by independent firms.
- Actual written offers from similar institutions competing for the

143. *Id.* § 53.4958-6(c)(1)(i).
144. *Id.* § 53.4958-6(c)(1)(iii).
145. Treas. Reg. § 53.4958-6(a)(2).
146. *Id.* § 53.4958-6(c)(2)(i).

services of the disqualified person.[147]

For certain small organizations reviewing compensation arrangements, the authorized body is considered to have appropriate data for comparability if it has data showing the compensation paid by three comparable organizations in the same or similar communities. A small organization is one having gross receipts of less than $1 million per year.[148]

A frequently asked question is whether the organization should retain a third-party compensation consultant to assist in collecting and evaluating comparability data. The regulations do not require that the comparability data relied on be provided by an independent compensation consultant or other third-party adviser. However, reliance on data provided by such a person may insulate the board or committee members from potential penalties under the excess benefit transaction rules if the requirements for the presumption are not met and the compensation is found to be unreasonable.[149] In addition, a compensation consultant generally will have ready, available access to a broader and more detailed set of compensation data than the organization can compile on its own. Finally, a compensation consultant may also be helpful in advising the board or committee on related issues, such as identification of appropriate peer organizations for compensation comparability, compensation arrangement design and delivery, and new trends in exempt-organization compensation practices.

Required Documentation. The authorized body must adequately document the basis for its determination concurrently with making that determination. For a decision to be documented adequately, the written or electronic records of the authorized body must note the following:

- The terms of the compensation arrangement that was approved and the date of the approval;
- The members of the authorized body who were present during the debate on the compensation arrangement that was approved and those who voted on it;
- The comparability data obtained and relied upon by the authorized body and how the data were obtained; and
- Any actions taken, with respect to the compensation arrangement, by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the compensation arrangement.[150]

147. *Id*.
148. *Id.* § 53.4958-6(c)(2)(ii).
149. *See* discussion *supra* Part II.B.
150. Treas. Reg. § 53.4958-6(c)(3)(i).

For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or sixty days after the final action or actions of the authorized body. Records must be reviewed and approved by the authorized body as reasonable, accurate, and complete within a reasonable time period thereafter.[151]

H. Correction of an Excess Benefit Transaction

An excess benefit transaction occurs when the disqualified person receives the excess benefit for federal income tax purposes.[152] To avoid the second-tier tax, a disqualified person must correct an excess benefit transaction in the time between when the transaction occurs and the earlier of the date on which the twenty-five percent initial tax is assessed and the date of mailing of a notice of deficiency under I.R.C. § 6212 with respect to the twenty-five percent initial tax.[153]

To correct an excess benefit transaction, the disqualified person must undo the excess benefit to the extent possible and take any additional steps necessary to place the organization in a financial position not worse than it would be in if the disqualified person were dealing under the highest fiduciary standards. Correction requires payment of the correction amount, which is the excess benefit plus interest at the applicable federal rate, compounded annually.[154]

Generally, correction may only be made by making a cash payment.[155] But, with the agreement of the organization, correction may be made by returning specific property.[156] If payment is made with property, the amount of the payment is the lesser of the fair market value of the property on the date of return and the fair market value at the time the excess benefit transaction occurred.[157] If the fair market value of the property is less than the correction amount, the disqualified person must make a cash payment also. If the fair market value of the property is greater than the correction amount, the organization may make a cash payment to the disqualified person.[158] The decision to accept property must be made by the organization without the participation of the disqualified person.[159] The organization may always refuse the return of property and require a cash

151. *Id.* § 53.4958-6(c)(3)(ii).
152. *Id.* § 53.4958-1(e)(1).
153. *Id.* § 53.4958-1(c)(2)(ii)(A), (B).
154. *Id.* § 53.4958-7(c).
155. *Id.* § 53.4958-7(b)(1).
156. Treas. Reg. § 53.4958-7(b)(4)(i).
157. *Id*.
158. *Id.* § 53.4958-7(b)(4)(ii).
159. *Id.* § 53.4958-7(b)(4)(iii).

payment.[160] In the case of an ongoing contract, the contract may be modified so that the excess benefit transaction is corrected going forward.[161] If correction is of less than the full correction amount, the 200% second-tier tax is imposed only on the unpaid portion.[162]

I. Planning to Avoid an Excess Benefit Transaction

In light of increased scrutiny of executive compensation, as well as the adverse publicity that can be associated with high compensation (the details of which will now be fully available to the public with the revised Form 990), colleges and universities must adopt procedures designed to avoid an excess benefit transaction as well as adverse publicity. All colleges and universities should take steps to identify persons subject to the rules and compensation arrangements that could potentially constitute excess benefit transactions. In addition, colleges and universities should evaluate the availability and appropriateness of the initial contract exception and the rebuttable presumption of reasonableness for compensation arrangements involving persons who will become disqualified persons or for proposed new compensation arrangements for persons who are currently disqualified persons.

At a minimum, the following practices should be implemented and performed on a regular basis as part of the institution's overall compensation program:

Identify Disqualified Persons. Colleges and universities should regularly identify disqualified persons in their organizations. As discussed above,[163] the process for identifying disqualified persons requires not only identification of the persons who hold certain positions in the organization, but also those persons whose specific responsibilities and authorities provide them with the ability to substantially influence the affairs of the organization (without regard to whether they actually exercise those authorities and responsibilities). In addition, transactions with a disqualified person's family members and thirty-five percent controlled corporations should be identified.

Periodically Review Compensation Arrangements for Disqualified Persons. Colleges and universities should have a process for regularly reviewing the compensation of their disqualified persons to confirm that the compensation, if not otherwise exempt from the excess benefit transaction rules, is reasonable. This review requires consideration of a number of factors. First, all compensation of any kind paid to the

160. *Id.* § 53.4958-7(b)(4)(ii).
161. Treas. Reg. § 53.4958-7(d).
162. *Id.* § 53.4958-1(c)(2)(ii).
163. *See supra* Part II.D.

disqualified persons should be identified, including compensation paid by related parties. Second, each item of compensation should be evaluated to determine whether it may be excluded from the reasonableness test. Third, the reasonableness of the non-excludible compensation should be evaluated based on the general standards applicable under I.R.C. § 162, including comparison of appropriate compensation data.

Establish Standards for Independent Review and Approval. Where compensation for a disqualified person is set annually or on some other periodic basis, consideration should be given to implementing compensation-setting procedures designed to comply with the rebuttable presumption of reasonableness. The college or university should make certain that the independent board or committee establishing the rebuttable presumption is truly independent and that any conflict of interest is avoided. This standard may necessitate establishing a standing compensation committee.[164]

Establish Procedures for New Compensation Arrangements. Colleges and universities should adopt procedures for evaluating whether new compensation arrangements can be structured to fall under the initial contract exception or whether a rebuttable presumption of reasonableness can be established for the arrangement. Because of the various limitations associated with the initial contract exception, reliance on the rebuttable presumption of reasonableness may be the more appropriate alternative for addressing potential excess benefit transaction issues. It is important to remember that the three requirements for the rebuttable presumption must be satisfied before any proposed compensation is paid.

Establish Procedures for Emergency Situations. Colleges and universities should consider procedures for handling unexpected benefits that become payable to disqualified persons during the year. The procedures should follow the steps necessary to obtain the rebuttable presumption of reasonableness. For example, in the case of reimbursement of expenses not otherwise covered under an accountable plan, the organization should consider requiring the disqualified person to pay the expense initially, with later reimbursement from the organization once the proper steps are taken to establish the rebuttable presumption of reasonableness.

J. Advisory Committee's Online Executive Compensation Tutorial

Colleges and universities may have another tool in the future to assist

164. For an in-depth discussion of compensation committees, see Steven D. Kittrell et al., *Compensation Committees*, 73-2nd Corp. Prac., Ser. (BNA 2009).

with compensation arrangements and avoidance of excess benefit transactions. In a recent response to the ongoing discussion over appropriate levels of compensation in the tax-exempt sector, the Advisory Committee on Tax Exempt and Government Entities ("ACT") developed an online instructional guide regarding executive compensation for charities.[165] The tutorial offers step-by-step, plain-language advice designed for managers and board members of charities on topics such as developing internal procedures and compensation comparables, reporting salary information on Form 990, determining the proper tax treatment of fringe benefits, and maintaining appropriate records necessary to meet the rebuttable presumption of reasonableness and comply with the excess benefit transaction rules.

ACT suggested in its report that the IRS coordinate its efforts to provide the tutorial with other nonprofit organizations whose purposes are to promote good governance and best practices among nonprofits. ACT provided a prototype of the tutorial to the IRS's Tax-Exempt and Government Entities Division on a DVD and recommended that the IRS adopt a version of the tutorial as part of its public education program. The IRS will likely subject the tutorial to extensive review before considering posting a final product on the IRS website, but such a product could provide valuable information for colleges and universities attempting to develop procedures to avoid a § 4958 excess benefit transaction.

III. UNRELATED BUSINESS TAXABLE INCOME AND DEBT-FINANCED PROPERTY

Although compensation, community benefit, and college and university endowments have received the most attention from the Senate Finance Committee and the tax-exempt community recently, the IRS has looked towards another issue as a major revenue raiser: the proliferation of unreported, and untaxed, unrelated business taxable income ("UBTI"). Indicative of the increased IRS focus on unrelated business income were the thirty-two questions on the college and university questionnaire regarding receipts, cost of goods sold, deductions, operating-loss deductions, and the expense allocation method used to arrive at the taxable net income of forty-seven activities ranging from advertising to golf course operations. The IRS was also interested in which of these activities resulted in debt-financed income and what percentage came from partnerships, S corporations, and controlled organizations.[166]

Generally, the institutions responding to the questionnaire reported

165. Jack Siegel et al., *Exempt Organizations: Getting It Right – An Online Guide to Setting Executive Compensation for Charities*, ADVISORY COMM. ON TAX EXEMPT AND GOV'T ENTITIES (June 9, 2010), http://www.irs.gov/pub/irs-tege/tege_act_rpt9.pdf.

