2014 Higher Education Tax Reporting Trends Project

FALL 2014

Photo courtesy of Reinhardt University, Waleska, GA

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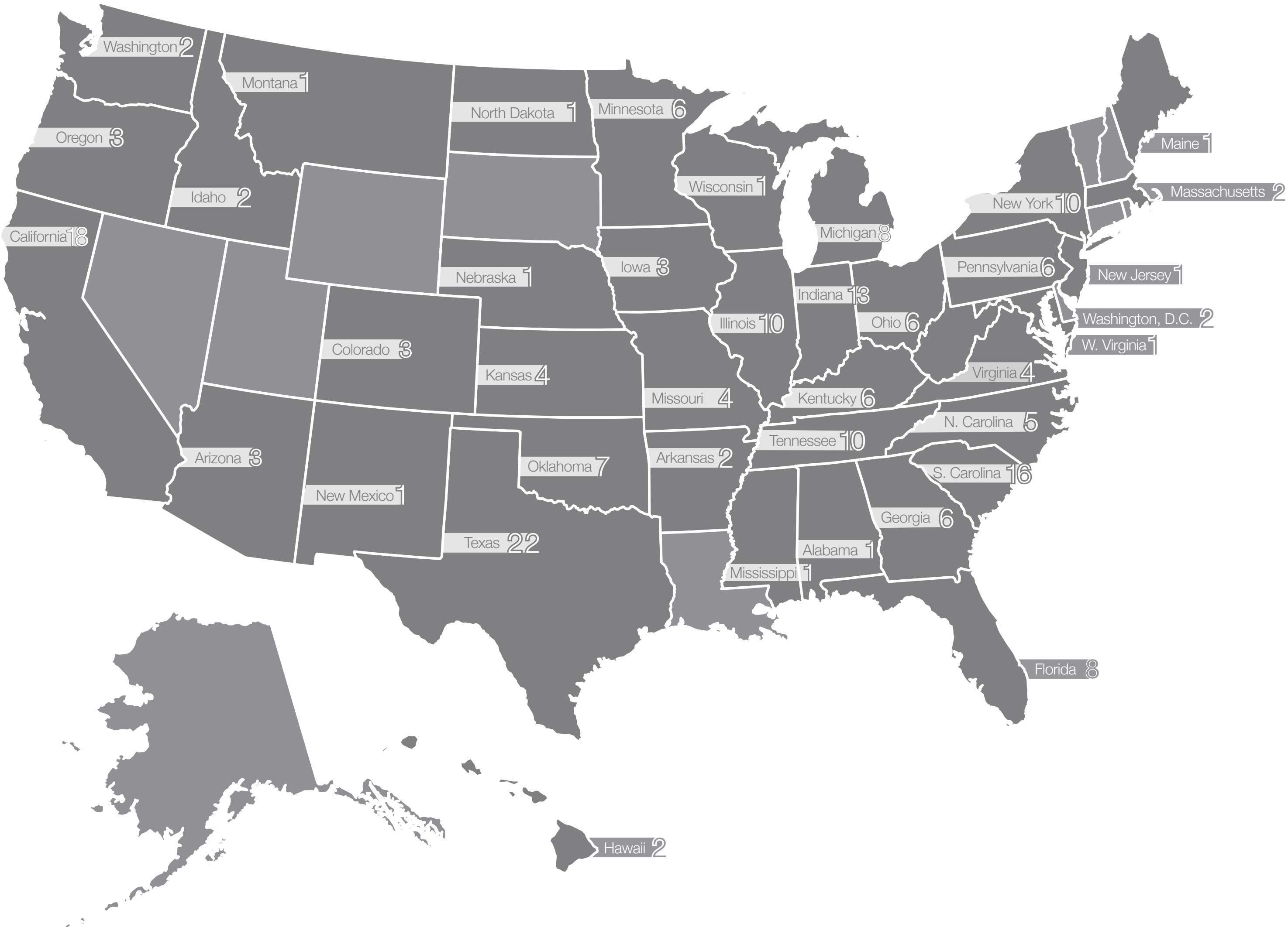

We are very pleased to present the 2014 edition of CapinCrouse LLP's annual *Higher Education Tax Reporting Trends Project*. We would like to start by sincerely thanking the 203 colleges and universities that participated in the study. Participating institutions were located in 39 states across the U.S., from Maine to Hawaii and California to Florida.

The current enrollment of the 203 participating institutions of higher education averaged 1,570, with the largest having 15,840 students and the smallest having an enrollment of 25 — quite a range.

We separated the respondents into three categories, based on enrollment size:

	Category A	Category B	Category C
Enrollment	1,700+	500 -1,700	Under 500
Respondents	66	77	60

CAPINCROUSE LLP
Certified Public Accountants
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October 2014

Dear Colleague,

Welcome to the fifth edition of CapinCrouse's annual *Higher Education Tax Reporting Trends Project*. This unique statistical review includes financial, tax, and demographic data compiled from our 2014 college, university, and seminary survey.

Our goal is for this report to be a useful reference guide and information tool. While we recognize that no two higher education institutions are exactly alike, the editorial and statistical information contained here should help your accounting team gain a better understanding of potential tax reporting issues that you and peer institutions face.

Our annual survey — which participants completed online, at conferences, and via email — was a great success again this year. We incorporated a music group theme that seemed to interest many people. As you will see throughout this report, respondents submitted beautiful pictures of music groups and programs on their campuses. We wish we could have included them all!

As a preview of the *2015 Higher Education Tax Reporting Trends Project*, we plan to diverge from the annual model we've used for the past five years and do two or three smaller surveys and four-page electronic reports throughout the year instead. We plan to couple these with three 2015 webcasts specific to colleges, universities, and seminaries, and look forward to your feedback on this new format.

Again, it is our hope that you are able to use the data contained in this report to help with your future tax compliance filings and assist in training and informing your board, management group, and accounting team. We would be happy to discuss any questions you may have or how any of these industry-wide tax reporting trends may be affecting your institution.

Also, we welcome any comments and suggestions on how we might improve the content or presentation of this report in future years. Please direct your comments or questions to collegetax@capincrouse.com. We appreciate your continued support and thank you for allowing us to serve your audit, tax, and consulting needs.

