The Tax Law of Colleges and Universities

Third Edition

Bertrand M. Harding, Jr.

John Wiley & Sons, Inc.

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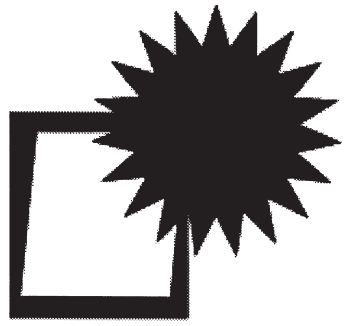

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To my wife, Linda, with love

About the Author

Bertrand M. Harding, Jr., operates his own law firm in Alexandria, Virginia, where he specializes in nonprofit law with emphasis on tax issues and problems facing colleges and universities. A substantial component of his practice also involves representation of colleges, universities, and other nonprofit organizations in controversies with the Internal Revenue Service, including audits, all levels of administrative appeal, and court. He speaks frequently to groups involved in college and university tax issues.

Mr. Harding's interest and involvement in nonprofit tax law began in the early 1970s when he worked for the IRS Exempt Organizations division while attending the George Washington University Law School in the evenings. After graduation from law school in 1975, Mr. Harding served for two years as an attorney-adviser to the Honorable Judge Bruce M. Forrester, United States Tax Court. In 1977, he joined the Washington office of the international law firm of Baker & McKenzie, where he was elected a tax partner in 1984. While at Baker & McKenzie, Mr. Harding represented a number of clients in tax controversy matters and, in addition, developed a nonprofit tax practice drawing on the knowledge and experience that he had gained while working at the IRS. In 1996, he left Baker & McKenzie to establish his own law firm specializing in nonprofit tax matters and representation of clients in tax controversies with the IRS.

Mr. Harding received his BA from Duke University in 1968.

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Preface

This third edition of the book is being released approximately six years after the second edition. During this period of time, there have been a number of significant developments in the college and university tax area, resulting in the addition of substantial new material to this third edition as well as the deletion of a fair amount of superseded and outdated text from the second.

For the past two decades, the college and university tax area has evolved quite dramatically. It is worth remembering that up until the early 1990s the IRS took almost no notice of colleges and universities, and not coincidentally, most schools had little knowledge of or interest in tax issues. During this time period, it was quite common for a school with hundreds of millions of dollars (or even a few billion) in gross receipts to have no employees with any federal tax expertise, and virtually no schools had a ''tax manager'' position. Over the past 15 years or so, that has changed quite dramatically, in large part because of the comprehensive audit program directed at colleges and universities instituted by the IRS in the early 1990s. Now, virtually all colleges and universities have at least one employee who is responsible for federal tax issues; many schools have a tax manager who has his or her own tax department; most college and university financial and legal conferences have at least one session devoted to tax issues; and there are at least two large groups of colleges and universities that get together for a few days each year to discuss tax issues.

The issues that arose in the early to mid-1990s were fairly basic (for example, will royalties paid by a university to employee-inventors be treated as a true royalty or as additional employee wages?); however, resolution of the basic issue often led to more subtle and difficult issues (what will be the impact if the royalty is paid to the employee-inventor in stock of the licensed company instead of cash?). As has been the case in other areas of the tax law, as these more complex issues are resolved, they, in turn, raise more complex issues still (if the royalty can be paid in the form of stock, when is the employee-inventor treated as in receipt of the stock for tax purposes and how is the stock to be valued?). Unfortunately for colleges and universities, and fortunately for the IRS, this peeling away of the onion skin of issues is a never-ending process, and colleges and universities have now entered the tax world that the for-profit corporations have lived in for decades.

I have retained the same overall approach to the third edition that I followed in both the first and second—I have attempted to cover all of the different tax issues that a college or university might face, but at the same time I realized that some of these topics (403(b) plans and tax-exempt bonds, to name

the most obvious examples) each deserved a book of their own. Therefore, I have covered these areas in fairly cursory form and have tried to direct readers to sources where they may be able to find a more in-depth treatment of the topic.

Chapter One provides a historical overview of how the IRS has dealt with colleges and universities over the years and discusses some of the reasons why the IRS decided in the early 1990s to focus its compliance efforts on institutions of higher education. This chapter also provides some recommendations as to resource material that a college or university tax administrator might obtain to assist in identifying and resolving tax issues as they arise and, in addition, to stay current on new developments. And it contains a discussion of the various legal authorities, such as revenue rulings, court cases, and the like.

Chapter Two contains a general treatment of the unrelated business income tax rules, including the definition of ''unrelated business income,'' the specific statutory exceptions to the application of this tax, and other related topics, such as income from controlled organizations, foreign insurance income, debt-financed income, and deductions that can be claimed in computing unrelated business income.

Chapter Three identifies and discusses those peculiar college and university activities that raise potential unrelated business income tax concerns. These include some of the obvious activities, such as bookstores, affinity credit cards, travel tours, and corporate sponsorships, as well as some that are less obvious, such as parking lots, summer sports camps, catering activities, and business incubators.

Chapter Four looks at the employment tax obligations imposed on a college or university in its capacity as an employer and as an entity that retains independent consulting services. This chapter devotes considerable attention to the problem of classifying workers as employees or independent contractors; discusses whether student and nonresident alien employees are subject to the FICA tax; and covers the tax treatment of royalty, early retirement, severance, and settlement payments.

Chapter Five focuses on fringe benefits. After a general discussion of the basic fringe benefit rules, this chapter looks at the treatment of those particular fringe benefits typically provided by colleges and universities to their employees, such as cafeterias and dining rooms, athletic facilities, free or discounted athletic tickets, free or subsidized housing, and section 127 educational assistance programs.

Chapter Six deals with the rules regarding charitable contributions and includes a general discussion of these rules together with an analysis of those provisions of special interest to colleges and universities, such as the distinction between making a gift and paying an individual's tuition, and payments made for the right to purchase seating at athletic events.

Chapter Seven deals with the taxation of scholarships and fellowships, both from the standpoint of the student-recipients (whether and to what extent the grant is taxable to the student) and from the institution's standpoint (i.e., the school's tax withholding and reporting obligations on making scholarship and fellowship payments). This chapter also contains a discussion of two major issues typically raised in IRS audits—distinguishing between compensation and a scholarship/fellowship, and the withholding and reporting requirements imposed on an institution making scholarship/fellowship payments to nonresident aliens.

Chapter Eight includes a discussion and analysis of nonresident alien tax issues, such as what constitutes taxable income to the nonresident alien, how tax is to be withheld and reported, and the impact of tax treaties.

Chapter Nine contains a discussion of a number of different issues, many of which would require an entire book to treat comprehensively. The chapter covers the rules relating to (1) maintaining tax-exempt status and avoiding problems involving potential private inurement and the intermediate sanctions rules, (2) organizing and operating related entities, (3) 403(b) and other retirement plans typically adopted by colleges and universities, (4) tax-exempt bonds, (5) filing the Form 990, and (6) intermediate sanctions. Many educational institutions operate in foreign countries, and this chapter also contains a discussion of the legal issues and potential pitfalls that can arise in conducting activities abroad.

Finally, Chapter Ten covers IRS audits. It describes how most audits of colleges and universities are conducted and offers some tips on how to handle the audit, including a discussion of the attorney-client privilege and how to ensure that the privilege is maintained. The chapter also discusses how a tax case moves beyond the audit stage to the IRS Appeals Office and on to court.

In the Preface to the first and second editions, I expressed my frustration with not having the time to be able to provide a more in-depth analysis of the different topics and issues discussed, and to some extent, that frustration carries over to the third edition, although there are a number of areas where I have included a deeper analysis of the issue in question. It is, however, simply not possible within the constraints of conducting my private practice to write essays on each different issue. There is another limiting factor that stems from the fact that much of my practice involves representing clients before the Internal Revenue Service. In discussing and analyzing the pros and cons of various issues, I have to be careful that I do not assert an opinion that may be contrary to one that I previously asserted on behalf of a client, or one that I may want to assert in the future. This is a problem that is not faced by, say, a law professor or other academic, and readers should be aware of this limitation since it applies to virtually all private practitioner authors.

Finally, I would like to express special thanks to people who have been of assistance over the four years since the first edition was published. These

include my secretary, Jo Ann Bashford, who has labored through all of the annual updates and new editions with her usual good humor and skill; the many individuals in the college and university business and general counsel offices with whom I work on a daily basis and who are kind enough to contact me for advice when, in many instances, they know as much as I do about the issue; and my wife, Linda, who continues to be my biggest cheerleader and my best friend.

Bertrand M. Harding, Jr.
April 2007

CHAPTER ONE

Overview of College and University Taxation

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§ 1.1 HISTORICAL OVERVIEW

The current strong interest in college and university tax matters on the part of both educational institutions and the Internal Revenue Service (IRS) is a relatively recent development. For decades, the IRS, while not totally ignoring colleges and universities, paid little attention to the tax issues and problems facing higher education. There are a number of reasons for this neglect—the substantial amount of work imposed on the IRS in order to implement the private foundation rules during the 1970s and early 1980s; the attention paid by the press (and therefore by the IRS) to the perceived abuses of tax-exempt status by television evangelists and churches during the 1980s; the perception by the IRS during the mid- to late 1980s that significant attention and resources should be directed toward hospitals and other health care organizations; and, perhaps most importantly, the relatively low profile that the ''tax-exempt organization'' area had within the IRS during the hot and heavy years of tax shelters and major corporate acquisitions and mergers.

The IRS has traditionally been concerned with auditing those organizations where the organization's right to tax-exempt status was in question, and much of the agency's time and resources have historically been devoted to exemption issues. Colleges and universities virtually never raise exemption issues—their right to tax-exempt status as an educational organization is almost never in

doubt, and it is almost unheard of for an institution of higher education to have its tax-exempt status revoked, or even have revocation threatened.

For all these reasons, colleges and universities blissfully operated through the decades of the 1960s, the 1970s, and the 1980s, with little concern that any activities they were conducting might raise unrelated business income concerns; that any tax-free fringe benefits they were providing to faculty and other employees might be taxable to them; that the Social Security tax exemptions they were giving to their student-employees might be invalid; or that they may have income tax withholding and reporting obligations with respect to certain payments they made to nonresident aliens. The problems caused by the schools' general inattention to tax matters was fueled by the fact that the IRS provided very little guidance to institutions in identifying which tax issues were important and how (at least according to the IRS) those issues should be handled. For the most part, colleges and universities are good tax citizens; that is, if they know what the IRS position is with respect to an issue, most schools will comply rather than contest the issue with the IRS or in court. But if the IRS does not even advise the schools what the issues are, let alone provide guidance as to how the issues should be handled, the schools have difficulty in bringing themselves into compliance.

The prime example of how this lack of IRS guidance leads to major compliance problems by colleges and universities can be seen in the nonresident alien withholding and reporting area.[1] This area of the law underwent a revolution in 1986 when Congress made major changes to the taxation of scholarships and fellowships, thereby causing schools for the first time to have to identify nonresident aliens on campus and begin withholding on scholarship and fellowship payments made to them. It was not until the mid-1990s, however, that the IRS began to focus on this issue and began to provide some guidance to the schools. In the meantime, many schools were in gross noncompliance with the rules, which would not have been the case had the IRS issued guidelines early on to assist them in establishing the proper withholding and reporting procedures.

The problems caused by the general lack of guidance by the IRS were compounded by the tendency of some schools to solve their tax problems, not by researching the issue and coming up with their own solution or seeking professional tax advice but by finding out how other schools are handling the same matter and acting accordingly. Most schools are very generous in telling their sister institutions how they are handling a particular tax issue, and this is a good and efficient way to get answers to questions, assuming that what the other schools are doing is correct in the first place. Unfortunately, this was not always the case, and a great deal of ''the blind leading the blind'' was taking place during the 1970s and 1980s.

[1] *See* the discussion in Chapter 8.

All this began to change, and change quite dramatically, during the late 1980s and early 1990s. In the late 1980s, the IRS exempt organization policy makers decided to focus their efforts on compliance (i.e., audits) and to direct those efforts on large exempt organizations, including most particularly hospitals and colleges and universities. The IRS exempt organization officials decided to borrow an audit technique that had been used quite successfully for several years in the audits of large for-profit companies—the coordinated audit. This is an audit technique in which a number of different agents with different specialties are brought together to conduct a ''coordinated'' audit of the large taxpayer.[2] In 1991, the IRS issued the Coordinated Examination Procedures for Large Case Audits of Exempt Organizations. Under these procedures, these audits would now involve a team of IRS specialists, including (1) income tax, international tax, and employment tax agents; (2) computer audit specialists; (3) economists; (4) valuation and appraisal experts; and (5) exempt organization specialists. This move away from a ''one-case, one agent'' approach to a coordinated team of specialists dramatically changed the scope and depth of the IRS audits of exempt organizations.

The IRS began looking at the hospitals first. In 1992, the IRS issued the Hospital Examination Guidelines, which served as a blueprint for agents conducting hospital audits.[3] Later that same year, the IRS issued proposed audit guidelines for college and university audits and in the same general time frame selected seven schools to serve as ''pilot audits.'' It was reliably reported in the educational press that these seven schools were the University of Michigan, Michigan State University, the University of Nebraska, St. John's University, Stanford University, Texas Christian University, and Vanderbilt University. As an indication of how lengthy and thorough these coordinated audits are, several of these audits were still open three years later.

The IRS asked for public comment on the proposed college and university audit guidelines, and after receiving and reviewing a number of different comments submitted by individual institutions and higher-education associations, the IRS issued the final guidelines in 1994.

Through the knowledge that the IRS gained through the conduct of these large, coordinated audits of colleges and universities (and it is estimated that well over 50 such audits have been initiated at this writing), the IRS has made up for the ground it lost in the prior decades of relative neglect of higher-education tax matters and has developed a real expertise in how colleges and universities work and where the high-dollar tax issues can be found. As a result, the audits have recently become much more focused and

[2] *See* the discussion in Chapter 10.

[3] For a detailed discussion and analysis of these guidelines and tax issues generally affecting hospitals and other health care organizations, see Thomas K. Hyatt and Bruce R. Hopkins, *The Law of Tax-Exempt Healthcare Organizations*, 2nd ed. (New York: John Wiley & Sons, 2001).

efficient in their ability to extract large tax deficiencies from those institutions that have not put their tax house in order.

As a consequence, many colleges and universities have developed internal procedures to be able to identify tax issues (both existing and prospective) and trained personnel to be able to resolve them. A company with $500 million in annual gross revenue generally has its own ''tax department'' and several full-time employees working on the company's tax matters. But several years ago, there were some educational institutions in this country with annual gross revenues of three or four times that amount that did not have a single employee dedicated on a full-time basis to the tax area. That has, for the most part, changed today, and most schools have in place full-time tax departments to deal with the myriad tax issues and problems they face.

§ 1.2 TAX RESOURCE MATERIAL

In addition to the qualified personnel that are necessary to staff any effective tax department, a comprehensive tax library is essential to permit the institution's tax managers or other officials to be able to conduct research that is required to resolve tax issues that arise. Although different tax professionals may have different recommendations as to which reference materials should be included in a college or university's tax library, a reasonable list is as follows:

- The two leading companies in this area are Commerce Clearing House (CCH) and the Research Institute of America (RIA). They both offer detailed tax material in hard copy and online. This is a fast-changing industry, and anyone interested in reviewing the different types of tax services that each company provides should contact the company or visit their web sites. When acquiring a tax service, it is important to make sure that the service contains not only information on income taxes but also information on employment taxes, for example, Social Security taxes, federal unemployment taxes, and wage withholding.
- In addition to an income and employment tax service, a school should have access to information regarding its obligations to withhold tax and report payments to nonresident aliens. Income tax treaties and Social Security totalization agreements are obviously important in this area, and both can be easily found online. The IRS web site contains not only the text of the different tax treaties but also the technical explanations prepared by the Treasury Department. In addition, schools can obtain a wide variety of nonresident alien tax assistance from Arctic International and Windstar Technologies, Inc., and again, information about these companies and the products they offer can easily be found online.

- In order to stay current on new developments in the college and university tax area, an institution should consider subscribing to the College & University Tax Information Service, which is offered by this author and provides subscribers with e-mail updates of new college and university tax developments, copies of relevant items, and a monthly newsletter.
- A loose-leaf book entitled *A Guide to Federal Tax Issues for Colleges and Universities*, published by the National Association of Colleges and Universities Business Officers, is another good resource. This book covers the major tax issues affecting colleges and universities, with each chapter written by a different expert in the field. It is updated on a periodic basis, and a monthly newsletter is included with the subscription.

§ 1.3 DESCRIPTION OF LEGAL AUTHORITIES

Those colleges and universities that begin reviewing and analyzing their own tax situations in terms of the existing federal income tax law will come upon a host of different types of IRS rulings and court cases. Some of these IRS rulings and court cases have precedential value in that the school can rely on them with the assurance that the IRS will agree with the conclusion; however, a surprising number of these rulings and cases are not binding on the IRS.

(a) Court Cases

Starting with the court cases, the IRS is required to follow decisions of the Supreme Court; therefore, if there is a Supreme Court case that supports a particular tax position, a college or university can take that position with the assurance that the IRS will accept it. This is not necessarily true, however, with respect to any other court cases. The IRS will generally follow a decision of a federal circuit court of appeals in other cases that arise within that same circuit but may very well continue to take a contrary position in cases outside that circuit. For example, if the Ninth Circuit Court of Appeals (which covers the West Coast) decides a case against the IRS and the IRS disagrees with that decision, the IRS may concede the issue in a subsequent case involving a California school but continue to press the same issue against a school located in Massachusetts.

Likewise, the IRS is not required to follow cases decided by trial courts—that is, district courts, the U.S. Tax Court, and the U.S. Court of Federal Claims. It is not unusual for the IRS, for example, to lose a case in the Tax Court and assert a deficiency against another taxpayer based on the very same issue. The IRS does, however, have a procedure under which it announces its ''acquiescence'' or ''nonacquiescence'' with a Tax Court decision

by publishing the decision in the *Internal Revenue Bulletin*.[4] The acquiescence or nonacquiescence may only be issued, however, with respect to a particular issue or issues in a case and may not relate to the entire case. Thus, during the course of researching a Tax Court case, a school should determine whether the IRS has indicated any formal agreement or disagreement with it. Any such announcements, however, are quite rare, and more often than not, the IRS will lose a case in the Tax Court, decide for one reason or another not to appeal the decision, and not announce whether it agrees or disagrees with the Court's decision. In these cases, it is impossible to know whether the IRS will contest the issue again in another forum without actually going through the IRS audit to see what the IRS decides its final position will be.

(b) IRS Regulations

The IRS issues regulations under the different provisions of the Internal Revenue Code. Regulations are authorized by the Code[5] and explain the IRS's position on technical issues and questions that arise under each particular Code section. A taxpayer is entitled to rely on these regulations, and the IRS follows them religiously.

Regulations fall into three different categories: legislative, interpretative, and procedural. Legislative regulations are fairly rare. They are regulations promulgated pursuant to a Code section that specifically authorizes the IRS to prescribe the operating rules for that section.[6] As a general rule, legislative regulations have the same force and effect as the statute itself, and these regulations can only be found to be invalid if they are clearly outside the delegation of authority set forth in the Code section.[7] Most of the Treasury regulations are interpretative regulations. While these regulations do not have the same weight and authority as legislative regulations, the courts customarily accord them substantial weight and will find such a regulation invalid only on the rare occasion that it is clearly contrary to the underlying statute.[8] The procedural regulations are considered to be directive and not mandatory and are generally considered not to have the force and effect of law.[9]

There are two other categories of regulations worth mentioning: temporary regulations and proposed regulations. Temporary regulations are issued to give taxpayers some temporary guidance as to the particular Code section until such time as final regulations are issued.[10] Even though they are only

[4] *See*, *e.g.*, 1980-1 C.B. 1.
[5] IRC § 7805.
[6] *See*, *e.g.*, IRC § 1502.
[7] *Rowan Cos. v. United States*, 452 U.S. 247 (1981).
[8] See Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948).
[9] *See H.G. Lurhing v. Glotzbach*, 304 F.2d 560 (4th Cir. 1962).
[10] *See, e.g.*, the temporary regulations issued under the IRC § 4958 ''intermediate sanctions'' provisions discussed in Chapter 9.

temporary and will be replaced by final regulations, taxpayers are entitled to rely on temporary regulations until such time as the final regulations are issued. Proposed regulations, however, do not have the force of either a temporary or a final regulation, and taxpayers are technically not able to rely on them to support a tax position unless, as sometimes happens, the IRS states that taxpayers are entitled to rely on a particular proposed regulation. After a set of proposed regulations is issued, the IRS asks for and receives comments on the regulations, and the regulations are then issued in final form, sometimes taking into account the comments received but sometimes not.

(c) Revenue Rulings

A revenue ruling is an official interpretation by the IRS of the internal revenue laws, tax treaties, and regulations and sets forth the conclusion of the IRS as to how the tax law is to be applied to a certain set of facts.[11] Revenue rulings are issued only by the IRS national office, and taxpayers are entitled to rely on these rulings in determining the tax treatment of their own transaction, assuming, of course, that the underlying facts of both are substantially the same. Revenue rulings, however, do not have the same authority in a court as do the Treasury regulations. Courts generally accord a revenue ruling the same weight and authority as the position stated by the IRS in its legal brief.[12]

(d) Revenue Procedures

Revenue procedures are official statements of procedures that affect the rights or duties of taxpayers under the Code. They essentially reflect internal IRS management documents and do not contain any statements of substantive tax law as do the Treasury regulations and revenue rulings. As with the procedural regulations, revenue procedures are directive and not mandatory, and if the IRS deviates from a revenue procedure, a taxpayer generally has no right to require the IRS to follow the procedure.[13]

(e) Internal Revenue Manual

In analyzing the applicable tax law, colleges and universities may also encounter citations to the *Internal Revenue Manual*. This is a compilation of instructions promulgated by the IRS to guide its own employees in the administration of the tax laws. Like procedural regulations and revenue procedures, the provisions set forth in the *Internal Revenue Manual* do not have the force of law and are not binding on the IRS.[14] Nevertheless, the *Internal*

[11]Treas. Reg. § 601.601(d)(2).
[12]See, e.g., Stubbs, Overbeck & Assoc. v. United States, 445 F.2d 1142 (5th Cir. 1971).
[13]*Houlberg v. Commissioner*, T.C. Memo 1985-497, 50 T.C.M. (CCH) 1125 (1985); *Rosenberg v. United States*, 450 F.2d 529 (10th Cir. 1971).
[14]First Fed. Sav. & Loan Ass'n of Pittsburgh v. Goldman, 644 F. Supp. 101 (W.D. Pa. 1986).

Revenue Manual provides insight into the inner workings of the administration of the IRS and contains a great deal of information that is useful to colleges and universities.[15]

(f) Announcements and Notices

The IRS also publishes a number of announcements and notices, which contain guidance of both a substantive and procedural nature. Taxpayers are entitled to rely on these notices and announcements in the same manner as revenue rulings, and at least in the exempt organizations area, it seems that the IRS is relying much more heavily on announcements and notices in lieu of revenue rulings, perhaps because they require less internal review and therefore can be issued more expeditiously.

(g) Private Letter Rulings

The next category of IRS authority with which most persons are familiar is the private letter ruling. A private letter ruling is a written response issued to a taxpayer by the IRS national office that interprets and applies the tax laws to the taxpayer's specific set of facts.[16] The Internal Revenue Code specifically prohibits a taxpayer or the IRS from relying on private letter rulings as precedent in other cases.[17] Nevertheless, as a practical matter, private letter rulings are often cited by taxpayers to the IRS as authority for an asserted legal position, and vice versa. Once a case gets into court, however, any reliance on a position set forth in a private letter ruling is normally of little value.