166. *See* IRS Form 14018 Part II (2008), *available at* http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf.

engaging in trade or business activities, but not reporting the activity on a Form 990-T (Unrelated Business Income Tax).[167] The obvious reason was that the institutions believed either that the activities were related to their tax-exempt functions or the activities fell under one of the modifications and exceptions contained in the unrelated business income tax ("UBIT") rules.

A. Overview of the UBIT

1. Purpose of the UBIT

The main objective of the UBIT rules is to eliminate unfair competition between tax-exempt and taxable entities. This objective is accomplished by taxing trade or business revenue generated by an exempt organization that, aside from making funds available, is not related to the organization's tax-exempt function.

2. Application of the Unrelated Trade or Business Rules to Colleges and Universities

Generally, private colleges and universities that are described in I.R.C. § 501(c)(3) are exempt from federal income tax, and public colleges and universities that are state instrumentalities are exempt from federal income tax under I.R.C. § 115. I.R.C. § 511, however, imposes a tax on the UBTI of colleges and universities that are exempt under § 501(c)(3) as well as public colleges and universities exempt under § 115. Broadly defined, UBTI is income an otherwise tax-exempt organization receives from engaging in a trade or business that is unrelated to the tax-exempt organization's exempt purpose.

Unfortunately, many tax-exempt organizations do not fully understand the rules for determining whether income is UBTI requiring the filing of a Form 990-T and the payment of UBIT. As a result, many organizations likely underreport their UBTI and underpay their UBIT. Not only does this increase the organization's audit risk, but it also may require the payment of back taxes with interest, as well as penalties for failure to file and failure to pay.

The UBIT rules are not complex. They are, however, very detailed. Tax administrative officials and outside tax advisors serving colleges and universities must know and understand these rules in order to report the institution's revenues properly and avoid underpaying UBIT and the interest and penalties that can follow. Business activities typically conducted by colleges and universities that have piqued the IRS's interest include (but are by no means limited to) college book stores,[168] travel

167. *Interim Report*, *supra* note 11, at 29.

168. Related (and therefore not subject to UBIT) items include sales of course

programs,[169] athletic programs,[170] alumni use of university facilities (e.g., golf courses),[171] rental of university facilities,[172] corporate sponsorships,[173] bartering,[174] and telecommunication rentals.[175]

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books, supplies, tapes, compact discs, athletic wear necessary for participation in athletic and physical education programs, computer hardware and software, and items to induce school spirit. There is also an exception for convenience items used by students such as sundry articles, cards, film, etc. The IRS will tax sales to the general public. *See* Squire v. Students Book Corp., 191 F.2d 1018 (9th Cir. 1951); Rev. Rul. 58-194, 1958-1 C.B. 240.

169. Regulations on travel and tour activities were issued by the IRS on February 4, 2000. Treas. Reg. § 1.513-7. The regulation contains only a brief statement of the UBIT general rule and two examples pertaining to colleges and universities. Example 1 states that income from an alumni association tour open to its members and their guests and arranged by a travel agency that pays a per-person fee to the association is UBTI; although a faculty member is present, none of the tours include any scheduled instruction or curriculum related to the destinations being visited. Example 2 states that there is no UBIT where there is a "substantial amount of required study, lectures, report preparation, examinations, and [the tour] qualif[ies] for academic credit[.]" *Id.* For instance, a program, sponsored by an organization whose purpose is education about the geography and culture of the U.S., consisting of tours of parks and other locations in the U.S. and conducted by education professionals and where participants agree to participate in the required study program, including five or six hours per day devoted to study, would not be subject to UBIT. *Id.* *See also* BERTRAND M. HARDING, JR., THE TAX LAW OF COLLEGES AND UNIVERSITIES, § 3.6 (3d ed. 2008) (discussing other examples of travel tours).

170. Revenue generated from entrance fees at college and university athletic events is considered income from a related trade or business and therefore not subject to UBIT. Similarly related is income generated by the telecasting and radio broadcasting of athletic events, including the sale of exclusive television and radio rights. *See* Rev. Rul. 80-295, 1980-2 C.B. 194; Rev. Rul. 80-296, 1980-2 C.B. 195.

171. In Tech. Adv. Mem. 96-45-004 (July 17, 1996), the IRS concluded that the alumni use of a university's golf course or ski facility does not contribute importantly to the accomplishment of the university's exempt purposes. The IRS rejected the argument that by making a golf course available the university is providing an "inducement" for alumni to make financial contributions or otherwise be involved in the university. *See* I.R.S. Priv. Ltr. Rul. 80-20-010 (1980). *See also* Oakland Univ. v. Comm'r, No. 2570-97 (T.C. stipulated decision entered May 27, 1998). *But see* I.R.S. Priv. Ltr. Rul. 83-40-101 (July 11, 1983).

172. Generally, the income from the rental of college or university athletic facilities, dormitories, and facilities to non-students would be considered passive rental income and not taxable as long as collateral services such as meals or services beyond ordinary maintenance are not provided. I.R.C. § 512(b)(3); *see also* I.R.S. Gen. Couns. Mem. 38060 (Aug. 22, 1979) (concluding that revenue from the operation of a hotel and restaurant for the general public adjacent to a college campus was UBTI).

173. A qualified sponsorship payment is not UBTI even when the payment is based on a contingent level of attendance or broadcast rating indicating a degree of public exposure. I.R.C. § 513(i)(2)(A). Congress added I.R.C. § 513(i) in order to reduce uncertainty regarding any payments to nonprofit organizations, including colleges and universities. A "qualified" payment received by either a private or public state college or university is not subject to UBIT even if there is a complimentary receipt of tickets or receptions for the donor corporate sponsor.

174. Bartering activities are considered income for services rendered. Treas. Reg. § 1.61-2(d)(1) (as amended in 2003).

175. Telecommunication rentals can take several forms, from the passive rental of

B. Definition of "Unrelated Trade or Business"

In order for an activity to constitute an unrelated trade or business, three requirements must be met. First, the activity must constitute a trade or business. Second, the trade or business must be regularly carried on. And third, the activity must not be substantially related to the exempt purposes of the college or university.[176]

1. "Trade or Business"

A "trade or business" includes any activity carried on for the production of income from the sale of goods or the performance of services.[177] The regulations under I.R.C. § 513 provide some guidance as to what activities constitute a trade or business for purpose of the UBIT rules. Factors indicative of UBTI include: whether the activities are carried on for the production of income and have the characteristics of a trade or business under I.R.C. § 162; whether the trade or business is carried on to produce income from the sale of goods or performance of services; and whether the activities do not contribute importantly to accomplishment of the organization's tax exempt purposes.

Although a primary purpose for adoption of the UBIT rules in 1950 was to eliminate "unfair" competition from nonprofits engaged in commercial endeavors, the case law does not require an actual showing of competitive effect.[178] Competition with for-profit businesses is, nonetheless, a consideration under the Treasury Regulations in determining whether there is a "trade or business."[179] It is not necessary, however, to establish actual competition for there to be a finding of unrelated trade or business income.[180] Rather, the IRS and the courts have used this factor to test an organization's argument that the business is substantially related.

It is difficult to distinguish the test used for UBTI and the test used for the requirement that an exempt organization must "operate" for its exempt purposes. According to the Tax Court, determining the existence or absence of a commercial purpose in exemption cases is a "facts and circumstances" determination.[181] Although the I.R.C. and the Treasury Regulations do not make the presence or absence of profits a factor in determining the existence of a trade or business, several federal courts have held that a trade or business exists if the activity was entered into to

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telephone poles to carrying other utility lines. *See* I.R.S. Priv. Ltr. Rul. 78-28-001 (Mar. 13, 1978).

176. I.R.C. § 513.

177. I.R.C. § 513; Treas. Reg. § 1.513-1(b) (as amended in 1983).

178. *See, e.g.*, United States v. Am. Bar Endowment, 477 U.S. 105 (1986).

179. Rev. Rul. 68-505, 1968-2 C.B. 248.

180. La. Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982).

181. Redlands Surgical Serv. v. Comm'r, 113 T.C. 47, 72 (1999); B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352, 357-58 (1978).

"realize a profit."[182] The accumulation of profits has been considered by various courts, but the ultimate decision of exemption rests on the purpose for the accumulation.[183] The appearance of "commercialism" is also an important factor.[184] The courts recognize, however, that passive activities do not constitute a "trade or business." Thus, investing is not normally a trade or business, nor is a covenant not to compete.[185]

2. "Regularly Carried On"

Whether a trade or business is "regularly carried on" is determined by reference to the "frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued . . . in light of the purpose . . . to place exempt-organization business activities upon the same tax basis as the non-exempt business endeavors with which they compete."[186] A relevant factor is the typical time span of the activities—for instance, whether the activities are engaged in only discontinuously or periodically without the competitive and promotional efforts typical of commercial endeavors.[187]

The IRS generally views preparatory activity as part of the business activity for purposes of determining whether a trade or business is regularly carried on.[188] The courts, however, have held that preparation time should not be taken into account to determine "regularity." For instance, advertising in programs for the three-week NCAA basketball tournament was held not to produce income from a "regularly carried on" activity despite the fact that the year-round sale of advertising was characterized by the court as "preparation time."[189] The IRS disagrees with this position and

182. *Am. Bar Endowment*, 477 U.S. at 110, n.1; Am. Postal Workers Union v. United States, 925 F.2d 480 (D.C. Cir. 1991); Prof'l Ins. Agents of Mich. v. Comm'r, 726 F.2d 1097, 1102 (6th Cir. 1984); Carolinas Farm & Power Equip. Dealers v. United States, 699 F.2d 167, 169 (4th Cir. 1983); *La. Credit Union League*, 693 F.2d at 532; Fraternal Order of Police v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987).