Sincerely,

David C. Moja

Dave Moja, Partner
National Director of Not-for-Profit Tax Services

College band at Pasadena College (now Point Loma Nazarene University) in the 1940s.
Courtesy of Point Loma Nazarene University, San Diego, CA.

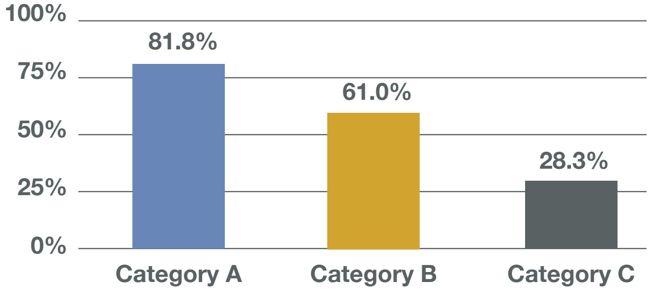
SURVEY	Responses	"Yes" Responses			
		Total Survey	Category A Universities	Category B Universities	Category C Universities
Does your school have/sponsor a traveling performance music group, choir, chorale, etc.?	203	58.1%	81.8%	61.0%	28.3%
Do you hire nonresident alien students or other NRAs as employees or outside contractors?	203	54.7%	69.7%	59.7%	31.7%
Do you have any overseas activities (including foreign campuses, study abroad programs, mission trips, sending staff to conferences outside the U.S.)?	203	82.3%	95.5%	87.0%	61.7%
Is there art — such as original paintings or bronze statues — displayed anywhere on your campus?	201	72.1%	90.9%	75.0%	47.5%
In your opinion, does your board take an active role in deciding what non-cash contributions to receive?	199	24.6%	20.0%	24.3%	30.0%
In response to the government's proposed "College Scorecard" plan, has your institution yet developed any new financial reports?	198	6.6%	11.1%	2.7%	6.7%
Overall, how would you rate the video meetings you have participated in over the past 12 months?					
Poor	203	1.5%	1.5%	1.3%	1.7%
Borderline	203	8.9%	6.1%	13.0%	6.7%
Good	203	32.0%	36.4%	29.9%	30.0%
Excellent	203	5.9%	6.1%	6.5%	5.0%
No participation	203	51.7%	50.0%	49.4%	56.7%
Does your accounting team provide any Form 990-based benchmarking/comparative data or ratios to your board?	203	10.8%	10.6%	14.3%	6.7%
Bonus: Does your school fund grants for homebound travel for students when school is out?	149	2.0%	1.3%	0.7%	0.0%

EXECUTIVE SUMMARY

***2014 Higher Education Tax Reporting Trends Project* Survey**

Thanks again to all 203 participants in this year's *Higher Education Tax Reporting Trends Project* survey. The answers to our eight survey questions are charted below, along with some notes on why we asked what we did. We hope you will let us know if you have questions regarding any of these queries — there is a lot going on in the "higher ed tax world!"

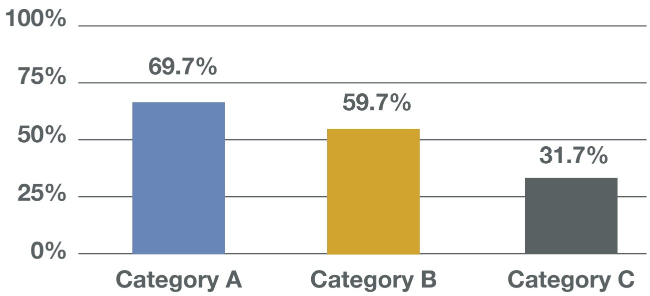
Does your school have/sponsor a traveling performance music group, choir, chorale, etc.?



This question came out of a conversation we had with several CFOs at a higher education conference. The CFOs were concerned about unrelated business income tax (UBIT) issues with respect to traveling music groups, concerts, radio stations, and sales of music performance CDs and DVDs.

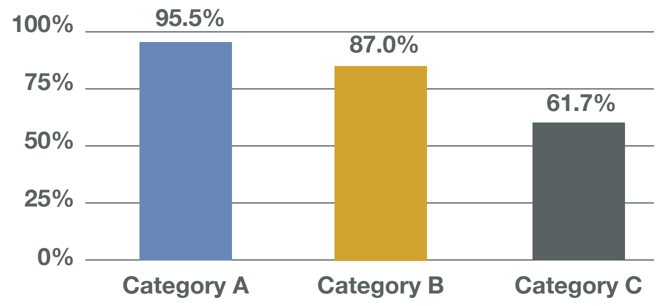
Your school should be careful with the content of "sponsorship" wording and displays. In addition, concerts could create issues with "private business use" if the venue is encumbered by tax-exempt bond funding. Beyond that, if a music group sells CDs or t-shirts in multiple states, there could be sales tax requirements that should be addressed. There is a lot that needs to be monitored in this area!

Do you hire nonresident alien students or other NRAs as employees or outside contractors?



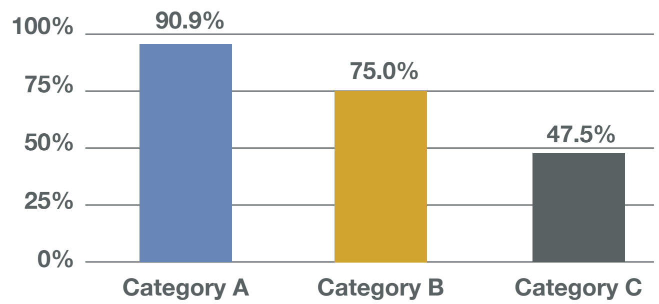
Another way of asking this question is, "Do you have a requirement to file Form 1042-S for some of your 'foreign workers'?" What about "foreign student employees" who are receiving financial aid? Is your accounting team up to speed on the tax treaty rules and potential 14% withholding?

Do you have any overseas activities (including foreign campuses, study abroad programs, mission trips, sending staff to conferences outside the U.S.)?