(h) Determination Letters

Another type of IRS ruling is a determination letter. These are similar to private letter rulings in that they set forth a written response to a taxpayer's particular set of facts, except for the fact that they are issued by an IRS district office, not the national office. Determination letters are issued only where the determination can be made on the basis of clearly established rules in the Code or the regulations, or on the basis of an IRS ruling or court decision. Any request for a determination letter that presents a novel or controversial issue will either not be answered or be referred to the national office for a private letter ruling.

(i) Technical Advice Memorandums

Another type of ruling issued by the IRS national office is the technical advice memorandum. These are written memorandums setting forth legal

[15]See Archie W. Parnell, Jr., ''The Internal Revenue Manual: Its Utility and Legal Effect,'' 32 *Tax Lawyer*, No. 3, at 687 (Spring 1979).
[16]Treas. Reg. § 301.6110-2(d).
[17]IRC § 6110(j)(3); Treas. Reg. § 301.6110-7(b).

advice and guidance prepared by the IRS national office to either a district office or an appeals office in response to a technical or procedural issue that has arisen in that office and for which the office needs the technical assistance of experts in the national office.[18]

(j) Exempt Organizations (EO) Continuing Professional Education Texts

Another important source for determining IRS thinking on college and university tax issues is the *Continuing Professional Education Text* that the IRS Tax-Exempt and Governmental Entities Division publishes. At one time, these CPE Texts were published annually, but the IRS has not published a CPE Text since 2004. The CPE Text is prepared by the IRS national office and is intended to serve as guidance for field agents, but it also provides colleges and universities, as well as all tax-exempt organizations and their tax advisers, with a description and analysis of the IRS position on both old and new tax issues. Copies of CPE Texts from 1979 through 2004 can be found on the IRS web site at *www.irs.gov/charities/article/0,,id=161088,00.html*.

[18]For a detailed discussion of the technical advice procedures, *see* § 10.8.

CHAPTER TWO

Unrelated Business Income

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§ 2.1 INTRODUCTION—GENERAL PRINCIPLES OF THE UNRELATED BUSINESS INCOME TAX

Because colleges and universities are generally interested in maximizing revenue from any income-producing activities, one of the major tax issues facing higher-education institutions is potential exposure to the unrelated business income tax. This chapter describes the basic principles and concepts underlying the application of this tax and the computation of any resulting net taxable income.[1]

The commonly used term *tax-exempt organization* is a misnomer. All tax-exempt organizations, including colleges and universities, have been granted tax-exempt status because they are organized and operated primarily to pursue one or more exempt purposes, such as providing education or engaging in scientific research in the case of colleges and universities. Notwithstanding its tax-exempt status, a tax-exempt organization is potentially subject to a special unrelated business income tax that is imposed at the normal corporate tax rates on the net income earned by the organization from the conduct of a trade or business that is unrelated to its exempt purposes.[2]

As discussed in greater detail elsewhere in this book, these same unrelated business income tax rules also apply to state colleges and universities even though many of these institutions have not been recognized by the IRS as ''tax-exempt organizations.''[3]

Congress enacted the unrelated business income tax in 1950, with two primary purposes in mind: to give the IRS a means to penalize a tax-exempt organization that conducts unrelated business activities instead of having to revoke the organization's tax-exempt status,[4] and to put tax-exempt organizations engaged in business activities on the same level playing field as for-profit business enterprises engaged in the same activity.[5]

On this latter point, organizations sometimes argue that if the particular activity is not conducted by for-profit companies, there is, by definition, no

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[1]For additional discussion and analysis of the unrelated business income tax principles, readers should consult the ''bible'' of the tax-exempt organization law: Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 9th ed. (New York: John Wiley & Sons, 2007). See also Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures*, 4th ed. (New York: John Wiley & Sons, 2004); Frances R. Hill & Douglas M. Mancino, *Taxation of Exempt Organizations* (Boston: Warren, Gorham & Lamont, 2005).

[2]IRC § 511.

[3]*See* § 9.7(c).

[4]Nevertheless, if the organization's unrelated business income activities are ''substantial,'' revocation remains an option the IRS can pursue.

[5]S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). See *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986). For a comprehensive history of the unrelated business income tax, see Sharpe, ''Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later,'' 3 *Florida Tax Review*, No. 7, at 347 (1996).

competition with a for-profit enterprise and the unrelated business income tax should not apply. The IRS, however, rejects this argument as illustrated in a 1998 ruling in which it said that competition ''is neither the sole nor the primary criterion to be considered in determining whether an activity is an unrelated trade or business.''[6] In addition, the preamble to the travel tour regulations issued in 1999 makes it clear that the existence or nonexistence of competition with for-profit ventures has no effect on whether the activity will be subject to tax.[7] And, in a training manual published in 2000 dealing with the tax consequences resulting from the operation of health clubs, the IRS said that whether a ''fitness center may be in competition with a commercial counterpart is immaterial in determining whether or not [the fitness center's] income is subject to the unrelated business income tax.''[8]

While a tax-exempt organization risks revocation of its exempt status if it conducts business activities that represent a ''substantial'' part of its overall activities, this is not generally a concern for colleges and universities because their educational activities (i.e., providing instruction to students) or their scientific research activities will always be the substantial part of what they do. At the same time, however, some educational institutions conduct a wide variety of activities that have only a tangential relationship (or, in some cases, no relationship at all) to pure educational instruction or scientific research, and it is within the context of these noneducational and nonscientific activities that the unrelated business income tax rules come into play.

Under the statute, three elements must be present in order for an activity conducted by a college or university 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 school's exempt educational purposes.[9]

(a) The ''Trade or Business'' Requirement

Generally, any activity carried on for the production of income that involves the sale of goods or the performance of services and that otherwise has the characteristics of a business enterprise is considered a ''trade or business'' for purposes of the unrelated business income tax rules.[10] This is a broadly worded

[6]Priv. Ltr. Rul. 9848002 (July 28, 1998), which involved an IRC § 501(c)(6) organization that operated a recycling facility for its members and unsuccessfully argued that the income from this activity should not be subject to the unrelated business income tax because there were no commercial facilities in the area offering this same service.

[7]Treas. Reg. § 1.513–7.

[8]*2000 Exempt Organizations Continuing Professional Education Technical Instruction Textbook* 16, 22nd ed. (2000).

[9]IRC § 512(a)(1).

[10]Treas. Reg. § 1.513–1(b). For a rare case in which a court found that no trade or business existed, see *Vigilant Hose Co. v. United States*, 2001–2 U.S.T.C. (CCH) 50,485 (D. Md. 2001), where the court found that a tax-exempt volunteer fire department's activities in connection with ''tip jar'' gambling were not extensive enough to constitute a trade or business.

definition, and both the courts and the IRS interpret the ''trade or business'' concept quite expansively, meaning it is unusual for a particular activity to be treated as a nontrade or -business activity. The following are several of the issues that arise under this first component of the unrelated business income activity test.

(i) Profit Motive. The same basic principle that is used to determine whether an activity is a trade or business for business expense deduction purposes is also used to determine whether an activity is a trade or business for purposes of the unrelated business income tax,[11] that is, whether the activity is conducted for the primary purpose of generating income or a profit.[12] Although the profit motive concept arises most often in the for-profit context, the courts have held that the same principle applies in analyzing income-producing activities conducted by tax-exempt organizations. As the Supreme Court stated in determining whether an activity was an unrelated business income activity, the organization's ''primary purpose for engaging in the activity must be for income or profit.''[13] The question is what factors are used to determine whether the requisite profit motive is present.

It is not necessary that the organization hold itself out to the general public as engaged in a trade or business. The Tax Court at one time followed this approach[14] but subsequently determined that the test was ''overly restrictive,'' so instead adopted a facts-and-circumstances test.[15] This facts-and-circumstances approach was later adopted by several courts of appeals as well as by the Supreme Court.[16] The IRS also makes profit motive determinations by using a facts-and-circumstances test, as evidenced in a 1996 technical advice memorandum in which a tax-exempt health care organization sold a nursing home to another exempt organization and then provided food service to the patients for a fee.[17] The issue was whether the food service activity was conducted with a profit motive, and the IRS found that it was not, based on the following factors: (1) there was no business plan; (2) the organization did not solicit business from other unrelated organizations or otherwise attempt to expand the food service business; (3) the organization

[11] *Id*. These principles arise as part of determining whether a person can claim a business expense deduction for an expense incurred in connection with the activity in question. The trade or business expense deduction rules are set forth in IRC § 162.
[12] *Commissioner v. Groetzinger*, 480 U.S. 23–35 (1987).
[13] *United States v. American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986).*See also Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984);*Professional Ins. Agents v. Commissioner*, 726 F.2d 1097, 1102 (6th Cir. 1984).
[14] *Gentile v. Commissioner*, 65 T.C. 1, 5 (1975).
[15] *Ditunno v. Commissioner*, 80 T.C. 362, 366–67 (1983).
[16] *Commissioner v. Groetzinger*; *see* note 12.
[17] Tech. Adv. .Mem. 9719002 (Nov. 27, 1996).

did not increase its per-meal charges, which were substantially below cost; and (4) there was no contract between the two organizations.[18]

Notwithstanding the use by the courts and the IRS of a facts-and-circumstances test in making the profit motive determination, one cannot escape the fact that, if the activity in question actually generates a net profit, there is a strong likelihood that it will be held to be a trade or business. Or, as one court said, ''There is no better objective measure of an organization's motive for conducting an activity than the ends it achieves.''[19] In addition, IRS agents conducting audits of colleges and universities have been known to look only at whether the particular activity generated a profit on a consistent, year-after-year basis. If so, the agents have concluded that the activity was conducted with a profit motive intent; if not, they have concluded that there was no such intent. Some agents have even gone so far as to follow the ''hobby loss'' rules applicable to for-profit activities and treat the activity as a trade or business if it earns profit in at least three of the last five years.[20] Although this might seem to be a logical way of addressing the issue, it ignores the fact that the regulations under the hobby loss rules contain a myriad of other factors to be taken into account in making the profit motive determination, and perhaps more importantly, that these rules apply only to individuals and Subchapter S corporations. It also ignores the clear statement by the national office that no activity can be excluded from classification as a trade or business simply because it does not result in a profit.[21]

One must keep in mind that, while educational institutions often use the ''lack of a profit motive'' argument as a shield to contend that a particular activity should not be treated as an unrelated trade or business activity, the IRS uses the same concept as a sword—by disallowing claimed loss deductions with respect to allegedly unrelated activities. To illustrate how the IRS fashions such an argument based on a situation that arose in one university audit, assume that a school books 15 different professional entertainment events for the academic year.[22] Some of these events earn a net profit, but others do not. The school offsets the net income derived from the profitable events by the losses incurred on the unprofitable ones, resulting in an overall net loss

[18] *See also* Tech. Adv. Mem. 200047049 (Aug. 2, 2000), wherein the IRS ruled that the provision of municipal services (water, sewer, garbage pickup, etc.) for a fee was not a trade or business because of the lack of a profit motive intent.

[19] *Carolinas Farm & Power Equip. Dealers Ass'n. v. United States*, 699 F.2d 167, 170 (4th Cir. 1983). See also *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *American Academy of Family Physicians v. United States*, 91 F.3d 1155 (8th Cir. 1996).

[20] *See* IRC § 183. The ''hobby loss'' rules are designed to determine whether an individual is really conducting a trade or business or is instead simply pursuing a hobby or activity for personal pleasure, such as operating a horse farm. *See also Freed v. Commissioner*, T.C. Memo 2004–215, which contains a good discussion of the different factors that are taken into account in applying the ''hobby loss'' rules of IRC § 183 to an alleged nonprofit motive situation.

[21] Tech. Adv. Mem. 9719002 (Nov. 27, 1996).

[22] *See* § 3.9.

on the 15 programs for the year. Using the ''fragmentation rule'' discussed below, the IRS examines each individual entertainment event as a separate trade or business and determines that the unprofitable events do not constitute a trade or business because there was no intent by the school to earn a profit on those particular events. Because only losses incurred in connection with bona fide unrelated business income activities can be used to offset unrelated business income, the IRS denies the school's attempt to use the losses on the nonprofitable events to offset the income earned on the profitable ones. Thus, the school is left with unrelated business income on the profitable events only.

(ii) Fragmentation Rule. Another important aspect of the trade or business definition is that an activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities, which may be related to the exempt purposes of the organization.[23] This so-called fragmentation rule permits the IRS to carve out a particular unrelated component of an overall related activity and tax that unrelated ''fragment'' as a separate trade or business with its own allocable income and expenses. There are dozens of situations illustrating how the fragmentation rule operates within the college and university context, but one classic example is the campus bookstore. The operation by a college or university of an on-campus bookstore is a ''related'' activity because the sales of textbooks and other educational materials are directly related to the school's educational purposes. Under the fragmentation rule, however, the IRS is able to identify and separately tax as unrelated business income certain types of sales made at the bookstore. For example, the IRS takes the position that certain sales made to the general public are not related to the school's exempt educational purposes. The fact that these general public sales are made within the context of the overall ''related'' bookstore operation does not prevent the IRS from carving out and taxing the net income from these general public sales as unrelated business income.[24] As another example, assume that a university has a ski facility that it uses in its physical education program and maintains for the recreational use of its students. Members of the general public also use the facility and pay fees comparable to those charged by commercial enterprises. The use of the ski facilities by the general public is considered a separate and distinct trade or business.[25]

(iii) Efficiencies in Operation. In some cases, the courts have looked to whether the organization operated the activity in an efficient and well-managed

[23]IRC § 513(c).
[24]*See* § 3.1.
[25]Rev. Rul. 78–98, 1978–1 C.B. 167.

manner as evidence that the activity should be treated as a trade or business.[26] However, the Tax Court in one case rejected a tax-exempt organization's argument that its crop and cattle operation was not a trade or business because it used outdated equipment, did not expand its operations, neglected to finance its activities, and failed to institute automated procedures. The Tax Court held that it is not necessary that an activity be conducted as efficiently as possible in order to be a trade or business and that failure to maximize profits does not necessarily mean a lack of the requisite profit motive.[27] Thus, any argument by a school that an activity is not a trade or business because it is not efficiently conducted or managed will certainly be rejected by the IRS, and very likely by a court as well.

(iv) Covenant Not to Compete. Another issue that has arisen in the ''trade or business'' area is whether the amount of the payment received by a section 501(c)(3) organization in return for entering into a covenant not to compete is taxable. The IRS took the position in a 1991 General Counsel Memorandum (GCM) that refraining from competition under a covenant not to compete constitutes a trade or business,[28] but the Tax Court took a contrary position in a 1996 case, stating:

> We simply do not think that a one-time agreement not to engage in certain activities constitutes the kind of continuous and regular activity characteristic of a trade or business. . . . We, therefore, decline to treat the absence of activity resulting from a covenant not to compete as equivalent to the affirmative performance of such activity for purposes of applying the definition of a trade or business in this context.[29]

In light of this Tax Court decision, the IRS announced that its earlier GCM was revoked,[30] and in a technical advice memorandum said that because of this case, ''we are not prepared to conclude that the covenant not to compete is an activity that rises to the level of an unrelated trade or business.''[31]

(b) The ''Regularly Carried On'' Requirement

For income to be subject to the unrelated trade or business tax, the trade or business must also be ''regularly carried on.'' The regulations provide that

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[26] *Incorporated Trustees of the Gospel Workers Soc'y v. United States*, 510 F. Supp. 374 (D.D.C.), aff'd, 672 F.2d 894 (D.C. Cir. 1981); *Presbyterian & Reformed Publ'g Co. v. Commissioner*, 79 T.C. 1070 (1983).

[27] *St. Joseph Farms of Ind. Bros. of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner*, 85 T.C. 9, 20–21 (1985), nonacq., 1986–2 C.B. 1.

[28] Gen. Couns. Mem. 39,865 (Dec. 12, 1991).

[29] *Ohio Farm Bureau Fed'n, Inc. v. Commissioner*, 106 T.C. 222, 234–35 (1996).

[30] Gen. Couns. Mem. 39,891 (Jan 2, 1997).

[31] Tech. Adv. Mem. 9721002 (Nov. 27, 1996). See also *1999 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 294, 21st ed. (1999).

a trade or business activity is regularly carried on if it manifests a ''frequency and continuity, and [is] pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.''[32]

Over the years, the IRS has issued numerous private letter rulings analyzing whether different activities meet this ''regularly carried on'' test.[33] Although it is difficult to draw any hard-and-fast rules from these rulings and the IRS regulations, some general principles emerge. First, the time span over which a comparable commercial activity is conducted should be compared with the time span of the activity in question. If they are about the same, the activity is regularly carried on. However, if the activity in question is conducted for a substantially shorter period of time, the activity may not be treated as regularly carried on. As an example, the regulations cite a sandwich stand operated for a two-week period at a state fair.[34] Because taxable food service operations are typically conducted on a year-round basis, the sandwich stand sales activities are not regularly carried on. By contrast, the operation by a church of a commercial parking lot one day a week for the entire year is treated as regularly carried on because parking lots are typically operated on a year-round basis.[35] Also, if a commercial activity is normally conducted on a limited or seasonal basis (e.g., Christmas card sales), an activity conducted on the same basis by the tax-exempt organization will be regularly carried on.[36]

Additional guidance on the IRS approach to the regularly carried on test can be found in a 1968 ruling that involved ''casual'' sales of drugs by a hospital pharmacy to nonpatients and members of the general public.[37] The IRS ruled that the sales were not regularly carried on because the hospital did not promote the sales, the sales were infrequent, and they represented only a small percentage of the pharmacy's total sales. The rationale of this ruling should apply equally to sales in the college and university context, for example, situations where a school's bookstore makes only irregular and infrequent sales to members of the general public.

With respect to intermittent activities (i.e., activities conducted only at intervals and not on a continuous basis), the manner in which the activity is carried on is compared with the manner in which commercial activities are carried on. As a general rule, if the organization's activity is not conducted with the same marketing and promotional efforts as a commercial business, the activity is not regularly carried on.[38] For example, in one ruling the IRS found that the advertising income earned by an organization from an annual

[32]Treas. Reg. § 1.513–1(b).
[33]*See*, *e.g.*, Priv. Ltr. Rul. 8345001 (n.d.) (annual variety show); Priv. Ltr. Rul. 9217001 (Sept. 30, 1991) (annual carnival).
[34]Treas. Reg. § 1.513–1(c)(2)(i).
[35]*Id*.
[36]*Id*.
[37]Rev. Rul. 68–374, 1968-2 C.B. 242. *See also* Priv. Ltr. Rul. 200203070 (Oct. 22, 2001).
[38]Treas. Reg. § 1.513–1(c)(2)(ii).

publication was taxable because of the organization's ''extensive campaign of advertising solicitation'' that was conducted ''in a manner not materially different from similar commercial activities.''[39] Other activities may be conducted so infrequently that they are not treated as regularly carried on regardless of the manner in which they are conducted. For example, an activity that lasts only a short period of time and recurs only sporadically (e.g., a fundraising dance) is not regularly carried on, even if conducted each year.[40] The Tax Court has characterized this exception as a ''safe haven'' for activities that ''occur too infrequently'' to be deemed regularly carried on.[41]

As noted above, in making a determination regarding whether an activity is regularly carried on, the IRS looks to the frequency and continuity of the activity. An ongoing issue in this area is whether, and to what extent, preparatory time should be taken into account in making a ''frequency and continuity'' determination. The clear position of the IRS is to take preparation time into account.[42] The Tax Court, however, disagrees. In one case, involving an annual vaudeville show consisting of three or four performances over a single weekend, the organization expended one to two months of preparatory time in selling advertising and otherwise getting ready for the shows. The court said that ''the fact that the organization seeks to ensure the success of its fundraising venture by beginning to plan and prepare for it earlier should not adversely affect the tax treatment of the income derived from the venture.''[43] An appeals court reached the same conclusion in a case involving the sale of advertising at the National Collegiate Athletic Association's (NCAA's) Final Four national collegiate basketball tournament.[44] In that case, the tournament lasted less than three weeks, but the advertising activities were conducted for a considerably greater period of time. The court refused to include the preparatory time in the regularly carried on determination, holding that the proper length of time was three weeks.

In 1996, the IRS ruled that a concert series conducted by a tax-exempt organization was regularly carried on even though it was only conducted two times a year, once in the spring and again in the fall. The IRS noted that ticket solicitation and other preparatory activities consumed up to six months and said that this time had to be taken into account in making the regularly carried on determination.[45] While the IRS still clings to its basic position

[39]Rev. Rul. 73–424, 1973-2 C.B. 190.

[40]Treas. Reg. § 1.513–1(c)(2)(iii). See also Priv. Ltr. Rul. 9745025 (Aug. 11, 1997), in which the IRS ruled that a one-time sale of an apartment complex did not meet the regularly carried on test.

[41]*Veterans of Foreign Wars, Mich. v. Commissioner*, 89 T.C. 7 (1987).

[42]Rev. Rul. 73–424, 1973-2 C.B. 190; Rev. Rul. 75-200, 1975-1 C.B. 163. See also Tech. Adv. Mem. 9721001 (Oct. 17, 1996).

[43]*Suffolk County Patrolman's Benevolent Ass'n Inc. v. Commissioner*, 77 T.C. 1314, 1324 (1981), acq., 1984–10 I.R.B. 5.

[44]*National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), rev'g 92 T.C. 456 (1989).

[45]Tech. Adv. Mem. 9712001 (Oct. 17, 1996).

that preparatory time must be taken into account, this ruling provides some indication of how much preparatory time is enough to mean an activity is being regularly carried on. In this ruling, the IRS distinguished its acquiescence in an earlier case[46] because the preparatory time in that case (one to two months) was ''much shorter.''

Thus, as matters now stand, the courts that have considered this issue have held that preparatory time should not be taken into account, but the IRS disagrees with this position and will continue to litigate it.[47] But, while the IRS contends that preparatory time must be taken into account, it seems to also believe that less than two months a year of preparatory time may not be sufficient to meet the regularly carried on threshold.

(c) The ''Not Substantially Related'' Requirement

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 relationship is a substantial one and ''contributes importantly'' to the conduct of the organization's exempt purposes.[48] Within the four corners of these broad definitional elements lies an extraordinary amount of interpretative room, resulting in great opportunities for conflict with the IRS.

A college or university's primary exempt purpose is obviously educational, and those institutions that also conduct research activities have a secondary scientific exempt purpose.[49] Certain activities conducted by colleges and universities clearly have the requisite substantial ''causal relationship'' to the furtherance of the school's educational purposes (e.g., operating a bookstore where textbooks and school supplies are sold), whereas other activities clearly do not (e.g., operating a downtown retail clothing store). Most activities, however, fall somewhere in between, and it is these activities that generate controversies with the IRS.[50]

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[46] *Suffolk County Patrolman's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314 (1981), acq., 1984–10 I.R.B. 5.

[47] *National Collegiate Athletic Ass'n v. Commissioner*; *see* footnote 44, Action on Decision 1991–015 (July 3, 1991); Tech. Adv. Mem. 9147007 (Aug. 16, 1991).

[48] Treas. Reg. § 1.513–1(d)(2).

[49] Because a college or university's exempt purpose is providing educational benefits, the tuition and fee revenue that it receives is obviously related to the conduct of its exempt purposes. The IRS has ruled that such tuition/fee revenue will continue to be related income even if it is derived by the school from a section § 529 prepaid tuition program. Priv. Ltr. Rul. 200313024 (Jan. 2, 2003).