183. *See* Presbyterian & Reformed Pub'g Co. v. Comm'r, 743 F.2d 148 (3d Cir. 1984); Scripture Press Found. v. United States, 285 F.2d 800 (Ct. Cl. 1961).

184. *See* Estate of Haw. v. Comm'r, 71 T.C. 1067 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981).

185. San Antonio Dist. Dental Soc'y v. United States, 340 F. Supp. 11 (W.D. Tex. 1972); Ohio Farm Bureau Fed'n, Inc. v. Comm'r, 106 T.C. 222, 235 (1996).

186. Treas. Reg. § 1.513-1(c)(1) (as amended in 2003).

187. *Id.* § 1.513-1(c)(2)(i), (ii) (as amended in 2003). *See, e.g.,* Nat'l Collegiate Athl. Ass'n v. Comm'r, 914 F.2d 1417 (10th Cir. 1990), *action on dec.*, 1991-15 (July 3, 1991); *see also* Rev. Rul. 68-505, 1968-2 C.B. 248 (holding that the conduct of an activity for all or a significant portion of the season satisfied the "regularly carried on" requirement).

188. Rev. Rul. 73-424, 1973-2 C.B. 190; *but see* Suffolk Cnty. Patrolmen's Benevolent Ass'n v. Comm'r, 77 T.C. 1314, 1323 (1981) (rejecting the notion that preparatory time is a business activity).

189. Nat'l Collegiate Athletic Ass'n v. Comm'r, 914 F.2d 1417, *action on dec.*,

continues to litigate the issue.

Also, activities of those acting on the organization's behalf can be attributed to the organization on an "agency" theory.[190]

3. "Substantially Related"

An "unrelated" trade or business is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of the purpose or function constituting the basis for the organization's exemption.[191] A trade or business activity is "related" to the tax-exempt purpose of the organization if the activity is causally related to the achievement of the organization's exempt purpose, and if the causal relationship, in a substantial way, "contribute[s] importantly" to that exempt purpose.[192] If the activity is carried on more extensively than necessary, income from the excess activity is treated as unrelated.[193] Thus, where income is realized from activities that are related but are conducted on a scale that is not reasonably necessary to accomplish the tax-exempt purpose, the excess income will be UBTI.

Because the determination of whether a trade or business is substantially related to an organization's exempt purposes depends upon the facts and circumstances of each case, the numerous IRS pronouncements and judicial decisions offer limited comfort to a particular organization carrying on a particular activity. But there are some indicia that the IRS and the courts have looked to when concluding that an activity is not substantially related. These indicia include:

- Fees charged to the general public are comparable to commercial facilities;
- Only those that purchase the goods or services are benefited and the benefits are in direct proportion to the fees charged;
- The organization furnishes and operates the facilities through its own employees who perform substantial services in providing the activity; and
- Revenue maximization is a predominant element in the exempt organization's conduct of the activity.[194]

1991-15 (July 3, 1991).

190. State Police Ass'n of Mass. v. Comm'r, 72 T.C.M. (CCH) 582 (1996), *aff'd* 125 F.3d 1 (1st Cir. 1997).

191. I.R.C. § 513(a). In the case of state colleges and universities, the educational purpose or function described in I.R.C. § 501(c)(3) is controlling.

192. Treas. Reg. § 1.513-1(d)(2) (as amended in 1983).

193. *Id.* § 1.513-1(d)(3); *see also* Rev. Rul. 76-94, 1976-1 C.B. 171.

194. I.R.S. Gen. Couns. Mem. 39863 (Nov. 26, 1991); I.R.S. Tech. Adv. Mem. 91-47-008 (Nov. 22, 1991).

C. Volunteer, Thrift Store, and Convenience Exceptions.

UBTI does not include income from any trade or business in which substantially all the work is performed without compensation;[195] income from the selling of merchandise substantially all of which has been received as gifts or contributions; or, in the case of a college or university, income derived from businesses carried on primarily for the convenience of its students, officers, or employees.[196]

The convenience exception can be applied to certain goods sold by colleges and universities, such as articles that are of a recurrent demand and do not have a useful life of more than one year. Such articles would include athletic clothing with the college or university insignia, other low-cost apparel, novelty items such as jewelry, cups, and pillows imprinted with the school's logo or name, and items such as film, cards, candy, newspapers, and magazines.[197]

As a general rule, items do not fall into the above categories if they have a useful life of more than one year. Sales of items such as cameras, tape recorders, radios, record players, television sets, and small appliances would be subject to UBIT.[198] Exceptions have been made if a school demonstrates that its campus is located a considerable distance from commercial retail facilities.[199] The IRS has held, however, that revenue from the sale of multiple computers to students, faculty, and non-students is UBTI.

Dormitory rentals to students during the school year, as well as the provision of food, laundry, and similar services, come within the convenience exception. Questions have been raised, however, regarding

195. "Substantially all" has not been defined by the IRS except in limited situations. *See* I.R.S. Priv. Ltr. Rul. 95-44-029 (Nov. 3, 1995) (concluding that the "substantially all" test was met where a religious organization used volunteers supervised by paid staff in a ratio of ten-to-one to sell clothing, crosses, buttons, key chains, flags, and bumper stickers containing inscriptions or artwork with a Biblical message or theme). *See also* St. Joseph Farms of Ind. Bros. of the Congr. of the Holy Cross v. Comm'r, 95 T.C. 9 (1985) ("substantially all" test was met where uncompensated workers constituted ninety-one percent of the farm labor force and ninety-four percent of the total hours worked on the farm); Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Comm'r, 42 T.C.M. (CCH) 1202 (1981), *aff'd in part and rev'd in part*, 696 F.2d 372 (9th Cir. 1982) (holding that regular bingo nights where a compensated bartender and caller constituted 23.1% of the total man-hours failed the "substantially all" test); Greene Cty. Med. Soc'y Found. v. United States, 345 F. Supp. 900 (W.D. Mo. 1972) (concluding that the reimbursement of volunteer expenses is not considered compensation).

196. *See* Treas. Reg. § 1.513-1(e); Rev. Rul. 55-676, 1955-2 C.B. 266 (convenience rule applies to on-campus laundry and dry-cleaning services for college and university students).

197. Squire v. Students Book Corp., 191 F.2d 1018 (9th Cir. 1951); I.R.S. Gen. Couns. Mem. 33323 (Aug. 29, 1966).

198. I.R.S. Gen. Couns. Mem. 35811 (May 7, 1974).

199. *Id*.

the provision of similar services to students during the summer months and to for-profit companies conducting educational programs using the school's facilities.[200] But the IRS ruled that such rental activities were related to the school's tax-exempt purpose.[201] In another ruling, a theological school had rented out dormitory quarters to family members of students and faculty, potential students and their parents, guest speakers, guests of other nonprofit organizations, and members of the general public.[202] There, the IRS expanded the convenience exception to include the first four cited categories but held that the rental income from the general public was UBTI.[203]

D. Special Rules Relating to Unrelated Trade or Business

Special rules apply under I.R.C. § 513 for qualified convention and trade-show activities, certain hospital services, certain bingo games, certain distributions of low-cost articles, certain exchanges and rentals of member lists, certain travel and tour activities, and certain sponsorship payments.[204]

E. Modifications to UBTI

Certain Investment Income. Dividends, interest, payments from securities, loans, annuities, and other substantially similar income from routine and ordinary investments, and all deductions directly connected with any such investment income, are excluded from UBTI (except in the case of debt-financed income).[205]

Royalties. Royalties and all deductions connected with royalties are excluded from UBTI except in the case of debt-financed income and receipts from controlled organizations. Royalties (including overriding royalties), whether measured by production or by gross, are excluded from UBTI.[206] Generally, a royalty is a payment for the use of a valuable right such as a trademark, trade name, service mark, or copyright, regardless of whether the property represented by the right is used.[207] If, however, the

200. *See* I.R.S. Priv. Ltr. Rul. 90-14-069 (Apr. 6, 1990).
201. *Id*.
202. I.R.S. Priv. Ltr. Rul. 2006-25-035 (June 23, 2006).
203. *Id*.
204. I.R.C. § 513; Treas. Reg. § 1.513-3.
205. I.R.C. § 512(b)(1); Treas. Reg. § 1.512(b)-1(a)(1).
206. I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). Working interests in oil and gas leases are not considered a royalty, and the income is taxable where the organization is liable for the operating expenses associated with the interest. *See* Rev. Rul. 69-179, 1969-1 C.B. 158.
207. *See* Comm'r v. Wodenhouse, 337 U.S. 369, 377 (1949); Rohmer v. Comm'r, 153 F.2d 61, 62 (2d Cir. 1946); Comm'r v. Affiliated Enters., Inc., 123 F.2d 665, 667 (10th Cir. 1941); Sabatini v. Comm'r, 98 F.2d 753, 755 (2d Cir. 1938); Nat'l Well Water Ass'n, Inc. v. Comm'r, 92 T.C. 75, 100 (1989).

payment for such rights is coupled with a duty to perform services by the licsensor, it is not treated as a royalty for tax purposes. But, if a licensor retains quality-control rights with respect to the licensed product, it does not cause payments to the licensor to lose their character as royalties.[208] The IRS has held that payments received for personal endorsements of products and services made by an athletic organization's members are payments for personal services and not royalties.[209] Royalties may be received from books, plays, copyrights, trade names, patents, and the exploitation of natural resources.

