Brigham Young University Education and Law Journal

Volume 2012 | Number 2 Article 2

Fall 3-2-2012

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THE TAXMAN ON CAMPUS: HOW AGGRESSIVE IRS INITIATIVES ARE INCREASING AUDIT AND COMPLIANCE RISK FOR COLLEGES & UNIVERSITIES

*William A. Bailey**

I. INTRODUCTION

In October 2008, the Internal Revenue Service sent an unprecedented 33 page questionnaire to 400 public and private colleges and universities requiring answers to detailed, never-before sought questions regarding the institutions' governance practices and tax compliance.[1] Of the 400 colleges and universities that received the questionnaire,[2] thirteen did not respond to the IRS—those institutions were met with IRS audits.[3] Of the institutions that completed the questionnaire, more than 30 additional colleges and universities were selected for an extensive audit examination.[4] The IRS reported the audits would be focused on abuses regarding unrelated business taxable income and executive compensation.[5] The Service has also reported that it may open up more audit examinations for certain colleges and universities that left

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1. Internal Revenue Serv., IRS Exempt Organizations Colleges and Universities Compliance Project: Interim Report 1 (2010) [hereinafter Interim Report]. The questionnaire's 94 primary questions (along with scores of sub-questions) were categorized into four areas: organization information, activities, endowment Funds, and executive compensation. IRS Form 14018 Compliance Questionnaire: Colleges and Universities (2008) [hereinafter College and University Questionnaire].

2. The IRS identified 2,402 public and private colleges and universities in the population sample of organizations thought to be exempt under I.R.C. §501(c)(3) or §115, including 1,752 private institutions and 650 public institutions. Questionnaires were sent to 100 large institutions, 100 medium institutions, and 200 small institutions. INTERIM REPORT, *supra* note 1, at 2. For category size data, *see infra* text accompanying note 56.

3. INTERIM REPORT, *supra* note 1, at 2. Another 31 organizations indicated they were in some way technically not the type of organization subject to the questionnaire. IRS audit teams followed up on those organizations as well. *Id.*

4. *Id.* at 5.

5. *Id.*

some questions unanswered.[6]

In May 2010, the IRS released an interim report analyzing much of the data it had received from its College and University Questionnaire.[7] The report noted that the questionnaire was part of a much larger compliance check by the IRS into tax-exempt organizations. Indeed, the IRS has been extremely active in the exempt organization area over the past several years, culminating most notably in a vastly reformed IRS Form 990—the annual informational return that is required to be filed by most sizable organizations with tax exemption under §501(c)(3) of the Internal Revenue Code, including most traditional colleges and universities.[8] The changes in this form have significantly increased higher education reporting burdens in recent years.

The IRS Questionnaire and its resulting IRS Interim Report—along with the new reporting requirements under the overhauled Form 990—provide significant insight into current trends of IRS concern regarding higher education institutions. Specifically, the data gathering informs colleges and universities where the greatest IRS scrutiny will be spent in upcoming years. Correspondingly, the information warns colleges and universities where they are most vulnerable to IRS audit and compliance risk.

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6. *Id.* at 3. The recent expansion of activity by the IRS regarding colleges and universities is unparalleled. Historically, colleges and universities have avoided significant IRS scrutiny for two major reasons: a distracted IRS and a willingly compliant higher education system. Throughout the 1960s, 1970s, and 1980s, the IRS was concerned with newsworthy abuses surrounding tax shelters, television evangelists, and the heyday of corporate mergers & acquisitions. Additionally, the IRS historically devoted its limited exempt organization time and resources for offenses so egregious as to put an organizations tax exemption at stake. Because of the inherently educational mission of colleges and universities, exemption status was uniquely protected—thus, the IRS had little to gain by diverting its resources to investigating colleges and universities. In 1992, the IRS finally got around to significant examination practices in higher education when it selected seven major universities for audit. Some of these audits took more than three years. Information from these audits led to more than an estimated 50 colleges and university audits throughout the 1990s. Over that decade, the IRS developed some expertise on how colleges and universities work, and where the high-dollar tax issues were likely to be found. In recent years, IRS energy regarding colleges and universities has been a rapid increase in activity compared to that undertaken in previous decades. BERTRAND M. HARDING, JR., THE TAX LAW OF COLLEGES AND UNIVERSITIES 1-3 (3d ed. 2008).

7. INTERIM REPORT, *supra* note 1, at i.

8. BRUCE R. HOPKINS ET AL., THE NEW FORM 990 1-2 (2009).

The term audit risk as used in this article can be thought of as the likelihood that the IRS will conduct an audit—a burdensome, stressful ordeal that may end in troubling consequences (e.g., negative publicity, discovery of non-compliance with the law, etc.). An organization is best protected against audit risk when it avoids being an outlier in its periodic filings with the IRS. Compliance risk, on the other hand, is the risk that the organization has actually been noncompliant with tax law. When the IRS discovers noncompliance with tax law as a result of an audit, it may assert an array of penalties—typically in the form of fines and excise taxes (and, in egregious circumstances, the potential revocation of tax exemption status—putting the entire mission of the organization at risk). An organization is best protected against compliance risk by understanding and meeting tax law requirements and seeking competent, expert advice. Of course, audit risk leads to compliance risk.

The purpose of this article is to review recent IRS interest in colleges and universities so that higher education institutions and their advisors can consider ways to reduce audit and compliance risk in the elevated atmosphere of scrutiny in years ahead. The reduction of audit and compliance risk allows institutions of higher education to continue unimpeded in sustaining and maintaining their central missions of educating students and research.

This article investigates shifts in IRS behavior that will increase audit and compliance risk at colleges and universities for the foreseeable future. It begins in Part II by discussing the policies driving the IRS in its strategic focus on tax exempt organizations in general and colleges and universities in particular—especially in regard to its new governance monitoring practices. Part III discusses areas of IRS interest specific to colleges and universities as highlighted by the IRS Interim Report on higher education, and discusses subject matter colleges and universities should consider as they prepare for increased IRS scrutiny. Part IV discusses academic criticisms of the IRS in its aggressive activity toward nonprofits and colleges and universities—specifically concerns over increased compliance costs, concerns that the IRS is overstepping its statutorily and judicially defined audit authority boundaries, and concerns that the IRS is overstepping constitutional bounds by participating in stealth preemption. Part V offers a conclusion.

II. BACKGROUND ON INCREASED ACTIVITY IN NONPROFIT SECTOR

A. Scandals Lead to Calls for Oversight

Current IRS activity in the nonprofit sector has its roots in scandal. The College and University Compliance Project—the project that prompted the College and University Questionnaire—is part of a larger effort by the IRS to dramatically correct perceived management abuses believed to have seeped from the for-profit sector into the nonprofit sector.[9] Former Commissioner Everson stated in a 2005 speech that three major factors were contributing to emerging problems in the tax-exempt sector at the time: "a dramatic increase in the size and complexity" of the nonprofit sector, a simultaneous decline in IRS resources to administer the tax law, and "lax attitudes" in organization governance.[10] Commissioner Everson's concerns were not without at least anecdotal evidence—between 2001 and 2004, scandals emerged at several iconic nonprofits including: the United Way, the American Red Cross, and the Nature Conservatory.[11] Everson's proposed means to solve abuse included a focus on transparency, inter-

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9. Mark W. Everson, Comm'r of Internal Revenue, Remarks at the Greater Washington Society of CPAs (Dec. 14, 2005) ("[T]he twin cancers of technical manipulation and outright abuse that we saw develop some years ago in the profit-making sector of the economy are now spreading to parts of the non-profit sector.").

10. *Id.* at 4. A fourth factor Commissioner Everson discussed in his speech at the time was "abusive tax avoidance transactions generally, including a number that involve tax exempts."

11. Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 20 (2011). "The concerns about charities [in the first half of the 2000s] surfaced largely through press reports and are legion: spending of earmarked contributions for non-earmarked purposes; excess compensation to organization insiders; mission drift—deliberate, or aided by faulty corporate governance; acceptance of property contributions when donors or others are the principal beneficiaries; participation in illicit tax shelter transactions; spending for non-charitable purposes; accumulations of income; failure to provide charitable services; use of the charitable form for non-charitable purposes; questionable investment practices; participation in political campaigns; and self-dealing transactions, to name a few." *Id.* at 3.

agency sharing of information, and intermediate sanctions.[12]

B. Oversight Leads to Higher Reporting Burdens in Nonprofit Sector

In the mid and late 2000s, the IRS shift to make nonprofits more transparent was significant. IRS focus on transparency mushroomed into its so-called "governance initiative"—a range of actions taken by the IRS that now scrutinize the way tax-exempt organizations are governed.[13] Beginning with the 2008 tax year, and phased in over three years, the IRS issued a new version of IRS Form 990 (the annual informational return for most sizeable public charity tax exempt organizations, including colleges and universities).[14] The changes were the form's most significant revisions since 1979.[15] Former chair of the American Bar Association's Committee on Exempt Organizations wrote that "[t]he promulgation of this return is one of the most extraordinary developments affecting the nonprofit community in recent times;"[16] and "[t]he revised Form 990 is no mere government form; the issuance of the redesigned Form 990 is akin to publication of a mammoth set of regulations. . . . In the context of nonprofit law, there has

12. Everson, *supra* note 9, at 12. The blunt instrument of tax-exemption revocation has been considered too harsh a penalty in many abusive situations involving nonprofits. Everson advocated other means by which to prevent abuse (in addition to tax exempt status revocation). For a discussion of intermediate sanctions *see infra* Parts III.A, III.C.4.

13. James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 546-49 (2010).

14. INTERNAL REVENUE SERV., BACKGROUND PAPER: SUMMARY OF FORM 990 REDESIGN PROCESS 1 (Aug. 19, 2008), *available at* http://www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf.

15. *Id.* For a brief history of the evolution of the Form 990, *see* James J. Fishman, *Commentary: The Federalization of Nonprofit Regulation and Its Discontents*, 99 KY. L.J. 799, 799-803 (2010-11) ("In 1942, the Treasury Department required all tax-exempt organizations to file an annual information return, a two-page form that covered the 1941 tax year and consisted of three questions, an income statement, and a balance sheet. . . . No one could have imagined from such a modest beginning that Form 990 would exponentially expand in page-length and importance to become the principal disclosure tool for government oversight of exempt organizations."). For a more expanded history of disclosure forms for tax-exempt organizations, *see generally* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004).