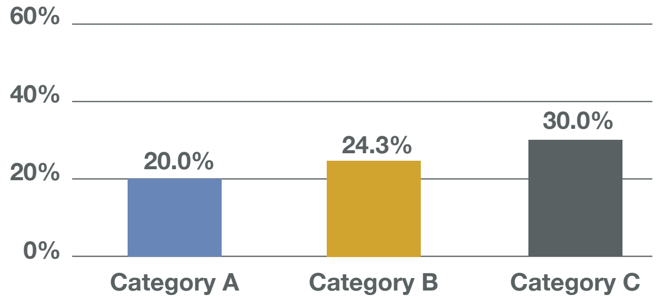
This question is related to Schedule F (Form 1040), Part I, which causes a great deal of confusion and teeth-gnashing for many colleges, universities, and seminaries. Schedule F requires reporting based on nine IRS-defined global "regions," and the instructions state that you should include "activities conducted outside the United States," including "grants and other assistance, program-related investments, fundraising activities, unrelated trade or business, program services, investments, or maintaining offices, employees, or agents for the purpose of conducting any such activities in regions outside the United States." That covers an immense amount of reporting ground!

Is there art — such as original paintings or bronze statues — displayed anywhere on your campus?



As we've traveled across the U.S. visiting higher education campuses, we have been blessed to get to view paintings, sculptures, bronze statuary, and other art on virtually every campus we set foot on. When we review Form 990s for these institutions, however, most have checked "No" on Part IV, Line 8, which asks, "Did the organization maintain collections of works of art, historical treasures, or other similar assets?" Hence this awareness-raising question in our survey. Note that a "Yes" answer would generally require the institution to complete Schedule D (Form 990), Part III.

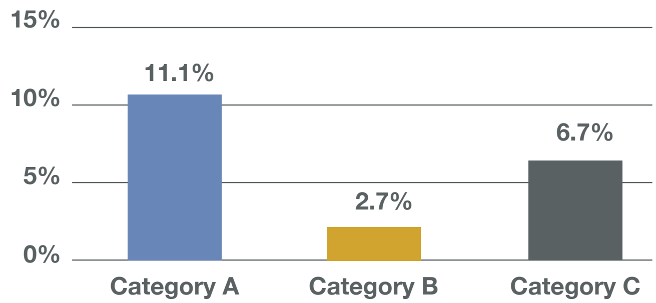
In your opinion, does your board take an active role in deciding what non-cash contributions to receive?



This question is somewhat related to the art and historical treasures issue above, but it goes beyond that. We were surprised to see that the boards at smaller institutions appear to be more engaged in this area than the boards at larger schools. In our travels and meetings with audit/finance committees, it seems that many boards are not involved in major gifts of non-cash assets — and they need to be!

Do you have a gift acceptance policy in place? Does the board follow it? Do they know that art and collections can cause headaches with donors? Do they know that taxes owed on gifts of S corporation stock can be astronomical? You should ensure that your board (or at least your audit/finance committee) is well-versed in this area.

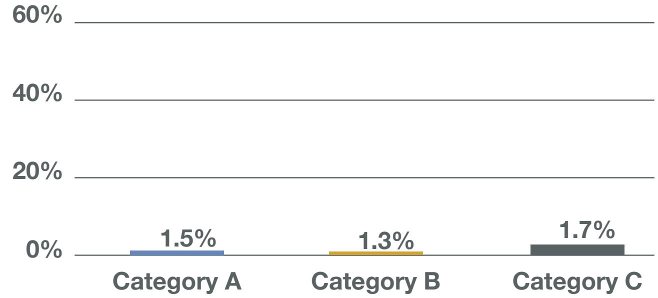
In response to the government's proposed "College Scorecard" plan, has your institution yet developed any new financial reports?



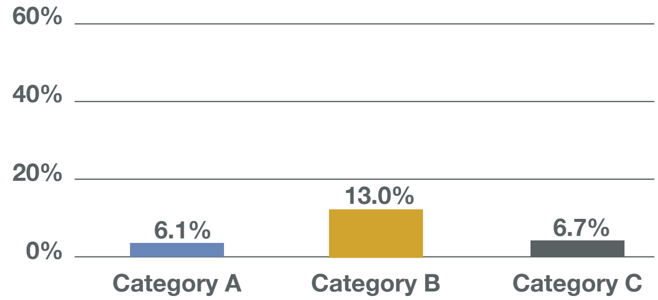
It appears that the current Administration's "College Scorecard" system will come out this fall. This survey question was designed to gauge what, if anything, participating institutions may be doing in anticipation of the ratings. It looks like we are all in wait-and-see mode on this issue.

Overall, how would you rate the video meetings you have participated in over the past 12 months? *(Video meetings and video conferences, not webinars, webcasts, or web-based training.)*