Mailing Lists and Affinity Cards. Mailing-list rentals, affinity cards, and the like are often used by colleges and universities and their affiliates to generate revenue. The IRS previously took the position that income from the rental of mailing lists to organizations marketing their affinity cards to members was subject to UBIT. However, after several contrary court decisions including the *Oregon State University Alumni Association* case, where the court said that the organization's activity in the program was insubstantial,[210] the IRS has conceded the issue. In Private Letter Rulings 1999-38-041 and 2001-49-043, the IRS held that, under certain circumstances, a subsidiary organization's marketing and licensing for its exempt parent will not be attributed to the parent for purposes of determining the parent's continued qualification for exempt status or liability for tax on UBTI. There, the IRS allowed the tax-exempt organization to bifurcate payments under a licensing agreement; one part was a royalty to the parent for use of the intellectual property and the other was a payment to the taxable subsidiary for services.

Rents. Except in the case of debt-financed income and receipts from controlled organizations, rents from real property and incidental rents from personal property leased with real property are excluded in the computation of UBTI. Rents from personal property are "incidental" only if they do not exceed ten percent of the total rents from all the property leased. However, if rents from personal property exceed fifty percent of the total rents, all rents (including the rent from real property) are UBTI. Also, rents are UBTI if it is dependent in whole or in part on the income or profits derived

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208. Lemp Brewing Co. v. Comm'r, 18 T.C. 586 (1952), *acq*. 1952-2 C.B. 2; Rev. Rul. 81-78, 1981-2 C.B. 135, situation 1; I.R.S. Tech. Adv. Mem. 94-36-001 (Sept. 9, 1994); I.R.S. Priv. Ltr. Rul. 2006-01-033 (Oct. 14, 2005).

209. Rev. Rul. 81-178, 1981-2 C.B. 135, situation 2.

210. Or. State Univ. Alumni Ass'n v. Comm'r, 193 F.3d 1098 (9th Cir. 1999); Common Cause v. Comm'r, 112 T.C. 332 (1999); Planned Parenthood Fed. of America, Inc. v. Comm'r, 77 T.C.M. (CCH) 2227 (1999); Miss. State Univ. Alumni, Inc. v. Comm'r 74 T.C.M. (CCH) 458 (1997); Sierra Club v. Comm'r, 65 T.C.M. (CCH) 2582 (1993), *aff'd*, 86 F.3d 1526 (9th Cir. 1996); *see* Lloyd Hitoshi Mayer, *Tax Court Rules (Again) on Sierra Club Affinity Card Income*, 24 EXEMPT ORG. TAX REV. 311 (May 1999). *See also* Rev. Rul. 69-179, 1969-1 C.B.158.

from the property leased (other than an amount based on a fixed percentage of receipts or sales).[211]

The IRS has ruled that payments to a college or university for the use of excess radio frequencies are non-taxable royalties.[212] Payments for the use of the university broadcast tower, however, are taxable. The IRS has held that such income is not rent under I.R.C. § 512(b)(3) because, under I.R.C. § 1.48-4(a), broadcasting towers are treated as tangible personal property rather than real property.[213]

Rent loses its characterization as passive, and thus its status as excluded income, if the organization provides substantial services to occupants. Furnishing heat and light, cleaning public entrances, providing parking lots, and collecting trash are not considered services rendered to the occupant.[214] Income from valet or maid services to particular occupants would be considered income from services. Similarly, the rental of a college or university facility to corporate business patrons for special events where the university provides food service would be subject to UBIT.[215] The IRS has ruled that the income from the lease of a university football stadium to a professional football team for several weeks during the summer months was subject to UBIT because maintenance, security, and linen services were provided to the team.[216] Parking lot revenues at a college or university stadium are generally regarded by the IRS as exempt rental income because of the lack of services. But if the space is dedicated to a particular payor who is responsible for the property, it may not be exempt, even without the provision of services.

Sales or Other Dispositions of Property; Options; Forfeiture of Deposits; Short Sales; etc. Except in the case of debt-financed property, gains or losses from the sale, exchange, or other disposition of property are excluded from the computation of UBTI, except for inventory-type property or property held primarily for sale to customers in the ordinary course of business.[217] There is no UBTI from gains or losses on the lapse

211. I.R.C. § 512(b)(3); Treas. Reg. § 1.512(b)-1(c) (as amended in 1992); I.R.S. Priv. Ltr. Rul. 95-51-019 (Dec. 22, 1995).

212. I.R.S. Priv. Ltr. Rul. 98-16-027 (Apr. 17, 1998).

213. I.R.S. Priv. Ltr. Rul. 2001-04-031 (Jan. 26, 2001).

214. Treas. Reg. § 1.512(b)-1(c)(5).

215. In I.R.S. Tech. Adv. Mem. 97-02-003, the IRS determined that a museum's rental of its facilities to corporate and business patrons for special events was not sufficiently related to the museum's educational purposes. The rent exclusion did not apply because the museum provided substantial services, including food and liquor, primarily for the convenience of the patrons. The same rationale would be applied to the rental of college and university facilities, including hotels. *See* I.R.S. Tech. Adv. Mem. 97-02-003 (Jan. 10, 1997).

216. *See* Rev. Rul. 80-298, 1980-2 CB.197.

217. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 96-19-069 (May 10, 1996) (no UBTI where a tax-exempt organization, whose purpose was to support the endowment of a school,

or termination of options to buy or sell securities in connection with the organization's investment activities, from gains or losses from options on real property, or from the forfeiture of good-faith deposits (consistent with established business practices) for the purchase, sale, or lease of real property.[218] There is no UBTI from the short sale of stock through a broker.[219]

Income from Scientific Research. Income (and all related deductions) from research is excluded in the calculation of UBTI in the following situations: (1) income derived from research for the United States, or any of its agencies or instrumentalities, or any state or political subdivision thereof;[220] (2) in the case of a college, university, or hospital, income derived from research performed for any person;[221] and (3) in the case of an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public, all income derived from research for any person.[222]

Technology transfer is an area that has caught the attention of the IRS. In 1982, the IRS held that a university foundation formed to transfer technology from nonprofit research institutions to private industry by obtaining patents, copyrights, and rights from researchers and licensing them to third parties was not a tax-exempt activity.[223] Since then, the IRS has not provided much guidance on the taxation of technology transfer and its commercialization. The IRS has held in several private letter rulings that the transfer of technology from laboratory to public use was a tax-exempt activity and thus would not be subject to UBIT.[224] Colleges and

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subdivided and sold unimproved farm land to unrelated third parties at fair market value); I.R.S. Priv. Ltr. Rul. 97-04-010 (Jan. 24, 1997) (no UBTI where school participated directly or indirectly in partnerships created to finance infrastructure improvements and subdivide large land parcels with the hope of selling such parcels to real-estate developers); I.R.S. Priv. Ltr. Rul. 97-45-025 (Nov. 7, 1997) (sale of an apartment building). *See generally* I.R.C. § 512(b)(5).

218. I.R.C. §§ 512(b)(1), (5). However, the Senate Finance Committee and the IRS are looking into alternative investments including offshore hedge funds and private equity funds. In a recent inquiry, the Senate Finance Committee questioned the $100 million of investments by the Boys and Girls Clubs of America in offshore funds registered in foreign countries investing in U.S. stocks and bonds for tax advantages.

219. *See* I.R.C. § 512(b).

220. *Id.* § 512(b)(7).

221. *Id.* § 512(b)(8).

222. *Id.* § 512(b)(9).

223. *See* Wash. Research Found. v. Comm'r, 50 T.C.M. (CCH) 1457 (1985). For a broad discussion of the tax issues regarding technology transfers by colleges and universities and their tax-exempt foundations, see Milton Cerny & Kelly Hellmuth, *Economic Crisis: Technology Transfer to the Rescue*, TAX'N OF EXEMPTS (May/June 2010).

224. I.R.S. Priv. Ltr. Rul. 85-12-084 (Dec. 31, 1984) (holding that a university assignment of a copyright to specialized research software for a percentage of gross income was not taxable); I.R.S. Priv. Ltr. Rul. 92-43-008 (Oct. 23, 1992) (holding that

universities also have used taxable subsidiaries to transfer research conducted at the institution that may have applied uses in the marketplace.[225]

F. Debt-Financed Income

Until the introduction of the UBIT, tax-exempt organizations enjoyed a full exemption from the payment of federal income tax. The Revenue Act of 1950 subjected charities to tax on their unrelated trade or business income but excluded from the tax certain forms of passive income. Charities could acquire property on credit with all financing provided by the seller and then lease the property back to the seller under a long-term lease and service the loan with tax-free rental income from the lease.[226] Over the years, the IRS found that many tax-exempt organizations were making debt-financed acquisitions of going businesses. The IRS attempted to revoke the tax-exempt status of these organizations and require sellers to report their gains as ordinary income, but the courts ruled against the IRS on these issues.[227]

Fearing an erosion of the tax base, Congress expanded I.R.C. § 514 in 1969 to include UBTI from any passive investment income to the extent that the property generating income was acquired directly or indirectly with borrowed funds. Today, income from investments subject to acquisition indebtedness purchased by the exempt organization, in addition to investments subject to acquisition indebtedness contributed to the organization, are subject to UBIT under I.R.C. § 514(b).

The general rules excluding dividends, interest, royalties, rent, and proceeds from dispositions of certain property do not apply if the income is from "debt-financed" property—property subject to "acquisition indebtedness."[228] "Acquisition indebtedness" is debt incurred by an

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an organization's transfer of communication technology among public and private sectors lessened the burdens of government under § 501(c)(3) and such commercialization was not taxable); I.R.S. Priv. Ltr. Rul. 93-16-052 (Apr. 23, 1993) (holding that a governmental instrumentality conducting research in the public interest creating marketable technologies to develop industries to aid the economies of surrounding states was a charitable activity).

