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DAILY TAX REPORT

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IRS Audits Harvard, Other Universities in Probe of Exempt Purpose Rules

Harvard College, Suffolk University, the University of Texas, Texas A&M, and Kansas City University of Medicine and Biosciences are among the institutions of higher learning that have announced they are being audited by the Internal Revenue Service.

The examinations are the result of a college and university study IRS began two years ago and is expected to release soon.

IRS is now examining 40 colleges and universities of the roughly 400 schools that received compliance check questionnaires from IRS in October 2009, according to a recent McGuireWoods legal update. Practitioners familiar with the service's workings said there is no magic to that number and the number of colleges and universities being audited could go higher.

IRS is now examining 40 colleges and universities of the roughly 400 schools that received compliance check questionnaires from IRS in October 2009, according to a recent McGuireWoods legal update.

Harvard College, the nation's wealthiest school in terms of endowments, disclosed in a Jan. 14 bond offering document that it was being audited. Harvard sold $480 million of tax-exempt securities to pay for an expansion of its law school and other capital projects, as well as refinancing of existing debt.

IRS announced in 2008 that it had several higher education issues in its crosshairs—unrelated business income or trade, endowments, and executive compensation.

''We know the endowment issue is going to be looked at very closely,'' Milton Cerny of counsel with McGuire Woods told BNA in late February. The Senate Finance Committee has been critical of some of the larger name endowments funds not using more of their money to offset the growing cost of college tuition and expenses. The issue that has been raised is whether some of the institutions with large endowments are abiding by the restrictions in their covenants, some of which require them to provide assistance to students. ''The IRS is reviewing those restrictions to see if they are having any effect on what is being paid out by the endowment,'' Cerny said.

Meanwhile, McGuire Woods attorneys said compensation may be at issue in the audit of Suffolk University. Its president, David Sargent, was slated to receive $5.1 million in total compensation, making him the second-highest-paid private university president in 2008.

IRS Disallowing Losses

Many of the examinations will focus on losses that are claimed on the unrelated business income tax return, Bert Harding of Alexandria, Va., told BNA in early March. Harding is involved in five university audits on behalf of clients. IRS has disallowed claimed loss deductions because it says the activity was not engaged in with the intent to make a profit.

For there to be unrelated business income or an unrelated business loss deduction, the activity must be a trade or business, Harding said. For the activity to be a trade or business, it must be conducted with the intent to make a profit. If it is not conducted with the intent to make a profit, it is not a trade or business. Therefore, it is not an unrelated trade or business, and if an institution loses money on it, they cannot put that loss on their return.

''The IRS says that the fact that you lost money on this activity year-after-year is proof that you didn't have the intent to make a profit,'' Harding said. Expense allocations are one of the primary motivations behind the issuance of the compliance check questionnaire, and one of the primary motivations behind the audits that are coming out, he said. They will probably be reflected in the university report once it is issued, he said.

Allocating Expenses Is Number One Issue

IRS has not been subtle about what it is looking for, Bruce Hopkins, senior partner with Polsinelli Shughart told BNA March 17. In fact, expense allocation is the number one issue that triggered the university compliance check to begin with, he said. ''The IRS doesn't understand how there could be so much unrelated business, so much gross revenue being generated by it, and so little tax paid,'' he said.

The basic question of how to allocate expenses between exempt and commercial uses is at issue. The IRS rule is that only expenses directly connected to the unrelated business can be taken as deductions against unrelated business income, Hopkins said. Some organizations are not doing that, he said; they are allocating more expenses to unrelated activity than they should be, particularly with respect to indirect expenses for things such as overhead.

The IRS rules dictate that an organization with dual use of facilities or personnel allocate expenses ''between the two uses on a reasonable basis.'' But what is ''reasonable'' has been open to interpretation.

The statute is clear, Hopkins said, but some universities are relying on a 1984 circuit court decision that suggested the government regulations are vague and gave a signal to the higher education community that some type of ''reasonable'' allocation was permissible.

Under the reasonable expense allocation approach upheld in *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058, 1060 (2d Cir. 1984), some universities have been allocating more expenses to unrelated business income than IRS might believe is correct. The school used a methodology for allocating fixed expenses related to commercial use by comparing commercial use time over the total time the facility was in use. IRS did not agree with that methodology or the court's decision in that case. Believing that ''standards have gotten fairly lax in that area over the years, they have decided to take a fresh look, '' Hopkins said.