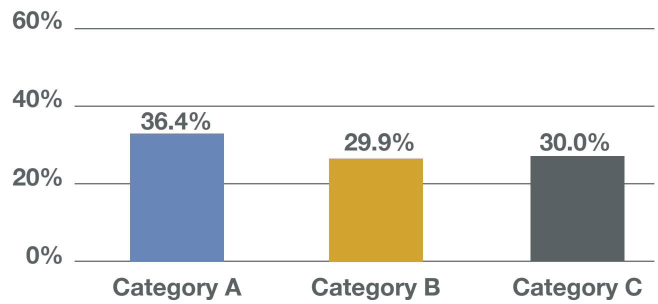
Poor



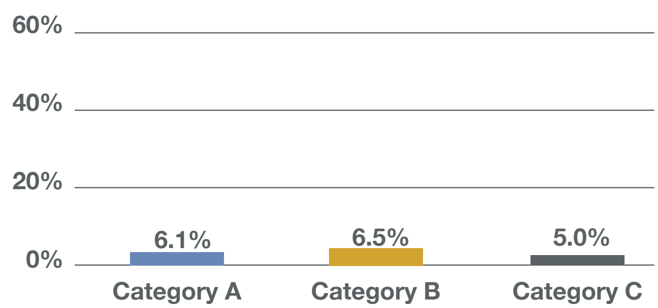
Borderline



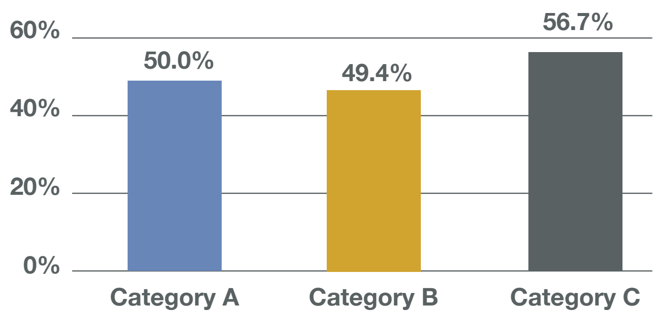
Good



Excellent

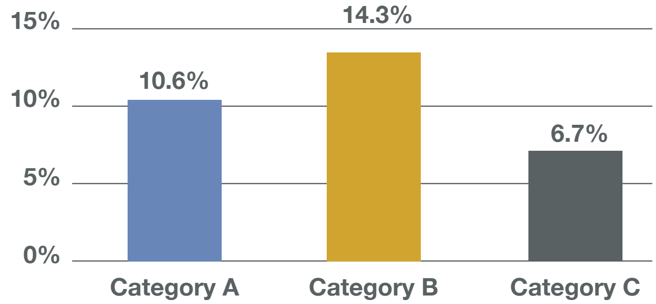


No Participation



Video conferencing technology continues to improve. Our best meetings in the past few months have combined video conferencing technology (nice to see you!) and WebEx — two computers at our end and two computers at your end. We'd love to schedule one of these meetings to talk with you for a few minutes about tax issues or get down to real work!

Does your accounting team provide any Form 990-based benchmarking/comparative data or ratios to your board?



You may have noticed that we omitted the Form 990 survey items in the 2014 edition of this report. As we spoke with institutions over the past four years and attempted to clarify and examine what the data was telling us, one thing became abundantly clear — there is still a great deal of inconsistency in much of what is reported on Form 990 (and the supporting schedules).

Having said that, each institution can use various Form 990 line items to compare their results and activities year-by-year to great benefit. Also, it is always a great idea to find four or five "like-minded" colleges, universities, or seminaries with "the same demographics, but different geographics" to use as comparables for your data. Use www.guidestar.org to find these schools, meet their accounting team members at conferences, and then compare and contrast operations to help each other with best practices. (And check out the article later in this report for some ideas on Form 990 line items to include on your "990 Dashboard.")

BOARD OF DIRECTORS/TRUSTEES REVIEW AND APPROVAL OF FORM 990-SERIES RETURNS

In our work with nearly 80 colleges, universities, and seminaries over the past few years, we've seen a wide range in how involved boards of trustees are in reviewing Form 990. Many institutions have the impression that the IRS requires a board review of the form. While this is not technically correct, the IRS certainly encourages board review and it is a great best practice.

One of the issues we find is that frankly, most boards are not very savvy when it comes to Form 990-series returns and the nuances thereof. As we have the opportunity to present these returns to boards of trustees — generally finance or audit committees — we often find that no one asks any questions. This should be of concern to your accounting team.

Every board of directors or trustees should be informed enough to answer the following questions:

1. Has your institution provided a complete copy of your Form 990 (nothing redacted, even Schedule B – List of Contributors) to all members of your governing body before filing the form?
2. Did your institution engage in an excess benefit transaction with a disqualified person during its most recent tax year or become aware of an excess benefit transaction that occurred in a prior tax year?
3. Did your institution have any amounts recorded on its financial statements for receivables from or payables to any current or former officers, directors, trustees, key employees, highest compensated employees, or disqualified persons?
4. Did your institution provide a grant or other assistance to an officer, director, trustee, key employee, substantial contributor or employee thereof, a grant selection committee member, or to a 35% controlled entity or family member of any of these persons?
5. Was your institution a party to a business transaction with a current or former officer, director, trustee, or key employee?
6. Was your institution a party to a business transaction with a family member of a current or former officer, director, trustee, or key employee?
7. Was your institution a party to a business transaction with an entity of which a current or former officer, director, trustee, or key employee (or a family member thereof) was an officer, director, trustee, or direct or indirect owner?
8. Did your institution maintain any donor-advised funds or any similar funds or accounts for which donors have the right to provide advice on the distribution or investment of amounts in such funds or accounts?
9. Did your institution, directly or through a related institution, hold assets in temporarily restricted endowments, permanent endowments, or quasi-endowments?
10. At any time during the calendar year, did your institution have an interest in, or a signature or other authority over,

a financial account in a foreign country (such as a bank account, securities account, or other financial account)?

11. Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?
12. Did your institution make any significant changes to its governing documents during its most recent tax year?
13. Did your institution have a written conflict of interest policy wherein officers, directors or trustees, and key employees were required to disclose annually interests that could give rise to conflicts?
14. If so, was your conflict of interest policy regularly and consistently monitored and enforced in a manner that ensured compliance with the policy?
15. Does your institution have a written whistleblower policy?
16. Does your institution have a written document retention and destruction policy?
17. Did your institution's process for determining compensation of the CEO, executive director, president, and/or other officers and top executives include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?
18. Have you reviewed Form 990, Part VII – Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors for accuracy and understanding?
19. Does your institution have a committee that assumes responsibility for oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant?
20. Does the institution have a gift acceptance policy that requires the review of any non-standard contributions?

It's important to note that Form 990, Part VI, Line 11a asks, "Has the institution provided a complete copy of this Form 990 to all members of its governing body before filing the form?"

And then Line 11b says, "Describe in Schedule O the process, if any, used by the institution to review this Form 990."

The instructions to Line 11b state:

> Describe on Schedule O (Form 990 or 990-EZ) the process, if any, by which any of the institution's officers, directors, trustees, board committee members, or management reviewed the prepared Form 990, whether before or after it was filed with the IRS, including specifics about who conducted the review, when they conducted it, and the extent of any such review. If no review was or will be conducted, enter "No review was or will be conducted."

Notice the emphasis on "specifics" related to three things:

- Who conducted the review
- When they conducted it
- The extent of any such review

So who should conduct the review of Form 990 and what should be the extent of that review? The answer is multi-faceted, but the Form 990 review should at least provide the board with enough information to:

1. Protect the institution from losing its exempt status
2. Protect the institution from potential financial penalties
3. Protect the board from potential penalties that they may owe personally

Most college, university, and seminary accounting team members are aware of the penalties for filing a late, inaccurate, or incomplete Form 990. But are your board members aware of these potential penalties?

Under section 6652(c)(1)(A), a penalty of $20 a day, not to exceed the lesser of $10,000 or 5% of the gross receipts of the institution for the year, can be charged when a return is filed late, unless the institution shows that the late filing was due to reasonable cause. Institutions with annual gross receipts exceeding $1 million are subject to a penalty of $100 for each day failure continues (with a maximum penalty of $50,000 for any one return). The penalty applies on each day that the return is not filed after the due date.