225. *See* I.R.S. Priv. Ltr. Rul. 96-04-019 (Jan. 26, 1996) (examining a § 501(c)(3) organization that exchanged all of its intellectual property rights in software technology for stock in a for-profit subsidiary); I.R.S. Priv. Ltr. Rul. 97-05-028 (Jan. 31, 1997); I.R.S. Priv. Ltr. Rul. 97-20-031 (May 15, 1997); I.R.S. Priv. Ltr. Rul. 2006-02-039 (Jan. 13, 2006).

226. In a famous case involving the New York University School of Law, a corporation that purchased and operated a macaroni company was held to be a tax-exempt organization. Mueller Co. v. Comm'r, 190 F.2d 120 (3d Cir. 1951). Congress enacted the feeder rules to deny exemption to such transactions. I.R.C. § 502. (2006).

227. *See*, *e.g.*, Comm'r v. Brown, 380 U.S. 563 (1965); *but see* Univ. Hill Found., etc. v. Comm'r, 446 F.2d 701 (9th Cir. 1971).

228. I.R.C. §§ 512(b)-(c), 514. *See* Henry E. and Nancy Horton Bartels Trust v. United States, 209 F.3d 147 (2d Cir. 2000) (holding that the purchase of securities on

exempt organization to acquire or improve property that was either incurred before the purchase of the property or incurred after the property is acquired if the debt would not have been incurred but for the acquisition of the property.[229] The amount of income reported as UBTI is generally determined by a ratio of the average amount of acquisition indebtedness during the taxable year to the property's average adjusted basis (including straight-line depreciation) during such taxable year.[230] An important exemption from the debt-financed income rules is provided for certain indebtedness incurred in connection with the acquisition or improvement of real property by colleges and universities and their affiliated support foundations, pension plans, title-holding companies described in I.R.C. § 501(c)(25), or partnerships, all of whose partners are one of the foregoing or which meet rigid profit and loss allocation rules.[231] Property "substantially related" to the organization's exempt purpose is not subject to the debt-financed-property rules. Debt-financed-property rules do not apply to real property used by colleges and universities to carry out their tax-exempt functions.[232] If an exempt organization uses eighty-five percent or more of the debt-financed property for exemption-related purposes, the property will not be treated as debt-financed.[233]

G. Internet and Catalogue Sales

The extensive use of the internet by colleges and universities and other tax-exempt organizations has raised a number of issues, but to date there has been a paucity of guidance from the IRS. It was anticipated that the final sponsorship regulations under Treas. Reg. § 1.513-4 would include guidance on internet and catalogue sales. Those issues were, however, reserved for further consideration.[234] The regulations, as discussed previously, did provide useful guidance on other issues of advertising and incidental benefit. But guidance on internet and catalogue sales has not been forthcoming since the IRS raised a series of questions that were to be incorporated into Treas. Reg. § 1.513-4 regarding sponsorships and

margin gave rise to UBTI).

229. I.R.C. § 514(c).

230. *Id.* § 514(a)(1); Treas. Reg. §§ 1.514(a)-1(a)(1), 1.514(a)-1(b)(2)(ii). As an example, a building with an adjusted basis of $100,000 and acquisition indebtedness of $50,000 generates $10,000 in rent. The debt/basis ratio is fifty percent ($50,000/$100,000); $5,000 of the $10,000 income is taxable.

231. I.R.C. § 514(c)(9); Treas. Reg. § 1.514(c)-2. *See* Priv. Ltr. Rul. 95-10-040 (Dec. 9, 1994).

232. Rev. Rul. 55-676, 1955-2 C.B. 266; Rev. Rul. 81-19, 1981 C.B. 533; *see also* I.R.C. § 514(c)(9) (special exception for debt-financed real estate of schools).

233. This exception also applies to certain activities that are exempt from the UBIT such as research under I.R.C. §§ 512(b)(7) and (9) and under the voluntary-work and thrift-store exceptions under I.R.C. § 514(b)(1)(D).

234. *See* T.D. 8991, 2002-1 C.B. 972.

unrelated trades or businesses.[235] The FY 2000 Exempt Organizations Technical Training Program article, "Tax Exempt Organizations and World Wide Web Fund Raising and Advertising on The Internet," raised a number of red flags in this area.[236] The IRS, in Private Letter Ruling 1997-23-046, caused further confusion regarding the parameters allowed to a sponsor's page, converting what would be an acknowledgement of a sponsor into potentially taxable advertising.

If a website is being used to create a periodical, then there is a question of whether the exception for an acknowledgement of a sponsor that is not subject to UBIT in "printed material" that is distributed in connection with a specific event under I.R.C. § 513(i) would also apply to an acknowledgement on a website. It would appear that this restriction should not apply to a website acknowledgement of a sponsor. Thus, the determination of UBIT derived from the sale of advertising in exempt organization periodicals under Treas. Reg. § 1.512(a)-1(f) would also seemingly not apply.[237] Therefore, while the IRS has not ruled on this matter, websites should not be seen as periodicals coming under the restrictions imposed on acknowledgements by I.R.C. § 513(i).[238] A hyperlink, with no advertising, posting the name and address of a for-profit business on an I.R.C. § 501(c)(3) organization's website was a "qualified sponsorship" and not subject to UBIT.[239] Where, instead, a tax-exempt organization "endorses" the business sponsor's product, such endorsement is advertising and not a qualified acknowledgement of the sponsorship.[240]

Providing a link to a business vendor on the educational organization's website for a fee may be UBTI depending on whether or not the sale of goods or services is related to the organization's tax-exempt purposes. If the services or products are not related, then the question might be whether the fee comes under the exception for the exploitation of an intangible such as the royalty exclusion from UBTI under I.R.C. § 512(b)(2). The IRS has not ruled on whether the sale of educational courses on the internet is a related activity. However, there should not be a reason to treat fees from these sales any differently from those fees derived from providing educational programs under Treas. Reg. § 1.501(c)(3)-1(d)(3). Similarly, e-mail list rentals would be treated in the same way as mailing lists under I.R.C. § 513(1)(b) and thus should not be subject to UBIT.

Finally, there is some uncertainty on the question of when an institution serves as an internet service provider and what tax effect it will have. This

235. *Id*.

236. *See* Cheryl Chasin et al., *Technical Instruction Program*, 2000 WL 34402221.

237. *See* I.R.S. Priv. Ltr. Rul. 2003-03-062 (Jan. 17, 2003) (Treas. Reg. § 1.512(a)-1(f) did not apply where an agricultural organization sold banner advertisements on its website).

238. *See* Treas. Reg. § 1.513-4(e).

239. *Id.* § 1.513-4(f), Ex. 11.

240. *Id.* § 1.513-4(f), Ex. 12.

issue appears to be a factual issue that depends on the group of end users being served and the context in which the services are offered. This issue arises when "electronic strips" or "charity malls" serve as a third-party website, hosting a collection of hyperlinks to online vendors. The charity mall encourages shoppers to purchase goods and services from featured vendors and agrees to pay a portion of the sales income to the exempt organization selected by the purchaser. In some instances, the payment over the fair market value of the articles is considered a contribution to the tax-exempt organization.[241] The IRS has issued private letter rulings that permit an income tax charitable deduction for the donation where the entity acts as the agent for the charity.[242] In either case, the income received by the exempt organization should be treated as an exploitation of the organization's tax-exempt function resulting in a royalty payment, and as such, exempt from UBIT.

The IRS included several questions on the compliance questionnaire for colleges and universities regarding internet activities. Possibly, the information that is gathered through the questionnaire or the pending audits will lead to some additional guidance that will shed some light on these issues.

H. Partnerships, Limited Liability Companies, and S Corporations

Exempt organizations are permitted to be either general or limited partners in partnerships or members in limited liability companies ("LLCs").[243] If an exempt organization is a member of a partnership that regularly carries on a trade or business that is unrelated to the organization's exempt purpose, it must include the unrelated taxable income of its partnership share and the deductions directly connected with that income.[244] The IRS has required an exempt organization that participates in a general partnership to show that the tax-exempt purposes of the organization are served and that its interests are properly protected through guarantees, indemnities, and penalties that would prevent potential benefits to the limited partners. Additionally, the IRS considers "control" of the substantive functions of the partnership to be an important factor when the exempt organization or its affiliate is a general partner.[245]

241. *See, e.g.*, Rev. Rul. 85-184, 1985-2 C.B. 8.

242. *See* I.R.S. Priv. Ltr. Rul. 2002-28-001 (July 12, 2002); I.R.S. Priv. Ltr. Rul. 2001-42-019 (Oct. 19, 2001).

243. I.R.C. § 512(c)(1). *See also* Treas. Reg. § 1.512(c)-1 (regarding income and expenses includible in UBTI).

244. Internal Revenue Amendments, Pub. L. No. 103-66, § 13145(a)(1)-(3) (codified at I.R.C. § 512(c)(1)).

245. Rev. Rul. 98-15, 1998-1 C.B. 718; Redlands Surgical Servs. v. Comm'r, 113 T.C. 3 (1999) (judgment of exempt status for subsidiary in typically reorganized hospital system in California). *See* St. David's Health System v. United States, 349 F.3d 232 (5th Cir. 2003); I.R.S. Priv. Ltr. Rul. 2005-48-026 (Dec. 2, 2005); Priv. Ltr.

