



## **An IRS Audit Roadmap: Report of the College and University Compliance Project**

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On May 2, 2013, the IRS's Exempt Organizations division released its much awaited [Colleges and Universities Compliance Project](#) final report. One of two IRS divisions that audits colleges and universities (the other, Employee Plans, focuses on benefit plans), Exempt Organizations provided some unique insight into the type of issues investigated upon a general audit of a higher education institution. Although these audits were not focused on benefits-related issues, several such issues did indeed emerge in the investigations. This article examines the project report and its implications for college and university plan sponsors.

Page | 1

### **Background:**

The project dates back to 2008, when detailed compliance questionnaires were sent to 400 colleges and universities selected at random. Though completion of such compliance questionnaires is voluntary, most benefits attorneys would advise that their clients complete such questionnaires, since the consequence of noncompliance is generally an audit.

34 of the organizations to whom questionnaires were sent (8.5%) were targeted for audit due to the fact that their response were a) sufficiently incomplete or b) when combined with the organization's annual tax return (Form 990), revealed potential issues with executive compensation or unrelated business taxable income (UBTI). It is important to note that benefit programs were NOT criteria for audit targeting, but that benefits information for some institutions was later reviewed by investigators as part of the audit process.

### **The Examinations:**

The 34 audits revealed several areas of noncompliance, as follows:

- 1) Underreporting of Unrelated Business Taxable Income (UBTI): The IRS investigators discovered that colleges and universities should have reported more UBTI than they actually reported, resulting in less taxable income and thus, less taxes paid. Most underreported taxable income was related to the following areas:
  - a) Fitness, recreation centers and sports camps;
  - b) Advertising;
  - c) Facility rentals;
  - d) Arenas; and
  - e) Golf.

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The primary reasons for underreporting were:

- a) Reporting losses for activities that lost money year after year, so much so that they could not qualify as a trade or business with a sufficient profit motive so that a loss could offset taxable income; and
  - b) Reporting losses unrelated to any business activity that generated taxable income (the loss must be directly attributable to the business activity).
- 2) Key executive compensation: The IRS found several instances where compensation was in excess of what is defined as reasonable under Section 4958 of the Code at private universities (public universities are exempt from this requirement). Such excess compensation is subject to excise tax to the institution in question. The primary reason that such compensation was identified was improper benchmarking of the compensation amounts (*e.g.*, data that was not truly comparable was used).

Although not part of the key executive group, compensation of other individuals at college and universities was reviewed as well. Not surprisingly, the IRS reported that compensation of head coaches and investment managers often greatly exceeded salaries of the president of the college/university and other key management employees.

***Practice Pointer: Advisors should be fully cognizant of the difference between public and private colleges and universities in this regard in order to avoid misinforming public clients/prospects that executive compensation rules apply to them when they do not.***

- 3) Employment tax returns: Various errors in the completion of employment tax returns resulted in the underreporting of wages to the IRS, which required adjustment for additional income tax withholding.
- 4) Retirement plans and deferred compensation: Though the investigators examined retirement plans at only about one-quarter of the institutions audited, several compliance issues were discovered in about half of the institutions examined, as follows:
- a) Deferrals in excess of the 402(g) limit;
  - b) Total contribution in excess of the 415 limit;
  - c) Loans that exceeded the borrowing limits under 72(p);
  - d) 457(f) plans with no substantial risk of forfeiture, resulting in current taxation of contributions to such plans.

***Practice Pointer: Advisors of large private universities should be particularly cognizant of d) since 457(f) plans are commonplace at such entities.***

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**Conclusion:**

The full report is a must-read for anyone involved in these issues, particularly finance officials who put together the information for the annual tax returns. Colleges and universities should be cognizant of the fact that some areas, namely UBTI and executive compensation for private universities, are subject to particular scrutiny by the IRS. Finally, those who work with retirement plans should not take anything for granted, as errors as simple as a violation of 402(g) elective deferral limits continue to be discovered upon audit. Page | 3

***Practice Pointer: Though obviously the retirement plan related audit developments are more relevant to your practice, knowledge of all of the report's findings may have value in establishing/enhancing relationships with college and university finance officials and other senior executives.***

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