Further, under current law, individuals and corporations are subject to a 20% accuracy-related penalty with respect to the portion of an underpayment that is attributable to any substantial understatement of income tax. Tax-exempt institutions subject to UBIT must file a return (Form 990-T) each year to report unrelated business taxable income. Under current law, the 20% accuracy-related penalty and the penalty for reportable transactions and listed transactions apply to tax-exempt institutions, but only at the entity level. No manager-level penalty applies in such cases, unlike other penalties under current law that impose a penalty on both the tax-exempt institution and its managers (e.g., penalties applicable to public charities with respect to excess-benefit transactions and penalties on private foundations relating to self-dealing).

Next, board members should be aware that they can be subject to the disqualified person and/or the foundation manager penalties under the excess benefit transaction rules. Under section 4958, any disqualified person who benefits from an excess benefit transaction with an applicable tax-exempt institution is liable for a 25% tax on the excess benefit. The disqualified person is also liable for a 200% tax on the excess benefit if the excess benefit is not corrected by a certain date. Also, institution managers who participate in an excess benefit transaction knowingly, willfully, and without reasonable cause are liable for a 10% tax on the excess benefit, not to exceed $20,000 for all participating managers on each transaction.

Finally, in the current 2014 Tax Proposal (the "Camp" proposal), there is a provision for a 5% penalty to be assessed to officers, directors, and trustees (foundation managers) who participate in understating or not reporting unrelated business activities on Form 990-T. Under the provision, a 5% penalty would apply to managers of a tax-exempt institution when an accuracy-related penalty is applied to the institution for any substantial understatement of UBIT. The manager-level penalty would be limited to $20,000. The provision would also apply a 10% penalty on managers of a tax-exempt institution for an understatement of UBIT relating to a reportable transaction or listed transaction.

The manager-level penalty for reportable transactions and listed transactions would be limited to $40,000. The provision would be effective for tax years beginning after 2014.

We strongly advise higher education institutions to take the steps necessary to train their governing board (and its applicable committees) on the myriad Form 990 provisions that could cause issues in the public, the press, or the IRS if they are uninformed.

Courtesy of Cornerstone University, Grand Rapids, MI

SUMMER YOUTH CAMPS AND UBIT

In the past year, we've seen a number of colleges, universities, and seminaries take a long look at whether their youth camps generate unrelated business income. In response, we at CapinCrouse have been conducting UBIT surveys specifically designed to look at athletic and youth camps.

In its Colleges and Universities Compliance Project (CUCP) Final Report, the IRS stated:

> The exams of 90 percent of colleges and universities ended with increases to UBTI. This includes more than 180 adjustments totaling about $90 million. The activities below, in order of frequency, were connected to more than half of the adjustments:
>
> 1. Fitness and recreation centers and sports camps
> 2. Advertising
> 3. Facility rentals
> 4. Arenas
> 5. Golf courses

Notice that "sports camps" are combined with fitness and recreation centers (not sure why) as the number-one occurring UBIT activity in the 34 audits that comprised the data for the CUCP Final Report.

This has elevated the overall issue of youth camps in immediacy and concern. Higher education institutions need to make sure they have their i's dotted and t's crossed with regard to whether their camps produce income and expenses that are required to be reported on Form 990-T.

For our purposes, we are including sports camps, music camps, Bible camps, cheerleading camps, and similar activities in the term "youth camps." This leads to a range of factors, from day camps to dorm use, food services, t-shirts, sponsorships, and more. Further, some camps are run by the school, while others are run by coaches or outside vendors. It can get complicated.

There are several rulings related to youth camps and frankly the guidance, when taken as a whole, is about as clear as mud. One particular ruling has to do with several facets and types of youth camp activities. That guidance comes in the form of Private Letter Ruling (PLR) 8151005. The "headnote" of that ruling states the facts as:

> Exempt college C has nationally known athletic director D to supervise its athletic programs. D's salary is limited by C's pay structure. D owns corp. that runs basketball camp for pre-college age children, using C's residence, dining and athletic facilities. Corp. was underbilled by C, which stated that this was to ensure that D's total compensation would be competitive with that of others with D's reputation. C also runs a hockey camp directly. Hockey camp participants, as well as C's students, high school and youth teams, professional team and general public use C's ice arena.
>
> RULED: C didn't jeopardize its exempt status by underbilling D's camp. Underbilling was part of his compensation and total amount was reasonable.
>
> RULED: Income from hockey camp is from exempt activity related to C's purposes and isn't subject to tax. It was directly operated by C, to provide hockey instruction for children and is integral part of C's educational program.
>
> RULED: Income from fees and sales to general public, including noncollege groups, is from unrelated trade or business and is taxable. There's no relationship between this use and C's purpose.
>
> RULED: Expenses exclusively and directly related to unrelated activity are deductible fully from attributable income. Non-exclusive expenses must be allocated; only pro rata portion corresponding to unrelated activity can be deducted from unrelated income of his compensation and total amount was reasonable.
>
> RULED: C's income from D's camp is unrelated.

Wow! There is a lot going on there. Let's try and unpack it a little bit.

So there are three activities in question (we break them out a little differently than the PLR):

1. A basketball camp at the college, run by the athletic director's corporation, producing "dual-use" rental income
2. A hockey camp directly run by the college

3. Income from use of the ice hockey arena by students, high school and youth teams, a professional team, and the general public

There is a side issue regarding the college's "underbilling" of the athletic director in order to make his overall compensation competitive, but let's stick to the UBIT issues.

First, the basketball camp generates rent. Generally, rental income is excluded from UBIT. However, the college provides additional services (food services, maid service, etc.) for the rental fees. The ruling states:

> The camp utilizes the college's facilities including residence, dining and athletic facilities under the terms of a contract between the college and the corporation entered into at the same time as the athletic director's employment agreement with the college. Food, linens, and related services are provided by the college under the contract and the corporation pays the college for the various services and facilities provided.

The provision of these "services" results in "dual-use" of the facilities, resulting in UBIT. Note that in other rulings, if the services were provided by a third party the college may avoid the dual-use determination. Another applicable ruling on this issue is Revenue Ruling 76-402, which involves a tennis camp.

Second, the hockey camp directly run by the college was ruled to be related to the college's educational exempt purpose and not subject to UBIT.