16. HOPKINS ET AL., *supra* note 8, at xxi.

never been anything like it."[17]

The revamped Form 990 requires tax-exempt organizations—including colleges and universities—to now report a variety of organization practices never before required, including significant information about compensation policies, independence of board members, conflict of interest policies, whistleblower and document retention policies, governing board minutes, and investment policies.[18] In addition to vast new requirements regarding the reporting of governance information, the overhauled Form 990 also requires significantly more information concerning compensation of highly paid employees.[19]

In general, the reaction by the nonprofit sector to the increased reporting requirements has been mixed. In a June 2009 speech, IRS Tax Exempt and Government Entities Commissioner Sarah Ingram admitted as much, noting "[t]he tax-exempt sector has had a variety of reactions to our efforts, which is to be expected when our community engages in an important conversation. Some have welcomed our involvement, and some have suggested we mind our own business. . . . Overall the reaction has been cautious."[20]

C. IRS Defends its Increasingly Active Role

Of course, the IRS sees its expanding role as imperative to the health of the nonprofit sector. IRS Commissioner Douglas Shulman stated in a November 2008 speech:

> I know that [the nonprofit] sector has had its encounters with abuse and misuse. The combination of tax-exemption and the over $3 trillion of assets held by nonprofits seems too

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17. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS xxxiii (10th ed. 2011) ("Despite its size, complexity, and overreaching, this return [the revamped Form 990] is a work of art. . . . [T]his return entails considerable lawyering. The revised Form 990 is no mere government form; the issuance of the redesigned Form 990 is akin to publication of a mammoth set of regulations. Much new 'law' is embedded in this return.").

18. William A. Bailey, *Navigating Form 990's Governance Section to Reduce a Nonprofit's Risk Exposure*, 88 PRAC. TAX STRATEGIES 4, 6-12 (2012).

19. *See* HOPKINS et al., *supra* note 8, at 89.

20. Sarah Hall Ingram, IRS Tax Exempt and Gov't Entities Comm'r, Remarks before the Georgetown University Law Center Continuing Legal Education (June 23, 2009).

> compelling a prize to resist for some. The IRS has fought hard to protect the sector against corruption, and the diversion of tax-exemption's public purposes to mere private benefit. We will continue to insist that the sector be squeaky clean, and that the high ideal of public benefit that underlies tax-exemption is honored.[21]

Intertwining the mission of nonprofit sector protection with the monitoring of governance practices, former Comptroller General of the United States David Walker explained: "Good governance and transparency are essential elements to ensure that tax-exempt entities operate with integrity and effectiveness in carrying out their missions. . . . Transparency sheds light on entities' practices, which enhances incentives for ethical, efficient, and effective operations and facilitates oversight by the public and others."[22] Former IRS Commissioner of Tax Exempt and Government Entities Steven Miller additionally explained the intent of the governance questions:

> [T]o let the sun shine on governance practices. Let the public see how your organization is run [and] what standard of conduct you desire and aspire to. . . . We care about governance because we believe . . . that a *well-governed organization is more likely to be compliant with the tax law, while poor governance can easily lead to trouble.* Good governance also allows organizations to self-identify and self-resolve problems.[23]

These statements echo the strongest argument the IRS has maintained in broadening its tax compliance mission from tax law enforcement to monitoring governance practices—its position that a better governed organization is more likely to be compliant with tax law.[24] The argument may be vulnerable,

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21. Douglas Shulman, Comm'r of Internal Revenue, Remarks before Independent Sector (Nov. 10, 2008).

22. *Tax-Exempt Sector: Governance, Transparency, and Oversight Are Critical for Maintaining Public Trust: Testimony Before the House Comm'n On Ways and Means*, 109th Cong. 4 (2005) (statement of David M. Walker, Comptroller General of the U.S.).

23. Steven T. Miller, Comm'r, Tax Exempt and Gov't Entities Div. of the Internal Revenue Serv., Remarks at the Western Conference on Exempt Organizations: Nonprofit Governance 3 (Nov. 20, 2008) (emphasis added).

24. HOPKINS, *supra* note 17, at 140.

however, as critics have argued that (1) the IRS has overreached its audit authority by unprecedentedly going beyond the enforcement of actual tax compliance to the realm of enforcing the *means* by which taxpayers perform tax compliance, and (2) without congressionally mandated statute, the IRS has overreached its constitutional authority under principles of preemption. Both criticisms are discussed in Part IV below.

The IRS has clearly seen results from flexing its audit power muscle in the area of nonprofit governance. As word spread that the IRS would require organizations to report on governance procedures beginning in 2008, accounting firm Grant Thornton conducted a 2008 survey[25] where 652 nonprofit officers indicated:

> 26% created governance policies for the first time in the previous year
>
> 71% reported having annual meetings to discuss executive compensation
>
> 72% had a board or committee review the Form 990 (up from 40% in the previous year), and
>
> 92% had a written conflict of interest policy (up from 62% three years previously).

Colleges and Universities should be particularly aware of the new governance policy and practice issues addressed by the Form 990. As many nonprofit organizations are increasingly seeking to make their organizations transparent, those that fail to implement such procedures are likely to become outliers in a stream of IRS data, thereby increasing their risk of IRS audit.

D. Governance Initiatives Turn Focus to Hospitals & Higher Education

Although the new governance and other reporting burdens have been applied across all areas of the nonprofit sector by means of the Form 990 Annual Return, the IRS has moved to a phase of focusing further scrutiny on specific groups within the tax-exempt sector: hospitals and higher education.

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25. Ingram, *supra* note 20.

In May, 2006, questionnaires were sent to more than 500 nonprofit hospitals. The two principal purposes of the questionnaire were to (1) determine "whether and how nonprofit hospitals demonstrate their qualification for exemption as organizations described in section 501(c)(3) under the community benefit standard, and (2) [to] identif[y] how hospitals establish executive compensation" so that the IRS could end abusively high executive compensation.[26]

In February 2009, the IRS issued its Final Report on Tax-Exempt Hospitals.[27] The Service concluded that tax-exempt hospitals spent on average 9% of their revenues on community benefit expenditures including uncompensated care, medical education and training, research, and community programs.[28] The IRS also concluded that "[n]early all hospitals in the study reported complying with key elements of the rebuttable presumption procedure[29] available to establish compensation of certain executives and disqualified persons."[30] Thus, the IRS found substantial compliance with rules relating to reasonable compensation throughout the hospital sector, even though 20 of the hospitals had been selected for detailed compensation audits due to high compensation amounts relative to the size and circumstances of the hospital.[31] Ultimately, the IRS indicated in its final report that compensation practices at the 20 hospitals audited were found to be reasonable under tax law.[32]

Following the IRS hospital study, the Service significantly revised its Schedule H (Schedule for Tax-Exempt Hospitals)—a detailed schedule attached to a nonprofit hospital's Form 990. IRS Commissioner Douglas Shulman stated: "I'm confident

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26. INTERNAL REVENUE SERV., HOSPITAL COMPLIANCE PROJECT: INTERIM REPORT 3 (2007).

27. INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS HOSPITAL STUDY EXECUTIVE SUMMARY OF FINAL REPORT 1 (2009).

28. *Id.* at 3; INTERNAL REVENUE SERV., IRS EXEMPT ORGANIZATIONS (TE/GE) HOSPITAL COMPLIANCE PROJECT FINAL REPORT 3 (2009) [hereinafter HOSPITAL FINAL REPORT].

29. *See* discussion of rebuttable presumption *infra* Part III.C.4.b.

30. HOSPITAL FINAL REPORT, *supra* note 28, at 5.

31. Press Briefing, Lois Lerner, Dir. of the IRS Exempt Org., on the IRS Report on Nonprofit Hosp. 3 (Feb 12, 2009) (on file with the author).

32. HOSPITAL FINAL REPORT, *supra* note 28, at 5.

that the new hospital schedule for the Form 990—the Schedule H—is the right tool to allow nonprofit hospitals, of all types and sizes, to report how they promote the health of their communities and to justify their tax exemption."[33] It can be speculated that, as the IRS revamped a special schedule for nonprofit hospitals in the wake of its hospital study, the IRS may create a new schedule designed specifically for colleges and universities once the Service has completed its study of higher education.[34]

The study for hospitals was more rapid and concise than the college and university study. Within 6 months of sending questionnaires to over 500 hospitals, the IRS sent another batch of questionnaires to 400 universities and colleges. The focus of IRS inquiry for Colleges and Universities was fourfold—the IRS solicited 94 questions (with a myriad of sub questions) in areas of (1) organization information, (2) activities potentially unrelated to the school's education mission (and therefore creating taxable income under the unrelated business income rules), (3) endowment funds, and (4) executive compensation.[35] Although the IRS issued an interim report concerning universities and colleges in May 2010, the study is ongoing as the IRS has yet to issue a final report.[36] These developments are discussed in more detail below.

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33. Shulman, *supra* note 21, at 2.

34. *Grassley Tones Down Endowment Threats*, POLITICO (Sept. 10, 2008), http://www.politico.com/news/stories/0908/13340.html. "'I would like to ask [federal agencies] to develop a Form 990 schedule for colleges and universities,' Grassley said in reference to the form required for tax-exempt and non-profit organizations." He added that he wanted a specialized form to require information about 'student populations or costs.'" *Id.*

35. COLLEGE AND UNIVERSITY QUESTIONNAIRE, *supra* note 1.

36. On October 6, 2011, Congressman Charles W. Boustany, Jr., Chairman of the Subcomm. of Oversight on the U.S. House Ways and Means Comm., requested an update from the IRS on its progress regarding the Final Report. Letter from Subcomm. on Oversight Chairman Charles W. Boustany to Comm'r Douglas H. Shulman (Oct. 6, 2011), *available at* http://waysandmeans.house.gov/UploadedFiles/Tax-exempt.Oct_6.11_Redacted.pdf. No answer was given by the time of this printing.