[50] To illustrate the difficulty in this area, it is generally the position of the IRS that the performance of administrative and financial services for third parties will be treated as unrelated to the

For example, some business schools are reportedly setting up ''venture capital funds'' that are controlled by business school students and make actual investments in start-up and other businesses.[51] The reported objective of these funds is both to earn a profit and to serve as a teaching vehicle for the students. Will the IRS conclude that this activity is substantially related to the school's exempt purposes? Guidance can perhaps be found in a 2003 private letter ruling involving a section 501(c)(3) organization that was organized and operated to benefit students within a particular state earned income from securitizing student loans.[52] The IRS concluded that this activity was a trade or business that was regularly carried on but said that the loan securitization activity was substantially related to the organization's purpose of assisting the students by providing a source of capital and added flexibility to the state's student improvement programs.

The substantially related test requires an analytic comparison of the activity in question to the school's exempt purposes. An evolving issue in this area is whether a college or university's exempt purpose is necessarily limited to educational or scientific purposes. Many schools believe that they have an additional responsibility to benefit the city or community in which they are located.[53] Thus, a school may believe that it is in furtherance of its exempt purpose to provide low-cost recreational facilities to members of the community or to permit members of the local community to attend events at the campus community center. If the school earns revenue from these activities, can it legitimately argue that these activities are in furtherance of its ''community benefit'' exempt purpose? If so, perhaps certain activities that the IRS has historically regarded as unrelated (e.g., permitting the general public to use the school's recreational facilities for a fee) can be pulled within the related umbrella by expanding the basis for the school's exempt status. For example, in a ruling issued in 2000, the IRS held that the operation by a

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organization's exempt purposes because the performance of such services is not an educational or scientific activity. Rev. Rul. 72–369, 1972-2 C.B. 245. This is true even if the recipient of the services is itself an IRC § 501(c)(3) organization unless the services are provided at ''substantially below cost.'' Rev. Rul. 71-529, 1971-2 C.B. 234. But the IRS follows a different rule if the services are performed for related, tax-exempt entities. See Priv. Ltr. Rul. 9651047 (Sept. 24, 1996); Priv. Ltr. Rul. 9849027 (Sept. 10, 1998). These rulings say that such services will be treated as related if there is a parent subsidiary relationship between the parties, the services that are provided are essential for that entity to perform its exempt functions, the other entity could provide the services for itself without giving rise to unrelated business income, and the services occur in the context of the close relationship between the parties.

[51]''Graduate Business Schools Begin to Finance Start-ups,'' *Wall Street Journal*, Nov. 25, 1997, at B2.

[52]Priv. Ltr. Rul. 200345041 (Aug. 15, 2003).

[53]For example, Georgetown University was reported to have invested up to $1 million of its operating funds to help create a local bank to serve needy people in Washington, D.C. According to this news report, Georgetown's intent to earn a return on its investment was secondary to its purpose of benefiting the community. *Chronicle of Higher Education*, Jan. 19, 1996, at A29. See also ''Building Hope in a City,'' *Chronicle of Higher Education*, Mar. 15, 1996, at A35, describing Trinity College's plan ''to revitalize a troubled neighborhood.''

hospital of a fitness center that was open to the general public for a fee was in furtherance of the hospital's exempt purposes of serving the health care needs of the community.[54] It would not take a large leap of logic to apply the rationale of this ruling to a health club or fitness center operated by a college or university that had as one of its exempt purposes benefiting the community.

This community benefit concept is further illustrated by a 1999 IRS ruling in which a private foundation proposed to fund a program at a college that would include a research and business incubator and a venture capital fund.[55] The incubator would be owned and operated by the college and would include state-of-the-art laboratories, computers, information systems, and various administrative services. The venture capital fund would provide loans and equity investments to enterprises associated with the incubator or other local businesses. These loans and equity investments would be made by the college with the funds it received from the foundation. The IRS approved the funding by the private foundation, saying that the program furthered the college's exempt purposes and, in addition, contributed to the general economic development of the area.

Although there are scores of IRS rulings and court cases involving the issue of whether a particular trade or business activity conducted by a tax-exempt organization is related or unrelated to the organization's exempt purposes, most of these rulings and cases have little application beyond their specific facts.[56] Unless another college or university has previously fought the battle with respect to a particular activity, the chances are that a school will be forced to make a related/unrelated determination on a purely subjective basis and without any precedential guidance. However, two general concepts can be helpful in making these determinations:

1. If the size and extent of the business activity is in excess of what would be necessary to further the particular exempt function, this will be one factor in favor of a determination that the activity is unrelated to the organization's exempt purposes,[57] for example, if a school builds an athletic facility for its students, but includes in the facility equipment and amenities normally found in a for-profit health club.

[54]Priv. Ltr. Rul. 200051049 (Sept. 26, 2000).

[55]Priv. Ltr. Rul. 200010052 (Dec. 10, 1999).

[56]For an excellent compendium of these different cases and rulings, and a comprehensive discussion of the ''substantially related'' concept, see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 9th ed. (Hoboken, NJ: John Wiley & Sons, 2007).

[57]Treas. Reg.§1.513–1(d)(3). For cases in which the activity was held to be conducted on a larger scale than necessary to accomplish charitable or educational purposes, see Rev. Rul. 73–386, 1973-2 C.B. 191; Rev. Rul. 73–127, 1973-1 C.B. 221; Priv. Ltr. Rul. 9535023 (May 31, 1995). For cases in which the activity was conducted on a scale no larger than reasonably necessary to accomplish such purposes, see Rev. Rul. 76–94, 1976-1 C.B. 171; Rev. Rul. 73–128, 1973-1 C.B. 222.

2. If an activity benefits individuals in direct proportion to what they pay, this is evidence that the activity is unrelated because it indicates that the benefit to the individual is greater than the benefit to the general public.[58] Using the same athletic facility example, if the facility charges fees to the general public equivalent to what a commercial health club would charge, the IRS would likely contend that the individuals are receiving a benefit in direct proportion to the amount paid.[59]

(d) The Agency Issue

In analyzing whether it is engaged in an unrelated business income activity, a college or university must also consider those activities that are conducted by its agents because, under basic principles of agency law, the actions of the agent are attributed to the principal. Thus, for example, where an institution retains a for-profit company to sell advertising in the institution's publications, if the for-profit company is deemed to be the institution's agent, the advertising income will be treated as received by, and taxable to, the institution.[60] However, if the for-profit company is acting as an independent contractor vis-à-vis the institution, the company is viewed as acting in its own right, and the substantially related analysis will be made by examining the institution's relationship to the for-profit company.

In late 2002, the IRS national office issued detailed guidelines to its agents as to how agency determinations should be made in a variety of unrelated business income tax situations, including advertising, royalties, and the receipt of charitable contributions. These guidelines contain an excellent overview of the agency issue and describe how the IRS applies these rules to different situations.[61]

§ 2.2 STATUTORY EXCEPTIONS TO UNRELATED BUSINESS INCOME

Within the statutory framework of the unrelated business income tax rules, Congress has carved out several specific categories of activities that will not be treated as an unrelated trade or business, regardless of whether they might otherwise meet the applicable tests.

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[58] *See National Water Well Ass'n Inc. v. Commissioner*, 95 T.C. 75, 99 (1989), rev'd on other grounds, 914 F.2d 1419 (10th Cir. 1990).

[59] *See, e.g.*, Priv. Ltr. Rul. 200051049 (Sept. 26, 2000), wherein the IRS concluded that the operation by a hospital of a fitness center was a related activity, in part because the membership fees were set at an amount to permit an ''economic cross-section'' of the community to join.

[60] *National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), rev'g 92 T.C. 456 (1989).

[61] 2002 Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, at 127 (24th ed. 2001).

(a) Capital Gains Transactions

All gains and losses from the sale, exchange, or other disposition of property are excluded from the computation of a college's or university's unrelated business income.[62] Thus, all gains and losses from stock and bond transactions are exempt, as is income derived from the sale of land, a building, or some other asset that the institution owns.[63] This exclusion does not apply, however, to property that is treated as inventory in the hands of the institution or property that is held primarily for sale to customers in the ordinary course of a trade or business.[64]

In determining whether property is held in the ordinary course of business, the IRS applies a facts and circumstances test, taking into account such factors as (1) the purpose for which the property was acquired; (2) the cost of the property; (3) the extent to which the owner was involved in improvements to the property and the nature of those improvements; (4) the proximity of the sale of the property to its purchase; (5) the purpose for which the property was held; (6) prevailing market conditions; and (7) the frequency, continuity, and size of the sales.[65] In one case, a school attempted to raise funds by buying and selling 22 different pieces of real property over a two-year period. The Tax Court held that the capital gains exclusion did not apply because the properties were held as part of a regularly carried on trade or business.[66]

Even if the asset is partially or exclusively used in the conduct of an unrelated business income activity, the capital gains exclusion will still apply, assuming that the sold asset does not represent an inventory asset or property primarily held for sale to customers. Therefore, if a college or university sells a building used exclusively in an unrelated trade or business, such as a building located off-campus that houses all the school's advertising staff and activities, any gain or loss on the sale is not unrelated business income, although the

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[62] IRC § 512(b)(5).

[63] *See, e.g.*, Priv. Rul. 9616039 (Jan. 23, 1996), holding that a college's sale of land for commercial and residential development is not subject to the unrelated business income tax, and Priv. Ltr. Rul. 9619069 (Feb. 13, 1996), holding that a school's endowment trust can subdivide its real estate and sell small portions periodically without being subject to the unrelated business income tax. *See also* Priv. Ltr. Rul. 9505020 (Nov. 7, 1994), Priv. Ltr. Rul. 9510039 (Dec. 9, 1994), and Priv. Ltr. Rul. 9509041 (Dec. 6, 1994), all of which are discussed in 1996 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook 250 (20th ed. 1996). *See also* Priv. Ltr. Rul. 9745025 (Aug. 11, 1997), in which the IRS ruled that income earned by an IRC § 501(c)(3) organization from the sale of an apartment complex was not taxable both because the sales activity was not regularly carried on and because the sale qualified for the capital gains exclusion.

[64] IRC §§ 512(b)(5)(A) and (B). *See also* Priv. Ltr. Rul. 9704010 (Oct. 24, 1996), which held that income derived by a college from the sale of real property through a limited partnership was not taxable as unrelated business income because the limited partnership did not hold the property primarily for sale to customers.

[65] *See, e.g.*, Priv. Ltr. Rul. 9619069 (Feb. 13, 1996); Priv. Ltr. Rul. 200119061 (Feb. 14, 2001).

[66] *Parklane Residential Sch,, Inc. v. Commissioner*, 45 T.C.M. (CCH) 988 (1983).

depreciation recapture rules may require a portion of the gain to be taxable as ordinary income.

The capital gains issue also arose in a 2003 technical advice memorandum where a taxpayer received a payment in return for the cancellation of a long-term power purchase contract, and the issue was whether the payment qualified for capital gains treatment.[67] The IRS said that the payment received by the taxpayer for the termination of the contract should be treated as ordinary income.

(i) Property Acquired by Bequest or Gift. The issue as to whether the capital gains exclusion applies arises frequently in those situations where a college or university sells property (e.g., real estate) that it acquired by a bequest or gift. Even if the school converts the property into property that it holds primarily for sale, there is some authority for the proposition that, when the property is sold, a court should give primary consideration to the taxpayer's original purpose for acquiring the property and that the importance of any subsequent change in the purpose for holding the property is minimized.[68] Under this rationale, the property would not be held primarily for sale because no such intent existed at the time of the acquisition. Moreover, the fact that the taxpayer may have acquired the property by inheritance or gift, as opposed to purchasing the property, has been found by some courts to be a strong factor in favor of capital gains treatment.[69] There are, however, other cases where the court refused to accord capital gains treatment simply because the taxpayer did not purchase the property.[70] One commentator has suggested that the differing treatment may depend on whether the taxpayer who acquired the property by inheritance or gift was actively involved in any subdivision/development activities or whether most of this work was done by independent agents.[71]

(ii) Subdividing and Improving Real Property. In addition, if a college or university acquires real property, whether by purchase, bequest, or gift, and subsequently subdivides and/or improves the property before sale, the general rule is that such activities constitute evidence that the property is held primarily for sale and that the capital gains exclusion will not apply.[72] But if the taxpayer can show that the improvements added little in the way

[67] Tech. Adv. Mem. 200427025 (Dec. 9, 2003).
[68] *Redwood Empire Savings & Loan Ass'n. v. Comr.*, 628 F.2d 516 (9th Cir. 1980); *Heller Trust v. Comr.*, 382 F.2d 675 (9th Cir. 1967); *Scheuber v. Comr.*, 371 F. 2d 996 (7th Cir. 1967).
[69] *Reidel v. Commissioner*, 262 F.2d 371 (5th Cir. 1958); *Fahs v. Taylor*, 239 F.2d 224 (5th Cir. 1956), cert. denied, 355 U.S. 936 (1957).
[70] *Ehrman v. Commissioner*, 120 F.2d 607 (9th Cir. 1941); *U.S. v. Winthrop*, 417 F.2d 905 (5th Cir. 1969); *Swanson v. Commissioner*, 1 T.C.M. 957 (1943).
[71] BNA Portfolio, No. 561 (Capital Assets), p. A-35.
[72] *Bush v. Commissioner*, 610 F.2d 426 (6th Cir. 1979).

of value[73] or if the subdivision and improvements were necessary to enable the property to be sold at market value,[74] some courts will disregard the subdivision/improvement factor.

This subdivided land sale issue arose in an IRS ruling involving an organization that was formed to provide assistance to disadvantaged children. The organization acquired land to support cattle that it used to provide milk and meat to feed the children in its program.[75] For various reasons, the organization no longer needed the land and retained a real estate consultant to assist in its sale. Among other recommendations, the consultant suggested subdividing the property into different parcels for sale. To ensure that the sales would not generate unrelated business income, the organization filed a ruling request with the IRS describing how it proposed to subdivide and sell the land and asking that any gain from the land sales not be taxable.

The IRS held that the sale of the subdivided property would not be taxable because it qualified for the section 512(b)(5) capital asset exclusion. In so ruling, the IRS relied on the following favorable factors:

- The land had been held for a lengthy period of time (over 50 years), the sales would not involve the short turnaround period experienced by a typical real estate broker.
- The decision to sell the land was caused by regulatory changes that compelled the organization to abandon its farming activities.
- The property could not be used for the organization's ongoing exempt activities.
- The organization had a need for additional revenue to continue to provide its assistance to the disadvantaged children.
- The organization would not advertise the subdivision sales through real estate brokers but would adopt a passive marketing approach.
- No more than nine sales would occur and no improvements to the property would be made.
- Although the land would be subdivided, the organization would not plat the property for specific lots, and all platting of lots and subdivision within the tracts would be the responsibility of the buyer.

The IRS has also provided additional guidance in the subdivided land area in two private letter rulings where, under quite different fact patterns, the IRS reached the same conclusion that the subdivided land sales qualified for the capital gains exclusion.

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[73] *Huey v. U.S.*, 504 F.2d 1388 (Ct. Cl. 1974).
[74] *Barrier Est. v. Commissioner*, 265 F.2d 517 (5th Cir. 1959).
[75] Priv. Ltr. Rul. 200510029 (Dec. 16, 2004).

The first ruling involved an organization that owned land that it could no longer use for charitable purposes, and the land's size made it ''impractical to offer the acreage for sale to a single buyer.''[76] The IRS held that the sales of the subdivided land would qualify for the capital gains exclusion based on the following favorable factors: the organization acquired the land by gift and bequest rather than by purchase; its inability to continue to use the land was the result of factors beyond its control; the size of the land made it impractical to sell to a single buyer; the organization planned to spread the sales over a substantial period time and anticipated about two sales a year for 20 years; the organization will not advertise the land through brokers but will adopt a passive marketing approach; and the organization will not improve the property in any manner. Based on these factors, the IRS ruled that the income derived from the land sales will qualify for capital gains treatment and, therefore, will be exempt from the unrelated business income tax.

In the second ruling, a charitable organization with limited funds decided to sell certain land to be able to afford necessary remodeling on other property that it owned and used for exempt purposes.[77] The property that it planned to sell was zoned for single-family residences, and it planned to subdivide the property into seven parcels, six to be used for single-family residences and one to be retained and used by the organization. Unlike the situation in the first ruling, the organization planned to make certain improvements to the property (curb, gutter, sidewalk, drainage, water, and electrical) before the sales. Here, the factors that the IRS used to conclude that the capital gains exclusion applied were that the organization had held the land for a significant period of time and the improvements that would be made were limited to those required by the county to make the land saleable and ''no other improvements were contemplated to enhance the sale of the property.''[78]

And in a 2006 ruling, the IRS said that the subdivided property sold by a community college generated capital gains, relying primarily on the fact that most of the improvements were required by the local government, the college said that it would only make minimal other improvements to the property, and the college had not subdivided other property in the past and does not plan on doing so in the future.[79]

(iii) Sales of Stocks and Securities. In making the ''primarily held for sale to customers'' determination in the case of real and personal property items, the IRS and the courts have historically examined the different factors described above. But when the property item involved is stock or securities, the courts

[76]Priv. Ltr. Rul. 200530029 (May 5, 2005).
[77]Priv. Ltr. Rul. 200532057 (May 16, 2005).
[78]S*ee also* Priv. Ltr. Rul. 200544021 (Aug. 11, 2005), which involved an IRC § 501(c)(4) organization that received a favorable capital gains ruling from the IRS on its proposal to sell land.
[79]Priv. Ltr. Rul. 200619024 (Feb. 16, 2006).

have generally not bothered with analyzing these different factors, but have instead attempted to distinguish between a ''dealer'' who buys and sells stocks and securities to customers, and a ''trader'' who buys and sells for his own account. The dealers are treated as recognizing ordinary income and loss on their stock and securities sales, while the traders are treated as recognizing capital gain and loss. The rationale for treating traders as recognizing capital gains and losses is that the trader is not selling property that is ''primarily held for sale to customers'' because the trader does not sell ''to customers'' within the meaning of section 1221(a)(1).[80]

The Tax Court has described the different ordinary income/capital gains treatment accorded dealers and traders in stocks and securities as follows:

> Those who sell ''to customers'' are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. [Citations omitted]. Such sellers are known as ''dealers.''

Contrasted to ''dealers'' are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a markup of the price of the securities he sells. The sellers depend on such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as ''traders.''[81]

The Tax Court in this case went on to hold that the taxpayers, who bought and sold securities for their own account, were ''traders'' and therefore recognized capital gain or loss on the sales of such securities. This case is just one in a long line of judicial decisions where the courts have made the ordinary income/capital gains distinction on the sale of stock and securities by distinguishing between a dealer and a trader and holding that a taxpayer that is buying and selling securities for his own account is buying and selling

[80]The purpose behind the addition of the ''sale to customers'' language in 1934 was specifically to ensure that ''a speculator trading on his own account could not claim that the securities that he sold were other than capital assets.'' *Commissioner v. Kemon*, 16 T.C. 1026, 1032 (1951). See also *Gruver v. Commissioner*, 142 F.2d 363, 368 (4th Cir. 1944), in which the court said that the addition of the ''sale to customers'' language made it ''abundantly clear that a stock speculator buying and selling securities for his own account and not for resale to customers was subject to the limitation of the deductibility of capital losses.''

[81]*Kemon v. Commissioner*, 16 T.C. 1026, 1032–33 (1951).

capital assets and therefore must recognize capital gain and loss on the sales.[82]

(b) Interest and Dividends

As a general rule, all interest and dividends received by a college or university are excluded from unrelated business income.[83] This exclusion does not apply, however, to the extent that the payments represent unrelated debt-financed income.[84] Also, in order to qualify for the interest income exclusion, the payment must constitute an amount that would qualify as ''interest'' under the Code.[85] Likewise, in order to be excludable as a dividend, the payment must be a true distribution of corporate profits and not some other type of corporate distribution. Even if the interest or dividend is earned as part of an unrelated trade or business activity, it is still excludable under the interest income exception.[86]

(c) Rental Income

Although it is possible that renting space or property to a third party can be viewed as a related activity, thereby shielding the rental income from the unrelated business income tax,[87] in most cases, colleges and universities must look to the specific rental income exception that exists in the Code in order to exclude rental income from the unrelated business income tax.[88]

A threshold issue that arises in the application of the rental income exception is whether the payment is properly treated as ''rent'' and is not instead a disguised distribution of profits from a partnership or joint venture

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[82] *Diamond v. Commissioner*, 788 F.2d 1025 (4th Cir. 1986); *Currie v. Commissioner*, 53 T.C. 185, 199–200 (1969); *Verito v. Commissioner*, 43 T.C. 429, 442 (1965); *Adnee v. Commissioner*, 41 T.C. 40, 43 (1963); *Polachek v. Commissioner*, 22 T.C. 858, 862 (1954).

[83] IRC § 512(b)(1). The expenses associated with the production of this income likewise cannot be deducted in making unrelated business income tax computations.

[84] *See* § 2.5.

[85] IRC § 163; Priv. Ltr. Rul. 8123088 (Mar. 12, 1981).

[86] Rev. Rul. 79–349, 1979-2 C.B. 233. See also Priv. Ltr. Rul. 9743054 (Aug. 1, 1997), in which the IRS ruled that income received by an IRC § 501(c)(3) organization under a charitable gift annuity program is excludable from unrelated business income as interest.

[87] *See, e.g.*, Priv. Ltr. Rul. 200016023 (Jan. 21, 2000), in which the IRS ruled that rental income received by an IRC § 501(c)(3) medical teaching facility under a lease of its excess space capacity to an IRC § 501(c)(3) rehabilitation hospital was not subject to the unrelated business income tax. The IRS determined that this lease of excess space to the hospital furthered the teaching facility's exempt purposes by providing healthcare services to the general public and, in addition, it afforded the teaching organization a convenient facility to which to send its own patients. Accordingly, the IRS ruled that the rental income was not taxable to the medical teaching facility. *See also Madden v. Commissioner*, T.C. Memo. 1997–395 (Aug. 27, 1997), in which the Tax Court analyzed a lease under the related/unrelated principles and ultimately found the lease to be unrelated.

[88] IRC § 512(b)(3). It should be noted, however, that the rental income exclusion is not available if the income is derived from debt-financed income. See § 2.5.

or some other type of business income.[89] For example, if the college or university is actively involved in the rental activity, the activity may be treated as a partnership or joint venture, or an agency relationship may be found to exist where the rented property is managed by a third party, with the institution exercising a significant degree of control over the operation of the property. Furthermore, the property in question must be leased as opposed to licensed. The difference is that a lease confers upon the tenant ''exclusive possession of the subject premises against the world, including the owner,''[90] while a license permits the licensee only general possession of the premises. For example, income received by a tax-exempt organization from allowing a third party to maintain advertisements on its wall space in its premises was held by the IRS not to be rental income but rather income derived from a license.[91]

If the income is properly denominated as ''rent,'' several restrictions come into play in determining whether the rental income exclusion is applicable. First, the rent must be of real property.[92] To the extent that personal property is leased together with the real property, the exclusion will apply, but only if the amount of the rent attributable to the personal property is incidental to the amount of total rent determined at the time the property is leased.[93] If the rent attributable to the personal property is equal to or less than 10 percent of the total rent, it is treated as incidental.[94] If the rent attributable to the personal is 10 to 50 percent, the amount of rent attributable to the real property (but not the personal property) still qualifies for the rental income exclusion; however, if the personal property rent exceeds 50 percent of the total rent, none of the rent is eligible for the exclusion.[95]

A second restriction relates to whether the rent depends, in whole or in part, on the income or profits of any person from operating the property being rented. If so, the rental income exclusion is not available.[96] It is permissible, however, to base the rental payments on a fixed percentage of receipts or sales.[97] Therefore, a school structuring a lease arrangement should try to ensure that, if the rent is based to any extent on the profitability of an activity

[89]Treas. Reg. § 1.512(b)-1.
[90]*Union Travel Assocs., Inc. v. International Assocs., Inc.*, 401 A.2d 105 (D.C. Ct. App. 1979).
[91]Priv. Ltr. Rul. 9740032 (Jan. 20, 1998).
[92]IRC § 512(b)(3)(A)(i).
[93]IRC § 512(b)(3)(A)(ii).
[94]Treas. Reg. § 1.512(b)-1(c)(2)(ii).
[95]Treas. Reg. § 1.512(b)-1(c)(2)(iii).
[96]*See, e.g., Madden v. Commissioner*, T.C. Memo 1997-395 (Aug. 27, 1997), in which the Tax Court held that because a portion of rent received by a museum from renting its auditorium to a for-profit company was derived from the profits earned by the for-profit company under a sublease, the rental income exclusion did not apply. This case also illustrates the point that if a portion of the rent is based on net profits, the entire rent payment is taxable, not just the portion attributable to the net profits.
[97]IRC § 512(b)(3)(B)(ii).

involving the leased property, the measuring stick is based on a percentage of gross sales or receipts and not on a percentage of net income.