S corporation stock owned by a charity is treated as an interest in an unrelated trade or business, regardless of whether it is related or unrelated to the organization's tax-exempt purpose.[246] All pass-through income, including dividends, interest, and other passive income attributable to the exempt organization's shareholdings in the S corporation, is subject to UBIT as well as any gains from the organization's sale of the S corporation stock.[247]

I. Controlled Organizations

A tax-exempt college or university foundation may own a for-profit subsidiary with an independent business purpose.[248] The exclusion from UBTI of interest, annuities, royalties, and rents (in the absence of acquisition indebtedness) does not extend to such income received from a "controlled organization."[249]

Control of a corporation means ownership by vote or value of more than fifty percent of the corporation's stock. For partnerships or other entities, control means ownership of more than fifty percent of the profits, capital, or beneficial interests. Control of non-stock corporations presumably will mean that more than fifty percent of the directors or trustees of the organization are representatives of, or directly or indirectly controlled by, the exempt organization. Under Treas. Reg. § 1.512(b)-1(1)(4)(i)(b), a trustee, director, agent, or employee of an exempt organization is a "representative" of that organization. The same regulations provide that an exempt organization controls any trustee or director that it has the power to remove or replace. The UBIT rules also apply to second-tier subsidiaries. Under I.R.C. § 512(b)(13), the constructive ownership rules of I.R.C. § 318 apply to determine control and ownership of interests. Thus, a parent college or university is deemed to control any subsidiary in which it holds

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Rul. 2004-48-048 (Nov. 26, 2004) (control of partnership that owns and operates an MRI facility). Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) (limited partners had no control over charitable general partner); *cf.* Housing Pioneers v. Comm'r, 65 T.C.M. (CCH) 2191 (1993), *aff'd*, 49 F.3d 1395 (9th Cir. 1995) (activities of co-general partner were so narrowly framed that for-profit partner was in a position of control with inappropriate private benefit).

246. I.R.C. § 512(e)(1)(A) (2006).

247. *Id.* § 512(3)(1)(B).

248. *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 97-20-036 (May 16, 1997) (§ 509(a)(2) charity established two for-profit subsidiaries); I.R.S. Priv. Ltr. Rul. 97-22-032 (May 30, 1997) (spin-off of a for-profit affiliate and transfer of technology and employees to commercialize pharmaceutical products).

249. I.R.C. § 512(b)(13) (2006). Colleges and universities have lobbied to eliminate this tax on income from subsidiaries operated on their behalf. The purpose of the legislation is to prevent a tax-exempt organization from housing an unrelated business activity in a separate but controlled organization and receiving non-taxable income by reason of the passive income rules. Instead of granting relief, Congress reduced the percentage of control used to determine what a "controlled" organization is.

more than fifty percent of the voting power or value directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

I.R.C. § 512(b)(13) also provides the method for determining how much of an annuity, interest, rent, or royalty payment made by a controlled subsidiary to a college or university parent is includible in the parent's UBTI. The payments are subject to UBIT to the extent the payment reduces the net unrelated income or increases the net loss of the subsidiary. This control test is based on the vote or value and the constructive ownership rules of § 318.

Congress further modified I.R.C. § 512(b)(13) in 2006 to add an exception for payments from controlled organizations that meet the requirements of I.R.C. § 482. This exception, made at the urging of the college and university community, applies only to payments made pursuant to a binding written contract in effect on the date of enactment (which was August 17, 2006). This special provision expired on December 31, 2009, and a one-year extension is currently pending as part of the package of "extenders" being considered by Congress.

J. Allocation of Expenses

The I.R.C. allows deduction of expenses from UBTI for all ordinary and necessary expenses incurred in carrying out the unrelated trade or business if the expense is directly connected with carrying out the business.[250] The expense must be an allowable deduction under one of the business deductions allowed to businesses, and the expense must be directly connected to carrying on the unrelated trade or business.[251] If the expense item satisfies both tests and is attributable solely to the conduct of a trade or business, then it is fully deductible in calculating UBTI.

Dual-Use Expenses. Dual-use expenses are expenses incurred for both related and unrelated activities. An exempt organization must make a "reasonable" allocation of the expenses between those activities.[252] This is

250. *Id.* § 512(a)(1); Treas. Reg. § 1.512(a)(1); *see also* I.R.C. § 162; Treas. Reg. § 1.162-1.

251. For example, I.R.C. § 162 defines ordinary and necessary business expenses. I.R.C. § 165 allows deductions for losses and I.R.C. §§ 167 and 168 allows deductions for depreciation. *See also* Amer. Med. Ass'n v. U.S., 887 F.2d 760 (7th Cir. 1989) (holding that the directly connected test is met if the dominant reason for incurring the expense was to engage in an unrelated trade or business).

252. Treas. Reg. § 1.512(a)-1(c). Rensselaer Polytechnic Inst. v. Comm'r, 732 F.2d 1058 (2d Cir. 1983), is the leading case in the area. The college operated a field house for both educational and commercial uses. In determining the expenses allocable to the commercial use, the college used a three-part methodology of (a) direct expense, (b) variable expense dependent on the percentage of commercial use, and (c) fixed expenses that did not depend on use. The IRS argued that fixed expense percentage should be based on the ratio of commercial use time to total time available. The court

an important issue for colleges and universities that rent out their facilities to the public.

Treas. Reg. § 1.512(a)-1(c) provides that if assets or personnel of an exempt organization are employed both in an unrelated trade or business and in an exempt activity, there must be a reasonable allocation with regard to the deduction attributable to such assets or personnel between the two uses. The basis for a reasonable allocation depends on the facts of the individual case. In *Disabled American Veterans v. U.S.*, the court directed that allocations should be based on gross receipts.[253] In *Rensselaer Polytechnic Institute v. Commissioner*, the court held that the allocation should be based on actual time of use.[254]

Direct or Indirect Expenses. "Direct" and "indirect" cost allocations have been at issue in several court cases, including *Rensselaer*, where the IRS attempted to assert its position that (1) indirect expenses for dual-use facilities must be directly connected to the unrelated activity to which they are allocated, and (2) the dual-use expense would not have been incurred but for that activity.[255] The IRS announced in 2006 that it was developing a project to review the treatment and allocation of income and expenses for colleges and universities.[256] While the project was to commence in 2008, to date the IRS has not published any further guidance. The IRS may be awaiting the results of the college and university compliance programs before announcing its position.

Aggregation of Deductions from Multiple Trades or Businesses. UBTI is calculated by aggregating the income and deductions attributable to all unrelated trades or businesses of an exempt organization.[257] Thus, a loss resulting from a deduction from one unrelated trade or business can be used to offset income from another trade or business. However, if a particular business continually operates at a loss, the IRS in most cases will challenge the deduction of the losses under I.R.C. § 165 because the activity is not engaged in to make a profit.[258] Net operating loss deductions are available in computing UBIT. These losses can be carried back two years

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agreed with the college's methodology and held that the time the facility was idle was part of the college's tax-exempt use. While the IRS has never acquiesced in this decision, it is generally followed by the college and university community in allocating expenses for dual-use facilities.

253. Disabled Am. Veterans v. United States, 704 F.2d 1570 (Fed. Cir. 1983).

254. *Rensselaer*, 732 F.2d at 1058.

255. The government's reasoning did not prevail in *Rennselaer*. *Id.*

256. IRS 2007 Exempt Organizations Workplan (2007), *available at* http://www.irs.gov/pub/irs-tege/fy07_teb_workplan.pdf.

257. Treas. Reg. § 1.512(a)-1(a).

258. *See* W. Va. State Med. Ass'n v. Comm'r, 882 F.2d 123 (4th Cir. 1989); I.R.S. Tech. Adv. Mem. 97-19-002 (May 9, 1997).

immediately preceding the loss year and, if not used up, can be carried forward twenty years.[259] Under a special rule, net operating losses for any year, including carry-back or carry-forward, are determined regardless of whether or not they were taken into account in determining income or deduction for UBTI purposes.

K. Advertising

Advertising income is taxable as UBTI if it is in a publication that promotes an advertiser's services or products, and if it is "regularly carried on."[260] Such advertising in a publication circulated to members "exploits" the exempt function of the organization even if the organization's exempt function is furthered by the circulation and distribution of the "readership content" of the publication.[261] If expenses of the exempt and non-exempt activities exceed the income of the exempt activity, some exempt expenses may be allocated to the non-exempt (advertising) activity, but a loss may not be created for carry-forward or carry-back purposes.[262]

If the advertising is profitable, after taking into account the direct costs of the advertising, the taxable profit may be further reduced (but to no more than zero) by the amount by which "readership costs" (the cost of producing and distributing the exempt activity readership content) exceed "circulation income" (the subscription income and/or the portion of dues attributable to receipt of the periodical).

Colleges and universities may sell commercial advertising (as described in I.R.C. § 513 rather than sponsorship acknowledgements under § 513(i)) in a variety of formats including student newspapers, professional journals, athletic programs, and the sponsorship or exclusive use of a business' products. Because the advertising is included in an otherwise related activity, the IRS will "fragment" a particular business activity, like a school newspaper or journal, into its component parts, some of which are related, like the editorial content, and others, like product advertising, that may be taxed as UBTI.[263] An example from a student-operated campus newspaper is presented in Treas. Reg. § 1.513-1(d)(4)(iv), example 5. There, the

259. I.R.C. § 172 (2006).

260. *See* I.R.C. § 512; Nat'l Collegiate Athl. Ass'n v. Comm'r, 914 F.2d 1417, 1421–26 (10th Cir. 1990) (holding that the activity was not regularly carried on and therefore not taxable); *see also* Rev. Rul. 68-505, 1968-2 C.B. 248 (where the conduct of an activity for all or a significant portion of the typical commercial season satisfied the "regularly carried on" requirement).