III. AREAS OF INCREASED SCRUTINY & RISK: SUBJECTS EITHER FASHIONABLE OR PUNISHABLE BY NON-REVOCATION SANCTIONS

A. *IRS Selection of Issues with Non-Revocation Sanctions*

The four areas of IRS scrutiny in the IRS College and University Questionnaire are telling. Traditionally, the IRS has focused its resources in the tax-exempt organization sector only in areas it thought prudent to use its most blunt and effective tool—revocation of tax-exemption.[37] As former IRS Commission Everson stated, this instrument is in many ways too blunt.[38] Tax-exemption revocation is often likely to punish the entire organization and its beneficiaries for the sins of a mere few—the equivalent of killing a mosquito with a cannon. Such action can lead to bad publicity for the IRS, severely limiting its enforcement capabilities. A better strategy, clearly, is for the IRS to cherry-pick areas of concern that allow the Service to launch surgical strikes—imposing penalties in a way, so to speak, that allows the punishment to fit the crime.

The areas of IRS scrutiny are apparently aimed at circumstances in which the IRS can use finer tools—penalties that do not consist of outright tax exemption revocation—to punish abuse and enforce tax compliance. This is most clearly demonstrated in the compensation area. The IRS has been continuously concerned with high compensation among tax-exempt organizations.[39] In 1996, Congress passed the

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37. CONRAD TEITELL & RICHARD A. SIEGAL, AVOIDING INTERMEDIATE SANCTIONS xiii (1998).

38. *See supra* note 12 and accompanying text.

39. *See* REPORT ON EXEMPT ORGANIZATIONS EXECUTIVE COMPENSATION COMPLIANCE PROJECT—PARTS I AND II, at 2 (2007) ("In 2002, final section 4958 regulations were promulgated. Shortly thereafter, EO created the Intermediate Sanctions Committee to coordinate all aspects of interpretation and enforcement of section 4958 and the final regulations issued thereunder, including helping identify and develop section 4958 issues. In 2004, EO formally implemented the Executive Compensation Compliance Initiative, designed to review compensation practices of exempt organizations to identify tax administration concerns and potential areas of abuse in the exempt sector. The Project, which was managed by the Executive Compensation Compliance Initiative Team, included education and outreach components complemented by an examination program focusing on executive compensation paid by a broad range of public charities, as well as private foundations.").

intermediate sanction rules under IRC §4958.[40] These rules provide that, instead of draconianly revoking an entity's tax-exempt status in cases of certain types of private inurement, certain private inurement occurrences called "excess benefit transactions" would impose excise taxes on an individual benefiting improperly from the transaction.[41] For example, if an executive received unreasonably high compensation, the portion of the compensation that was excessive is (1) taxed with an excise tax and (2) the excess amount of compensation would be mandatorily returned to the nonprofit organization.[42] Thus, the sanctions focus on punishing the bad actor who receives private inurement, instead of punishing the entire organization by revoking its tax exemption status.[43]

In addition to intermediate sanctions, the IRS can also require tax-exempt organizations like colleges and universities to pay higher taxes if they are underreporting taxable unrelated business income.[44] The unrelated business income ("UBI") rules were enacted by Congress in 1950 with two policies in mind: First, to discipline tax-exempt organizations that conducted business activities unrelated to the organization's exempt purpose (this would otherwise violate the public benefit doctrine thereby putting the organization's tax exemption at risk).[45] Second, to place nonprofit organizations engaging in for-profit business activity on a level playing field with for-profit businesses engaged in the same activity.[46] The solution was to impose excise taxes on UBI. UBI

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40. *See also* Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

41. IRC §4958(c). For detailed background on the Intermediate Sanctions rules under IRC §4958, *see generally* TEITELL & SIEGAL, *supra* note 37.

42. The excise tax is 25% of the excess benefit. For organizations that do not report the improper transactions before the IRS finds them, the excise tax rate is 200% of the excess benefit. IRC §4958(a)-(b).

43. The IRS has reserved the right to revoke tax exemption of the entire organization in cases of multiple or extremely severe cases of excess benefit transactions. *See* Caracci. v. Comm'r, 118 T.C. 379, 414-17 (2002) (*rev'd on other grounds* 456 F.3d 444 (5th Cir. 2006). "Although the imposition of section 4958 excise taxes as a result of an excess benefit transaction does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case." *Caracci*, 118 T.C. at 417.

44. *See* HOPKINS, *supra* note 17, at 634-37.

45. *Id.*

46. *Id. See also* HARDING, *supra* note 6, at 10.

and the associated excise tax are reported annually on an organization's Form 990-T Exempt Organization Business Income Tax Return.[47]

Colleges and Universities may typically engage in a variety of activities that are potentially subject to tax under the UBI rules; including bookstore operations; advertising income; restaurant operations; operations of parking lots; the sale, rental, or exchange of mailing lists; concession sales; etc.[48] It is apparent from the College and University Questionnaire that the IRS is concerned with the underreporting of UBI activities on Form 990-T. This concern is likely a product of IRS aspirations to both increase revenue and preserve fairness. Many colleges and universities reported that they had never filed a Form 990-T,[49] so the IRS presumably wants to ensure it is not leaving revenue on the table from colleges and universities that do not understand their UBI obligations. In regard to fairness, if some institutions are taxed on their correctly reported UBI, while other institutions fail to report UBI activities due to their failure to follow the rules, then the tax burden is unjustly shifted to organizations that correctly obey the law.

With the ability to assess excise taxes on excess benefit transactions and unrelated business income, the IRS has surgical weapons in its possession that it can use to both increase treasury revenue and bring organizations into compliance without overplaying their hand with the threat of tax exemption revocation. In addition to these sanctions, the IRS appears to be looking forward to other areas in which they may extend their oversight under the cover of potentially popular support: governance and endowment funds.

B. IRS Selection of Issues with Certain Popular Support

Although there are not specific sanctions in the areas of nonprofit governance and endowment fund management at the present time, there has been significant popular, political, and

47. INTERNAL REVENUE SERV., 2010 INSTRUCTIONS FOR FORM 990-T: EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN 2.

48. HARDING, *supra* note 6, at 49.

49. INTERIM REPORT, *supra* note 1, at 2.

scholarly discussion on the issues. The new governance reporting requirements discussed above are the progeny of popular calls for governance oversight in the wake of for-profit and nonprofit scandal in the early 2000s.[50] Questions on the College and University Questionnaire include areas such as student faculty ratio, tuition rates and discounts, and distance learning activities—questions that appear entirely unrelated to the tax compliance mission of the IRS (i.e., no tax statutes require the IRS to collect information about student/faculty ratios, or even governance for that matter). It is difficult not to infer a political motive on the part of the IRS in this line of questioning and information gathering, as no direct link to tax law compliance appears forthcoming.

Additionally, endowment funds have been highly politicized in recent years.[51] During the mid-2000s, total endowment assets at U.S. higher education institutions almost doubled in size—from $220 billion in 2003 to $432 billion in 2007.[52] As tuition rates increased during those years, critics charged universities with hoarding their wealth instead of using their assets to benefit students. Senator Charles Grassley (R-Iowa) spearheaded the charge suggesting "colleges with big endowments [should] be required to pay out funds and dedicate some of those funds to keep tuition costs in check for working families."[53] The IRS questionnaire was created and distributed at the peak of university endowment discussion; however, much of the fervor surrounding university endowments cooled down in the wake of the recent recession. In 2009 alone, university endowments suffered average losses of 18.7% of their value.[54] It remains important for colleges and universities to prepare for the implications of IRS interest in this area, however, as at least one commentator—discussed below—

50. *See* Fishman, *supra* note 13, at 546-49, 564-78.

51. Alexander M. Wolf, Note, *The Problems With Payouts: Assessing the Proposal for a Mandatory Distribution Requirement for University Endowments*, 48 HARV. J. ON LEGIS. 591, 596 (2011) (citing *Report Card on Tax Exemptions and Incentives for Higher Education: Pass, Fail, or Need Improvement?: Hearing Before the U.S. Senate Comm'n on Fin.*, 109th Cong. 2 (2006)).

52. U.S. Gov't Accountability Office, GAO-10-393, Postsecondary Education 10 (2010).

53. Wolf, *supra* note 51, at 598.

54. *Id.* at 593-94.

soundly predicts the issue will resurface in future years as the economy recovers.[55]

C. *Areas of Increased Scrutiny*

The 2010 Interim Report on Colleges and Universities preliminarily analyzed specific data regarding (1) organization and governance, (2) activities subject to unrelated business income, (3) endowment funds, and (4) compensation for high ranking officials. In its Interim Report, the IRS classified much of its gathered data into categories of schools based on student body size: large (more than 15,000 students), medium (10,000 to 15,000 students), and small (under 10,000 students).[56] Highlights of the data in each area are discussed below.

1. Organization and governance

The questions in the Organization and Governance section of the College and University Questionnaire included the following topics: asking institutions about their number of students and student/faculty ratio, published tuition rates and discounts offered on tuition, whether the institution had a written conflict of interest policy for its top management officials and whether such a policy applied to full-time faculty as well, questions about financial statements, whether the institution conducted distance learning activities, questions about its foreign activities, compensation for the five highest employees (and whether those individuals are faculty, department heads, administrators, investment managers, or sports coaches), a list of any and all related entities of the institution, and whether the institution had written policies regarding a variety of listed transactions with related and unrelated parties.[57]

While some of these questions are now asked each year on the new form 990[58]—such as financial information (e.g., revenue, expenses, assets, and liabilities), conflict of interest

55. *Id.* at 592.