Another tax issue involves the use of separate 501(c)(3) entities created by colleges and universities to perfect patents and license products from the research discoveries of faculty and students, said Cerny, a 28-year veteran of the tax-exempt division at IRS. ''While the Internal Revenue Code recognizes scientific research as a tax-exempt activity of colleges and universities that is related to their tax-exempt function, the perfection of patents and licensing of discoveries for commercial purposes by their subsidiaries has resulted in denial of tax-exempt status of the subsidiary,'' he said.

In a 1985 Tax Court memorandum opinion, *Washington Research Foundation v. Commissioner*, T.C. Memo 1985-570, 11/21/85, the foundation was denied exemption for engaging in these activities. ''This is of particular importance to land grant colleges that were created under a mandate to engage in research activities, not only to educate students, but to assist in community, industrial, and agricultural development,'' Cerny said.

In addition, the Bayh-Dole University and Small Business Patent Procedures Act of 1980 (Pub.L. 96-517), known as the Bayh-Dole Act, encouraged federally funded university research to be commercialized as long as the university retained the rights to the technology, Cerny said. ''This results in a potential conflict between the IRS view on commercialization of technology and other government initiatives to promote commercialization of government-funded research for the public good,'' he said.

Saving v. Spending: Endowment Funds

The use of endowment funds by wealthy universities has been a frequent target for Sen. Charles Grassley (R-Iowa).

Grassley began zeroing in on colleges and university endowments in 2007, highlighting perceived deficiencies in yet another slice of the tax-exempt sector. Institutions with big endowments should ''end the hoarding and start the helping with skyrocketing tuition costs,'' he said at the time.

National Association of College and University Business Officers President John Walda told BNA March 18 that market volatility has proven that college endowment fund managers have been appropriately cautious over the years about their spending rates.

''The organization's latest endowment survey shows that spending policies are right on target,'' he said. ''The average spending rate for institutions is about 4.4 percent over the last 10 years.''

From the endowment perspective, IRS will be trying to determine whether universities are serving their charitable purpose with their endowment spending and, more importantly, if they are spending enough of the money donors have given them rather than hoarding it.

Most funds held by endowments are restricted by the donor, so the donating public dictates how the funds are used, Walda said. The number one use of endowment funds is for student aid, and the second highest use is for faculty and academic support.

Walda noted that if endowment funds were not used to shoulder some of the burden of the operating budgets of universities, the money would have to come from somewhere else—probably tuition.

One of the objectives in an endowment is to retain the funds' real dollar value over a long period of time, so when spending rates are compared with rates of return, he said, the objective is to come out about even.

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JOHN WALDA, PRESIDENT, NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

The concern about endowment spending is a hangover from three to five years ago when returns were in-

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credibly high, Walda said. In 2007, the average return on investments was more than 17.2 percent, but for fiscal year 2009, it plummeted to -18.7 percent.

Grassley criticized colleges and universities at the time for spending only 5 percent, when they had earned 17 percent. In response, fund managers gave the same answer then that they do today, Walda said: ''You spend on a basis that is sustainable over long periods of time, not at a rate that is dictated by your annual returns. We know historically there are ups an downs in the market, and in the last decade the volatility has been incredible. So you spend in a way that won't get you into a hole.''

Testing the Limits of Compensation

While Grassley may have hoped that greater transparency about compensation on the new Form 990 would lead to public outrage that resulted in lower salaries for tax-exempt executives, that has not really happened, Lindalee Lawrence, president of Lawrence Consulting in White Plains, N.Y., told BNA March 18. The consulting firm specializes in advising for-profit and nonprofit organizations in the area of compensation.

Apart from temporary recession-related reductions, compensation has not really come down, she said, and it is an area at which regulators should definitely be looking. IRS is concerned that no part of the net earnings of a section 501(c)(3) organization inure to the benefit of any private shareholder or individual—that person being anyone who has a personal and private interest in the activities of the organization. The fact that the colleges are getting a substantial tax break only heightens that concern. However, Lawrence said that universities, like other tax-exempt organizations, must be allowed to attract and retain talented people.