Third, the ruling stated that income from the rental and fees associated with the use of the ice hockey arena was UBIT — for "noncollege" groups. The PLR goes on to say that:

> … income from the operation of the ice arena derived from fees and sales to the general public, including **noncollege groups such as a professional hockey team, youth groups and high school teams**, as the college has not established a relationship between such groups' use of the arena and the college's educational purpose, is income from an unrelated trade or business and is subject to unrelated business income tax. (Emphasis added.)

This is an interesting PLR. We recommend that you read it.

In addition, the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT), Exempt Organization subcommittee covered issues of dorm rentals and youth camps in a proposed Revenue Ruling in their 2014 report, as follows:

> **Situation 10**
> X is a private university. X has several dormitories that are used to house students during the fall and spring semesters. During the summer months, X coordinates with Y, a charitable organization within the meaning of Section 501(c)(3), for Y to conduct summer sports and educational camps for youth. X leases dormitory space to the participants of the camps and for the camp's counselors. X's income from the lease of the dormitory space to the camp participants and counselors is not income from an unrelated business because the activity contributes to the educational purposes of X.
>
> **Situation 18**
> G is a public university that directly operates a basketball camp for children in grades 5 through high school. This camp operation utilizes G's residence, dining, and athletic facilities and is operated to provide basketball instruction to children and is an integral part of G's educational program. Income from the basketball camp is from an exempt activity that is substantially related to G's exempt purposes and is not unrelated business income.
>
> **Situation 19**
> Same facts as Situation 18, except that G employs a nationally known basketball coach, J, who runs G's basketball program. J owns a limited liability company, K, that operates a basketball camp for pre-college age children, using G's residence, dining, and athletic facilities. In addition, some of G's personnel provide services for the camp. Under a contract between G and K, G provides food, linens, and related services to K in addition to the personnel. K pays G fair market value for the various services and facilities provided by G. G's income from K is unrelated business income. Because this income is from the dual use of facilities and personnel, an allocable portion of the expenses attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under Code Section 512.

In conclusion, youth camps (along with your overall athletic program) rate special attention in the wake of the CUCP Final Report. We would be happy to discuss these matters with your team and could go through our proprietary 740-A or 740-C checklist, or both, to produce a tax memorandum for your guidance.

Courtesy of Patrick Henry College, Purcellville, VA

FORM 990-T REDESIGN PROJECT

As part of the 2014 ACT Exempt Organizations subcommittee report, there has been an ongoing effort over the past year to gain consensus on whether Form 990-T should be updated. And if so, what should that "redesign" look like?

The proposed results were part of the subcommittee's *2014 Report of Recommendations*, which was released on June 11, 2014. The process was interesting and informative, and involved the presentation of ideas and drafts to over 400 individuals within the IRS, the U.S. Treasury Department, and tax committees from the National Association of College and University Business Officers (NACUBO), the American Institute of Certified Public Accountants (AICPA), and the American Bar Association (ABA). There was a great deal of valuable input, and no consensus was reached in these meetings.

The guiding principles or goals as the process set sail were to:

- Educate organizations and enhance awareness of unrelated business income tax issues among all exempt organizations by providing step-by-step education on Form 990-T and its instructions and worksheets (including interactive components)
- Provide a concise, definitive Form 990-T that gives readers clear data regarding an organization's unrelated business activities — both through financial data and Yes/No queries
- Simplify a form that is currently convoluted and confusing
- Promote transparency with the interested public by requiring clear information — enhanced through education and outreach
- Ease the IRS's audit burden by developing an education/outreach path that produces standard taxpayer worksheets and evidentiary matter

The process began with a brainstorming session that acknowledged the need for more education in the UBIT arena and called for at least a "face lift" for Form 990-T. These discussions resulted in an idea to move Form 990-T to Schedule T of the current Form 990.

After that draft form was presented to over 100 people, the direction changed. On the "cons" side, there were concerns over whether organizations not required to file Form 990, such as churches and public universities, may be required to file Form 990-T. If unrelated business income and expenses were to be reported on Schedule T (Form 990), would those entities be required to file Form 990?

On the "pros" side, a suggestion entered by many of the reviewers centered on whether the new Schedule T should conform to Form 990, Part VIII (Revenues). This would provide a connection to the "core form" and should make Form 990 software solutions more efficient.

But the most compelling argument against the "Schedule T solution" was the desire for Form 990-T to migrate toward complete electronic filing. Many reviewers expressed the opinion that it might take a significant number of years to bring the full Form 990 to an electronic/web-based filing platform — and therefore it would be better to keep a Form 990-T and redesign it as a "smaller" form that could be automated more easily and quickly.

With the Schedule T idea tabled (for now), the focus turned toward redesigning the current Form 990-T. The form has not seen a significant retooling since it sprang on the scene 63 years ago. The overwhelming opinion of those who commented was that it needs some time in "dry dock" and a full retrofitting.

A few of the earliest commenters put forth the idea that the revenue and expense reporting part of the redesigned form might mimic Form 8825 (or Form 1040, Schedule E, Part I). In this iteration, each unrelated business activity would be listed and described at the top and given an A, B, C, or D designation. Then, income and expenses would be entered vertically on a typical grid basis. The concern with this proposed plan was two-fold. First, given the history of taxpayer reporting, there would likely not be much — if any — consistency in reporting. Getting every filing organization to classify their unrelated business activities in a consistent manner would be difficult. Second, there would be limitations in how to handle profits, losses, and net operating losses.

The next step was to go back and examine the idea of tying the revenue and expense line items of Form 990-T to Form 990, Part VIII. A draft of a new Form 990-T, Part I with lines that matched the 11 lines from Part VIII was developed for review. This third draft of a "990-T replacement" retained the columnar, horizontal reporting for revenues, expenses, and net income for each line item. Based on comments, the next step was to expand the 11 "main" line items from Form 990, Part VIII into "sub-lines." For example, Line 6, Rental income was expanded to Line 6a – Real property rentals, Line 6b – Personal property rentals, Line 6c – Debt-financed rentals, and Line 6d – Other rentals.