56. INTERIM REPORT, *supra* note 1, at 2.

57. COLLEGE AND UNIVERSITY QUESTIONNAIRE, *supra* note 1, at 2-6.

58. It should be noted that the questionnaire was submitted before the new Form 990 was introduced.

policies for management, and related entities—other questions such as those regarding student/faculty ratios,[59] tuition rates,[60] distance education,[61] and internal policies applying to faculty appear to have no basis in tax compliance statutes and are not reported annually. The IRS asserted in its interim report, however, that organizations that left specific questions unanswered in the College and University Questionnaire were subject to follow-up audit procedures or full-blown audits.[62]

Some of the disparities in the data resulting from the questions are noteworthy, and undoubtedly have been examined closely by the IRS. While 100% of large private colleges and universities reported having a written conflict of interest policy, only 58% of small private colleges and universities reported having written conflict of interest policies.[63] Additionally, while 97% of large public and private colleges and universities made their Audited Financial Statements available to the public, only 76% of small private colleges and universities made their Audited Financial Statements available to the public.[64] The data suggests the IRS may be concerned that smaller colleges and universities do not have sufficient controls in place to prevent abuses associated with conflicts of interest and lack of public oversight that can lead to self-dealing, excessive compensation, questionable investment practices, and uses of the charitable cloak for non-charitable purposes.

Additionally, the IRS noted that, of colleges and universities that reported having one or more controlled organizations, only 29%, 45%, and 26% of small, medium, and large institutions, respectively, reported receiving income from

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59. Median faculty ratios were for institutions based on size were: small: 12:1; medium: 17:1; large: 18:1. INTERIM REPORT, *supra* note 1, at 11.

60. Median in-state tuition rates for public and private notably decreased as the size of institutions increased: small: $14,000; medium: $6,000; large: $5,600. Median out-of-state tuition rates for public and private intuitions did not see the same trend, although out-of-state tuition was notably higher than in-state tuition for large institutions: small: $14,700; medium: $12,900; large: $15,300. *Id.* at 12.

61. Institutions that conducted distance learning activities based on size where: small: 54%; medium: 96%; large 99%. *Id.* at 16.

62. *Id.* at 3.

63. *Id.* at 12.

64. *Id.*

any controlled organizations.[65] The IRS stated in its report that although there may be cases where institutions would not have reportable income from controlled entities, the small ratio of reported income suggested to the IRS that the "inconsistency" would be subject to further review.[66] Here, the IRS appears to be concerned with potential abuses related to subsidiary entities, such as off-balance sheet accounting, underrepresentation of compensation paid to management and directors, and underreporting of unrelated business income that should flow to and potentially be taxed at the parent organization.

Another important observation by the IRS was in regard to organizations without written policies in place that governed transactions with controlled entities. The IRS noted that, among small and medium colleges and universities, there were a large number of schools that had controlled entities but did not have written policies in place in regard to dealings with those controlled entities.[67] This observation implies the IRS will cast more scrutiny in the future on transactions between small and medium colleges and universities and the organizations they control.[68]

A final observation in the organization and governance area is the data concerning the requested list of five highest paid non-officers/directors/trustees/key employees ("non-ODTKEs"). For large institutions, 43% reported a sports coach as their highest paid non-ODTKE, followed by 34% reporting a faculty member as their next highest paid non-ODTKE.[69] For medium institutions, 49% reported a faculty member as their highest paid non-ODTKE, followed by 16% reporting a faculty member

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65. *Id.* at 19.

66. *Id.*

67. *Id.* at 21.

68. While the IRS was not explicit in its purpose to note the lack of college and university policy regarding controlled entities, it can be presumed the IRS is concerned about issues such as expense allocation, reimbursement policies, and potential unrelated business revenue flows between controlling and controlled organizations—all of which can impact Form 990 accounting reporting generally, and unrelated business income tax liability amounts specifically. For further background on the various issues regarding tax-exempt organizations and their related parties, *see* HOPKINS, *supra* note 17, at 942-45.

69. INTERIM REPORT, *supra* note 1, at 51.

as their next highest paid non-ODTKE.[70] For small institutions 55% reported a faculty member as their highest paid non-ODTKE, followed by 19% reporting an administrator as their next highest paid non-ODTKE.[71] For large institutions, the data indicates that, at the very least, the IRS may be setting the groundwork for scrutinization into compensation packages of coaches at large universities (assuming the political will to investigate such compensation eventually surfaces).

One of the best ways to reduce audit risk is to avoid becoming an outlier. As colleges and universities review the IRS responses within the interim report, and compare themselves with their peers, they can seek to avoid being an outlying data point and better insulate themselves from audit risk and potentially, inadvertently attracting the curiosity of the IRS.

2. Activities subject to unrelated business income

It is apparent from the second section of the IRS questionnaire that the Service is concerned with the underreporting of UBI activities on Form 990-T. As discussed above, this concern is likely a product of IRS aspirations to both increase revenue and preserve fairness. Many colleges and universities reported that they had never filed a Form 990-T, including 4% of large universities, 29% of medium universities, and 48% of small universities.[72] The IRS clearly understands that as it—and, on a larger scale, organizations themselves—finds more unrelated business activities subject to tax, treasury revenues will correspondingly increase. Another goal the IRS implicitly highlights in its College and University Questionnaire is fairness. The UBI rules are relatively complex. If some institutions are taxed on their correctly reported UBI, while other institutions fail to report UBI activity, then the organizations actually following the rules will pay more than their fair share of tax.

In the second section of the IRS Questionnaire, the IRS solicited information on 47 activities that colleges and

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70. *Id.*
71. *Id.*
72. *Id.* at 27.

universities might engage in that can result in unrelated business income.[73] In addition to reporting whether the college or university participated in these activities, the organization also was required to answer multiple sub-questions regarding each reported activity, including: whether income from the activity was completely, partially, or not at all considered unrelated business income; whether income from such activities was debt financed; whether a third-party managed or operated the activity; whether the activity created a loss in 3 of the prior 5 years; whether the costs of each activity exceeded $50,000 paid to non §501(c)(3) affiliates; and whether the college or university expected the activity to yield future profits.[74]

Under IRC §512, three elements are required for an activity to be treated as an unrelated business activity: the activity must be (1) a trade or business, (2) regularly carried on, and (3) not substantially related to the college or university's exempt educational purpose.[75] The trade or business requirement is typically interpreted quite expansively such that it is atypical for any profit-making activity to be considered a non-trade or business activity.[76] In determining whether an activity is regularly carried on, the IRS looks to the "frequency and continuity" of the activity.[77] The sliding scale and complexity of the frequency and continuity standard cause the rules in this area to continuously evolve.

Regarding the "not substantially related element," Bertrand M. Harding, Jr. writes that:

> The taxation of nonprofit organizations is replete with subjective facts and circumstances tests, but none perhaps so difficult to apply as that used in determining whether an activity is 'substantially related' to the purposes for which the organization's tax exemption was granted. The regulations provide that an activity will be related only if there is a 'causal relationship' between it and the organization's exempt purposes and will be substantially related only if the causal

73. COLLEGE AND UNIVERSITY QUESTIONNAIRE, *supra* note 1, at 8-13.

74. *Id.*

75. *See* IRC §§ 512(a)(1) and 513(a).

76. HARDING, *supra* note 6, at 11.

77. *Id.* at 15.

> relationship is a substantial one and 'contributes importantly' to the conduct of the exempt purposes.[78]

The nebulous standards in this area promise both more guidance and more litigation. In addition to the three prong element test under §512 for unrelated business activities, the Internal Revenue Code has many statutory exceptions that shield certain types of UBI from being taxed. Some of the major exceptions include capital gain transactions; certain types of interest, dividend, rental, and royalty income; distribution of low-cost articles; certain research activities; certain volunteer activities; and activities that fall under a "convenience exception."[79]

Needless to say, the transactions that give rise to UBI are many and the UBI rules are complex. The most notable point the IRS made in its Interim Report is that more than 60% of colleges and universities "did not rely on advice from independent accountants or counsel for any of these determinations concerning unrelated business income."[80] It can be presumed that the IRS sees this as an area where colleges and universities are under-informed; thus, it may be presumed the IRS is highly likely to amplify its scrutiny of transactions in the UBI area in future years.

3. *Endowment funds*

According to the IRS, seven of the top ten largest nonprofit organizations in 2007 were universities or related universities.[81] Much of the wealth of these higher education

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78. *Id.* at 16 (explaining Treas. Reg. §1.513-1(d)(2)).

79. *See generally* HARDING, *supra* note 6, at 18-36. For example, gains and losses from the sale, exchange, or other disposition of property are excluded from the computation of a college or university's unrelated business income. Most types of interest and dividends are excluded from UBI, unless the interest or dividend income is received from a controlled corporation or debt-financed interest income. The rental income rules are more complex—interest and dividend income, and rental income received from a controlled corporation or from debt-financed property is subject to UBI tax. Royalties as UBI have been the subject of continual litigation between the IRS and tax-exempt organizations and the rules as to UBI treatment continue to evolve. *Id.*

80. INTERIM REPORT, *supra* note 1, at 33.

81. They are in order: 1. President & Fellows of Harvard College ($63.3 billion); 2. Yale University ($30.8 billion); 3. Stanford University ($26.7 billion); 4. Howard Hughes Medical Institute ($21.6 billion); 5. Kaiser Foundation hospitals ($16.5 billion); 6. Princeton University ($18.4 billion); 7. Harvard Management Private Equity Corp.

institutions comes from their endowments. An endowment is basically a reserve fund. Harvard has the largest university endowment ($27.6 billion), followed by Yale ($16.7 billion) and Princeton ($14.4 billion). In 2010, there were 62 universities with endowments exceeding $1 billion, and 128 universities exceeding $500 million.[82]

a. Endowments enter the public discourse

As has been discussed above, total endowment assets at U.S. higher education institutions almost doubled in size from $220 billion in 2003 to $432 billion in 2007.[83] But even as endowments grew, so did college tuition rates. The correlation caused commentators to criticize universities for "hoarding" their wealth at the purported expense of poor and middleclass students.[84] Critics were concerned that universities—beneficiaries of public tax benefits—were more concerned about growing wealth, then spending their investment earnings on operations and student aid. In September 2007, the Senate Committee on Finance held hearings that included the topic of university endowments.[85]

Political discussion culminated in proposals to enact a 5% mandatory payout each year by large university endowment

(14.9 billion); 8. Massachusetts Institute of Technology ($15.4 billion); 9. The Common Fund for Nonprofits ($12.5 billion); and 10. Columbia University ($11.7 billion). INTERNAL REVENUE SERV., IRS STATISTICS OF INCOME: CHARITIES AND OTHER EXEMPT ORGANIZATIONS (2009), *available at* http://www.irs.gov/pub/irs-soi/07eocharitiessnap.pdf.