For additional guidance regarding this gross revenue/net income issue, the regulations on the rental income exclusion cross-reference those regulations relating to real estate investment trusts (REITs).[98] These REIT regulations set forth various rules to take into account in making the gross revenue/net income determination, and address the situation where the owner leases property to a lessee for a rent based on a percentage of gross revenue, but the lessee subleases the property and receives rent based on the net income of the subtenants. The pertinent REIT regulation sets forth the general rule that in such a situation the rent received by the owner from the primary lessee will be treated as based on net profits if any of the rent received by the lessee from its subtenants is based on the subtenants' net receipts or sales. Therefore, schools that enter into lease agreements with a tenant need to ensure that the tenant is not subleasing the property to any of its subtenants on a net income basis. This can be accomplished by including a provision in the lease agreement prohibiting the tenant from entering into net income lease arrangements. In addition, it would be prudent for the school to include a provision giving it the power to review and approve any changes in the tenant's sublease rental arrangements to protect against any new tax law changes impacting the structure of lease income.

The final restriction on the application of the rental income exclusion relates to the services that may be conducted by the college or university lessor in connection with the leasing activity.[99] The regulations provide that the type of services that will render the exclusion inapplicable are those that are (1) rendered primarily for the convenience of the occupant, and (2) of a nature not customarily rendered in connection with the rental of rooms or other space for occupancy only.[100] This regulation is not as clear as one would hope, but the IRS appears to be making a distinction between (1) permissible services of a type that are customarily rendered in connection with the rental of space for occupancy, such as the provision of heat and light, cleaning of public areas, and collection of trash,[101] and (2) impermissible services of a type that benefit the individual who is occupying the rental property, such as maid services provided in the case of hotel room occupancy.[102]

The IRS has issued several rulings in the ''services'' area, some of which involve college and university rental activities. Rulings in which the IRS found the services of a sufficient magnitude to disqualify the rental exclusion include a university that leased its football stadium to a professional football team

[98] *See* Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b), which cross-references Treas. Reg. § 1.856-4(b)(3) and (6).
[99] Treas. Reg. § 1.512(b)-1(c)(5).
[100] *Id*.
[101] Rev. Rul. 80-297, 1980-2 C.B. 196.
[102] Treas. Reg. § 1.512(b)-1(c)(5).

for several weeks during the summer and provided maintenance, security, linen service, and other services to the team,[103] and a school that leased its facilities for use as a tennis camp and also provided administrative services in connection with the rental.[104] In another case, however, the IRS ruled that an organization that rented its meeting hall and provided only utilities and janitorial services to the lessee qualified for the exclusion.[105]

The IRS reached a similar conclusion in a case involving a lease between a section 501(c)(3) organization and a related fraternal lodge. The lodge had created the organization and had transferred property to it. The organization constructed a building on the property and leased a portion of the building to the lodge. The IRS determined that the organization only provided services customarily provided in connection with such leases and therefore concluded that the rental income was not subject to the unrelated business income tax.[106]

While there is no checklist of those services that can and those that cannot be provided, as a general rule, providing only a de minimis amount of services (measured by the nature and degree of the services) is likely to pass muster with the IRS. And, based on a 2001 private letter ruling, the IRS may allow more than de minimis services without disqualifying the rent from the rental income exclusion.[107] In this ruling, an owner of property rented the property to a lessee that provided telecommunications services to the tenants of the property. As part of the arrangement, the owner-lessor conducted certain marketing activities to help the lessee market its telecommunications services. These marketing activities included providing the tenants with marketing materials and order forms; including these materials in mailings to the tenants; allowing the lessor to display these materials in the common areas; advising the lessee of new tenants and providing their addresses; and allowing the lessee access to the common or lobby areas to hold informational or marketing sessions. The IRS concluded that these marketing activities were ''passive activities'' and, as such, did not operate to destroy the section 512(b)(3) rental income exclusion.

Notwithstanding this ruling, the IRS, as a general matter, clearly takes a restrictive view as to the nature and scope of the services that the organization/lessor can provide without jeopardizing the rental income exclusion. The Tax Court, however, takes a more relaxed approach as evidenced by a 1997 case involving a museum that leased its auditorium to a for-profit company to put on concerts.[108] While the museum argued that the income it received was exempt under the rental income exclusion, the IRS argued that

[103]Rev. Rul. 80-298, 1980-2 C.B. 197.
[104]Rev. Rul. 80-297, 1980-2 C.B. 196.
[105]Rev. Rul. 69-178, 1969-1 C.B. 158. *See also* Priv. Ltr. Rul. 9551019 (Sept. 21, 1995).
[106]Priv. Ltr. Rul. 199940034 (July 12, 1999).
[107]Priv. Ltr. Rul. 200147058 (n.d.).
[108]*Madden v. Commissioner*, T.C. Memo 1997-395 (Aug. 27, 1997).

the exclusion was not applicable because of the substantial services that the museum provided—namely, parking, maintenance of the grounds, security, and obtaining the necessary permits and licenses. The Tax Court disagreed with the IRS position and held that these services were not ''substantial.''

One technique that some institutions have reportedly used to circumvent the ''services'' restriction is to lease the property for a certain amount of rent and also enter into a separate agreement with the lessee under which the services are provided for a fee. The income received under the services agreement is treated as unrelated business income, while the income received under the lease agreement is treated as exempt under the rental income exception. It is unclear whether the IRS would respect such a bifurcation or would instead ignore the separate agreements under the so-called ''step transaction doctrine'' and treat the provision of the services as tainting the rental income.[109]

(d) Royalties

Another income item that is specifically excluded from the unrelated business income tax is royalties.[110] This relatively straightforward statutory provision has generated significant controversy and litigation between the IRS and tax-exempt organizations over the years, although the current position of the IRS on many of these issues seems today to be more in accord with the position of the courts.

Although not defined in the statute or the regulations, the IRS and the courts follow the same basic definition of a royalty. The Tax Court has defined a *royalty* as ''a payment for the use of a valuable intangible property right,''[111] and the IRS has said that

> [t]o be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.[112]

Third parties typically make payments to colleges and universities for a number of different ''intangible property rights,'' including the right to sell

[109]The ''step transaction'' doctrine provides that where a series of transactions would give one tax result if viewed independently of each other, but if viewed together would give a different tax result, the transactions may be combined and viewed together as one transaction. *See Commissioner v. Court Holding Company*, 334 U.S. 331, 334 (1945), where the Supreme Court said: ''To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.'' See also, *Grove v. Commissioner*, 490 F.2d 241, 246 (2d. Cir. 1973), where the court said that the step transaction doctrine applies to ''meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms.''

[110]IRC § 512(b)(2). It should be noted, however, that the royalty income exclusion is not available if the income is derived from debt-financed income. See § 2.5.

[111]*Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996).

[112]Rev. Rul. 81-178, 1981-2 C.B. 135.

goods or services on campus; the right to sell advertising in the school's publications; the right to use the school's mailing list to sell products to students, faculty, or alumni; and the right to use the school's logo on products, to name just a few. Any payment for the right to use the school's intangible property will qualify as a royalty, including such an esoteric right as income derived by the school from its sublicensing of excess television and radio channel capacity.[113]

(i) Active versus Passive Royalties. At one time, the IRS took the position that Congress intended only to exclude those royalties that represent ''passive'' income to the exempt organization, and did not intend to exclude royalties received as part of the active conduct of a trade or business. The U.S. Court of Federal Claims accepted this interpretation of the royalty exclusion in a 1981 decision involving Disabled American Veterans.[114] This organization refused to accept this court's decision, however, and several years later litigated the same issue before the Tax Court. In *Disabled Veterans of America v. United States* (*DAVII*),[115] the Tax Court disagreed with the U.S. Court of Federal Claims, holding that an excludable royalty includes all payments received by the exempt organization for the right to use a valuable intangible property right, regardless of the ''active'' or ''passive'' nature of the income-producing activity.[116]

Having lost the battle in *DAV II*, the IRS renewed its efforts to impose limitations and restrictions on the royalty income exclusion in subsequent litigation involving the Sierra Club. This case involved the question whether payments received by the Sierra Club in connection with the rental of its mailing lists and the operation of an affinity credit card program fell within the royalty exception. The case was decided in two parts. In the first case, *Sierra Club, Inc. v. Commissioner*[117] (*Sierra Club I*), which involved the mailing list income, the IRS asked the Tax Court to reconsider its decision in *DAVII*. Alternatively, the IRS also advanced another theory: Congress only intended that those royalties that constitute ''investment income'' (i.e., where the royalty is clearly a return on an investment made by the organization, such as investing in oil and gas wells) should qualify for the royalty exclusion. The Tax Court, however, stood by its prior position in *DAVII* that both ''active'' and ''passive'' royalties qualify for the royalty exclusion, and refused to impose an ''investment income'' gloss on the exclusion.[118]

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[113]Priv. Ltr. Rul. 9816027 (Jan. 20, 1998).

[114]*Disabled Am. Veterans v. United States*, 650 F.2d 1178 (Ct. Cl.1981).

[115]*Disabled Am. Veterans v. Commissioner*, 94 T.C. 60 (1990), rev'd, 942 F.2d 309 (6th Cir. 1991).

[116]94 T.C. at 72.

[117]*Sierra Club, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2582 (1993).

[118]The IRS continued to assert the active/passive position in its rulings. *See, e.g.*, Priv. Ltr. Rul. 9705001 (Sept. 16, 1996), in which the IRS ruled that income derived by a tax-exempt organization from a for-profit company was an exempt royalty because of the passive nature

(ii) Royalty or Joint Venture Distribution. In the second Sierra Club case, *Sierra Club, Inc. v. Commissioner*[119] (*Sierra Club II*), which involved the affinity credit card program, the IRS argued that the relationship between the Sierra Club and the bank offering the credit card was not that of a licensor-licensee but was instead a joint venture. Alternatively, the IRS argued that the Club was engaged in its own business enterprise, using the bank as its agent. The Tax Court rejected both contentions, holding that the payments received by the Sierra Club were royalties resulting from a true licensor licensee relationship. In its written opinion, the Tax Court presented a detailed analysis of how a royalty-producing licensing agreement differs in form and substance from both a joint venture and the conduct of a trade or business through an agent, and the Tax Court's opinion should be required reading for any college or university attempting to structure a license agreement that will produce a true royalty and not be recharacterized by the IRS as either a partnership or an agency.

In *Sierra Club II*, the Tax Court first addressed the IRS contention that the arrangement between the Sierra Club and the bank was a joint venture and that the payments made by the bank to the Club represented a distribution of net profits from the joint venture. Noting that the existence of a joint venture or partnership for tax purposes requires a finding that the parties intended to join together for the purpose of carrying on a business and sharing the profits or losses or both, the Tax Court stated that whether such an intention exists in a particular case is a question of fact that is made by examining a number of different factors that are indicative of joint venture status.[120] These factors include (1) whether the terms of the agreement between the parties reflect a ''joint venture'' intention, (2) whether the parties had a mutual coproprietorship interest in the profits and losses of the venture, (3) whether the venture maintained separate books of account, and (4) whether the parties jointly participated in the management of the enterprise. Finding these factors for the most part absent from the arrangement between the Sierra Club and the bank, the court held that the arrangement was not a joint venture.

(iii) Royalty or Agency Relationship. The alternate position of the IRS was that the promotion and marketing of the credit card and other financial services was the Sierra Club's own trade or business, which the Club conducted with the bank's assistance as the Club's agent. Under the law of agency, a party is the

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of the organization's involvement. Also, in a technical advice memorandum involving an organization that retained a manager to put on concerts, the IRS refused to apply the royalty income exclusion, both because the organization's involvement was more than passive and because the manager was the organization's agent. Tech. Adv. Mem. 9721001 (Oct. 17, 1996).

[119] *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307 (1994) rev'd and remanded, 86 F.3d 1526 (9th Cir. 1996). See Richard Holbrook, The Royalties Exception to Unrelated Business Income: Sierra Club v. Commissioner, 49 Tax Lawyer 517 (1996).

[120] *Sierra Club, Inc.*, 103 T.C. at 323.

''agent'' of another (the principal) if there exists a fiduciary relationship under which the principal grants to the agent the right to manage the principal's business in the principal's name or enter into contracts on the principal's behalf. The court first reviewed an earlier decision[121] in which it held that an agreement between the NCAA and a company that published programs for its annual men's basketball championship created an agency relationship under which the NCAA was the principal and the publisher was the agent. In that case, the Tax Court reached this conclusion because the language of the written agreement clearly stated that the publisher was to act on the NCAA's behalf and because of the significant control that the NCAA was able to exercise over the publisher's activities under the agreement. After reviewing the basis for its decision in the NCAA case, the Tax Court framed the issue in the Sierra Club's case as follows:

> The question that we must answer is whether the agreement allocates a sufficient portion of the risks and rewards of such marketing efforts to [the Sierra Club] such that we must deem [the Club's] compensation under the agreement, in whole or in part, to be in consideration of such marketing efforts. If so, then some, if not all, of [the Club's] compensation under the agreement cannot qualify as royalty income. Important to our consideration is [the Club's] control over [the bank]. [Citation omitted.] Put most simply, our inquiry is: Does the agreement put [the Club] in the business of selling financial services?[122]

In determining whether the agreement between the Sierra Club and the bank put the Club in the business of selling financial services, the court looked to (1) whether the Sierra Club shared in the risks and rewards of the marketing efforts, and (2) the extent to which the Club exercised control over the bank. It found the former factor to be ''inconclusive''[123] but determined that the Sierra Club ''had insufficient control over [the bank's] actions for such actions to be imputed to [the Club] so as to put [the Club] in the business of selling financial services.''[124] In finding that the requisite degree of control did not exist under the facts presented, the court was impressed by the fact that it was the bank that approached the Club to conduct the business enterprise, not vice versa; the Club required the bank to accept responsibility for soliciting members; in accepting advertising from the bank in the Club's publications, the Club dealt with the bank in the same manner as it would deal with any unrelated party; and the Club attempted to collect from the bank when it defaulted on a payment for the advertising.[125]

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[121] *National Collegiate Athletic Ass'n v. Commissioner*, 92 T.C. 456 (1989), rev'd, 914 F.2d 1417 (10th Cir. 1990).
[122] *Sierra Club, Inc.*, 103 T.C. at 332.
[123] Id. at 337.
[124] *Id.*
[125] *Id.*

The terms and conditions of the agreement, or the actual conduct of the parties, or both, can also cause the IRS to argue that the purported licensee is really the licensor's agent. Under traditional common law, an agency relationship exists between two parties if there is consent by one party that another party shall act on its behalf and subject to its control. Under the tax law, as opposed to traditional common law, the determination of whether a party is an agent of another party is a question of fact.[126] The Tax Court has held that persuasive evidence of the existence of an agency relationship includes (1) the principal's control over the purported agent, (2) the existence of an agency agreement, and (3) the principal's actions consistent with the agency.[127] If one of the parties in the relationship is not permitted to engage on its own account in the business of the principal, maintains the principal's funds in a separate account pending remission to the principal, and remits the funds to the principal, the party is an agent.[128] In contrast, if the party controls the funds, deposits them in its own account, and acts inconsistently with any fiduciary duty with respect to the funds, the party is not acting as an agent with respect to those funds.[129]

Although the IRS often relies upon the *NCAA* case to support an agency finding, that case turned on a single damaging factor not found in most other cases. In that case, which involved a contract that the NCAA entered into with a company to provide advertising in connection with the NCAA's Final Four Basketball Tournament, the contract specifically provided that the company was the NCAA's ''*exclusive agent* for the sale of advertising.''[130] While the NCAA introduced evidence at trial attempting to show that the conduct of the parties was in conflict with the specific grant of agency authority in the contract, the Tax Court rejected this argument and held that the contract language was clear and that the NCAA had not introduced sufficient evidence to negate the agency relationship intended by the parties. The fact that the NCAA did not even raise this argument during its appeal of the case indicates the weakness of its position and how difficult it is to convince the IRS and the courts that the explicit terms of a written agreement should be ignored.

In addition, it should be noted that the IRS does not always conclude that an agency agreement exists. In a ruling involving a tax-exempt organization that entered into a contract with a for-profit publisher to publish a newsletter and yearbook, the IRS ruled that the activities of the for-profit publisher should not be attributed to the organization. [131]

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[126]*Alexander v. Commissioner*, 56 T.C. 710 (1971), *aff'g*, 476 F.2d 974 (5th Cir. 1973); Rev. Rul. 54-596, 1954-2 C.B. 51.

[127]*North v. Commissioner*, 51 T.C.M. (CCH) 1085 (1986).

[128]*Olla State Bank of Olla, La. v. United States*, 77-1 U.S.T.C. (CCH) ¶ 9455 (W.D. La. 1977).

[129]*Miller v. Commissioner*, 56 T.C.M. (CCH) 1553 (1989).

[130]*National Collegiate Athletic Ass'n v. Commissioner*, 92 T.C. 456 (1989), rev'd, 914 F.2d 1417 (10th Cir. 1990).

[131]Priv. Ltr. Rul. 9810030 (Dec. 9, 1997).

Another agency-related issue arises when a college or university has complete ownership of a for-profit or nonprofit subsidiary and whether the subsidiary should be viewed as the school's agent. In a 1949 case, the Supreme Court set forth six factors that should be taken into account in making an agency determination in a parent-subsidiary context, [132] and the Tax Court has applied the following six factors in a number of subsequent decisions[133]:

1. Whether one party operates in the name and for the account of the other party
2. Whether one party is bound by the other party's actions
3. Whether one party transmitted to the other party money that it received
4. Whether the receipt of income by one party is attributable to the efforts, assets, or employees of the other party
5. Whether the purported agency relationship was based on the parent's control of the subsidiary
6. Whether the party's activities were consistent with the normal duties of an agent

A 2002 decision by the Eighth Circuit Court of Appeals has added yet another twist to the issue of whether the purported licensee should be treated as the organization/licensor's agent.[134] This case involved a tax-exempt organization that contracted with a company to publish its magazine, which included articles, photos, and other material relating to law enforcement activities. The publishing company designed the layout, printed and distributed the magazine, and solicited all advertising. The organization reviewed the draft but provided few other services, and organization officials spent no more than 15 to 20 hours a year on magazine publishing activities. The organization treated the advertising revenue as having been earned by the company and the payments that it received from the company as nontaxable royalties, relying on the affinity credit card cases and the fact that it provided few services in connection with the publishing operation. The Eighth Circuit rejected this argument, saying that in the affinity credit card cases the bank used the organization's name to promote the bank's own products, but in this case the publishing company used the organization's name to promote the organization's product. For this reason, it held that the publishing company was acting as the organization's agent and the advertising income was taxable to the organization.

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[132] *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949).

[133] See, e.g., *Roccaforte v. Commissioner*, 77 T.C. 263 (1981), rev'd, 708 F.2d 986 (5th Cir. 1983); *Ourisman v.Commissioner*, 82 T.C. 171 (1984), vacated and rev'd, 760 F.2d 541 (4th Cir. 1985).

[134] A*rkansas State Police Ass'n, Inc. v. Commissioner*, 282 F.3d 556 (8th Cir. 2002), *aff'g*, T.C. Memo 2001-38, 81 T.C.M. 1172 (2001).

The IRS has set forth a detailed analysis of the agency concept generally and its specific application to royalties (as well as other areas of the tax law) in a training manual for its agents published in 2002.[135]

(iv) Current Status of Royalty Exclusion. As a result of the above-described litigation, it is now clear that affinity credit card and mailing list income can qualify for tax-free royalty treatment if the transactions are properly structured. The IRS has abandoned its ''active versus passive'' royalty position and instead determines whether, as part of the royalty agreement, the licensor is required to perform any services for the licensee.[136] If so, the IRS will determine the fair market value of the services rendered and will treat a corresponding portion of the royalty as a payment for the services rendered. In all likelihood, the amount that is so treated as received in return for the services rendered will be treated by the IRS as unrelated business income. Of course, if the IRS determines that the value of the services rendered is equal to or exceeds the amount of the royalty payment, the entire amount of the royalty would be treated as taxable services income.

Thus, the IRS will examine all royalty agreements to determine whether the college or university is required to perform any services in connection with the income-generating activities (or whether any services are performed outside a legal requirement to do so), and if so, will attempt to reallocate some or all of the royalty payment as taxable services income. As a result, schools would be well advised to limit to the extent possible the services called for under these agreements and in addition limit the actual performance of any services even if not provided for in the agreement itself.

This ''services'' issue arose in a 1989 case involving payments made by an insurance company to a trade association in connection with an insurance program provided to the association's members. The Tax Court held that the payments received by the association were not excludable royalties but rather more akin to compensation for services rendered.[137] The services that the association performed in that case included providing the insurance company with its mailing lists, writing articles for the company, providing exhibit space at its meetings and conventions, placing advertisements in its journals,

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[135]*2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002*, at 127 (24th ed. 2001).

[136]See, for example, Priv. Ltr. Rul. 200601033 (Oct. 14, 2005), in which the IRS ruled that payments made to a IRC § 501(c)(3) organization under an agreement whereby it licensed its intellectual property to a third party were bona fide royalties and, therefore, exempt from the unrelated business income tax under IRC § 512(b)(2). Under the facts presented in that ruling, the IRS concluded that the organization did not take an ''active role'' in the licensing activity and that it was ''being compensated for a passive licensing of intellectual property rather than services that [the organization performs].''

[137]*National Water Well Ass'n v. Commissioner*, 92 T.C. 456, 468 (1989), rev'd on other grounds, 914 F.2d 1417 (10th Cir. 1990).

and permitting an association employee to assist in distributing information regarding the insurance program.

It is permissible, however, for the college or university to conduct limited activities in connection with the licensing activity and still obtain royalty treatment. For example, the IRS has ruled that payments received by a tax-exempt organization on patents it owned were royalties despite the fact that the organization was active in procuring and developing the patents on which the royalties were paid.[138] Also, the Tax Court has held that the retention of ''quality control'' rights by a licensor does not result in a joint venture or cause the payments to lose their royalty characterization,[139] and in a 1978 private letter ruling, the IRS ruled that payments were royalties even though the organization ''reserved extensive supervision rights over matters of quality control and pedagogical value... so as to insure preservation of [the organization's] educational reputation.''[140] Therefore, so long as the activities conducted by the college or university are limited to ''quality control'' activities—that is, ensuring that the quality of the product or service meets certain standards, as opposed to becoming involved in marketing or other business-related concerns—royalty treatment should not be disturbed.