Ultimately, Form 990-T, Part I grew to three pages, which violated the goal of minimizing the size of the form. It was also pointed out that the historical statistics on Form 990-T from the IRS's Statistics of Income (SOI) would no longer be valid if the revenue categories were significantly changed. And, it became clear that Form 990, Part VIII does not, in itself, provide a great basis for reporting. Contributions on Line 1 would likely not be used in the unrelated business income context. Then, Lines 2 through 5 and Line 11 are reported at gross revenue, whereas Lines 6 through 10 incorporate expenses to reach a net revenue presentation. This opened a Pandora's box of confusing possibilities.

Thus, the next draft of the form was developed by going to the SOI data and discerning which categories of activities were most commonly reported over the years since 2003. Although there was some dissension, most reviewers approved of this approach. The main source of negative response to this "final draft" was some murmuring about whether the SOI was valid. Several reviewers said things like, "No one fills out the Form 990-T correctly," and "The current form is confusing and taxpayers just do the best they can to enter their income and expenses."

This discussion led to a watershed moment: the biggest problem with Form 990-T reporting — beyond the confusing layout of the form — was lack of knowledge about UBIT issues. The Form 990-T redesign project quickly moved from format issues to the need for education!

As experts and stakeholders weighed in, it seemed that the Form 990-T instructions, Publication 598, and Publication 557 provided a large percentage of what exempt organizations needed to know. For some reason, they just weren't getting that insight.

So the focus moved toward a method by which organizations could go to a central web location (a "checklist" or "clearinghouse") and query the system as to whether or not they had unrelated business income. At this, the Unrelated Business Activities Checklist (UBAC) was born.

The UBAC would list 70 or more typical unrelated business activities. With a click, users would be linked to Guide Sheets with specific guidance on various types of unrelated business activities. Users would also be able to click links to the applicable worksheet for step-by-step computation of revenues and expenses.

Education and outreach could be designed to help organizations methodically move down the checklist, checking the "Yes" column (Column B) for any activities they currently conduct. If needed, they could click for further information.

The activity-related line numbers from the UBAC would always be brought forward to Form 990-T, Part I. This way, readers would be able to discern which activities from the UBAC line numbers make up the amounts on the combined line reporting of Income, Expenses, and Net unrelated business income reported on each line item.

Note that the proposed forms in the 2014 ACT report are intended to generate discussion and are not intended to be a final product. Much work and consensus-reaching will remain to be done if we desire to chart this course. If you would like to know more about this process and what the future might hold for it, check out the *2014 Report of Recommendations*, which is available at www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf. We will also keep you informed of any updates.

Courtesy of East Texas Baptist University, Marshall, TX

POST-ISSUANCE COMPLIANCE FOR EXEMPT COLLEGES, UNIVERSITIES, AND SEMINARIES THAT ISSUE TAX-EXEMPT BONDS

Of the 174 institutions that participated in our *2012 Higher Education Tax Reporting Trends Project* and filed Form 990, 45.4% had an outstanding tax-exempt bonds issue. (The breakdown was Category A = 78.3%, Category B = 46.9%, Category C = 4.0%.) As more and more institutions look to expand their facilities, they find that tax-exempt bonds may be a viable and advantageous option. These institutions need to be careful to avoid running afoul of the substantial penalties that can result from not staying in compliance with the various — and often complicated — rules governing "post-issuance compliance."

Virtually all of the exempt colleges, universities, and seminaries that might "issue" tax-exempt bonds will be "conduit borrowers." As a 501(c)(3) organization, you must "partner" with a federal, state, or local government entity that will be the "conduit issuer." In fact, the issuer borrows the tax-exempt money and then lends it to the 501(c)(3) borrower for qualified purposes, as permitted by federal tax law. This is generally the construction of facilities or purchase of equipment.

Both the conduit issuer and the conduit borrower will sign an agreement at the time of the issuance of the obligation. In this agreement, the borrower will agree to comply with the applicable provisions of federal tax law that enable the obligation to continue as a tax-exempt bond obligation and provide the tax-advantaged treatment that investors are looking for. This agreement will hold the borrower primarily responsible for federal tax compliance and the penalties that may be imposed.

This quick summary is a simplification. The agreement generally includes an attorney's opinion as to whether the obligation qualifies as a tax-advantaged obligation, as well as numerous codicils that the borrower institution agrees to abide by.

According to the IRS's Tax-Exempt Bond Community web pages, available at www.irs.gov/Tax-Exempt-Bonds, post-issuance federal tax requirements generally fall into two categories:

1. Qualified use of proceeds and financed property; and
2. Arbitrage yield restriction and rebate.

The IRS provides the following guidance on its "TEB Post-Issuance Compliance: Some Basic Concepts" webpage (www.irs.gov/Tax-Exempt-Bonds/TEB-Post-Issuance-Compliance-Some-Basic-Concepts):

> Qualified use requirements require monitoring of the various direct and indirect uses of bond-financed property over the life of the bonds and calculations of the percentage of nonqualified uses. Arbitrage requirements also require monitoring over the life of the bonds to determine whether both the yield on investments acquired with bond proceeds are properly restricted and whether the issuer must file Form 8038-T to pay a yield reduction payment and/or rebate payment.
>
> Some federal tax requirements that are generally issuance related might require some level of post-issuance due diligence monitoring. For example, adjustments to the

determination of issue price for federal tax purposes can affect compliance with volume cap allocation, arbitrage yield restriction, and other federal tax requirements. Similarly, some level of post-issuance monitoring may be required to determine compliance with the issuance costs limitations applicable to qualified private activity bonds…

Issuers should adopt written procedures, applicable to all bond issues, which go beyond reliance on tax certificates included in bond documents provided at closing. Sole reliance on the closing bond documents may result in procedures insufficiently detailed or not incorporated into an issuer's operations. Written procedures should contain certain key characteristics, including making provision for:

1. Due diligence review at regular intervals;
2. Identifying the official or employee responsible for review;
3. Training of the responsible official/employee;
4. Retention of adequate records to substantiate compliance (e.g., records relating to expenditure of proceeds);
5. Procedures reasonably expected to timely identify noncompliance; and
6. Procedures ensuring that the issuer will take steps to timely correct noncompliance.

The goal of establishing and following written procedures is to identify and resolve noncompliance, on a timely basis, to preserve the preferential status of tax-advantaged bonds. Generally, an issuer that has established and followed comprehensive written procedures to promote post-issuance compliance is less likely, than an issuer that does not have such procedures, to violate the federal tax requirements related to its bonds.