A universities' complexity might warrant high pay, she said, but that has been questioned in light of the fact that many of them serve a population that is not necessarily wealthy. The question then becomes whether a university or any tax-exempt organization will be able to retain talent by paying them less.

Nonprofits do not necessarily have all the perks of for-profit companies, Lawrence said. For instance, they cannot offer stock to their executives and their deferred compensation arrangements are much more limited than a for-profit organization's.

IRS relies on and accepts the ''rebuttable presumption of reasonableness,'' in which executive salaries are presumed to be reasonable if the governing body setting the salary can show that executives in comparable positions are paid as well and they document it.

Certainly IRS will be looking at whether the schools it is auditing are appropriately comparing the salaries of for-profit companies with nonprofit organizations, she said.

Ivy League institutions such as Harvard have no for-profit peers to choose from in reviewing salaries, Lawrence said, and choosing from an organization's peer group when setting salaries is key. The size of an organizations also plays a major role in setting compensation when looking for comparable organizations.

The increased disclosure of the 2008 Form 990 also comes with a greater opportunity to explain why compensation has been set at certain levels, she said. Some outlier universities have documented long-term and short term incentives, she said. ''There are a lot of reasons why the compensation might be more.'' For instance, a president may have served for 30 years and been under- compensated in prior years, and the institution may be trying to catch up. These are the kinds of factors IRS itself considers to be reasonable, she said.

According to former IRS Exempt Organizations Director Marcus Owens, now an attorney with Caplin & Drysdale, a review of compensation has now become a staple of every audit of an exempt organization.

The Audits

Harvard, like several of the other universities being audited, found itself in that position after responding to IRS's compliance check questionnaire.

Harvard's bond documents told investors that its examination, which began in January, would extend for more than a year and involve ''a team of agents reviewing a broad array of activities.''

The bond document added that the university ''has no reason to believe that the examination will have an adverse effect on its tax-exempt status or any other aspect of its operations.″

John Longbrake, Harvard spokesman, told BNA that Harvard's endowment exists to support teaching and research in perpetuity. Three-fourths of the endowment is restricted to purposes designated by the donors. The resources generated by endowment investments provide significant support for the university's operations—$1.4 billion or 35 percent of its total operations in FY 2009—which allows the university to provide ''generous financial aid to undergraduate and graduate students,'' he said.

This past year, Harvard College alone awarded $147 million in need-based aid and expects that number to rise again next year as the family circumstances of many of its students have changed due to the market collapse in 2008, Longbrake said. ''Despite last year's endowment loss, the College has remained committed to its financial aid initiative and to opening its doors to outstanding undergraduates from diverse economic backgrounds,'' he said.

In fact, Harvard announced March 18 that it would increase undergraduate financial aid by 9 percent for FY 2010-11, for a record $158 million for the upcoming academic year. This $13 million increase ''will help keep Harvard affordable and ensure no change in the financial burden for the more than 60 percent of students who receive aid,'' the college said.

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BRUCE HOPKINS, SENIOR PARTNER, POLSINELLI SHUGHARD

Meanwhile, Suffolk University made headlines in 2008 when it was revealed that its president, David Sargent, had a total compensation package of nearly $2.8 million. Suffolk pointed out that while Sargent's yearly salary was reported at $1.5 million for 2007-2008, he did not take home that amount that year. Nicholas Macaronis, chairman of the board of trustees pointed out that much of Sargent's compensation is deferred and is not yet available to him or will not become available to him until he retires. The university is required to report parts of his pay package twice, he said, once when it is made eligible and once when the president receives it. However, Sargent will only be paid once.

The Kansas City University of Medicine and Biosciences is being audited for the 2006, 2007, and 2008 tax years, spokeswoman Laurie Roberts told BNA recently. ''We are still in the midst of our [IRS] investigation,'' she said. The school's former CEO, Karen Pletz was terminated in December by the board of trustees. The allegations surrounding that termination have not been disclosed, Roberts said, so it is unclear if that is in any way figuring into IRS's investigation.

The university has filed for an extension of its 2009 Form 990, which is due May 15, she said. The school is cooperating fully with IRS.

By Diane Freda

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