(e) Distribution of Low-Cost Articles

The unrelated business income tax rules contain a specific exclusion for activities that involve the distribution of ''low-cost articles'' incidental to the solicitation of charitable contributions.[141] This type of fundraising activity raises not only potential unrelated business income concerns (whether the distribution of the articles in return for contributions constitutes a ''sales'' activity), but also charitable contribution deduction questions (whether the donor should be allowed a full charitable deduction for the amount of the gift or whether the deduction should be reduced by the value of the article received in return).[142]

From an unrelated business income standpoint, any net income derived from the distribution of the articles is not subject to the unrelated business income tax if (1) the distributed items qualify as ''low-cost articles,'' and (2) the distributions are incidental to a solicitation of charitable contributions. A *low-cost article* is defined as an article that does not cost the organization more than a set dollar amount that is annually indexed for inflation.[143] With respect to the second component of the test, it is usually fairly clear whether

[138]Rev. Rul. 76-297, 1976-2 C.B. 178.
[139]*National Water Well Ass'n*, 92 T.C. at 469.
[140]Priv. Ltr. Rul. 7841001 (n.d.).
[141]IRC § 513(h).
[142]*See* § 6.4(d).
[143]IRC § 513(h)(2). The IRS publishes the inflation-adjustment amount annually. For 2007, the amount is $8.90 or less. Rev. Proc. 2006-53, 2006-48 I.R.B 996.

the distribution is incidental to a charitable contribution solicitation. But the rules also require that the low-cost article not be distributed at the request of the recipient and that the contribution solicitation include a specific request for a charitable contribution and a statement that the distributee may retain the article regardless of whether a contribution is made.[144]

(f) Research Activities

Many colleges and universities conduct scientific research as part of their overall mission. In an attempt to seek new ways to fund these research activities, they frequently enter into research contracts with governmental agencies and commercial enterprises. These relationships normally take the form of a contract under which the institution conducts scientific research in return for monetary consideration. In other cases, the school enters into a joint venture with the governmental or commercial entity under which the institution retains the rights to patents, copyrights, trade secrets, and any know-how that is developed.

These scientific research and technology transfer agreements with governments and private businesses raise a number of potential tax issues for colleges and universities, including:

- Whether the arrangement results in prohibited private inurement being provided to the research scientists or other university personnel[145]
- Whether privately funded research conducted in facilities constructed with tax-exempt bonds will disqualify the bonds' tax-exempt status[146]
- Whether any separately incorporated scientific research foundations or technology transfer companies can qualify for tax-exempt status in their own right.

But perhaps the most basic issue raised by these research contracts is whether the income received by the college or university is taxable as unrelated business income.

(i) Exemption under the Traditional Principles. As with any other potential unrelated business income activity, income derived from research contracts must be analyzed under the three unrelated business income tests:

1. Is there a trade or business?
2. Is the trade or business regularly carried on?
3. Is the activity substantially related to the institution's exempt purposes?

[144] IRC § 513(h)(3).
[145] *See* § 9.1(b).
[146] *See* § 9.4.

In addition, there are special exclusions for certain types of research income that, if applicable, can cause research income to be nontaxable even if the traditional unrelated business income tests are met.

With respect to the first unrelated business income test—the existence of a trade or business—a college or university's research contract with a governmental entity or a private company will almost always be treated as a trade or business activity under the broad definition of that term,[147] although there is a question as to whether this test should be approached by looking at each individual research project or looking at the sum total of all the institution's research projects. The better answer is to look at the total of the research projects collectively, as one court did in determining whether a tax-exempt scientific research organization's privately equipped research projects should be treated as a ''trade or business.'' The court said that treating each research project as a separate trade or business is not ''uniformly appropriate,'' explaining that because the organization conducted research to develop a process for restoring the pile of material used in stuffed toys, the organization ''could not be said to be in the toy manufacturing business.''[148]

With respect to the second unrelated business income test—whether the research is regularly carried on—the test will be met in most cases because the arrangement usually has the requisite frequency and continuity. Again, the approach is to look at the totality of the research projects, not at each project individually. The same court also held that, while individual projects were discrete activities conducted over discrete periods of time, a ''description of all research projects conducted as the trade or business issue satisfies the regularly carried on requirement. . . .''[149]

Looking at what is normally the most difficult of the three tests—whether the research activity is substantially related to the institution's exempt purposes—certain types of research activities are clearly related. For example, if there is significant involvement by the institution's students in the research activity, a strong argument can be made that the activity is primarily educational in nature. Also, if the research activity qualifies as ''scientific research in the public interest'' under the regulations relating to whether scientific organizations qualify for tax-exempt status under section 501(c)(3), the research should also be treated as ''related.'' While a college or university normally obtains its tax-exempt status because of its educational and not its scientific activities, there is nevertheless such a close correlation between the ''exemption'' criteria and the ''related'' criteria that if a research activity

[147] *See* § 2.1(a).

[148] *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1384 (W.D. Mo. 1983), aff'd, 744 F.2d 635 (8th Cir. 1984).

[149] 554 F. Supp. at 1385.

conducted by a college or university qualifies under the exemption regulations, it should likewise be treated as related for unrelated business income tax purposes.[150]

In order for a research activity to qualify as an exempt activity under the tax exemption regulations, it must meet the following three tests:

1. It must be ''scientific research.''
2. The scientific research must not be conducted incident to commercial or industrial operations.
3. The research must be conducted in the public interest.[151]

Looking at the first test, the regulations state that scientific research includes practical and applied research, as well as research that is fundamental or theoretical.[152] The intention behind this broad definition is to permit less traditional forms of research (e.g., research in the social sciences) to qualify and to avoid limiting the concept merely to traditional types of scientific research, such as medical research.[153] In one case, the court amplified on what distinguishes ''scientific research'' from other types of research, stating that an activity will be regarded as scientific research ''if professional skill [was] involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth.''[154] Another court looked to the dictionary definition of *science* for guidance and arrived at its own definition of that term as ''the process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning.''[155]

The IRS, while not formally agreeing with the approaches taken by the courts, nevertheless takes a similar approach, concluding that the following three elements must be present in order to constitute ''scientific research'':

1. Project supervision and design by professionals
2. A specific design to solve a problem through use of a scientific method (the formation of hypotheses, the design and conduct of tests to gather

[150] *See* Priv. Ltr. Rul. 9833030 (May 20, 1998), in which the IRS ruled that a university that created a research consortium consisting of companies in a particular industry did not jeopardize its tax-exempt status or receive unrelated business income.

[151] Treas. Reg. § 1.501(c)(3)-1(d)(5).

[152] Treas. Reg. § 1.501(c)(3)-1(d)(5)(i). *See also* Priv. Ltr. Rul. 200303065 (Oct. 25, 2002), which involved a IRC § 501(c)(3) scientific research institution that conducted various research projects itself and through a limited liability company in which it owned an interest. In the ruling, the IRS reviewed eight different research projects (including those conducted by the LLC) conducted for the federal government and others and concluded that they all fell within the scope of IRC § 501(c)(3) because they benefited the public, lessened the burdens of government, advanced science and education, or were substantially related to an exempt, educational purpose.

[153] Gen. Couns. Mem. 39,883 (Apr. 1, 1992).

[154] *Midwest Research Inst*., 554 F. Supp. at 1386.

[155] *IIT Research Inst. v. United States*, 85-2 U.S.T.C. (CCH) ¶ 9734 (Cl. Ct. 1985).

data, and the analysis of data for effect on the truth or falsity of the hypotheses)

3. A research goal that consists of discovering a demonstrable truth[156]

The second scientific research test is that the research must not constitute activities of a type ordinarily carried on incident to commercial or industrial operations. The regulations describe as examples of such commercial or industrial operations ordinary testing or inspecting of materials or products, and the designing or construction of equipment and buildings.[157] Two courts have held, however, that research incident to commercial or industrial operations is not necessarily limited to these examples but can encompass a broader range of activities.[158] In another case, the court defined *testing* as ''generally repetitive work done by scientifically unsophisticated employees for the purpose of determining whether the item tested met certain specifications, as distinguished from testing done to validate a scientific hypothesis.''[159]

The IRS chief counsel's office has defined *testing* as those activities in which ''a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive, and the procedure is merely a matter of quality control.''[160]

In any event, if the activity is determined to be testing under any of these definitions, it is not eligible for the scientific research exemption. The IRS's position on whether an activity constitutes testing is not entirely clear. The IRS has ruled that clinical testing of drugs for a commercial pharmaceuticals company in connection with the company's submission of an application to the Food and Drug Administration is a testing activity incident to the pharmaceuticals company's ordinary commercial operations,[161] as is testing performed for commercial entities to obtain premarket clearance and environmental law compliance.[162] But in a later ruling, the IRS found that income earned by a dental school's research laboratory was not subject to the unrelated business income tax because of the ''unique circumstances'' involved in those testing activities. These unique circumstances included the fact that no commercial

[156]Gen. Couns. Mem. 39,883 (Apr. 1, 1992).

[157]Treas. Reg. § 1.501(c)(3)-1(d)(5)(ii).

[158]*IIT Research Inst.*, 85-2 U.S.T.C. (CCH) ¶ 9734 (Cl.Ct.1985); *Dumain v.Commissioner*, 73 T.C. 650 (1980), *acq.*, 1980-2 C.B. 5.

[159]*Midwest Research Inst.*, 554 F. Supp. at 1386.

[160]Gen. Couns. Mem. 39,883 (Apr. 1, 1992).

[161]Rev. Rul. 68-373, 1968-2 C.B. 206. *See also* Tech. Adv. Mem. 8230002 (n.d.), in which the IRS distinguished between ''for benefit'' and ''not for benefit'' drug testing. ''For benefit'' drug testing involved studies in which drugs were given to patients who had the disease that the drug was intended to cure, while ''not for benefit'' testing was all other drug testing. The ''for benefit'' testing was held to be a related activity, even though it served the business interests of the drug company, because it furthered patient care. The ''not for benefit'' testing was held to be an unrelated activity.

[162]Gen. Couns. Mem. 39,196 (Aug. 31, 1983).

laboratories performed the same testing services and the testing was used in the education of the dental students.[163] In all likelihood, it was primarily the educational aspect of this research activity that convinced the IRS to conclude it was not testing, and to the extent that a school can demonstrate that its testing-related research activity has an educational component, it may be able to avoid unrelated business income characterization.

The third test that must be met in order for an activity to be treated as an exempt ''scientific research'' activity involves meeting certain ''public interest'' requirements. The regulations set forth specific factors that demonstrate that the organization is serving public as opposed to private interests through its scientific research activities. These public interest factors that are the results of the research (patents, processes, copyrights, formulae) are made available to the public on a nondiscriminatory basis; the research is performed for a governmental entity; and the research is directed toward benefiting the general public.[164] The regulations expand on this last factor with specific examples, including (1) aiding the scientific education of college and university students, (2) obtaining scientific information published in a form that is available to the interested public, (3) discovering the cure for a disease, and (4) aiding a community by attracting new industry to the community or encouraging the development or the retention of an industry in that location.[165] Even though the research is performed under an agreement that gives the organization the right to retain ownership in the resulting patents, processes, copyrights, and formulae, the research is still regarded as in the public interest if it falls into one of these four categories.[166]

The IRS takes the position that there is a fourth ''general public interest'' test.[167] In order to pass this test, the organization must show that on an overall basis an activity is operated in the public rather than in the private interest, even though one of the specific public interest tests may otherwise be met. For example, if a scientific research activity is conducted to attract business to a particular community, the IRS requires that, looking at the activity as a whole, there must still be clear and specific indications that a public interest is served. Under this approach, an indication that a private interest is being served might be that the research is performed only for its nonexempt creators or that the organization retains more than an insubstantial portion of the patents, processes, copyrights, and formulae and does not make them available to the general public.[168] One court, however, has rejected this approach and held

[163]Priv. Ltr. Rul. 9739043 (June 30, 1997).
[164]Treas. Reg. § 1.501(c)(3)-1(d)(5)(iii).
[165]Treas. Reg. § 1.501(c)(3)-1(d)(5)(iii)(c)(1) to (4).
[166]*Id*.
[167]Gen. Couns. Mem. 39,883 (Apr. 1, 1992).
[168]*Id*.

that if the public interest tests set forth in the regulations are met, the analysis is over.[169]

(ii) Special Exceptions. If there is any question as to whether the scientific research activities conducted by a college or university qualify as ''related'' to either furthering the education of the student or constituting ''scientific research in the public interest,'' an institution can use two other statutory provisions to avoid treating the research income as unrelated business income.

The first is an exception for income derived from research for the U.S. government or any of its agencies or instrumentalities, or for any state or political subdivision.[170] The second pertains specifically to colleges and universities and provides that ''in the case of a college, university, or hospital, income derived from research performed for any person'' is not unrelated business income.[171] This provision is extremely broad, covering ''research'' (not necessarily ''scientific research'') that is conducted for ''any person.'' The only apparent restriction is that the activity must be research and therefore does not involve an activity of a type that is ordinarily carried on as an incident to commercial or industrial operations.[172] Thus, the same rules previously discussed in connection with whether scientific research will be regarded as prohibited testing also come into play in determining the applicability of this broad exclusion for income from research activities.[173]

(g) Volunteer Activities

If a college or university conducts a trade or business in which substantially all of the work in carrying on the business activity is performed by volunteers working for no compensation, the activity is not an unrelated trade or business.[174]

Where volunteers conduct the entire activity, it is generally clear that the exception applies; however, when some work is done by volunteers and other work by paid individuals, an issue arises as to whether ''substantially all'' of the work is done by the volunteers. This determination is normally made by comparing the number of hours worked by volunteers with those worked by compensated individuals. In one case, the fact that 77 percent of the work was done by volunteers was found to be insufficient to constitute ''substantially all'' of the work.[175] In another case, however, the court found that the ''substantially

[169] *Midwest Research Inst.*, 554 F. Supp. at 1391.
[170] IRC § 512(b)(7).
[171] IRC § 512(b)(8).
[172] Rev. Rul. 76-296, 1976-2 C.B. 141.
[173] *See also* Priv. Ltr. Rul. 8230005 (n.d.), in which the IRS ruled that income derived from laboratory tests conducted by a hospital on nonpatients and for other exempt hospitals with more than 100 beds is taxable as unrelated business income.
[174] IRC § 513(a)(1).
[175] *Waco Lodge No. 166 v. Commissioner*, 696 F.2d 372 (5th Cir. 1983), aff'g 42 T.C.M. (CCH) 1202 (1981).

all'' test was met where volunteers performed 91 percent of the full-time work and 94 percent of all work.[176] While the statute does not define *substantially all*, the IRS has noted that in other areas of the tax law the ''substantially all'' requirement is generally regarded as met if it equals or exceeds 85 percent.[177]

Another issue is whether the individuals work ''without compensation.'' Where there is no payment of monetary or nonmonetary compensation, this test is clearly met. Also, both the IRS and the courts have held that the reimbursement of expenses does not constitute compensation for these purposes.[178] In one case, the IRS contended, and the Tax Court agreed, that the provision of complimentary drinks from the bar represented ''compensation,'' and that these individuals could not be counted as volunteers in making a ''substantially all'' determination.[179] The appellate court, however, reversed the Tax Court, stating that such a ''trifling inducement'' cannot properly be viewed as compensation.[180]

In a 1978 ruling, the IRS added another test that must be met in order for the activity to fall within the ''volunteer exception''—the performance of services must be a material income-producing factor in conducting the business.[181] This ruling involved a tax-exempt organization that rented heavy machinery to third parties, with the lessees responsible for all insurance payments and repairs. Only minimal work was necessary to carry on this business, consisting of the occasional negotiation of leases and processing of rental payments, all of which was done by volunteers. The IRS refused to apply the volunteer exception on the ground that the exception was only applicable to those businesses in which labor was a material factor in the production of the income. Because this was not such a business, the exception did not apply.

(h) Convenience Exception

A trade or business carried on by a tax-exempt college or university (including a state institution that may not be exempt under section 501(c)(3)) primarily for the convenience of its members, students, patients, officers, or employees is not treated or taxed as an unrelated trade or business.[182] The ''convenience exception'' only applies if the persons whose convenience is served by the conduct of an unrelated trade or business fall within one of these five designated relationships, and in a 1996 ruling, the IRS refused to

[176] *St. Joseph Farms of Ind. Bros. of the Congressional of Holy Cross, Southwest Providence, Inc. v. Commissioner*, 85 T.C. 9 (1985), *nonacq.*, 1986-2 C.B. 1.
[177] Tech. Adv. Mem. 8433010 (May 7, 1984).
[178] Priv. Ltr. Rul. 8040014; *Green County Med. Soc'y Found. v. United States*, 345 F. Supp. 900, 902 (W.D. Mo. 1972).
[179] *Waco Lodge No. 166*, 42 T.C.M. (CCH) at 1203.
[180] *Waco Lodge No. 166*, 696 F.2d at 375.
[181] Rev. Rul. 78-144, 1978-1 C.B. 168.
[182] IRC § 513(a)(2).

extend the exception to cover sales to spouses and children of a university's students.[183]

In addition, the exception only applies if these persons themselves have the relationship directly with the college or university. For example, if a college's bookstore sells personal care items to its own students, the income from these sales will fall under the convenience exception; however, similar sales to students of another school will not. But the IRS has permitted the convenience exception to apply when an organization's activities were for the convenience of the employees of a related exempt entity.[184]

Whether an individual is a student, patient, officer, or employee is not usually a difficult determination to make.[185] Determining who is a ''member,'' however, can be tricky. In one case, the court was asked to determine whether staff physicians were members of the hospital.[186] In holding that they were, the court defined *members* as ''any group of persons limited in size who are closely associated with the entity involved and who are necessary to the achievement of the organization's purposes.''[187] The court justified this interpretation as consistent with the legislative history of the statute:

> [G]iving members a broader meaning than the excessively literal meaning advocated by [the government] is consistent with the legislative purpose underlying the unrelated business provisions and consistent with the rule requiring a liberal interpretation of statutory provisions which favor tax exemption. By permitting exempt organizations to furnish services to people closely associated with the achievement of its goals, the exempt purposes of the organization are directly furthered and the comparative effects of the activity restricted.[188]

Although the IRS has not expressly rejected this definition of *members*, it has disagreed with the court's characterization of staff physicians as members of a hospital.[189]

The scope of the term *members* was also considered by the U.S. Court of Federal Claims in a case that involved the tax treatment of income attributable to advertising in a medical journal, which was provided without charge to members of a tax-exempt medical organization.[190] According to the court, in order for the convenience exception to apply, an activity must be carried on

[183]Tech. Adv. Mem. 9645004 (July 17, 1996).
[184]Priv. Ltr. Rul. 9535023 (May 31, 1995).
[185]Although the IRS has struggled with the definition of a ''student'' for purposes of the ''student'' Social Security tax exemption in IRC § 3121(b)(10).
[186]*St. Lukes Hosp. of Kan. City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980). The staff physicians were not ''employees'' of the hospital for purposes of IRC§513(a)(2).
[187]*Id*. at 92.
[188]*Id* at 93.
[189]Rev. Rul. 85-109, 1985-2 C.B. 165; Rev. Rul. 85-110, 1985-2 C.B. 166; Tech. Adv. Mem. 8131063 (n.d.).
[190]*American College of Physicians v. United States*, 83-2 U.S.T.C. (CCH) ¶ 9652 (Cl. Ct. 1983), *rev'd* on other grounds, 743 F.2d 1570 (Fed. Cir. 1984), *rev'd* on other grounds, 475 U.S. 834 (1986).

for the convenience of an organization's members ''in their capacity as members.''[191] In that case, the court made a distinction between the organization's members in their capacity as physicians and in their capacity as members:

> The members' interests as members concern such matters as attending . . . educational functions, participating in research and testing, disseminating health information to the public and promoting quality medical education. The members' interests as physicians are much broader and include all of the aspects of medical practice.[192]

The court, recognizing that this distinction was ''subtle but important,'' held that the convenience exception was inapplicable (and therefore the activity was subject to unrelated business income tax) because advertising served the convenience of the organization's members in their capacity as physicians but not in their capacity as members of the organization.[193]

One issue that is unique to the college and university tax area is whether alumni can be treated as ''members'' for purposes of the convenience exception. If they could, for example, income derived from bookstore sales to alumni could be excluded from unrelated business income. Using the previously discussed broad interpretation that found hospital staff to be members of a hospital, it can be argued that alumni likewise satisfy this definition in that they are a group of persons (1) limited in size, (2) closely associated with the institution, and (3) necessary to the achievement of the institution's purposes. In order to strengthen this argument, a college or university should be able to demonstrate the scope of its alumni support (e.g., in the form of contributions, involvement in the school's activities, recruitment, etc.) and their importance in assisting the school in fulfilling its tax-exempt purpose. Notwithstanding these arguments, the current position is that alumni may not be treated as members of a college or university for purposes of the convenience exception.[194]

In order to qualify for the convenience exception, the trade or business must be operated ''primarily for the convenience'' of the organization's members, students, patients, officers, or employees. Although neither the Code nor the regulations define the term *primarily*, the Supreme Court, in another context, has interpreted *primarily* to mean '''of first importance' or 'principally.'''[195] In the previously mentioned case involving the tax treatment of income derived from the sale of advertising in a tax-exempt organization's monthly medical journal,[196] the court held that the convenience exception was not applicable, in

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[191] 83-2 U.S.T.C. (CCH) ¶ 9652, at 88,340.
[192] *Id*.
[193] *Id*.
[194] This is the position asserted by the IRS in a number of college and university audits and was set forth in the previously published College and University Examination Guidelines.
[195] *Malat v. Ridell*, 383 U.S. 569, 572 (1966) (construing IRC § 1221(1), which denies capital gains treatment to ''property held . . . primarily for sale . . . in the ordinary course of . . . business'').
[196] *American College of Physicians v. United States*, 83-2 U.S.T.C. (CCH) ¶ 9652 (Cl. Ct. 1983).

part, because this primary purpose requirement was not satisfied.[197] Although the court recognized that there was some incidental benefit to the readers of the advertising, the court held that the primary purpose for publishing the advertising was to earn income.[198]

In one case,[199] the court, in defining the primary purpose requirement, noted that it is not necessary for an organization to show that no commercial alternatives are available:

> The plaintiff need only prove that the service performed is *primarily* for the convenience of its members—not that it is *primarily necessary* for the convenience of its members. Plaintiff is not required to show that there were no other alternatives available. . .[200]

In evaluating the applicability of the unrelated business income tax to sales of novelty items embossed with a college or university's logo, the IRS concluded that ''[n]ovelty items (such as jewelry, beer mugs, pillows, etc. imprinted with the school name or seal) . . . will be considered as coming within the convenience rule of section 513(a)(2), and therefore not subject to tax.''[201] In a 1980 technical advice memorandum, the IRS followed the same rationale, stating:

> Based on the information submitted the clothing sold by the organization includes *clothing embossed with university insignia*, clothing used in university sports and activities and a limited amount of other low-cost sundry apparel. Accordingly, the sale of the clothing items herein above mentioned should be regarded as sales activity which comes within the convenience rule of section 513(a). Sales of items of clothing with a useful life of more than one year (*other than* sundry items, *items embossed with the university emblem*, and items used in school activities) should not be considered apparel sold for the convenience of students and would be subject to tax.[202]

Based on these rulings, it appears that the income derived from the sale of clothing, novelty, or other items embossed with the school's logo can qualify for the convenience exception even though they have a useful life in excess of one year.