82. NAT'L ASS'N OF COLLS. AND UNIVS. BUS. OFFICERS AND COMMONFUND INSTITUTE, U.S. AND CANADIAN INSTITUTIONS LISTED BY FISCAL YEAR 2010 ENDOWMENT MARKET VALUE AND PERCENTAGE CHANGE IN ENDOWMENT MARKET VALUE FROM FY 2009 TO FY 2010 (2011), *available at* http://www.nacubo.org/Documents/research/2010NCSE_Public_Tables_Endowment_Market_Values_Final.pdf.

83. U.S. Gov't Accountability Office, *supra* note 52.

84. John Hechinger, *When $26 Billion Isn't Enough*, WALL ST. J., Dec. 17, 2005, at P1. *See also Report Card on Tax Exemptions and Incentives for Higher Education: Pass, Fail, or Need Improvement?: Hearing Before the U.S. Senate Comm'n on Fin.*, 109th Cong. (2006) [hereinafter *Report Card*], *available at* http://finance.senate.gov/imo/media/doc/120506cg.pdf ("It appears that for too many colleges and universities, particularly our nation's elite institutions, the response to efforts to make college affordable has been a bad triple play: big tuition increases; expanding endowments; and now million-dollar salaries for college Presidents.").

85. *Report Card*, *supra* note 84.

funds.[86] During 2009, however, the effects of the recession saw university and college endowments lose an average of 18.7% of their value.[87] The economic setbacks to endowments chilled calls for the 5% mandatory payout.[88]

Although the endowment payout argument has been shelved for the time being, recent scholarship argues that the issue is likely to return as the economy improves in time. Alexander Wolf gives five reasons the issue is likely to return: (1) the restoration of positive returns by endowment funds (e.g., Harvard's endowment gained an 11% return in its 2010 fiscal year, adding $1.5 billion to its endowment fund); (2) tuition has continued to rise at a rate that outpaces inflation, (3) a widely cited study lays partial blame of the economic crisis on university endowments because they added capital and "academic credibility" to risky investment strategies; (4) another study found that "endowments deviate from their stated payout policy during bad times, *reducing* payout rates . . . ";[89] and (5) recent scrutiny of for-profit education is leading commentators to believe that more oversight of the nonprofit education sector is forthcoming.[90]

b. IRS reaction to mandatory payout discussions and findings

The IRS created and issued the Endowment section of the College and University Questionnaire during the peak of discussion concerning the mandatory payout. By the time the IRS issued its Interim Report in 2010 concerning the 2006 data gathered, it admitted that "[g]iven the fluctuations in the financial markets since 2006, the responses to certain endowment related questions (e.g., valuation and spending

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86. Wolf, *supra* note 51, at 591-92. Proposed floors on endowment funds that would be affected by a mandatory payout included $500 million and $1 billion. *Id.*

87. Press Release, NACUBO-Commonfund Study of Endowments, Press Release on the 2009 Endowment Study Results (Jan. 28, 2010), *available at* http://www.nacubo.org/Documents/research/2009_NCSE_Press_Release.pdf.

88. Wolf, *supra* note 51, at 602.

89. *Id.* at 605 n.97 (quoting Jeffrey Brown et al., *Why I Lost My Secretary: The Effect of Endowment Shocks on University Operations* 5 (Nat'l Bureau of Econ. Research, Working Paper No. 15861, Apr. 2010), *available at* www.nber.org/papers/w15861).

90. Wolf, *supra* note 51, at 603-05. For a vigorous defense of why the mandatory payout should not be implemented, *see id.* at 605-22.

practices) may be significantly different than if based on a more recent year."[91] Notwithstanding the dated information, a few findings are relevant going forward, particularly if the issue returns as Mr. Wolf predicts.

Areas of questioning in the Endowment section of the IRS Questionnaire included inquiries regarding endowment assets per student ratio, the implementation of target spending rates (i.e, what percentage of the endowment assets were targeted to be spent each year), whether the organization met its target rate, investment policies in place, use of investment committees, use of outside consultants, compensation of investment managers, a diversification breakdown of fund assets (i.e., what percentage of the funds fell into each of the following categories: equity funds, real estate, international funds, fixed income funds, cash, or alternative investments (e.g., hedge funds, private equity, venture capital, etc.)), what rate of return was expected (i.e., a metric of how much risk the fund managers tolerated), and whether donor restrictions on donated assets to the endowment funds were respected and monitored.[92]

Noteworthy findings by the IRS in its Interim Report included the ratio of endowment fund assets to full-time equivalent students: large universities had an average of $66,000 per student, but a median of a mere $7,000 per student.[93] The discrepancy suggests that there is significant disparity in the asset size in endowment funds among large universities—specifically, these numbers suggest a minority segment of large universities have extremely large endowment funds-per-student in relation to most other universities in the large category.[94]

91. INTERIM REPORT, *supra* note 1 at 34.

92. COLLEGE AND UNIVERSITY QUESTIONNAIRE, *supra* note 1, at 20-24. The revised Form 990 does ask several annual questions regarding college and university endowment funds including whether the organization has an endowment fund, Form 990, Part IV, beginning and ending balances of the endowment fund for current and previous years, and a description of intended uses of the endowment fund, Form 990 Schedule D, Part V.

93. INTERIM REPORT, *supra* note 1, at 38.

94. Medium and small institutions' *average* asset/student ratios are $34,000 and $56,000 per student, respectively, and *median* asset/student ratios are $14,000 and $5,000 per student, respectively. *Id.*

Additionally, between 95% and 100% of colleges and universities from each category reported that they made distributions for scholarships, awards, grants and/or loans from their endowment funds.[95] Thus, it is evident that most colleges and universities do use endowments to aid students, although, neither the questions nor the IRS Interim Report indicated the portion or amount of endowment expenses that actually went to student aid.

Probably the most politically poignant finding by the IRS in its Interim Report was the target spending rate reported and the percentage of organizations that met their self-imposed targeted spending rate. The median target spending rates set by higher education institutions (the percentage of assets the organizations attempt to spend out of their endowments each year) were reported at an average of 4.8% for large institutions, 5.0% for medium institutions, and 5.0% for small institutions.[96] The percentage of organizations that met their target spending rate above for 2006 (before the economic crisis) was 89% for large institutions, 92% for medium institutions, and 89% for small institutions.[97] In other words, the vast majority of organizations—including large universities—were already essentially meeting a near 5% payout anyway, without Congressional or IRS mandate.

c. Arguments surface discouraging mandatory payout

Although more empirical data over non-recession years would be beneficial, the IRS preliminary 2006 payout data of roughly 5% at most institutions, coupled with various academic defenses offered in Alexander Wolf's article discussed above, may cripple the argument to require mandatory payouts of endowments. Wolf's arguments[98] against the mandatory payout include: (1) a mandatory payout would not necessarily improve affordability across the higher education sector, but may instead subsidize wealthy students who do not need the subsidy, (2) wealthy universities are already generous with

95. *Id.* at 48.

96. *Id.* at 39.

97. *Id.*

98. *See generally* Wolf, *supra* note 51.

their financial aid to underprivileged and middle class students, (3) universities do not need additional federal oversight since a host of watchdog groups and individuals already police a university's use of wealth (including "students, prospective students and their parents, faculty and staff, alumni, donors, trustees, accrediting agencies, credit rating agencies, the media, institutions' local communities, state governments, and government agencies like the IRS"), (4) proponents of the payout make a flawed comparison with private foundations that currently require a payout (but are fundamentally different because private foundations do not have operations), (5) mandatory payouts would constrain a university's ability to respond to economic fluctuations, (6) a mandatory payout would increase risk to American higher education's international strength, and (7) a mandatory payout would infringe on the important purpose of free speech.[99]

These arguments, coupled with the IRS finding that most large universities already spend roughly 5% of their endowment in good years may cause efforts to impose mandatory payouts to ultimately fade away.

4. Executive compensation

Four pillar tests for maintaining tax-exempt status[100] require tax-exempt organizations to: (1) be *organized* exclusively for a charitable purpose, (2) be *operated* primarily[101] for a charitable purpose—including the requirement to provide public (and not private) benefits,[102] (3)

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99. Free speech has highly protected status at Universities. For example, Justice Sandra Day O'Conner's wrote in 2003: "[E]xpansive freedoms of speech and thought associated with the university environment . . . [make universities] a special niche in our constitution." (quoting Grutter v. Bollinger, 539 U.S. 306, 329 (2003)).

100. NICHOLAS P. CAFARDI & JACLYN FABEAN CHERRY, TAX EXEMPT ORGANIZATIONS: CASES & MATERIALS 113-14 (2003). *See also* JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 97-99 (2nd ed. 2006).

101. Although the statute uses the term "exclusively" when providing the operational test, Treas. Reg. 1.501(c)(3)-1(c)(1) asserts that "exclusively" means operated "primarily" for exempt purposes.

102. CAFARDI & CHERRY, *supra* note 100, at 143 ("In your studies of tax-exempt organizations do not assume that *private benefit* and *private inurement* are the same thing. They are not. Exempt organizations that confer benefits on those in control of the organization (an overlap of control and benefit) are in violation of the private

not allow *private inurement*, and (4) meet specific limitations on lobbying and political activities. Specifically, the private inurement prohibition was designed "to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use."[103]

Historically, a single violation of private inurement would allow the IRS to revoke tax exempt status for the entire organization.[104] However, the 1996 passage of the intermediate sanctions rules gave the IRS an additional enforcement tool that represented "the most dramatic and important package of federal statutory tax law rules concerning tax-exempt organizations since enactment of the basic statutory structure of the exempt organizations field in 1969."[105]

a. Intermediate sanctions

The intermediate sanction rules impose a penalty excise tax when the tax exempt organization engages in an "excess benefit transaction," a transaction in which (1) a direct or indirect economic benefit is provided to an organization insider, and (2) the economic benefit provided exceeds the value (if any) of consideration received by the organization.[106] As discussed above, a common excess benefit transaction would be an executive or director that is compensated above fair market

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inurement test. Those exempt organizations that confer a benefit on too small a group of beneficiaries (independent of those who control the organization) have conferred a private, not public, benefit and are in violation of the operational test, i.e. they are engaging in a non-exempt activity.").