261. United States v. Am. Coll. of Physicians, 475 U.S. 834 (1986) (holding that revenues from advertising in a scholarly journal were unrelated trade or business income because such advertising was not substantially related to the organization's exempt purposes).

262. Treas. Reg. § 1.512(a)-1(f)(3)(iii).

263. *Id.* § 1.513-1(b). An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of activities or endeavors that may or may not be related to the organization's tax-exempt purpose.

students solicited, sold, and published paid advertising in the campus newspapers under the instruction of the university.[264] While the services provided to the advertisers normally would have constituted commercial advertising, the preparation and publication of the advertising contributed importantly to the university's educational program. Thus, the income was not UBTI.[265]

L. Substantiation

Both the IRS and the courts require substantiation rather than estimates of expenses. In Private Letter Ruling 1993-24-002, the IRS denied an allocated overhead deduction because the organization failed to justify its fifty-percent allocation rate. Colleges and universities should take note that, in connection with a compliance audit of the University of Michigan, the IRS disallowed virtually all of the direct expenses claimed by the University against its UBTI because the University could not prove that the amounts were expended for designated purposes. The indirect cost deductions were disallowed because they were not based on a reasonable method.[266]

Colleges and universities are also allowed to take charitable contributions as deductions, but they cannot exceed ten percent of the institution's UBIT as computed without the charitable contribution deduction.[267] A specific deduction of $1,000 is also allowed in computing UBTI.[268]

M. Controlled Foreign Organizations, Partnerships, and Operations

1. Overview

Many colleges and universities are involved in a complex web of international operations, partnerships, and investments. Educational institutions have established foreign campuses, international collaborative research, student activities, and strategic partnerships for various development activities. Providing these services requires the allocation of start-up funds and the support, management, and involvement of the institution's governing board. The planning and management aspects of

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264. *Id.* § 1.513-1(d)(4)(iv), Ex. 5.

265. *Id*. In an interesting, related ruling, the IRS held in I.R.S. Tech. Adv. Mem. 1999-14-035 (Apr. 9, 1999) that even a separately incorporated organization publishing a daily university newspaper that had student journalists and faculty and solicited and published advertising was not subject to UBTI.

266. Regents of Univ. of Mich. v. Comm'r, No. 4625-95 (T.C. filed Mar. 21, 1995) (this case was settled prior to trial, and all of the expenses in question were allowed); for further discussion of this case, *see* BERTRAND M. HARDING, JR., THE TAX LAW OF COLLEGES AND UNIVERSITIES 64 (3d ed. 2008).

267. I.R.C. § 512(b)(10).

268. *Id.* § 512(b)(12).

the ventures are critical to the success or failure of any such projects.[269]

While it may seem obvious that the establishment of overseas branches is important to the U.S. economy, Congress has been skeptical about the sizable international operations of major colleges and universities that are in part subsidized by U.S. taxpayers, for fear that they may be undermining America's economic competitiveness. The concern is that these activities help other countries create and develop their own scientific and technological work force.[270]

Educators who testified before the House Committee on Science and Technology pointed out that the overseas programs expanded opportunities for talented students in other countries in the sciences, technology, engineering, and mathematics fields that might draw them to the United States because of the lack of interest by U.S. students in working for U.S. companies. These research programs also enable colleges and universities to attract resources from overseas governments and companies.

2. Doing Business Abroad

When a college or university chooses to directly engage in work abroad rather than to distribute grants or engage in other passive financial assistance, there is a whole host of issues that must be considered, such as the appropriate legal form for its presence in that country, either as an independent organization under the host country's laws, a subsidiary branch of the U.S. educational institution, or a branch with no separate status in the foreign country. Each option has its own set of issues.

For example, what are the reporting, labor, tax, and other implications of each? In the case of a parent college or university, what responsibilities must be exercised by the parent institution's board of trustees over the activities of the subsidiary organization overseas? Taxes and accounting procedures may be different for the foreign entity, for instance, the treatment of exempt status from value added tax ("VAT"), custom taxes, personal and corporate income taxes, profit, and business taxes. It is important to realize that most foreign countries have limitations regarding tax-exempt activities and do not recognize a related trade or business as does the United States. There are also certain practical issues, including whether the foreign country imposes taxes on in-kind contributions, donated labor, or donated equipment.

In some jurisdictions, grants to or from local donors, or to local individuals or non-governmental organizations ("NGOs"), may not be exempt from income tax by that country. If fees are charged to the host

269. *See* John Fielden, *Leading International Partnerships: 7 Roles for Presidents*, CHRON. HIGHER EDUC., July 18, 2010.

270. *See* Goldie Blumenstyk, *Overseas Branches are Vital to American Academe and the U.S. Economy, University Officials tell House Panel*, CHRON. HIGHER EDUC., (Wash., D.C.), July 27, 2007, at 26.

country or to other NGOs, they may be subject to the country's VAT. On the administrative side, there may be specific procedures and requirements for establishing employee residence or obtaining work permits for employees outside the country.

While operating overseas may be an appropriate way to carry out a university's tax-exempt purposes, there are a number of issues that must be considered. There are also United States rules and regulations that need to be observed. U.S. nonprofit organizations must be careful in granting funds to foreign charitable organizations. Tax-exempt educational institutions are subject to the Foreign Corrupt Practices Act.[271] Moreover, Executive Order 13224 prohibits transactions between a domestic charity and foreign organizations deemed by the federal government to be terrorist groups or individuals associated with such groups. Embargoed countries are listed by the Treasury Department of Foreign Asset Control.

The establishment of offshore activities serves a tax-exempt purpose for colleges and universities as well as our economy. However, care must be taken to understand the laws of the country where the operation takes place in order to weigh both the benefits and detriments of establishing an independent organization. There are many other options open to the college or university to provide assistance to foreign organizations, including "friends of" groups, donor-advised funds, program-related investments (PRIs), and direct grants to international organizations and foreign governments.[272]

N. Investment Structures to Avoid Unrelated-Business-Income Tax

There are two primary ways in which certain investments, typically those in some type of investment partnership such as a hedge fund, a fund of funds, or private equity fund, can generate UBTI. First, UBTI includes debt-financed income. If the charitable organization invests in a fund that is a partnership for federal tax purposes, and the fund borrows to make investments and generates income (i.e., is leveraged), the charitable organization will have to pay tax on its share of the income attributable to the debt-financed property. Second, if the fund is a pass-through entity and invests directly in a business that is operated as a pass-through entity, the income received by the fund from this operating business will be UBTI which will pass through to the charitable organization for federal income

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271. *See* Mark Brzezinski, *Obama's Foreign Bribery Crackdown*, WASH. POST, May 28, 2010, at A23.

272. Lois Lerner, the IRS Director of Exempt Organizations, said that the IRS is looking at foreign entities that receive IRS recognition of exemption, and the IRS will publish a new publication describing special rules for domestic charities conducting overseas activities. *See* Diana Freda, *New Publication on International Compliance*, Daily Tax Rep. (BNA), Nov. 26, 2010, at G-3.

tax purposes.[273]

When considering these investments, a college or university must consider the effect of these possible taxes on the projected returns from the investment and must also determine what protections or options, if any, may be available to avoid or minimize any adverse tax consequences from UBTI. For instance, investment partnership agreements can prohibit the fund manager from making investments that generate UBTI or require the manager to use his or her "best efforts" to avoid or minimize UBTI.

Many funds are structured in a manner specifically designed to address the UBTI concerns of tax-exempt organizations. These are generally funds whose investments likely generate significant UBTI. Typically these funds use a "blocker corporation," often created offshore in a jurisdiction that does not impose income taxes on corporations, so that a corporate-level tax is avoided for its tax-exempt investors. The tax-exempt investors invest in the blocker corporation, instead of the partnership vehicle, and the blocker corporation then invests in the investment partnership. This blocker corporation will distribute dividends, and the sale of the interest will generate gains, neither of which are UBTI to a tax-exempt organization (assuming no borrowing by the charitable organization to acquire the investment).[274] The IRS has ruled favorably on the use of such an arrangement.[275]

The tax consequences of these types of investments, however, must be carefully considered as these structures can also cause the organization to incur taxes on income that would otherwise be exempt. While the blocker corporation is an effective method of eliminating UBTI for tax-exempt investors, other taxes could potentially be greater for a tax-exempt entity investing through a blocker corporation. Foreign corporations are generally subject to U.S. federal income tax on income that is "effectively connected" with the conduct of a trade or business in the U.S.[276] Foreign corporations that are partners in a partnership are considered as being engaged in a trade or business within the U.S. if the partnership is so engaged.[277] A foreign corporation is subject to U.S. federal income tax on its effectively connected income at the regular graduated rates applicable to U.S. corporations. In addition, a foreign corporation may be subject to the branch-profits tax at a rate of thirty percent.[278] The branch-profits tax is basically a tax on the amount of the foreign corporation's effectively connected income that is not reinvested in the U.S. If the foreign corporation is subject to the branch-profits tax, the effective tax rate on the

273. I.R.C. § 512(c)(1) (2006).
274. *Id.* § 512(b)(1), (5).
275. *See, e.g.,* I.R.S. Priv. Ltr. Rul. 2003-15-028 (Jan. 13, 2003); I.R.S. Priv. Ltr. Rul. 2003-15-035 (Jan. 14, 2003).
276. I.R.C. § 882 (2006).
277. *Id.* § 875.
278. *Id.* § 884.

effectively connected income can be as high as 54.5%. Additionally, a U.S. private investment fund is required to withhold tax at the highest applicable marginal rate on the effectively connected income, including U.S. source interest and dividends, allocable to each foreign partner.[279]

A tax-exempt investor that invests directly in a U.S. partnership would only be taxed on the portion of effectively connected income that constitutes UBTI, and that tax is substantially lower than the 54.5% that a blocker corporation may have to pay. Furthermore, the tax-exempt investor would not be subject to any tax on non-debt-financed U.S. source interest and dividends.[280]

The United States' four-year, post-secondary educational institutions collectively held more than $400 billion in endowment assets in 2008.[281] The United States Senate Finance Committee has expressed concern about investments of college and university endowments in overseas hedge funds, offshore tax shelters, and potentially risky investments. Before the market crash in 2008–2009, endowment managers were putting a larger percentage of their endowment funds into hedge funds and other alternative investments. The National Association of College and University Business Officers estimated that, in 2000, three unidentified colleges had invested forty to sixty percent of their endowments in hedge funds. The hedge fund craze continued to build when stock prices declined.[282]

That trend continued into 2008–2009 when we saw the collapse of the stock market, which resulted in the fall of major investment houses and banks that had invested in risky products composed of credit default swaps and other exotic products. Congress, the IRS, and the public have been concerned about the growth of college and university endowments and whether colleges and universities are engaged in charitable activities commensurate with their resources.