The convenience exception issue also arose in connection with income derived from the operation of a parking lot. This case involved a tax-exempt organization that was affiliated with a college and a consortium of educational organizations and operated a parking lot to be used by the students, faculty, and staff. The IRS ruled that the income was not taxable under the section 513

[197] *Id*. at 88,340.
[198] *Id*. In arriving at this conclusion, the court noted that the organization's advertising business was conducted like an ordinary commercial advertising business.
[199] *St. Lukes Hospital of Kan. City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980).
[200] *Id*. at 93.
[201] Gen. Couns. Mem. 35,811 (May 7, 1974).
[202] Tech. Adv. Mem. 8025222 (n.d.) (emphasis added).

convenience exception.[203] It should be noted, however, that the IRS did not rule with respect to any parking income that might be derived from persons other than students, faculty, and staff, such as visitors and other members of the general public.

§ 2.3 INCOME FROM CONTROLLED ORGANIZATIONS

Prior to 2006, section 512(b)(13) provided that interest, annuities, rents, and royalties, while generally excluded from the unrelated business income tax, were nevertheless subject to the tax if they were received from a ''controlled'' organization. In 2006, however, Congress substantially changed these controlled organization rules.[204] In some circumstances, however, the old rules will continue to apply. In addition, the changes are effective only for payments received or accrued after December 31, 2005, and before January 1, 2008.[205] Thus, it is important for colleges and universities to be aware of the prior law controlled organization rules because they will continue to apply under certain circumstances, and it is possible that the prior law rules may again be applicable in the same manner as before.

(a) Pre-2006 Controlled Organization Rules

Under the pre-2006 section 512(b)(13) rules, if a school received, for example, a royalty from a controlled nonprofit or for-profit subsidiary, the royalty was taxable to the school as unrelated business income, notwithstanding the normal royalty exclusion. These same rules applied to interest, annuities, and rents received from the controlled organization. Note, however, that dividends were not covered by this rule, so that if a college or university established a wholly owned, for-profit subsidiary and received dividend distributions from it, the dividends were nontaxable.

In order to constitute ''control'' under these rules, the tax-exempt organization had to have more than a 50 percent ownership interest in the subsidiary.[206] And, in making the control determination, the constructive ownership rules of section 318 were taken into account.[207] In 1999, the IRS applied these control requirements in a ruling that held that interest, rents, and royalties received by a university from its for-profit, real estate management subsidiary will be treated as taxable to the university under the ''more than 50 percent'' control test.[208] The application of the control test varied depending on the legal structure of the subsidiary in question. If the subsidiary was a stock

[203]Priv. Ltr. Rul. 199949045 (Sept. 14, 1999).
[204]Pension Protection Act of 2006, Pub. L. No. 109-280, § 1205(a).
[205]*Id*. § 1205(c).
[206]IRC 512(b)(13)(D).
[207]IRC § 512(b)(13)(D)(ii).
[208]Priv. Ltr. Rul. 199941048 (July 20, 1999).

company, control existed if the tax-exempt organization owned more than 50 percent of the stock of the company whether determined by vote or value; if the subsidiary was an unincorporated association or a partnership, control meant ownership of more than 50 percent of the profits, capital, or beneficial interests.[209]

In the case of a nonstock organization, control existed if more than 50 percent of the directors or trustees were representatives of, or were directly or indirectly controlled by, the college or university parent.[210] An individual was deemed to be a ''representative'' of the college or university if he or she was a trustee, director, agent, or employee of the institution, and a director or trustee was deemed to be ''controlled'' by the college or university parent if the institution had the power to remove the individual and appoint a new director or trustee.[211]

The amount that the college or university parent was required to include in income from the controlled organization was determined based on a ratio that varied depending on whether the organization was an exempt organization or taxable entity. The rules and ratios that were applied to make these calculations are quite complex and probably best explained in the regulations, which contain several helpful examples of the computational rules.[212]

(b) The Rules for 2006 through 2007

In 2006, Congress made substantial changes to these rules. Under the new section 512(b)(13) regime, the former controlled organization rules apply only to the portion of payments received that exceed the amount of the payment that would have been made if the payment had been determined under an arm's-length arrangement.[213] Thus, if a payment of rent by a controlled subsidiary to its university parent exceeds fair market value, the excess amount (as determined in accordance with section 482) is included in the university's unrelated business income. In addition, the new rules impose a 20 percent penalty on the excess amount.[214]

In addition, the change made in 2006 imposed on colleges and universities the obligation to report on their Form 990 amounts of interest, annuities, royalties, or rent received from a controlled organization; loans made to any controlled entity; and transfers of funds to and from the controlled entity.[215]

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[209]IRC § 512(b)(13)(D)(i).
[210]Treas. Reg. § 1.512(b)-1(*l*)(4)(i)(b).
[211]*Id*.
[212]Treas. Reg. §1.512(b)-1(l)(2)(ii), Examples 1 and 2; Treas. Reg. §1.512(b)-1(*l*)(3)(iii), Examples 1 and 2.
[213]IRC 512(b)(13)(E)(i).
[214]IRC 512(b)(13)(E)(ii).
[215]IRC § 6033(h).

§ 2.4 FOREIGN INSURANCE INCOME

In 1996, Congress added a new item of unrelated business income relating to insurance income earned by tax-exempt organizations from conducting overseas insurance activities through a ''controlled foreign corporation.'' Under the foreign tax provisions of the Code, the U.S. shareholders are required to report this foreign-earned income as taxable ''Subpart F'' income; however, the IRS ruled on a number of occasions that this Subpart F income should be treated as a dividend for unrelated business income tax purposes and therefore excludable under the dividend exclusion.[216]

Because Congress was not happy with this IRS position, it changed the law in 1996 by adding a new provision under which ''insurance income'' earned by a tax-exempt organization from a controlled foreign corporation (generally, a corporation in which U.S. shareholders own more than a 50 percent interest) will be treated as unrelated business income.[217] There is an exception, however, if the insurance income is related to insuring the tax-exempt organization itself or one or more of its ''affiliates.'' The provision includes an important exception for colleges and universities: For purposes of determining whether an entity is an ''affiliate'' that qualifies for the exception, all colleges and universities (as well as hospitals) will be treated as affiliated,[218] even if there is, in fact, no relationship among them. This permits a consortium of college and universities to own the stock of a foreign income company and still receive dividends from the company on a tax-free basis.

§ 2.5 UNRELATED DEBT-FINANCED INCOME

Because of a number of press reports regarding allegedly abusive transactions, in 1969 Congress enacted a new set of ''unrelated debt-financed income'' rules. These rules are generally designed to tax as unrelated business income the investment income attributable to property acquired by a tax-exempt organization with borrowed funds. The basic structure of this statutory scheme is to tax the net investment income (gross investment income less directly related expenses) from property acquired with debt in the same ratio as the debt that was used to make the acquisition. For example, if an asset is purchased by borrowing 50 percent of the purchase price, 50 percent of the investment income produced by the property (less 50 percent of the allocable expenses) will be taxed as unrelated debt-financed income.[219]

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[216]Priv. Ltr. Rul. 9407007 (Nov. 12, 1993); Priv. Ltr. Rul. 9027051 (Apr. 13, 1990); Priv. Ltr. Rul. 9024086 (Mar. 22, 1990); Priv. Ltr. Rul. 9024026 (Mar. 16, 1990). But see Priv. Ltr. Rul. 9043039 (July 30, 1990), which for some unexplained reason holds the underlying income as taxable.

[217]IRC § 512(b)(17). ''Insurance income'' is defined in IRC § 953.

[218]IRC § 512(b)(17)(B)(ii)(II).

[219]See William H. Weigel, ''Unrelated Debt-Financed Income under Section 514: A Retrospective (and a Modest Proposal),'' 50 *Tax Lawyer*, No. 3, at 625–658 (American Bar Ass'n, Spring 1997).

(a) Debt-Financed Property

The tax on unrelated debt-financed income applies only if the property involved is ''debt-financed property.'' Debt-financed property is defined as any type of property (real, tangible, intangible) (1) that is held to produce income, and (2) with respect to which there is an ''acquisition indebtedness.''[220] Although both definitional elements contain a number of special rules and exceptions, as discussed in more detail below, the debt-financed income rules carve out a major exception for real property acquired by colleges and universities for debt, and provide that such property is not treated as acquired through ''acquisition indebtedness'' for purposes of the tax on unrelated debt-financed income.[221] Colleges and universities remain subject, however, to the normal rules applicable to debt-financed purchases of other income-producing items of personal or intangible property.

If the property that is acquired with debt is used substantially by the tax-exempt organization to further the organization's exempt purposes, the property is not treated as debt-financed property.[222] The term *substantially* is defined as at least 85 percent.[223] If, however, less than 85 percent of the use is for related purposes, only the unrelated use will be subject to the unrelated debt-financed income rules.[224] These rules are illustrated in the following example:

> U, an exempt university, owns a computer with respect to which there is acquisition indebtedness. U's staff uses the computer in performing admissions, secretarial, recordkeeping, and other administrative functions of U, all of which are substantially related to U's exempt educational purpose. Because the computer is not in full-time use by U, U allows X Corporation to use the computer for an hourly charge during times when the computer is not being used by U. During one year, U used the computer 450 hours and X used the computer 50 hours. Comparing U's usage to the total time of use, the computer was used in a substantially related use 90 percent

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See also two IRS rulings that provide additional guidance on how the debt-financed income rules operate. In the first, an organization deducted 100 percent of the interest incurred on the debt itself, but the IRS ruled that the interest expense must be multiplied by the same debt-basis ratio as applied to all other expenses. Tech.Adv. Mem. 9717004 (Dec. 13, 1996) (citing Treas. Reg. § 1.514(a)-1(a)(1)(ii)). In the second ruling, an exempt organization was a partner in a partnership that owned debt-financed property. The IRS looked through the partnership and ruled that the partnership's debt should be attributed to the exempt organization partner, even though the organization had not borrowed money to acquire the partnership interest. Tech. Adv. Mem. 9651001 (June 27, 1996).

[220]IRC § 514(b)(1); Treas. Reg. § 1.514(b)-1(a).

[221]IRC § 514(c)(9). *See* Priv. Ltr. Rul. 200534025 (May 31, 2005), in which the IRS ruled that amounts borrowed by a state university under a credit agreement to finance renovations and repairs to certain buildings it leases to third parties do not constitute acquisition indebtedness under the special rules of IRC § 514(c)(9).

[222]IRC §514(b)(1)(A)(i). *See ,e.g.*, Priv. Ltr. Rul. 200032050 (May 16, 2000).

[223]Treas. Reg. § 1.514(b)-1(b)(1)(ii).

[224]IRC § 514(b)(1)(A)(ii).

of the total time the computer was used (450 hours used by U/500 total hours used). All of the use of the computer was substantially related to the performance of U's exempt function; therefore, the entire computer is excepted from treatment as debt-financed property.

If debt-financed property is later sold or otherwise disposed of, the regulations provide that a portion of the gain or loss is included in the unrelated debt-financed income, notwithstanding the general unrelated business income exclusion for gains and losses derived from capital gains transactions.[225] The gain or loss is computed by applying the ''unrelated'' percentage of use to the debt-financed debt/basis of the property ratio.

(b) Other Exceptions

There are several other exceptions to the application of the unrelated debt-financed rules.

One such exception is where the income is already subject to tax under the normal unrelated business income tax rules.[226] For example, the unrelated debt-financed provisions do not apply to rental income that does not otherwise qualify for the rental income exclusion.[227] Other exceptions apply to (1) income that is excluded from unrelated business income tax as income from research activities, [228] (2) income that is exempt from the unrelated business income tax rules under the ''convenience'' exception, the ''volunteer labor'' exception, or the exception for sales of merchandise substantially all of which was received as gifts or contributions,[229] and (3) income received under a ''gift annuity.''[230]

In addition, property that is acquired by an exempt organization with debt is used by another exempt organization that is related to it (or by an organization that is related to the ''related'' organization) in furtherance of either organization's exempt purposes, the unrelated debt-financed income rules do not apply.[231] Two organizations are related if one organization has control of the other, or if more than 50 percent of the members of one organization are members of the other organization.[232] Accordingly, if a university controls a tax-exempt foundation, any use by the foundation of

[225]IRC § 514(b)(1)(B); Treas. Reg. § 1.514(b)-1(b)(2)(i).
[226]IRC § 514(b)(1)(B).
[227]*See* § 2.2(c).
[228]IRC § 514(b)(1)(C).
[229]IRC § 514(b)(1)(D).
[230]IRC § 514c)(5). *See* Priv. Ltr. Rul. 200449033 (Sept. 7, 2004), in which the IRS held that the income derived by an IRC § 501(c)(3) organization under a gift annuity contract did not result in unrelated business income. The IRS reached this conclusion because the annuity met the requirements of IRC § 514(c)(5), which excludes a gift annuity from the definition of *acquisition indebtedness* for purposes of the debt-financed income provisions.
[231]IRC § 514(b)(2).
[232]Treas. Reg. § 1.514(b)-1(c)(2)(ii)(b), (c).

a computer acquired by the university for debt will be treated as a related use of the property for purposes of making the ''substantially related use'' determination.

Also, the IRS has ruled that the use of gross proceeds of an issue of qualified 501(c)(3) bonds to acquire investments does not constitute an unrelated trade or business and does not result in income from debt-financed property.[233] In this ruling, however, the IRS did not determine whether the use of property financed with expenditures of proceeds of the bonds results in unrelated business income.

(c) Acquisition Indebtedness

Another definitional component of *debt-financed property* is that the property must have been acquired with ''acquisition indebtedness.'' This term includes not only indebtedness incurred in acquiring or improving the property, but also (1) indebtedness incurred before the acquisition or improvement if the indebtedness would not have been incurred ''but for'' the acquisition or improvement, and (2) indebtedness incurred after the acquisition or improvement if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.[234] Whether a particular indebtedness would not have been incurred ''but for'' the acquisition or improvement and whether the incurrence of the indebtedness was ''reasonably foreseeable'' are both questions of fact that depend on the particular facts and circumstances of the situation.

There are a number of specific exceptions to ''acquisition indebtedness'' classification, but only one has significant importance to educational institutions.[235] Certain qualified organizations are exempt from the application of the unrelated debt-financed income rules with respect to the acquisition or improvement of real property. Organizations that are eligible for this special exclusion include educational organizations, as well as organizations organized and operated to support an educational organization (which could include alumni associations, foundations, or other related entities, depending on how the organization is organized and operated).[236] This special rule was originally enacted by Congress in 1980 to cover only tax-exempt pension

[233]IRS Notice 2002-10, 2002-6 I.R.B. 490.

[234]IRC § 514(c)(1).

[235]IRC § 514(c)(9). There is another exception set forth in IRC § 514(c)(5), which provides that acquisition indebtedness does not include income derived from an annuity if the annuity meets the requirements of that provision. In Priv. Ltr. Rul. 9743054 (Aug. 1, 1997), the IRS ruled that income received by an IRC § 501(c)(3) organization under a gift annuity program was exempt from the unrelated debt-financed income provisions because the annuity involved in that ruling satisfied these rules.

[236]IRC § 514(c)(9)(C)(i).

trusts but was expanded in 1984 to cover educational organizations and their affiliated support organizations as well.

In order for an organization that is affiliated with a college or university to qualify for this special exception, the organization must qualify as a ''supporting organization'' under the private foundation rules.[237] The regulations contain the following two examples of organizations affiliated with a university that qualify for this exception:

> **Example 1:** M is a separately incorporated alumni association of X University and is an organization described in section 501(c)(3). X University is designated in M's articles as the sole beneficiary of its support. M uses all of its dues and income to support its own program of educational activities for alumni, faculty, and students of X University and to encourage alumni to maintain a close relationship with the university and to make contributions to it. M does not distribute any of its income directly to X for the latter's general purpose. M pays no part of its funds to, or for the benefit of, any organization other than X. Under these circumstances, M is considered as operated exclusively to perform the functions and carry out the purposes of X. Although it does not pay over any of its funds to X, it carries on a program which both supports and benefits X.[238]
>
> **Example 2:** X is a university press, which is organized and operated as a nonstock educational corporation to perform the publishing and printing for M University, a publicly supported organization. Control of X is vested in a Board of Governors appointed by the Board of Trustees of M University upon the recommendation of the president of the university. X is considered to be operated, supervised, or controlled by M University within the meaning of section 509(a)(3)(B).[239]

(d) Computation of Debt-Financed Income

If the property is determined to be debt-financed property under the rules discussed above, the computation of the debt-financed income that is subject to tax is made by applying the following fraction:[240]

Annual average acquisition indebtedness /annual average adjusted basis of the property

Note that the numerator of the fraction is the acquisition indebtedness as averaged over the tax year, not the indebtedness at the end of the year.[241] This is to prevent the organization from trying to avoid the tax by paying off the debt immediately before the end of the year.

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[237] *See* IRC § 509(a)(3).
[238] Treas. Reg. § 1.509(a)-4(e)(3), Example 1.
[239] Treas. Reg. § 1.509(a)-4(g)(2), Example 1.
[240] IRC § 514(a)(1).
[241] IRC § 514(c)(7).

§ 2.6 ALLOWABLE DEDUCTIONS

(a) Background

The unrelated business income tax is imposed on the net taxable income from the unrelated activity. While much attention is normally focused on the amount of gross income derived from the activity, an area of often equal importance is whether, and to what extent, the college or university can deduct expenses to reach net unrelated business taxable income. It is not unusual for a college or university to be able to reduce significantly, or even eliminate, its final unrelated business income tax liability by offsetting the income through deductible expenses. Moreover, to the extent that the deductions exceed the income from the activity, the resulting loss can be used to offset income from other unrelated business income activities.[242]

The fundamental authority for a school's ability to deduct expenses in computing unrelated business income lies in the definition of the term *unrelated business income*, which is defined in the Code as the gross income derived from the unrelated business income activity, ''less those deductions . . . which are directly connected with the carrying on of such trade or business.''[243] This statutory provision sets forth the two basic tests that must be met in order for an expense to be deductible in computing unrelated business income:

1. The expense must be allowable as a deduction under one of the Code provisions that allow business deductions for for-profit companies in computing their taxable income; and
2. The expense must be ''directly connected'' with the carrying on of the unrelated trade or business.

Looking at the first test, a variety of Code sections provide for potentially deductible expense items. Perhaps the most obvious and important is section 162, which allows a business expense deduction for ''ordinary and necessary'' expenses paid or incurred during a taxable year in carrying on a trade or business. There are a mind-boggling number of IRS rulings dealing with the issue whether a particular expense is deductible under section 162, and the clear intent of Congress is that these authorities are applicable in the unrelated business income context as well. Other deduction provisions that may be applicable to unrelated business income activities include section 163 (interest expense deduction), section 165 (deduction for losses), and sections 167 and 168 (depreciation deductions). The IRS unrelated business income tax return (Form 990-T) specifically contemplates other less common deductions, including bad debts, taxes, depletion, and contributions to deferred compensation and other

[242] *See* § 2.6(e)(i).
[243] IRC § 512(a)(1).

employee benefit programs.[244] In addition, unrelated business income can be reduced to reflect net operating deductions and charitable contributions, but these are technically treated as modifications rather than deductions.[245]

The second test—that the expense must be ''directly connected'' with the carrying on of the trade or business—is met if the expense has a ''proximate and primary relationship'' to the conduct of the trade or business.[246] One court has held that this test is met if the dominant reason in incurring the expense is to further the organization's unrelated business.[247]

(b) Direct and Indirect Cost Allocations

If the expense item satisfies both of these tests and is attributable solely to the conduct of a trade or business, it is deductible in full in calculating unrelated business taxable income from the activity.[248] For example, salaries of personnel working full-time in the conduct of a trade or business are fully deductible in computing the unrelated business taxable income from the activity, assuming the salaries otherwise qualify as deductible business expenses under section 162.[249] Similarly, if a building is used entirely in the conduct of an unrelated trade or business, depreciation is allowed as a deduction to the full extent allowable by sections 167 and 168.[250]

One of the key issues that often arise in the expense deduction area relates to situations where a college or university's assets or personnel are used in the conduct of both an unrelated business income activity and an activity that is in furtherance of the school's exempt purposes. This could include, to name just a few of many possible examples, a multipurpose auditorium that is used to conduct graduation ceremonies, class registration, theater classes, etc., and is also used to host public entertainment events[251]; an ice rink used to conduct physical education classes and intercollegiate hockey games, and is also rented to members of the general public[252] ; and a parking lot in which university personnel can park, with a portion rented to local businesses.[253] In each case, there are expenses attributable to personnel and facilities that are used for both related and unrelated activities, and the issue is how to allocate the proper expenses to the unrelated activity, thereby reducing the net taxable income derived from that activity.

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[244] *See* IRS Form 990-T, Part II.
[245] IRC § 512(b)(6) and (10).
[246] Treas. Reg. § 1.512(a)-1(a).
[247] *American Med. Ass'n v. United States*, 887 F.2d 760 (7th Cir. 1989), *aff'g in part and rev'g in part* 668 F. Supp. 1085 (N.D. Ill. 1987).
[248] Treas. Reg. § 1.512–1(b).
[249] *Id*.
[250] *Id*.
[251] *See* 3.9.
[252] *See* § 3.10.
[253] *See* § 3.7.

There is a paucity of guidance on how this ''direct use'' allocation should be made, but the place to start is with the IRS regulations, which provide:

> Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167 or other relevant provisions of the Code.[254]

This regulation sets forth only two requirements for deducting a dual-use expense from unrelated business income: (1) the expense must be allocated between exempt and unrelated activities on a reasonable basis, and (2) the expense must otherwise be deductible under other relevant Code provisions. If a dual-use expense is allocated to an unrelated business activity on a reasonable basis, the regulations provide that the dual-use expense is, by definition, proximately and primarily related to the activity to which it is allocated.[255]

In a number of situations, the IRS has asserted the position that indirect dual-use expenses must be a priori ''directly connected'' to the unrelated activity to which they are allocated.[256] This IRS position was rejected by the Tax Court and the Second Circuit in a case in which both courts refused to accept the government's argument that the above-quoted regulation required any per se direct relationship between indirect dual-use fixed expenses and the unrelated trade or business to which they were allocated.[257] In that case, the government asserted that an organization must demonstrate that fixed indirect dual-use expenses (such as overhead) must be ''directly connected'' with the activity to which they are allocated to satisfy the requirement that such expenses be allocated on a ''reasonable basis.'' The government further argued

[254]Treas. Reg. § 1.512(a)-1(c).

[255]*Id. See Rensselaer Polytechnic Inst. v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), aff'g 79 T.C. 967 (1982); *American Med. Ass'n v. United States*, 668 F. Supp. 1085, 1102 n.6 (N.D. Ill. 1987), modified, 887 F.2d 760 (7th Cir. 1989).*See also National Ass'n of Life Underwriters, Inc. v. Commissioner*, 64 T.C.M. (CCH) 379 (1992), rev'd and remanded on other grounds, 30 F.3d 1526 (D.C. Cir. 1994) (''items of deduction solely attributable to, or reasonably allocated to, unrelated business activities are by definition directly connected'').

[256]*See, e.g., Rensselaer*, 732 F.2d at 1060; Priv. Ltr. Rul. 9324002 (Feb. 11, 1993); Priv. Ltr. Rul. 9149006 (Aug. 12, 1991); Priv. Ltr. Rul. 9147008 (Aug. 19, 1991); Priv. Ltr. Rul. 8151005 (Sept. 24, 1981); Gen. Couns. Mem. 39,863 (Nov. 26, 1991). Compare Rev. Rul. 76-402, 1976-2 C.B. 177 (no such prerequisite imposed).