103. HARDING, *supra* note 6, at 235 (quoting GCM 39862 (Dec. 2, 1991)).

104. *See, e.g.*, Anclote Psychiatric Ctr., Inc. v. Comm'r, T.C. Memo 1998-273, 76 T.C.M. 175 at *8 (1998) ("The presence of a single substantial nonexempt purpose destroys the exemption regardless of the number or importance of the exempt purposes."). *See also* HARDING, *supra* note 6, at 234 (stating that it is possible to have tax exempt status revoked for violations of the private inurement rules, however, "it would be quite unusual for the IRS to attempt to revoke a major educational institution's tax-exempt status for such violations, unless there was a continuous pattern of violations and the institution refused to change its ways or cooperate with the IRS.").

105. HOPKINS, *supra* note 17, at 548. *See also id.* at 565 n.152 ("The lawyers for the IRS wrote that the primary purpose of the intermediate sanctions rules is to 'require insiders who are receiving excess benefits to make their exempt organizations whole, with the goal of keeping them operating for the benefit of the public.'" (quoting Chief Counsel Adv. Mem. 200431023)).

106. HARDING, *supra* note 6, at 242.

value for his services. Although excess benefit transactions may include excessive compensation, they may also include any other benefit to the insider such as below-market sales, loans, or lease transactions.[107] In addition to excise tax penalties assessed on the benefit received above market, the insider must also correct the excess benefit by restoring the value of the benefit back to organization, often by paying an equivalent amount of cash back to the exempt organization.[108]

The excise tax penalties in this area of law are termed "intermediate sanctions" because they are middle-ground penalties—not so severe as to revoke an organization's exempt status and not so light that the IRS simply ignores the violation of law:

> [W]hen the IRS determines that a form of private inurement has occurred, [the assessment of excise taxes] stand between the two extremes of the absence of action by the agency (other than perhaps an examination and warning) and revocation of the tax-exempt status of the organization (often with the principal impact of harming the organization's programs and beneficiaries).[109]

The excise tax is 25% of the excess benefit and is levied against the individual receiving the excess benefit—not the organization.[110] Intermediate sanctions may also require complicit managers in the organization to pay an excise tax of 10% of the excess benefit.[111] For organizations that do not report the improper transactions before the IRS discovers them, the excise tax rate assessed is 200% of the excess benefit (again levied against the organization insider).[112] In extreme cases, where multiple excess benefit transactions occur within an organization, the IRS may bypass the intermediate sanction rules altogether and simply revoke the tax exempt status of the entire organization.[113]

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107. *Id.*

108. I.R.C. §4958(f)(6); HOPKINS, *supra* note 17, at 565.

109. HOPKINS, *supra* note 17, at 548.

110. I.R.C. §4958(a)(1).

111. I.R.C. §4958(a)(2).

112. I.R.C. §4958(b).

113. *See* Caracci v. Comm'r, 118 T.C. 379, 414-17 (2002) (*rev'd on other grounds* 456 F.3d 444 (5th Cir. 2006) ("Although the imposition of section 4958 excise taxes as a

It is important to note that state colleges and universities that qualify for tax exemption under IRC §115 are not subject to intermediate sanction provisions as the intermediate sanctions only apply to 501(c)(3) organizations.[114] The IRS has taken the position that schools that are exempt under §115 are not subject to the intermediate sanction rules even if they have also sought and obtained tax-exemption under §501(c)(3).[115] Therefore, the questions related to intermediate sanctions on the IRS College and University Questionnaire applied typically to private colleges and universities only.

b. Rebuttable presumption of excess benefit

The analysis of whether intermediate sanctions apply in a specific transaction necessarily pivots on whether the benefit—such as compensation received by an officer or director—was excessive.[116] The intermediate sanction rules provide for a "rebuttable presumption of reasonableness."[117] In other words,

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result of an excess benefit transaction does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case.").

114. Temp. Treas. Reg. § 53.4958-2(a)(1); HARDING, *supra* note 6, at 243; INTERIM REPORT, *supra* note 1, at 60.

115. INTERIM REPORT, *supra* note 1, at 60.

116. Bertrand Harding notes that "[t]o the extent that a college or university might encounter a private inurement problem, it will most likely arise in the context of unreasonable compensation payments made to an officer, director, or trustee, or some type of 'sweetheart deal' entered into between the school and one of these individuals. . . . With respect to potential 'sweetheart arrangements' between colleges and university and an officer, director, or trustee, the possibilities are virtually endless. They could involve rental arrangements in which a school rents property from the individual at more than fair market value or leases property to the individual at less than fair market value. Or they could involve loan arrangements whereby the school loans funds to the individual at less than a fair market value interest rate or borrows funds from an individual at greater than a fair market value interest rate. Also, if the loan is not repaid in a timely fashion, there is the possibility of a private inurement. In one case, a school's tax exemption was revoked, in part, because the school provided two of its officers with interest-free and unsecured loans that, according to the court, subjected the school to uncompensated risk for no business purposes." HARDING, *supra* note 6, at XXX. *See* Best Lock Corp. v. Comm'r, 31 T.C. 1217 (1959); Rev. Rul. 67-5, 1967-1 C.B. 123; John Marshall Law Sch. v. United States, 1981 WL 11168, at 3 (Ct. Cl. 1981).

117. HOPKINS, *supra* note 17, at 562 n.126 (The "rebuttable presumption is not provided for in the Internal Revenue Code; it was created by the legislative history (H. Rep. 104-506, 104th Cong., 2d Sess. 56-57 (1996)) and is reflected in and amplified by the regulations (Reg. § 58.4958-6).").

organizations can get to a pseudo-safe harbor that the compensation they pay must be presumed to be reasonable by the courts if they meet several baseline requirements—most importantly, the comparability data. The presumption is rebuttable because even if the organization meets its baseline requirements, the IRS can still prove unreasonableness if "the IRS develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the authorized governing body."[118] In other words, the IRS has a significantly higher burden of proving that compensation or a benefit received by an insider is above fair market value. Therefore, when the organization meets the rebuttable presumption, the IRS is less likely to pursue intermediate sanction due to the greater resources it would require to prosecute and the higher risk that it will lose in litigation.[119]

So what baseline elements must be met by the organization to receive a presumption of reasonableness in its compensation practices? Compensation payment (and similar transactions) are considered reasonable—and therefore *not* an excise benefit transaction subject to intermediate sanctions—if: (1) the transaction was *approved by an independent body* (e.g., an independent board of directors or trustees) to review and establish the amount of compensation in advance of actual payment, (2) the transaction involved use of appropriate *comparability data*, and (3) the transaction involved appropriate *contemporaneous documentation* of the process used to establish the compensation amount.[120]

The foregoing discussion of intermediate sanctions and rebuttable presumption rules illuminate the motivation behind IRS strategy in this area. The IRS is most likely to target private colleges and universities with the following characteristics: (1) the appearance of excessive compensation or suspicious insider transactions, and (2) a lack of policies to ensure the intermediate sanctions rebuttable presumption is in

118. HOPKINS, *supra* note 17, at 564.

119. Examples of where the IRS may still overcome the rebuttable presumption necessitate highly persuasive facts, such as where "the compensation data relied on by the parties was not for functionally comparable positions or . . . the disqualified person in fact did not substantially perform the responsibilities of the position." *Id.*

120. *Id.* at 562-63; INTERIM REPORT, *supra* note 1, at 60 (emphasis added).

place. Organizations fitting such a profile are clearly low hanging fruit for the Service in its search for transactions in which to apply intermediate sanction excise taxes. Thus, it behooves colleges and universities to have rebuttable presumption procedures in place.

c. IRS scrutiny of colleges & universities that lack the rebuttable presumption

Some of the most key questions in the Executive Compensation portion of the Colleges and Universities Questionnaire point to the strategy mentioned above. The IRS Interim Report itself discussed this motivation: "A principal focus of the college and university study is to gather a better understanding of how organizations use the rebuttable presumption procedure and other governance practices in setting compensation."[121]

Private institutions were asked whether the institutions used "a process intended to satisfy the rebuttable presumption procedure of [IRC §] 4958 to determine [compensation]."[122] Of the institutions that responded, 45% of small, 29% of medium,

121. INTERIM REPORT, *supra* note 1, at 59-60. The report goes on to explain that "[s]ection 4958, the intermediate sanction on excess benefit transactions, provides that an excess benefit transaction occurs when a disqualified person (any person in a position to exercise substantial influence over the affairs of the tax-exempt organization) receives an economic benefit from an exempt organization that exceeds the value of consideration received by the organization. In addition to or in lieu of revoking the charity's tax-exempt status, section 4958 imposes an excise tax against the disqualified person and possibly the organization manager. The section 4958 regulations provide a rebuttable presumption process that public charities may (but are not required to) use when establishing what appropriate compensation is for a disqualified person [Treas. Reg. §53.4958-6]. This process involves three criteria—an independent body to review and establish the amount of compensation in advance of actual payment, use of appropriate comparability data to establish the compensation, and contemporaneous documentation of the process used to establish the compensation in the particular instance. Under the regulations, compensation determined pursuant to a process that satisfies the rebuttable presumption requirements is presumed to be reasonable in amount, and the IRS has the burden of proving that the compensation is excessive for section 4958 excess benefit transaction tax purposes. If the rebuttable presumption is not met, the burden is on the organization to prove that the compensation is reasonable. . . . Public colleges and universities are not subject to the provisions of section 4958; therefore, they were instructed not to complete this portion of the questionnaire. To the extent public organizations responded to these questions, their responses were not included in the results." *Id.* at 60.