The IRS's Tax-Exempt Bond Community web pages describe the "key characteristics" as follows:

Due diligence review at regular intervals
The IRS prefers that conduit issuers and borrowers conduct due diligence reviews at least annually to ensure that federal tax requirements concerning tax-advantaged obligations are being met. As part of such review, conduit borrowers might want to request that bond counsel or other financial professionals address their employees for professional training. Most bond counsel distribute client alerts and client memos that can assist in such training. The due diligence review should substantiate continuing compliance with all applicable tax requirements, including a review of all private use and private payments involving financed property, monitoring the yield on (and type of investments of) proceeds of the obligations, and determining whether any arbitrage rebate payments or yield reduction payments must be paid to the U.S. Treasury.

Identification of responsible officials or employees
A written compliance policy should identify the officials or employees responsible for the regular due diligence review and for ongoing compliance with tax requirements. As discussed above, there may be several different employees and departments responsible for such ongoing compliance. In addition, such personnel may change over time. Conduit borrowers may therefore want to identify responsible officials or employees by title so that the compliance duties are clearly the responsibility of the holder of the employee who has such job title.

Training of responsible officials or employees
The IRS recommendation to provide for the training of responsible officials or employees in a compliance policy is somewhat vague and may be unsettling to the officials or employees who will be charged with compliance responsibilities. Those officials and employees are not expected to act as lawyers who know the proper response to all compliance situations that may arise, but they should be familiar enough with federal tax issues that they know when to ask for legal or other compliance advice. The IRS provides information on its Web site that can be used by officials or employees for continuing education. The Web site contains publications specifically targeted to issuers and conduit borrowers, such as IRS reports on avoiding troubled tax-advantaged bonds and the sale of assets financed with tax-exempt bonds by state and local governments and Section 501(c)(3) organizations. The IRS also frequently hosts phone forums to discuss tax-advantaged obligations and compliance issues. In addition, as mentioned above, conduit issuers and borrowers might want to ask bond counsel or other financial professionals for occasional training of officials and employees and should review client alerts and client memos distributed by bond counsel or other professionals.

Retention of records
The conduit borrower should institute record-keeping policies to substantiate compliance with federal tax requirements. Records should be kept until at least the later of three years after the maturity date of the obligations or three years after the maturity date of any obligations refunding the original obligations. Conduit issuers and conduit borrowers are not allowed a shorter record retention period if state policies permit shorter record retention periods. For example, the conduit borrower should retain records showing the use of proceeds (such as invoices) and contracts showing the use of financed property (such as management contracts, certain service contracts, and research contracts).

Procedures to identify noncompliance
As part of its written policy, a conduit borrower should implement procedures that are reasonably expected to help the borrower timely identify noncompliance.

However, a conduit borrower that is contemplating adopting written post-issuance compliance procedures should ascertain its compliance requirements and its compliance resources before adopting procedures.

A conduit borrower should only adopt procedures with which it can actually comply. If it adopts elaborate procedures that it does not, or cannot, follow, such procedures will not help it actually comply with federal tax requirements. In addition, the existence of such procedures, and the conduit borrower's noncompliance with such procedures, may actually be a negative factor that is taken into account by the IRS in an examination.

Finally, the written policies should not be written so that third parties, such as the holders of the tax-advantaged obligations, have a legal right to rely on such policies. Doing so could possibly give such third parties a possible cause of action if the conduit borrower does not comply with its own written procedures. These are internal policies of the conduit borrower and no other party should be able to rely on them.

Procedures to timely correct noncompliance
The written policy should include procedures ensuring that the issuer and the conduit borrower will take steps to timely identify and correct noncompliance. Such steps should include remedial actions, which are steps that the issuer may generally take if there has been a change in use of financed property. These steps are outlined in the regulations. Remedial actions are detailed and require various timely actions, so the issuer and the conduit borrower should involve bond counsel before any change in use of financed property occurs. In addition, the written procedures should recognize that the issuer and the conduit borrower could participate in the Service's voluntary closing agreement program, described below.

Adoption of written compliance procedures.
The IRS does not require the issuer or the conduit borrower to adopt a written compliance procedure using any specified internal procedure. The issuer and the conduit borrower should adopt written compliance procedures so that such procedures can be easily updated when necessary.

FORM 990 DASHBOARD?

Finally, we want to take a few minutes to brainstorm (in print) about Form 990 metrics. As we have said many times over the past five years, the "new" Form 990 requires a huge amount of data that is reported to the IRS — and open to review by the general public.

One of the questions in our 2014 survey was, "Does your accounting team provide any Form 990-based benchmarking/comparative data or ratios to your board?" Amazingly, less than 11% of the 203 institutions in this year's survey responded "Yes" to this question.

It seems intuitive that colleges, universities, and seminaries that file Form 990 would build annual comparisons, based on various line items from the core form and supporting schedules. This would provide great insight into the growth, performance, and viability of their schools. Clearly, value could be gained by charting contributions (Part I, Line 8), investment income (Part I, Line 10), and total fundraising expenses (Part I, Line 16b). Your development team might find great value in an analysis of, say, the number of volunteers (Part I, Line 6) and government grants (Part VIII, Line 1e).

Then, metrics could be built around formulas such as total fundraising expenses over contributions, fundraising event gross receipts (Schedule G, Part II, Line 1) over fundraising event expenses (Schedule G, Part II, Line 10), or investment management fees (Part IX, Line 11f) over investment income (Part VIII, Line 3) — and there are myriad other possibilities. Think about it: the press and general public have the ability run these numbers on your institution. Shouldn't you be doing it, too?

Another tangible use of Form 990 data is in the area of compensation comparison. Clearly the potential is there to use Form 990, Part VII, Section A data on executive compensation to provide your compensation committee with viable comparative data. (This can help your institution be able to answer "Yes" to Form 990, Part VI, Lines 15a and 15b.)

More and more, we are helping colleges, universities, and seminaries build financial dashboards from Form 990 data. We have tools that can quickly build comparative analyses from this information for our tax clients. Internal metrics (your data analyzed year-by-year) and external comparisons (analyzing your Form 990 entries against institutions with operations comparable to yours) can be best practices that allow you to use readily available data to improve your school's operations and strategic planning.

Please contact us if you'd like to talk about this or any other tax issues you may be contemplating.

Courtesy of Northwest Nazarene University, Nampa, ID

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