[257]*Rensselaer*, 732 F.2d at 1058.

that an indirect dual-use expense is only deductible for unrelated business income tax purposes if it would not have been incurred in the absence of the activity.[258]

In rejecting this proposed construction of the regulation, the Second Circuit construed the language of the regulation literally and found that imposing such a ''directly connected'' requirement on indirect dual-use expenses was irreconcilable with the very nature of such expenses. The court further noted that to impose such a requirement on exempt organizations unfairly penalized those organizations by disallowing indirect expenses otherwise deductible to taxable entities under less stringent standards.

Despite this defeat, the IRS has continued to assert that to be deductible from unrelated business income, indirect dual-use expenses must be a priori ''directly connected'' to the activity to which they are allocated. The IRS has recognized, however, that the regulation currently in force requires only that dual-use expenses be allocated on a ''reasonable basis.'' As such, while it continues to assert that its position is correct, the IRS has stated that until this regulation is amended to reflect this standard, it will not litigate that position.[259]

The determination whether dual-use expenses have been allocated on a ''reasonable'' basis is a factual one. With respect to the costs of operating dual-use facilities, the IRS considers a reasonable basis for the allocation of such costs to be one based on the actual use of the facility.[260] The IRS's position is that variable dual-use expenses (i.e., expenses that vary in proportion to the use of the facility but cannot be identified with specific events) should be allocated on the proportion of unrelated use to actual use, while fixed dual-use expenses (i.e., expenses that do not vary in proportion to actual use of the facility) must be allocated on the proportion of unrelated use to available use. The leading case construing this aspect of cost allocation provisions involved Rensselaer Polytechnic Institute, and in this case both the Tax Court and the Second Circuit refused to adopt the IRS's position with respect to fixed dual-use expenses.[261] Both courts held that the allocation of both variable and fixed indirect expenses of a dual-use facility based on the proportion of

[258]This logic was adopted by the Third Circuit in *Pittsburgh Press Club v. United States*, 579 F.2d 751 (3d Cir. 1978). The court found it improper to charge against unrelated income fixed costs that would be borne absent that income. This case, however, did not deal with cost allocation for purposes of computing unrelated business taxable income. It dealt with computing unrelated income for purposes of determining whether a social club's exemption should be revoked.

[259]*See Stark v. Commissioner*, 86 T.C. 243 (1986), action on decision, 1987-16 (June 18, 1987); Priv. Ltr. Rul. 9147008 (Aug. 19, 1991); Gen. Couns. Mem. 39,863 (Dec. 13, 1991).

[260]*See, e.g., Inter-Com Club, Inc. v. United States*, 721 F. Supp. 1112 (D. Neb. 1989) (fixed costs should be allocated on basis of available hours on days of nonmember usage); Gen. Couns. Mem. 39,863 (Nov. 26, 1991); Priv. Ltr. Rul. 9149006 (Aug. 12, 1991); Priv. Ltr. Rul. 9147008 (Aug. 19, 1991); Priv. Ltr. Rul. 8151005 (Sept. 24, 1981). See also *Rensselaer*, 732 F.2d at 1062.

[261]*Rensselaer Polytechnic Inst. v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), *aff'g* 79 T.C. 967 (1982).

unrelated use of the facility to total actual use satisfy the reasonable basis allocation standard.[262]

With respect to the costs relating to dual-use personnel, the IRS regulations similarly suggest that those expenses should be allocated based on the relative percentages of time spent by employees on related and unrelated activities.[263] The regulation cites as an example the allocation of an organization's president's salary on the basis of estimated time spent on related and unrelated activities.

Although the IRS has clearly expressed a general preference for allocations based on use, there is authority to support allocations based on gross receipts or sales. In one case,[264] the court employed a formula based on receipts to allocate dual-use expenses. The case involved the allocation of expenses attributable to the organization's direct mail solicitation program, which was found to have both exempt and unrelated aspects. The court allocated direct expenses based on the proportion of unrelated receipts from the activity to total receipts derived from the direct mail solicitation program. By contrast, indirect expenses (including overhead) were allocated on the proportion of unrelated receipts from the activity over the organization's total receipts. The court assumed that the use of these approximating formulae was proper given that ''direct accounting information [was] not available.''[265]

There is also comparable authority in the social club context supporting the allocation of dual-use expenses on a sales or receipts basis. The courts, and in some cases the IRS, have permitted social clubs to allocate dual-use fixed expenses between unrelated and related activities based on the respective proportion of related and unrelated sales to total sales from a given activity.[266]

In late 2006, the IRS announced that it was in the process of developing a project to review the treatment and allocation of income and expenses in the college and university area.[267] The project is intended to review current

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[262]*See Disabled Am. Veterans v. United States*, 704 F.2d 1570 (Fed. Cir. 1983), aff'g 82-2 U.S.T.C. (CCH) ¶ 9440 (Cl. Ct. 1982) (fixed expenses allocated on basis of proportion of unrelated income derived from activity to total income of the organization; variable expenses allocated on basis of proportion of unrelated income from activity to total income from that activity).*See generally Occidental Petroleum Corp. v. Commissioner*, 55 T.C. 115 (1970) (allocation of indirect expenses in proportion to direct expenses is the preferred method under the ''properly apportioned'' standard of IRC § 613).

[263]Treas. Reg. § 1.512(a)-1(c).

[264]*Disabled Am. Veterans*, 704 F.2d 1570 (Fed. Cir. 1983), *aff'g* 82-2 U.S.T.C. (CCH) ¶ 9440 (Cl. Ct. 1982).

[265]*Disabled Am. Veterans v. United States*, 82-2 U.S.T.C. (CCH) ¶ 9440 (Cl. Ct. 1982).

[266]*See, e.g., Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990);*Cleveland Athletic Club v. United States*, 779 F.2d 1160 (6th Cir. 1985) (IRS conceded the reasonableness of allocation method); Priv. Ltr. Rul. 8133024 (May 4, 1981); Priv. Ltr. Rul. 7950015 (Sept. 11, 1979).*See also Indiana Retail Hardware Ass'n v. United States*, 366 F.2d 998 (Ct. Cl. 1966) (indirect expenses allocable on gross income basis).

[267]This information was contained in a 2007 Exempt Organizations Workplan, a copy of which was posted on the IRS website at *http://www.irs.gov/pub/irs-tege/fy07_teb_workplan.pdf*.

practices of calculating unrelated business taxable income, as well as the allocation of income and expenses more generally by and between the organizations (for-profit and nonprofit) comprising large university systems. The IRS said that the project is expected to commence in 2008, and it remains to be seen what impact, if any, this project will have in the cost allocation arena.

(c) Analogous Cost Allocation Standards and Methods

Although the regulations do not provide guidance as to what constitutes a reasonable basis for allocating dual-use expenses, additional guidance may be obtained from other regulations that address methods of allocating costs that benefit more than one activity or costs that are attributable to more than one source of income.

For instance, the income sourcing regulations provide that for purposes of apportioning deductions between foreign and U.S. source income, if a deduction is ''definitely related'' to a class of gross income, it is apportioned between U.S. and foreign source income in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income.[268] An expense is ''directly related'' to an activity giving rise to a class of gross income if it is incurred incident to, or as a result of, that activity.[269] Specific factors to be considered in determining a proper apportionment method under this discretionary allocation standard include gross sales, receipts, and income.[270] Deductions not definitely related to a specific class of gross income must be ''ratably apportioned'' to all gross income.[271]

As in the unrelated business income context, these regulations more specifically provide that expenses relating to supportive functions (e.g., overhead, general and administrative expenses, and supervisory expenses) may be allocated to a class of gross income in the same fashion as other related deductions that are more readily allocable.[272] It is equally acceptable, however, to allocate such expenses to classes of gross income on some ''reasonable basis.''[273] These regulations specifically deem a reasonable basis to include a method of allocation based on reasonable departmental overhead rates[274] and permit the use of a gross receipts or gross income allocation basis in the absence of facts or records supporting a more specific allocation base.[275]

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[268]Treas. Reg. § 1.861-8T(c)(1). For an excellent discussion of using the U.S. source/foreign source rules in making unrelated business income expense allocations, see Laura Kalick, ''Allocation of Expenses—A Foreign Solution,'' 11 Exempt Organization Tax Review 283 (1995).
[269]Treas. Reg. § 1.861-8(b)(2).
[270]Treas. Reg. § 1.861-8T(c)(1). *See generally* Treas. Reg. § 1.861-8(g), Example 19.
[271]Treas. Reg. § 1.861-8(b)(1); Treas. Reg. § 1.861-8(b)(3).
[272]Treas. Reg. § 1.861-8T(b)(3).
[273]*Id*.
[274]*Id*.
[275]*See* Treas. Reg. § 1.861-8(g), Example 19.

Also, regulations addressing the allocation of costs related to lobbying activities similarly adopt a ''reasonable'' method cost allocation standard. These regulations provide that an organization may use any ''reasonable method'' to allocate labor and general and administrative costs to lobbying activities.[276] The regulations set forth three methods to be used by taxpayers: (1) a ratio based on labor hours; (2) a method using a gross-up of labor costs; and (3) a method that applies the uniform capitalization principles of section 263A.[277]

All these analogous cost allocation regulations clearly suggest that discretionary allocation standards, such as the ''reasonable basis'' standard employed for purposes of the unrelated business income rules, by definition give rise to numerous permissible cost allocation methods. The IRS itself has stated that, by using the ''reasonableness'' standard in the unrelated business income regulations, it understood that ''more than one method of allocation was contemplated.''[278] The flexibility inherent in discretionary cost allocation standards has been acknowledged by the courts, with one court stating in a case involving the apportionment of indirect expenses between mineral properties and other activities that a ''properly apportioned'' requirement imposed by the regulations by no means implied that the ''best'' or ''most accurate'' method be adopted.[279] The court wholly rejected the IRS's argument for such a strict construction of the standard and observed that the ''choice of a theoretically more precise, but complex, allocation method must be tempered by the effort and cost required to make such allocations.''[280]

Moreover, these comparable cost allocation regulations suggest, first, that those cost allocation methods based on departmental overhead rates, burden rates, cost accounting methods, and relative proportions of gross income or receipts are ''reasonable'' cost allocation methods,[281] and second, that other consistently applied allocation methods employed at the taxpayer's discretion may nonetheless be ''reasonable'' if the results achieved under those methods do not deviate significantly from more standard or specifically enumerated methods.

(d) Substantiation Requirements

In order for an expense to be deductible in computing unrelated business income, the item must be substantiated. Exempt organizations are required

[276] Treas. Reg. § 1.162-28(b)(1).
[277] Treas. Reg. § 1.162-28(b)(1)(i) to (iii).
[278] *1991 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 23 (15th ed. 1991).
[279] *Shell Oil Co. v. Commissioner*, 952 F.2d 885 (5th Cir. 1992), *rev'g, vacating, and remanding on other grounds* 89 T.C. 371 (1987).
[280] *Id*.
[281] *See, e.g.*, Treas. Reg. § 1.263A-1(f)(2),(3); Treas. Reg. § 1.265-1(c); Treas. Reg. § 1.451-3(d)(9); Treas. Reg. § 1.861-8T(b); Treas. Reg. § 1.861-8(g).

to maintain books of account or records sufficient to establish the amount of gross income, deductions, credits, or other matters contained in any tax or information return.[282] In addition, exempt organizations subject to unrelated business tax must maintain adequate books and records sufficient to show specific items of gross income, receipts, and disbursements,[283] and to substantiate the information provided on the unrelated business income tax return (Form 990-T).[284]

Both the IRS and the Tax Court have quite strictly enforced the substantiation requirement with respect to exempt organizations. For instance, in one ruling the IRS denied an exempt organization's allocated overhead deductions on the ground that the organization failed to justify the propriety of its seemingly randomly estimated 50 percent allocation rate.[285] Similarly, in another case the Tax Court denied the majority of an exempt organization's claimed expenses for lack of substantiation,[286] stressing the organization's failure to meet its burden of maintaining adequate records to support the gross income and deductions attributable to unrelated business activity. In this case, the court denied deductions for expenses allocated on the basis of ''undocumented'' and ''unverified'' estimates of their relationship to related and unrelated activities, stating that a tax-exempt entity is obligated to show not only that expenses were incurred but also that they are deductible and are ''directly connected'' to the unrelated activities of the organization. The Court refused to permit deductions based on estimates given that the record before the Court provided no satisfactory basis for estimating the amount of particular expenses or for determining whether any expenditures were deductible.[287] In connection with an audit of the University of Michigan in the early 1990s, the IRS disallowed virtually all of the direct expenses claimed by the University of Michigan on its unrelated business income tax returns because, according to the IRS, it did not prove that the amounts were expended or, if expended, that they were expended for the designated purposes. Indirect cost deductions were also disallowed as not based on a reasonable method.[288]

(e) Special Deduction Provisions

Notwithstanding the general rule that the deductions that are allowable in computing unrelated business income are the same as those permitted

[282]Treas. Reg. § 1.6001-1(a).
[283]IRC § 6033(a)(1); Treas. Reg. § 1.6001-1(c).
[284]Treas. Reg. § 1.6033-1; Treas. Reg. § 1.6033-2.
[285]Priv. Ltr. Rul. 9324002 (Feb. 11, 1993).
[286]*CORE Special Purpose Fund v. Commissioner*, 49 T.C.M. (CCH) 626 (1985).
[287]The court's harsh holding in *CORE Special Purpose Fund* may be tempered by the fact that the taxpayer refused to produce documents when requested by the IRS and when ordered by the Court. Nonetheless, the Tax Court's decision highlights an explicit and enforceable requirement for proper recordkeeping.
[288]*Regents of Univ. of Mich. v. Commissioner*, No. 4625-95 (T.C. filed Mar. 21, 1995). This case was ultimately settled prior to trial and all of the expenses in question were allowed.

to for-profit companies in computing their taxable income, there are several special deduction rules that apply in the unrelated business tax area.

(i) Loss Deductions. Because one of the deductions that is allowed in computing unrelated business income is the loss deduction under section 165, a college or university is allowed to offset all losses from unrelated business income activities against the income derived from other unrelated activities. One aspect of any claimed loss deduction that is carefully reviewed by the IRS relates to expense allocations.[289] A loss arises only when expenses exceed income, and if any of the expenses are disallowed, the amount of the loss is affected. If the IRS determines, for example, that certain indirect salary and overhead costs were unreasonably allocated to the particular ''loss activity,'' the claimed loss will be reduced and might disappear altogether.

Another major issue relates to whether the loss activity was entered into by the college or university with an intent to make a profit. If a particular activity shows a history of losses year after year, the IRS may contend that the activity is not undertaken with the intent to earn a profit, and is therefore not a ''trade or business.'' Because only losses from an unrelated ''trade or business'' can be used to offset unrelated business income, the claimed loss deduction is disallowed.[290] Another possible, but less likely, attack by the IRS is to contend that the claimed loss activity is ''related'' to the institution's exempt purposes, thereby taking the activity out of the ''unrelated'' business income category and preventing the loss from being used to offset unrelated business income.

(ii) Net Operating Loss Deduction. The net operating loss rules[291] are available to an exempt organization in computing its unrelated business income.[292] These rules generally provide that if deductions for the year exceed gross income, the resulting net operating loss can be carried back to the 2 years immediately preceding the loss year. If the loss is not entirely used up in those 2 years, it can then be carried forward for up to 20 years.

There is a special net operating loss deduction rule stating that the net operating loss for any year, as well as any carryback or carryover loss to another taxable year, is determined without regard to any income or deduction that is not taken into account in computing unrelated business income. For example, a loss incurred in an unrelated trade or business is not offset by excludable dividend income.[293] There are also special rules that apply if the exempt organization was not subject to the unrelated business income tax

[289] *See* § 2.6(b).
[290] Tech. Adv. Mem. 9719002 (Nov. 27, 1996). For a discussion of the ''trade or business'' concept, see § 2.1(a).
[291] *See* IRC § 172.
[292] IRC § 512(b)(6).
[293] Treas. Reg. § 1.512(b)-1(e)(1).

(i.e., was a taxable entity) in subsequent years, or will not be subject to the unrelated business income tax in future years.[294] These rules are usually of no concern to colleges and universities because such institutions generally retain their exempt status throughout the period of their existence.

(iii) Charitable Contribution Deduction. A college or university is allowed to claim a charitable contribution deduction in the computation of its unrelated business income.[295] The deduction is permitted to the extent allowable by the charitable contribution rules,[296] but it cannot exceed 10 percent of the institution's unrelated business income computed without regard to the charitable contribution deduction.[297] For example, assume that a college contributes $10,000 during a year to an organization that is qualified to receive charitable contributions—for example, another college, an alumni association, or a related foundation. If the college's unrelated business income for the year is $50,000 without taking the charitable contribution into account, the charitable contribution deduction is limited to $5,000 ($50,000 unrelated business income x 10 percent), with the excess amount eligible to be carried forward to the next five succeeding taxable years.[298]

(iv) Specific Deduction. A college or university is also entitled to claim a $1,000 ''specific deduction'' in computing its unrelated business income.[299] The deduction cannot be claimed for purposes of the net operating loss deduction, and only one such deduction is allowed for the year, regardless of how many different unrelated trade or business activities the institution engages in during the year.[300] For example, if a university conducted 10 different unrelated business income activities during a year that resulted in gross unrelated business income of $100,000, with $75,000 of offsetting deductions, the resulting $25,000 of net income could be reduced by the $1,000 specific deduction. If, however, the university's 10 different business activities resulted in an overall $25,000 net loss for the year, the $1,000 specific deduction could not be used to increase the net operating loss to $26,000.

[294]Treas. Reg. § 1.512(b)-1(e)(4).
[295]IRC § 512(b)(10).
[296]IRC § 170.
[297]IRC § 512(b)(10).
[298]The five-year carryforward is allowed by IRC § 170(d)(2)(A).
[299]IRC § 512(b)(12).
[300]Rev. Rul. 68-536, 1968-2 C.B. 244.

CHAPTER THREE

Common Activities Conducted by Colleges and Universities that Raise Unrelated Business Income Tax Concerns

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The annals of tax-exempt organization law are replete with dozens of different activities that are potentially subject to the unrelated business income tax.

This chapter focuses on those activities that are most frequently conducted by educational institutions.

§ 3.1 BOOKSTORE OPERATIONS

Campus bookstores are operated in different manners by different schools. Some lease the bookstore facilities to a for-profit company and receive rental income in return. These situations raise, at the outset, a question as to whether (1) the relationship is a bona fide lease with the payments received from the company qualifying for the rental income exclusion, or (2) the for-profit company is simply acting as the institution's agent in return for a management fee.[1] Other institutions retain a for-profit company to manage the bookstore under a management contract. In still other cases, the college or university operates the bookstore itself or arranges for it to be operated by a separate, nonprofit entity controlled by the college or university. In these latter cases, the separate entity is generally entitled to section 501(c)(3) status because it is treated as conducting activities that are educational and for the convenience of the students and faculty.[2] For the same reason, the IRS generally views a campus bookstore operated directly by a college or university as a related activity.

When the bookstore is operated by the school (either directly or pursuant to a management contract with a for-profit company) or by a separate nonprofit corporation, the issues become more complex. In these situations, the IRS uses the fragmentation rule to carve out certain bookstore sales as unrelated and subjects those sales (less allocable cost of goods sold and expenses) to the unrelated business income tax.[3] Essentially, the IRS treats all bookstore sales as taxable, unless they fall into one of the following two categories:

1. Sales to students, faculty, and other employees of items that are directly related to the school's educational purposes, such as books, records, tapes, general school supplies (notebooks, paper, pens, and pencils), and athletic wear used in the school's athletic and physical education programs[4]
2. Sales of noneducational items that are for the convenience of the students and faculty, and other employees, and therefore fall within the ''convenience exception''[5]

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[1] *See* § 2.2(c).
[2] *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).
[3] *See* § 2.1(a)(ii).
[4] Tech. Adv. Mem. 8025222 (n.d.); Gen. Couns. Mem. 35,811 (May 7, 1974). It could be argued that no educational purposes are served by selling these items to staff employees of the college or university; however, the IRS clearly treats such sales as related and nontaxable.
[5] *See* § 2.2(h).

With respect to the second category, note that the IRS takes the position that alumni do not qualify for the convenience exception.[6]

In order to qualify for the convenience exception, the article (1) should be of a type that is of recurrent demand as a direct result of day-to-day campus living, and (2) should not have an ordinary useful life of more than one year. Items that qualify under both categories include clothing embossed with the school's insignia (e.g., uniforms, sweaters, hosiery, handkerchiefs); clothing used in university sports and activities and low-cost wearing apparel; novelty items (e.g., jewelry, beer mugs, pillows) imprinted with the school's name or seal; and low-cost items with recurrent demand (e.g., film, cigarettes and other smoking materials, cards, health and beauty aids, candy, newspapers, and magazines).[7]

Items that the IRS has held do not fall into either category, and are therefore subject to tax, include wearing apparel, cameras and photographic equipment and supplies, tape recorders, radios, record players, television sets, and small appliances.[8] As a general rule, any noneducational item with a useful life of more than one year does not fall within the convenience exception and will be taxable, except for clothing, and novelty and other items embossed with the school's logo.[9] If a school can demonstrate, however, that its campus is located a considerable distance from commercial retail facilities, it may be able to successfully argue that other items with a useful life of more than one year are nontaxable under the convenience exception.[10]

In IRS audits of colleges and universities over the past several years, agents have generally taken the position that sales of a single computer to students and faculty are generally related activities, but sales of multiple computers to students and faculty as well as sales of computers to non-students/faculty/staff are unrelated sales and generate taxable income.

§ 3.2 DORMITORY RENTALS

Many colleges and universities rent dormitory space to other organizations or individuals, usually in the summer months when most of the school's students have gone home. The issue is whether the income derived from this rental activity will be treated as unrelated business income. In most cases, the ''trade or business'' and ''regularly carried on'' tests will be met without any difficulty. The more difficult question, however, is whether the dormitory rental activity is substantially related to the school's educational purposes.

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[6] *Id.*

[7] The IRS has held that the fact such sales are made in an urban campus environment where other stores are readily available is irrelevant. Gen. Couns. Mem. 33,323 (Aug. 29, 1966).

[8] Gen. Couns. Mem. 35,811 (May 7, 1974).

[9] This ''logo'' exception can be inferred from Tech. Adv. Mem. 8025222 (n.d.).

[10] *Id.*

In 1990, the IRS released an interesting private letter ruling that shed some light on its position with respect to college and university dormitory rentals and reveals a streak of liberalism not seen in other unrelated business tax areas.[11] The ruling involved a college that constructed a dormitory using tax-exempt bond financing. During the regular school year, the college used the dormitory to house its students, but implemented two different rental programs during the summer months. The first was a ''summer internship rental program'' under which students from schools around the country stayed in the dormitories while participating in summer internship programs at local corporations and law firms. As part of this program, the college also conducted career counseling sessions for the students, provided a biweekly seminar program focusing on law and business, and permitted the students to use the school's library and other educational facilities.

The second program was quite different. It involved renting dormitory space to organizations (both tax-exempt and for-profit) that conducted educational classes, seminars, and workshops. In some but not all cases, the tax exempt organizations used the school's facilities to conduct these educational programs. With respect to the dormitory rentals to for-profit companies, the school required that (1) the classes be educational in nature and not directed at enhancing the sponsor's commercial objectives, (2) the company use the school's facilities to conduct the classes, and (3) the company submit a course description to the school to allow the school to monitor the classes to ensure they were educational in nature.