122. *Id.* at 62.

and 38% of large institutions reported *not* using rebuttable presumption procedures for any of their six highest paid officers, directors, trustees, or key employees.[123] The IRS also asked follow-up questions regarding the specific elements of the rebuttable presumption, documentation, approval process, and use of comparable data.[124]

Documentation. The IRS asked whether the organization had documented the basis for setting compensation for each of the six highest paid ODTKEs.[125] Over 85% of medium institutions reported documenting the basis for setting compensation prior to paying compensation for at least one of their six highest paid ODTKEs.[126] Approximately 74% of small institutions reported the same.

Independent Approval Process. Over 85% of medium institutions and 97% of small institutions reported approval of compensation by an independent governing body for at least one of their six highest paid ODTKEs.[127]

Use of Comparable Data. Only 63% of large institutions, 79% of medium institutions and 59% of small institutions reported using an independent compensation comparability survey when setting compensation for at least one of their six highest paid ODTKEs.[128] The IRS noted in its report that investigating the use of comparability data in setting compensation "is an area of continued focus for the IRS."[129] Obviously, the IRS understands that a significant portion of colleges and universities are not putting policies in place that

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123. *Id.* at 63. "Key Employee," for purposes of the Questionnaire, was defined as "an employee of the organization (other than an officer, director, or trustee) who has responsibilities, powers or influence over the organization similar to those of officers, directors, or trustees. Key employees include the chief management and administrative officials of an organization (such as an executive director or chancellor). A chief financial officer and the officer in charge of administration or program operations are key employees if they have the authority to control the organization's activities, or its finances." *Id.* at 51 n.24.

124. *Id.* at 62.

125. *Id.*

126. *Id.* at 63. The sample size of large institutions for this question was too small to be reported without creating a risk that the identity of the respondents would be revealed. *Id.*

127. *Id.* at 64.

128. *Id.*

129. *Id.*

protect them from charges of excess benefit transactions for many of their highly compensated officers, directors, and key employees.

Additionally, in its scrutiny of excessive compensation, the IRS looks beyond mere base salary of these managers and directors. The service requested information on 22 non-salary types of compensation in its Questionnaire.[130] The most commonly reported non-salary types of compensation included contributions to employee benefit plans; contributions to life, disability, and long-term care insurance; the value of organization provided housing and utilities; and personal use of organization vehicles.[131]

It is clear the IRS is keenly interested in the compensation of highly paid college and university individuals. This focus should alert colleges and universities to the importance of understanding the intricacies of the intermediate sanctions rules as they set compensation for their highest paid personnel. A leading scholar and practitioner in the field recently predicted:

> The coming . . . years will bring interpretations and amplifications of the intermediate sanctions rules, with emphasis on what does and does not constitute an excess benefit transaction . . . . [T]his process will draw heavily on existing law as shaped by the private inurement doctrine. . . . The intermediate sanctions rules probably will be invoked more frequently than revocation of tax-exempt status by application of the private inurement doctrine to public

130. Aside from an individual's base salary, the IRS requested whether the IRS paid the following types of compensation to at least one of its six highest paid ODTKEs: bonuses, contributions to employee benefit plans, incentives, contributions to life, disability, and long-term care insurance, split-dollar life insurance, forgiveness of debt or interest on loans or credit extensions, stock or stock options, severance or change of control payments, personal use of organization credit cards, personal use of organization vehicles, personal travel for the person or family members, expense reimbursement under non-accountable plans, value of organization provided housing and utilities, value of organization provided vacation home, personal services provided at person's residence (e.g., housekeeper, lawn service, etc.), other personal services provided, health or social club dues, personal use of organization owned aircraft or boat, first-class travel, taxable scholarship and fellowship grants, other (non-IRC §132) fringe benefits, and any other form of compensation. *Id.* at 57.

131. *Id.*

charities . . . .[132]

Colleges and universities should continue to improve their vigilance of tax and governance issues in the years ahead. They will be most efficient in that process by anticipating the direction and focus of the IRS in its monitoring and enforcement activities discussed above. Such anticipation will thereby allow colleges and universities to reduce compliance risk by avoiding IRS-imposed intermediate sanction excise taxes and defending its treatment of its potentially unrelated business income activities. Additionally, colleges and universities will also be able to reduce audit risk by implementing, improving, and reviewing specifically scrutinized governance policies and practices.

IV. CRITICISM OF EXPANDED IRS ACTIVITY

Critics of recent increased IRS activity in the nonprofit sector note three overarching concerns: (A) an increased compliance costs for tax-exempt organizations, (B) the IRS exceeding its statutory and judicial boundaries of audit authority, and (C) constitutional concerns over stealth preemption resulting from unilateral IRS action. Most of these concerns address new reporting burdens about governance policies and practices for tax-exempt organizations generally; however, these concerns also apply specifically to higher education institutions.

A. Compliance Cost Concern

Higher reporting burdens place strain on already scarce charitable organization resources—resources that would otherwise help public beneficiaries of the charity. Areas requiring the greatest burden are the resources that nonprofit organizations—including colleges and universities—must spend on changes to the new Form 990. Because of the many changes on the form introduced in 2008, the IRS phased the form in over three years.[133] Nonprofit scholar James J. Fishman notes that:

132. THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 119 (3d ed., 2008).

133. Fishman, *supra* note 13, at 564 (2010).

> One should not forget that disclosure comes with a cost to comply with new demands, borne by the organization. Every additional cost in time and money diverts the organization's human and financial resources away from achieving its charitable mission. . . . The Form 990 . . . has morphed into a legal, fundraising and public relations statement that requires professional assistance from lawyers, development advisors, and public relations personnel [thereby distorting an organization's charitable energy].[134]

Notably, the 2007 Form 990 Instructions estimated that the typical reporting burden for Form 990 and its schedules (including record keeping, learning about the law or form, preparing the form, etc.) took 261.4 hours to complete.[135] The instructions to the 2008, 2009, and 2010 Forms 990 and their accompanying schedules estimated a typical reporting burden of 497.4 hours for the same activities.[136] Clearly, the cost of compliance is diverting resources from charitable purposes. The IRS argues that this burden is justified in the name of transparency and public confidence. Some scholars dispute whether empirical evidence agrees with the IRS' bureaucratic approach.[137] Ultimately, in the absence of congressional or judicial oversight, the IRS will continue to prevail in its justified burden argument.

B. IRS Exceeding Statutory and Judicial Boundaries of Audit Authority Concern

The second concern involves the method by which the IRS asserts its authority to request certain information such as its governance questions on the Form 990, or the governance and endowment questions on the IRS College and University Questionnaire. Many of the Form 990's new governance questions are not required by statute by the IRS's own

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134. *Id.* at 589.

135. 2007 IRS Instructions for Form 990 and Form 990-EZ, at 65.

136. 2008 Instructions for Form 990 Return of Organization Exempt From Income Tax, at 40; 2009 Instructions for Form 990 Return of Organization Exempt From Income Tax, at 42; 2010 Instructions for Form 990 Return of Organization Exempt From Income Tax, at 46.

137. Fishman, *supra* note 13, at 572; Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83, 136 (2007).

admission.[138] Nor was a statute created allowing the IRS to ask questions concerning governance and endowment funds on its Questionnaire. But organizations that failed to fully complete the Questionnaire were referred for audit by the IRS.[139]

Additionally, the Form 990 Instructions state that its governance section must be filled out in its entirety for the form to be considered complete and accurate.[140] When an organization's executive signs the return, she signs under penalties of perjury that the return is complete and accurate.[141] Thus, if any questions in the governance section are left unanswered by an exempt organization—including colleges and universities—the return is deemed incomplete and the signer would presumably be subject to perjury penalties. Worse, the failure to file a complete and accurate informational return can also lead to tax-exempt status revocation for the entire organization as a violation of IRC §6033(b), which requires most tax-exempt organizations to file information "the Secretary may by forms or regulations prescribe."[142] Clearly,

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138. 2008 Form 990, 6. The title of Page 6 of the Form 990 states: "Governance, Management, and Disclosure (Sections A, B, and C request information about policies not required by the Internal Revenue Code.") Notably, the parenthetical letting tax filers know the governance section questions are not required by the Internal Revenue Code was removed from the main heading and moved to a subheading in the 2009 and 2010 versions of Form 990. On September 8, 2011, the treasury department issued finalized regulations it reported as necessary to implement the redesigned Form 990. T.D. 9549, Returns by Exempt Organizations—Revised Form 990. Although the finalized regulations address many areas of the form that have changed in recent years, including reporting issues concerning compensation, the finalized regulations do not specifically address the governance section of the Form 990.

139. INTERIM REPORT, *supra* note 1, at 2.

140. 2010 Instructions for Form 990 Return of Organization Exempt From Income Tax, 18 ("Although federal tax law generally does not mandate particular management structures, operational policies, or administrative practices, **every organization is required to answer each question in Part VI**. For example, all organizations must answer lines 11 and 11a, which ask about the organization's process, if any, it uses to review Form 990, even though the governing body is not required by federal tax law to review Form 990.") (emphasis added).

141. The officer's signature block for the Form 990 states: "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, **and complete**." 2010 Form 990, at 1 (emphasis added).

142. IRC §6033(b). *See also* Rev. Rul. 59-95, 1959-1 CB 627 (holding that the "failure or inability to file the required information return or otherwise to comply with the provision[s] of section 6033 of the Code and the regulations which implement it,

the IRS is extending its audit power to solicit new information from colleges and universities that does not have a direct basis in statute.

1. IRS audit power authority

The IRS has broad authority to request information in determining tax liability of an organization—but the authority does have limits. IRC §7602(a)(1)-(2) authorizes the IRS "[t]o examine any books, papers, records, or other data which may be relevant or material to such inquiry" and to summon individuals to produce such materials. A check on this power is given in IRC §7605(b), which provides that "[n]o taxpayer shall be subjected to unnecessary examination or investigations." Commentary by Marcus Owens notes that the IRS is acutely aware that at some point there is a limit on its ability to compel information.[143] Owens notes two areas where analysis of the limit has surfaced: summons enforcement and incomplete return penalties.[144]

Regarding summons enforcement, the courts have at times refused to enforce summonses against taxpayers on the basis of irrelevance under *U.S. v. Powell*.[145] The Powell rule requires that the IRS must demonstrate "that the information requested 'may be relevant' or 'may shed light on' a potential tax liability."[146] Owens concludes that a charity's governance policies and procedures do not appear to meet the Powell requirement of relevancy to a potential tax liability.[147] Additionally, two General Counsel Memoranda ('GCM") addressing limits on IRS information gathering power are telling and discussed below.