The Senate Finance Committee and the IRS began taking a closer look at college and university endowments and offshore investments that avoid federal taxes. Senator Grassley continues to express concern about these investments, and the college and university questionnaire specifically focused on these types of investments.[283] Investments by college and

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279. *Id.* § 1446.

280. In a letter dated August 16, 2010 to the House Ways and Means Committee, Senate Finance Committee, Treasury, and the IRS, the New York State Bar Association Tax Section recommended that Congress and the Treasury undertake a review of I.R.C. § 514 in order to determine whether the tax policy rationale for subjecting income from leveraged investments in securities and commodities to UBIT is appropriate today. The letter is on file with the author.

281. For a current discussion of the growth of college and university endowment, see U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13.

282. *See* John L. Pulley, *Betting the Endowment on Risky Investments*, CHRON. HIGHER EDUC., Jan. 18, 2002, at A28.

283. Charles E. Grassley, *Wealthy Universities Must Make Themselves More Affordable*, CHRON. HIGHER EDUC., May 30, 2008, at A36 (directing comments at

university endowments through offshore hedge funds and private equity funds can be quite profitable, but they should only be engaged in with full knowledge that Congress is reviewing these relatively tax-free investments in their continuing search for funds to finance the U.S. Treasury. What Congress grants, it can also take away.

O. Conclusion

The primary objective of the UBIT was to eliminate unfair competition by placing unrelated business activities conducted by exempt organizations on the same tax basis as that of for-profit businesses. Since 1950, when the UBIT rules were originally introduced, it has not really accomplished its statutory purpose. Over the years, the small business community, led by a consortium of trade associations, has urged Congress to expand the scope of the UBIT rules and improve its enforcement at the IRS. However, Congress has not, up to this point, been willing to take on the challenge to restructure the UBIT. This may be due to lack of political will, or, more importantly, lack of empirical data.

As the IRS completes its study of college and university business activities, some of the analysis and information will provide useful substance for future legislation. But Congress will still have the same tax policy issues to deal with. That is, should taxpayers with equal income pay the same amount of tax? Is it unfair for the tax system to favor one competitor over another?

There has been a plethora of court cases and congressional modifications to the UBIT rules. However, there has not been a comprehensive analysis of the formulation of the UBIT since the House Ways and Means Draft Report in 1988.[284] The following recommendations in the Draft Report could affect colleges and universities:

- Income from mail-order and catalog sales of bookstores would be treated as UBIT subject to certain exceptions that included sales of mementoes, T-shirts, and other items with the exempt organization's logo and costing less than $15.00.
- Special exemptions for sales of goods to students with a retail price of $15.00 or less, and for items with higher prices if the sales furthered educational programs and the articles were not common consumer goods. Books and computer software would be

colleges and universities with large endowments).

284. *See* SUBCOMM. ON OVERSIGHT OF THE HOUSE COMM. ON WAYS AND MEANS, 100TH CONG., DRAFT REPORT DESCRIBING RECOMMENDATION ON THE UNRELATED BUSINESS INCOME TAX (Comm. Print 1988). *See also* JAMES J. FISHMAN AND STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (3d ed. 2010); Thomas Troyer, *Changing UBIT: Congress in the Workshop*, 41 Tax Notes 1221 (Dec. 12, 1988).

exempted, but not appliances, cameras, television sets, VCRs, and recreational sports equipment. Exemptions for computer sales would be granted on the condition that the faculty member approved the purchase. (With the widespread use of computers, such sales with or without faculty approval would appear to be related).

- Health, fitness, exercise, and similar health-promotion activities costing a special fee would be subjected to UBIT.
- UBIT would not apply to income derived by a college or university from travel or tours conducted by the students and faculty, but only if the travel is related to a degree program curriculum.
- UBIT would not apply to income derived from food sales by a college or university for students, faculty, or employees, but only if it is provided on the institution's premises.
- Lodging-facilities income would be treated as UBTI when the facilities are used by the public, but not when they are used by students, faculty, or staff as dormitories or fraternity or sorority houses.
- Affinity credit card income or catalog and endorsement activities would be treated as UBTI. A number of these items were included in the college and university questionnaire issued by the IRS.
- Advertising income subject to UBIT could only be reduced by deductions associated with direct advertising costs.

The Draft Report also recommended that the UBIT convenience exception under I.R.C. § 513(a)(2) be repealed except for limited exceptions applicable to college and university dining halls and dormitories. The Draft Report went on to indicate that royalty income would be subject to UBIT whether measured by net or taxable income. There would be an exception for the licensing of a trademark or logo fostering name recognition, for certain non-property working interests, and for products directly related to the organization's tax-exempt function.

Two more significant recommendations that would apply to colleges and universities and on which the IRS is seeking more data in the current compliance review apply to controlled subsidiaries. The oversight subcommittee would have taxed the income of a non-exempt controlled taxable subsidiary as UBTI if the tax on such income would have been less than if the activity was carried on directly by the tax-exempt parent. This recommendation would have required the charity's taxable subsidiaries to pay tax at the level of the greater of (1) the amount computed under the normal corporate rates, or (2) the amount of UBIT that would have been paid if the activity were conducted in the parent charity.

Finally, the Report focused on the allocation of expenses and recommended, in the case of dual-use facilities, that the marginal costs attributable to the taxable activity would only be deductible if the taxable use of the facility was twenty-five percent or less of the facility's total use time. If the taxable activity use percentage was between twenty-five and seventy-five percent of the total use time, costs (including depreciation and general administrative costs) would be allowable to the taxable activity based on a percentage of actual use. Over seventy-five percent use in a taxable activity would result in all costs being deductible except for marginal costs.

It is evident from the above recommendations and discussions that the IRS and Congress are focusing more on the exceptions and modifications under the UBIT rules as the reviews of the business activities of colleges and universities proceed. Congress has certain recommendations on "the shelf" and may be awaiting the final IRS review before finding potential avenues of revenue to reduce budget shortfalls. The UBIT area may become a real target for congressional action in the next session.

IV. CONCLUSION: COSTS AND BENEFITS

In this article we have discussed the technical tax rules and the historical reasons for the law as it applies to colleges and universities in two important areas—executive compensation and business activities. We have seen that both Congress and the IRS are anxious to determine whether tax-exempt educational institutions' activities serve a broad public purpose justifying the loss of revenues to the government from granting tax exemption.

There is no doubt that the public benefits from the activities conducted by colleges and universities that produce educated individuals, innovations for our economy, and improvement in the quality of our lives are all beneficial to the general public. The question is not whether we should periodically review these activities to determine whether the activities continue to serve the public good, but rather whether the cost, time, and funding expended by the government in obtaining information and by the institutions in preparing the necessary responses to the government requests are justified in today's climate of economic distress. Could those funds be better put toward tax-exempt purposes, and is the information gathered worth the cost?

It would appear from the experience of other IRS audit programs of colleges and universities that such costs may not be justified by the results that are produced. For example, the audits of colleges and universities conducted over a decade ago resulted in meager returns in enforcement by the IRS and costly expenditures by colleges and universities. In that large case audit program, the IRS focused on a broad range of issues that covered compensation and benefits, fundraising and contributions, qualification of activity bonds, contracts, research, scholarships, related entities, investment activities, and corporate sponsorships. These areas are similar in many respects to those being examined today. In the earlier examinations, a wide variety of documents and financial information was requested.[285] Teams of IRS agents converged on college and university campuses for several years. It was reported that at least fifty or more colleges and universities were under a coordinated examination program,[286] but the IRS never issued a published report on the results of those examinations and its findings.

What was the result of these audits? What new regulations came into being as a result? How much tax was collected? While there have been reports issued by associations of institutions and practitioners representing specific colleges and universities, it would appear that most examinations resulted in minimal tax revenue, and that much of that tax was from non-compliance involving failure to report or pay employment taxes. If clarification of the rules on executive compensation and a rational approach to the unrelated trade or business income tax is the result, then, and only then, can it be said that this program is worth the time, money, and effort.

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285. For a detailed discussion of that program, see Milton Cerny and E. Mallon, *Extensive New IRS Audit Guidelines Intensify Scrutiny of Colleges and Universities*, 78 J. OF TAX'N, No. 5, at 299 (May 1993). *See also* R. Switzer, *New IRS Guidelines Target College and University UBIT*, 21 J.C. & U.L. 489 (1995).

286. *See* Marlis L. Carson, *IRS Officials Discuss Proposed University Audit Guidelines*, 7 EXEMPT ORG. TAX REV. 177 (1993); *see also* HARDING, JR., *supra* note 262, at ch. 10 (discussing audits of colleges and universities).