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may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of an exempt status.").

143. Marcus S. Owens, *Charities and Governance: Is the IRS Subject to Challenge?*, 119 Tax Notes 613 (2008).

144. *Id.*

145. 379 U.S. 48, 57-58 (1964).

146. Owens, *supra* note 143.

147. *Id.*

2. Governance questions are not necessary for the administration of tax law

A 1975 GCM involved IRS chief counsel considering the consequences of omission of some information by a tax-exempt organization on its Form 990.[148] The chief counsel observed:

> [I]f the material required and requested, but unsupplied, in those forms was *material and* thus *necessary for the proper administration of the tax laws*, then any failure to include such information on those forms, without reasonable cause, would subject the taxpayer to the penalty provided . . . . It should be pointed out that if the materiality of these items is questioned by a taxpayer or subsequently made the subject of litigation, the Service should be prepared to substantiate why it considers such items to be material.[149]

Thus, one path that may lead to prevailing against the IRS for the failure to answer governance questions not required by federal statute would be an argument that they are not material or necessary for the proper administration of the tax laws, but are—as the IRS has recently admitted in a relevant speech—merely an "aid" to understand principles that "*derive from* the requirements for tax exemption."[150] In other words, because the governance questions are not tied directly to tax statute, but are distant derivations of tax statute, answers to governance questions may not be required.

3. IRC §6033 was never intended by congress to apply to governance practices of tax-exempt organizations

A 1980 GCM indicates that IRC §6033—the section that grants the IRS broad authority to design returns to collect information for the "purpose of carrying out the internal revenue laws"—was never envisioned by Congress to elicit information from exempt organizations that might relate to a wagering excise tax.[151] By analogy, it can be argued that the IRS, by its own admission, should construe IRC§6033 narrowly in such a way that if Congress did not envision use of §6033 to

148. GCM 36506 (Dec. 8, 1975).

149. *Id.* (emphasis added).

150. Ingram, *supra* note 20, at 3 (emphasis added).

151. Owens, *supra* note 143 (quoting GCM 38382 (May 23, 1980)).

apply to tax exempt organization governance, then the IRS would exceed its authority by requesting such information. Ultimately, Owens believes a clear argument can be made that the IRS exceeded its audit authority by soliciting information that is not required by the Internal Revenue Code: "[I]t appears that this situation is truly unprecedented and that a challenge . . . would potentially be successful."[152]

IRS use of broadly granted discretion to threaten perjury and tax-exempt status revocation in order to implement new governance reporting—instead of administering reporting requirements mandated by Congressional statute—is somewhat disconcerting.[153] However, because of the uncertain limit of regulatory powers granted to the IRS in this area, and a lack of actual litigants by tax-exempt entities, the governance questions are likely here to stay unless or until they are actually challenged.

C. Stealth Preemption Constitutionality Concern

In addition to statutory boundary concerns regarding recent IRS extension into the governance areas, there are constitutional concerns as well. James Fishman argues that IRS regulation of nonprofit corporate governance is a type of stealth preemption that undermines the principles of the nation's federalist system, and is "at least one degree separated from traditional constitutional analysis."[154] He remarks:

> Stealth preemption refers to a process by which a federal agency or departmental regulator supersedes state or local officials or imposes legal rules that historically have been matters of state law. . . . The question is not whether good governance is desirable. Of course it is. But, has the Service identified appropriate indicators of that behavior, and does the Service have the authority and expertise to demand such

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152. Owens, *supra* note 143, at 6. Owens also notes that "[t]he executive branch functions—IRS Chief Counsel, the Treasury Department, and the Office of Management and Budget—that would traditionally operate to prevent such overstepping by the tax administrator have not acted, whether merely out of inattention to or perhaps in complicity with the Service's unilateral expansion of its authority." *Id.* at 5.

153. Included in the concern is the broad precedent these actions set for IRS authority.

154. Fishman, *supra* note 13, at 549.

steps as it recommends?[155]

Fishman notes that the American political system's major 20th century development was the growth of federal power—particularly federal administrative action—at the expense of traditional state authority.[156] He writes:

> The formal theory of federalism posits that our political system places limits on congressional action through states' representation in Congress, and the procedural safeguards that function through each state's constituency to restrain the ability of the federal government to reach beyond its powers. . . . Federalism provides citizens the opportunity to make an impact on government at a local level, helping to make it more responsive to the immediate needs and evolving values of individual communities, and less susceptible to bureaucratic inertia that exists on the federal level.[157]

In other words, limits are constitutionally in place to check increased federal power crowding out the ability of the individual citizens to influence local issues and values.

The IRS has lightly addressed this concern. IRS TE/GE Commissioner Sarah Ingram observed in a June 2009 speech that "we wondered if [the states] might see our work as a raid on their authority and jurisdiction, an overstepping of bounds on our part. But by and large that did not happen."[158] But Fishman explains that the Pension Protection Act of 2006 allowed increased cooperation between state charity regulators and the IRS, enabling state regulators to request IRS tax information to help prosecute misconduct with fewer resources.[159] Fishman observes that "[t]his may explain the reluctance to criticize the Service. One cannot expect [state] attorneys general to bite the hand that feeds them

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155. *Id.* at 549, 561. Fishman separates some areas of current IRS scrutiny from others. He notes that questions that related directly to tax compliance and ensure compliance with the Internal Revenue Code are appropriate, such as questions in the Form 990 concerning excess benefit transactions. Other questions, he argues, are attenuated from tax law compliance, including questions concerning independence of directors, conflicts of interest, and disclosure policies of governance practices. *Id.* at 567-68.

156. *Id.* at 578.

157. *Id.* at 580.

158. Ingram, *supra* note 20, at 7.

159. Fishman, *supra* note 13, at 578-88.

evidence."[160]

Fishman asserts the Service's lack of concern regarding its inappropriate preemption should not come as a surprise; he quotes Thomas Merrill, observing:

> Agencies are specialized institutions, intensely focused on the details of the particular statutory regimes they are charged with administering. By design and tradition, they are not expected to ponder larger structural issues such as the relative balance of authority between the federal and state governments, the importance of preserving state autonomy, the value of allowing policy to vary in accordance with local conditions, or the systemic advantages of permitting state experimentation with divergent approaches to social problems.[161]

In other words, agencies by nature have a narrow focus: their own policy goals trump larger issues of balanced government. Fishman closes his stealth preemption reasoning by noting that cases such as *Chevron* and *Skidmore* protect agency-made rules only where the rules were either promulgated by an applicable statute, or where the rules relied on the agency's expertise.[162] Fishman deftly points out that the IRS itself admits that many of its governance questions on the Form 990[163]—rules required under penalties of perjury and potential revocation of exemption status—have no substantive basis in statute. Additionally, it can be argued persuasively that the IRS has no expertise or experience in good corporate governance.[164]

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160. *Id.* at 588.

161. *Id.* at 581 (quoting Catherine M. Sharkey, *Federalism Accountability: 'Agency Forcing' Measures*, 58 Duke L.J. 2125, 2147 (2009)).

162. Fishman, *supra* note 13, at 583-86.

163. The IRS would also presumably admit that governance and endowment fund questions have no substantive based in statute (although the College and Education Questionnaire did not subject the organization's singing executives to perjury, however, as had been mentioned above, failure to answer the questions did automatically subject such organizations to automatic audit by the IRS—an event that potentially can open organizations up to risk of lost exemption status).

164. Fishman, *supra* note 13, at 586 (arguing that any experience the IRS has in governance is "based on anecdotal evidence or the opinions of nongovernmental experts, rather than any empirical basis of a link between good governance and tax compliance.").

D. Looking Forward

In the face of the legal criticisms offered above, there is no question the IRS has received substantial compliance in both the annual Form 990 compliance area and the College and University Questionnaire. Without litigation concerning the merits of IRS action, or increased oversight from Congress, it is likely the IRS will continue its unilateral quest for transparency in the nonprofit sector generally and higher education specifically, unbridled and without boundary beyond its own good conscience.

In its May 2010 College and University Interim Report, the IRS discussed its anticipation of issuing a final report that would provide more detailed analysis on information gathered from the College and University Questionnaire. On October 6, 2011, Congressman Boustany, Chairman of the Subcommittee of Oversight on the U.S. House Ways and Means Committee, requested an update from the IRS on its progress regarding the Final Report.[165] The IRS has recently reported it still anticipates releasing a final report on Colleges and Universities sometime after it has completed its current 30-plus College and University audits; however, no firm timeframe has been offered on when the report will be released.[166]

V. CONCLUSION

College and university tax exemption benefits invite an opening of the door for some transparency, but how wide that door should swing is an open question. The IRS has clearly pushed in recent years for more transparency, and, in the absence of significant challenge, has created considerable reporting hurdles for colleges and universities. These hurdles increase compliance costs and amplify audit and compliance risk.

As colleges and universities heed signals from the IRS

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165. Letter from Subcomm. on Oversight Chairman Charles W. Boustany to Comm'r Douglas H. Shulman (Oct. 6, 2011), *available at* http://waysandmeans.house.gov/UploadedFiles/Tax-exempt.Oct_6.11_Redacted.pdf.

166. IRS, EXEMPT ORGANIZATIONS 2011 ANNUAL REPORT & 2012 WORK PLAN 10, *available at* http://www.irs.gov/pub/irs-tege/fy2012_eo_work_plan_2011_annrpt.pdf.

regarding areas of future scrutiny, they will be able to reduce audit risk by avoiding the reporting of outlying data. Avoiding such outlying data will reduce the chances of IRS audit. Additionally, colleges and universities can reduce their compliance risk—and the associated penalties of noncompliance—as they and their advisors attain more expert comprehension of the law itself and the policies currently driving the discussion.