The IRS ruled that both dormitory rental programs were substantially related to the college's exempt purposes of ''advancing education'' and therefore were not subject to the unrelated business income tax. The rental activities were found to be analogous to a 1968 ruling in which educational programs conducted for a bank's employees using university professors and banking law specialists were determined to be a related activities.[12] The IRS conditioned its favorable determination with respect to the dormitory rentals by requiring that the school (1) establish requirements and criteria to ensure that the activities conducted during the summer were educational in nature; (2) provide other educational benefits, such as career counseling; and (3) make its nondormitory facilities (library, classrooms, auditorium, and computers) available to the individuals renting the dormitory space. For all these same reasons, the IRS ruled that the dormitory rentals did not jeopardize the tax-exempt status of the bonds.[13]

Interestingly, in its analysis the IRS did not mention the specific exclusion from unrelated business income for rental income, presumably because the fact that the rental activities were substantially related to the school's exempt

[11]Priv. Ltr. Rul. 9014069 (Jan. 11, 1990).
[12]Rev. Rul. 68–504, 1968-2 C.B. 211.
[13]*See* § 9.4.

purposes rendered the issue moot. In all likelihood, however, the IRS would have concluded that the rental exclusion did not apply because of the nature and degree of the services that the college no doubt provided to the students as part of renting the dormitory space.[14]

In 2006, the IRS issued a ruling that seems to indicate a change in the IRS position with respect to dormitory rentals.[15] The ruling involved a theological school that owned living quarters used by the school's students and faculty. In addition, the school rented out these living quarters to certain non-student/faculty individuals, including (1) family members of students and faculty; (2) potential students and their parents; (3) guest speakers; (4) guests of other nonprofit organizations in the immediate geographic area who are speakers or performers at the school; and (5) members of the general public. The IRS ruled that rental activities described in categories one through four have a substantial causal relationship to the conduct of the school's educational purposes and therefore any income derived from these rentals is not subject to the unrelated business income tax. However, renting to the general public, the IRS said, is not a related activity and, in addition, does not qualify for the rental exclusion under section 512(b)(3); therefore, this income is subject to tax.

This ruling seems to expand the IRS universe of dormitory and other living quarter rentals that are not subject to unrelated business income tax as evidenced in the 1990 ruling holding that dormitory rentals were only related (and nontaxable) activities if the school was able to show that the individuals staying in the dormitories were engaged in some type of educational activities.[16]

§ 3.3 ADVERTISING INCOME

(a) Background

Colleges and universities typically sell advertising in a variety of different ways, including commercial advertisements in the student newspaper, professional journals, and athletic programs, as well as ''sponsorship'' agreements under which a company pays the school a fee in return for the school's agreeing to use and display the company's product. As a general rule, income from the sale of advertising is treated as income from an unrelated trade or business. Advertising income presents a classic example of the ''fragmentation rule'' in that the advertising is often part of an overall exempt publication (student newspaper, scholarly journal, athletic program), but the fact that the advertising is conducted as a component of an otherwise exempt function does

[14] *See* § 2.2(c).
[15] Priv. Ltr. Rul. 200625035 (Mar. 28, 2006).
[16] Priv. Ltr. Rul. 9014069 (Jan. 11, 1990).

not prevent the IRS from carving out the advertising income and taxing it as a separate trade or business.[17]

Advertising also illustrates a concept known as ''exploitation of exempt function.'' The IRS describes this concept in the regulations as income derived from ''activities carried on by an organization in the performance of its exempt function [that] may generate good will or other intangibles which are capable of being exploited in commercial endeavors.''[18] The regulations go on to say that when this happens, ''the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from a related trade or business.''[19] The regulations illustrate this concept with an example involving a tax-exempt trade association that publishes a business journal for its members and sells commercial advertising for commercial products such as automobiles, soft drinks, and home appliances. According to the IRS, the advertising income is derived from an exploitation of the circulation developed and maintained as part of the association's exempt function. Because neither the publication of these advertisements nor the services that the commercial advertisers perform contribute importantly to the association's exempt function, the advertising income is treated as income from an unrelated trade or business.[20]

A threshold issue is whether the activity is, in fact, *advertising*. While there is little law in this area, the term is generally accorded a fairly broad definition. For example, in a 1986 Tax Court case, the court held that slogans, logos, trademarks, and other information similar to listings found in professional journals, newspapers, and the Yellow Pages constitute ''advertising.''[21] Also, the IRS has ruled that income received from advertisements placed on wall space in an organization's facilities constitutes advertising income, rejecting the organization's argument that the income should be treated as rental income excludable under section 512(b)(3).[22]

(b) General Unrelated Business Income Tax Rules

Advertising income, like all other income derived by a college or university, must be tested against the three basic tests in order to determine whether it constitutes unrelated business income—that is, it must be a trade or business, regularly carried on, and not substantially related to the school's exempt activities.

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[17] *See* § 2.1(a).
[18] Treas. Reg. § 1.513–1(d)(4)(iv).
[19] *Id*.
[20] Treas. Reg. § 1.513–1(d)(iv), Example 6.
[21] *Fraternal Order of Police, Ill. State Troopers Lodge No. 41 v. Commissioner*, 87 T.C. 747, 754 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987).
[22] Priv. Ltr. Rul. 9740032 (July 8, 1997).

The Supreme Court held in a 1986 case that the standard test for determining the existence of a ''trade or business'' is whether the activity is carried on with the dominant hope and intent of realizing a profit.[23] In most cases, the sale of advertising space to commercial providers of goods or services meets this test, as long as either the advertising activity or the sale of the publication itself is generally profitable. When both activities are operated at a loss year after year, an argument can be made that there is no trade or business because there is no profit motive.[24] For example, in a 1997 ruling the IRS said that losses incurred in connection with one publication cannot be used to offset income earned from another publication because the advertising in the loss publication was not entered into for the primary purpose of earning a profit.[25]

With respect to the ''regularly carried on'' test, it is clearly met if the advertising is part of a journal, newspaper, or similar periodical published on a regular basis. What if, however, the advertising is published in connection with a publication relating to a single event? The IRS has ruled that the solicitation and sale of advertising by an organization in a book that was distributed at an annual charity ball did not meet the ''regularly carried on'' test.[26] And the IRS regulations suggest that advertising in ''programs for sports events or music or dance programs'' will generally not be treated as regularly carried on.[27] But the IRS position seems to be that such advertising will fall within the scope of this only exception if there is minimal solicitation in connection with advertising activity.[28]

The final test is whether the advertising can be treated as ''substantially related'' to the college or university's exempt purposes. While most commercial advertising contained in most college or university publications will not be treated as substantially related, this is not always the case. The regulations contain the following example involving a student newspaper published by a university:

> Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same

[23] *United States v. American Bar Endowment*, 477 U.S. 105, 110 (1986) (quoting *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). See § 2.1.
[24] For a more detailed discussion of this ''profit motive'' issue, see § 2.1(a)(i).
[25] Priv. Ltr. Rul. 9724006 (Feb. 28, 1997).
[26] Rev. Rul. 75–201, 1975-1 C.B. 164.
[27] Treas. Reg. § 1.513–1(c)(2)(ii).
[28] *See*, for example, Rev. Rul. 73–424, 1973-2 C.B. 190.

> result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.[29]

The IRS had occasion to apply this particular example from the regulations in a 1997 technical advice memorandum.[30] The case involved a section 501(c)(3) organization that published a university's daily student newspaper. The organization was separately incorporated but had a close working relationship with the university, which donated office space to the organization in the same building where the school's journalism department was located. The organization's board of directors consisted mostly of students plus a few faculty members, and the reporting and writing functions of the newspaper were conducted solely by students. The business functions of the newspaper (advertising, production, circulation, and building and administration), however, were conducted by 17 students and 10 nonstudents. The nonstudent employees worked in mentoring or supervision capacities or in positions that students were ill-suited to serve, and all of the business department employees reported to a general manager who was a nonstudent.

The issue presented to the IRS was whether the advertising income earned by the organization was subject to the unrelated business income tax. The national office ruled that the income was exempt from tax because the advertising activity was related to the organization's exempt purposes, relying on the above-quoted example in the regulations. It noted that the case was distinguishable from the facts set forth in the example because not all of the advertising activities were conducted by students. The national office said, however, that the example in the regulations ''is more of a safe harbor than a bright-line rule'' and that ''there is room for nonstudent employees in the advertising department, especially where they serve in a managerial or training capacity, or in positions where it is impractical to employ students.'' Nevertheless, the IRS noted that mere incidental student involvement will not necessarily transform an otherwise unrelated activity into a related activity and that ''the enterprise should be primarily a student enterprise.''

In the leading case involving the issue whether advertising in an organization's otherwise exempt publication is substantially related to the organization's exempt purpose, the Supreme Court held that, under certain restrictive circumstances, advertising can be treated as related.[31] This case involved an exempt trade association of physicians that published a monthly medical

[29]Treas. Reg. § 1.513–1(d)(4)(iv), Example 5.

[30]Tech. Adv. Mem. 199914035 (n.d.). For a further discussion of this technical advice memorandum, see *2002 Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002*, 24th ed., at 208 (2001).

[31]*United States v. American College of Physicians*, 475 U.S. 834, 843 (1986).

journal. The association published commercial advertising in the journal but limited the advertising to items related to medical products. In addition, all advertising was screened for accuracy and relevancy to the medical profession. The advertisements were not scattered throughout the journal but were clustered in the front and back of the publication.

The IRS argued that the advertising income was taxable because advertising income is per se unrelated to an organization's exempt purpose. The Supreme Court rejected this argument but also rejected the organization's contention that the focus should be on the benefit derived by the readers. Rather, the Supreme Court held that, in determining whether advertising is substantially related to an organization's exempt purposes, the focus should be on whether the organization conducted the advertising business in a manner that evidences an intent to further an educational purpose.[32] The facts of this case did not, in the view of the Supreme Court, evidence such an intent. The advertisements did not constitute a systematic or comprehensive presentation of any aspect of the products advertised; only those advertisers who were willing to pay set advertising rates could advertise their products; and some of the advertisements were repeated month after month, which did not evidence an intent to educate.[33] Thus, while the Supreme Court has left the door open to treat some commercial advertising as substantially related, only a relatively small number of cases will pass this fairly strict test.

(c) Income and Expense Calculations

If the advertising activity results in unrelated business income, the regulations set forth special rules as to how the advertising income and the related deductions are computed.[34] The computation of the net advertising income requires familiarity with the following special terms:

Gross advertising income: All amounts derived from the unrelated advertising activities of the publication[35]

Circulation income: All income (other than advertising income) attributable to the production, distribution, or circulation of a periodical, including income from its sale or distribution[36]

Direct advertising costs: All expenses, depreciation, and similar items directly connected with the sale and publication of the advertising[37]

Readership costs: All items of deduction directly connected with the production and distribution of the publication and that would otherwise

[32] *Id*. at 847.
[33] *Id*. at 849.
[34] Treas. Reg. § 1.512(a)-1(f).
[35] Treas. Reg. § 1.512(a)-1(f)(3)(ii).
[36] Treas. Reg. § 1.512(a)-1(f)(3)(iii).
[37] Treas. Reg. § 1.512(a)-1(f)(6)(ii).

be deductible if the publication constituted an unrelated trade or business[38]

Net advertising income (or loss) is computed as follows:

- If direct advertising costs exceed gross advertising income, the resulting loss can be used to offset unrelated business income derived by the organization from other activities.
- If gross advertising income exceeds direct advertising costs, the readership costs can be used to reduce or eliminate the net advertising income, but only if readership costs exceed circulation income.

The regulations contain a number of examples that nicely illustrate how these rules operate.

> **Example 1:** X, an exempt trade association, publishes a single periodical that carries advertising. During 1971, X realizes a total of $40,000 from the sale of advertising in the periodical (gross advertising income) and $60,000 from sales of the periodical to members and nonmembers (circulation income). The total periodical costs are $90,000, of which $50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and $40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical ($50,000) exceed gross advertising income ($40,000) the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:
>
> Gross advertising revenues $40,000
> Direct advertising costs ..... ($50,000)
> Loss attributable to advertising ..... ($10,000)
>
> X has realized a loss of $10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.
>
> **Example 2:** Assume the facts as stated in Example (1), except that the circulation income of X periodical is $100,000 instead of $60,000, and that of the total periodical costs, $25,000 are direct advertising costs, and $65,000 are readership costs. Since the circulation income ($100,000) exceeds the total readership costs ($65,000), the unrelated business taxable income attributable to the advertising activity is $15,000, the excess of gross advertising income ($40,000) over direct advertising costs ($25,000).
>
> **Example 3:** Assume the facts as stated in Example (1), except that of the total periodical costs $20,000 are direct advertising costs and $70,000 are readership costs. Since the readership costs of the periodical ($70,000) exceed the circulation income ($60,000), the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical

[38]Treas. Reg. § 1.512(a)-1(f)(6)(iii).

cost. Thus, X has unrelated business taxable income attributable to the advertising activity of $10,000 ($100,000 total income attributable to the periodical less $90,000 total periodical costs).

Example 4: Assume the facts as stated in Example (1), except that the total periodical costs are $120,000 of which $30,000 are direct advertising costs and $90,000 are readership costs. Since the readership costs of the periodical ($90,000) exceed the circulation income ($60,000), the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical ($100,000) does not exceed the total periodical costs ($120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only $70,000 of the $90,000 of readership costs may be deducted in computing unrelated business taxable income since such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's unrelated trade or business income derived from any other unrelated trade or business activity.[39]

§ 3.4 CORPORATE SPONSORSHIP PAYMENTS

Corporate sponsorship funding represents a significant potential source of revenue for colleges and universities. A ''corporate sponsorship'' payment essentially represents a payment made by a corporation or business to a college or university, in return for which the company receives some mention or acknowledgment of its products or services. The IRS has defined the problem raised by such corporate sponsorship payments as follows: ''The fundamental problem presented by the issue of corporate sponsorships is distinguishing normal fundraising and the associated acknowledgment of donors from the sale of advertising.''[40]

The history underlying the ''corporate sponsorship'' issue is interesting. It begins with the so-called ''Mobil Cotton Bowl'' technical advice memorandum, in which the IRS ruled that the payments made by Mobil Corporation to the Cotton Bowl Athletic Association (a tax-exempt, charitable organization) in return for certain benefits constituted ''advertising'' income.[41] In return for the sponsorship payment, the Association agreed to change the name of the event to the Mobil Cotton Bowl; arrange for the television broadcast of the game; display the logo at certain times and places; provide signage space; make public address and scoreboard announcements; and provide automobiles, tickets, hospitality suites, and other amenities. The IRS followed

[39]Treas. Reg. § 1.512(a)-1(f)(2)(iii), Examples 1–4.

[40]*1993 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 244 (17th ed., 1993). *See also* Hasselback & Clark, ''Colleges, Commerciality, and the Unrelated Business Income Tax,'' *Taxes*, May 1996, at 335–342.

[41]Tech. Adv. Mem. 9147007 (Aug. 16, 1991).

the release of this technical advice memorandum with proposed examination guidelines stating that the distinction between taxable ''advertising'' and a nontaxable ''acknowledgment'' would depend on whether the company received a ''substantial return benefit'' in consideration for its contribution to the organization.[42] While mere acknowledgment of the contribution would not be enough, the guidelines stated that if the organization performed valuable advertising, marketing, and similar services on a quid pro quo basis for the sponsor, the income would be treated as advertising income.

There was, to put it mildly, a tremendous adverse reaction to the Mobil Cotton Bowl ruling and to the ''substantial return benefit'' test set forth in the proposed examination guidelines. Numerous bills were introduced in Congress to reverse the IRS position and create more liberal tests. For reasons known only to the decision makers at the IRS, in January 1993 the IRS retreated on the issue and published a set of proposed regulations that took an entirely new, and less restrictive, approach in the corporate sponsorship area.[43] The proposed regulations were modeled on the Federal Communications Commission (FCC) rules relating to the nature and type of ''enhanced underwriting'' acknowledgments that public broadcasting stations can air in return for contributions by companies and other businesses. The Taxpayer Relief Act of 1997 added to the Code a new section 513(i) that, for the most part, codified the corporate sponsorship rules set forth in IRS proposed regulations. And, in 2002, the IRS issued final regulations under section 513(i).

Under section 513(i) and the final regulations, an unrelated trade or business will not include the activity of soliciting or receiving ''qualified sponsorship payments.''[44] A ''qualified sponsorship payment'' is one that is made to a tax-exempt organization where the business making the payment receives in return no ''substantial return benefit'' other than (1) the use or acknowledgment of the business's name or logo in connection with activities conducted by the recipient organization, or (2) certain goods or services that have an ''insubstantial value'' under existing IRS guidelines.[45]

With respect to this second category, the regulations say that benefits are disregarded if the aggregate fair market value of all the benefits provided to the payor in connection with the payment during the organization's taxable year is not more than 2 percent of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2 percent of the amount of the payment, then the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit. For purposes of this rule, ''benefits'' include advertising; exclusive provider arrangements (discussed below); goods, facilities, and other privileges; and the exclusive or nonexclusive

[42]I.R.S. Announcement 92–15, 1992-5 I.R.B. 51 (Jan. 17, 1992).
[43]Prop. Treas. Reg. § 1.513–4.
[44]IRC § 513(i)(1).
[45]IRC § 513(i)(2)(A). Treas. Reg. § 1.513–4(c)(2)(ii).

rights to use an intangible asset of the organization, such as trademarks, patents, and logos.[46]

The regulations say that the use or acknowledgment of the name, logo, or product lines of the sponsor's trade or business in connection with the organization's activities will not be treated as a substantial return benefit.[47] This same regulation defines *use or acknowledgment* as:

- Logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities, or company
- A list of the sponsor's locations, telephone numbers, or Internet address
- Value-neutral descriptions, including displays and visual depictions, of the sponsor's product line or services
- The sponsor's brand or trade names and product or service listings

With respect to the first item, the regulations provide that a logo or slogan will not be regarded as containing qualitative or comparative descriptions if the logo or slogan ''is an established part of the [sponsor's] identity,'' but offer no guidelines for determining how this test might be met.[48] One way would be to look at the length of time that the company has used the logo or slogan and conclude that only those logos or slogans that have been used for a long period of time qualify. Another approach would be to look at the degree and extent to which the company uses the logo or slogan in its marketing activities. Under this latter approach, a logo or slogan that is only a few months old could qualify as an established part of the company's identity if the company has undertaken a major national advertising program using the logo or slogan. But the regulations do not provide any guidance as to how this determination is to be made.

The regulations say that ''advertising'' will be treated as a substantial return benefit for purposes of these rules and define advertising as ''any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product.''[49] The term includes (1) messages containing qualitative or comparative language; (2) price information or other indications of savings or value; (3) an endorsement; or (4) an inducement to purchase, sell, or use a product, service, or facility. With respect to this last item, the fact that, as part of the sponsorship arrangement, the sponsor's products may be displayed or distributed is not considered to be an inducement to purchase or sell and will not affect the qualified sponsorship determination, whether products are given away or sold or whether the display

[46]Treas. Reg. § 1.513–4(c)(2)(ii).
[47]Treas. Reg. § 1.513–4(c)(2)(iv).
[48]*Id*.
[49]Treas. Reg. § 1.513–4(c)(2)(v).

is that of the company or of the organization.[50] When a single message contains both an acknowledgment and advertising, the entire message will be treated as advertising and the payment received for the message will be taxable.[51] Finally, the regulations caution that these provisions apply only when it is the organization that conducts the advertising activity; when a company conducts its own advertising (e.g., by purchasing commercial time during the television broadcast of a university athletic event), the activities of the organization are not converted into advertising.[52]

The regulations also say that the mere existence of a written agreement, regardless of its degree of detail, will not disqualify a payment as a qualified sponsorship payment. It is the terms of the agreement, not its mere existence, that control.[53] Also, the fact that a payment may be contingent on the events taking place will not disqualify a payment; however, payments that are contingent on the degree of public exposure to a message (such as attendance at an athletic event) will cause a payment not to be treated as a qualified sponsorship payment.[54]

The most controversial section of the regulations relates to exclusivity arrangements.[55] These arrangements are divided into two different categories: exclusive sponsor arrangements and exclusive provider arrangements. An exclusive sponsor arrangement is one in which a company sponsors an event and the organization agrees that the company will be the exclusive sponsor. In most cases, the organization states in its publicity that the company is the exclusive sponsor of the event. The IRS says that this type of exclusive arrangement, in and of itself, will not be regarded as a substantial return benefit.[56]

An *exclusive provider arrangement*, however, will generally be regarded as a substantial return benefit.[57] This type of arrangement is defined quite broadly to include ''an arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity.''[58] But the preamble to the regulations provides that where the nature of the goods or services provided by the sponsor necessitates the use of only a single provider (e.g., because of limited space or the requirement for competitive bidding), the organization will not be treated as having entered into an exclusivity contract.[59]

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[50]Treas. Reg. § 1.513–4(c)(2)(iv).
[51]Treas. Reg. § 1.513–4(c)(2)(v).
[52]*Id*.
[53]Treas. Reg. § 1.513–4(e)(1).
[54]Treas. Reg. § 1.513–4(e)(2).
[55]Treas. Reg. § 1.513–4(c)(vi).
[56]Treas. Reg. § 1.513–4(c)(vi)(A).
[57]Treas. Reg. § 1.513–4(c)(vi)(B).
[58]*Id*.
[59]67 Fed. Reg. 20433 (Apr. 25, 2002).

An example in the regulations used to illustrate this rule involves a soft drink manufacturing company that makes a payment to a college's English department, and in exchange, the college (1) names a writing competition after the company and (2) agrees to limit all on-campus soft drink sales to that company's soft drink brand.[60] Here, the benefit that the company receives by having the exclusive right to sell its product to the college is a substantial return benefit. Because the regulations say that only the amount of a payment that exceeds the fair market value of the substantial return benefit will be treated as a qualified sponsorship payment,[61] the burden is placed on the college to prove whether and to what extent the value of the payment received exceeded the value of the ''exclusive provider'' benefit to the soft drink company—obviously a difficult task.

It should be noted that the regulations do not expressly state that payments received in return for an exclusive provider benefit are taxable; rather, they simply say that the exclusive provider benefit will be treated as a ''substantial return benefit'' and therefore the payment cannot escape taxation under section 513(i). The regulations do not go on to conclude that the exclusive provider payment may be taxable under some other theory, but that is certainly the clear implication of the regulations. At the same time, however, the regulations also make it clear that the taxation of a payment received in return for granting a substantial return benefit (including an exclusive provider benefit) will be determined under the other unrelated business income tax rules.[62] The preamble to the final regulations includes examples to illustrate this concept in connection with exclusive provider benefits. The first example involves a university that enters into an exclusive contract with a soft drink company to provide soft drinks on campus. The example says that if the university provides minimal services or activities in connection with this contract, payments under the contract will not be taxable. But if the company is deemed to be the university's agent or if the university conducts substantial promotional or marketing efforts, the income could be taxable as unrelated business income. The second example involves a university that enters into an exclusive contract with a sports drink company to be the university's exclusive provider of sports drinks. If, under the contract, the university agrees to perform various services for the company (e.g., guaranteeing that the coaches will make promotional appearances, assisting the company in marketing the product), the income allocable to these services will likely be unrelated business income.

Thus, it would seem that payments received in return for exclusive provider benefits should be able to escape taxation under the theory that the agreement to allow the sponsor to be the exclusive provider of goods and services is a

[60]Treas. Reg. § 1.513–4(f), Example 6.
[61]Treas. Reg. § 1.513–4(d)(1).
[62]Treas. Reg. § 1.513–4(d)(1)(i).

payment received for intangible property and can be excluded as a royalty, provided that the other royalty exclusion provisions are met.[63]

The IRS illustrates the many corporate sponsorship principles with a series of different examples. These examples are quite helpful in illustrating the different aspects of the new rules.[64]

> **Example 1:** M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgment of the sponsorship. The drinks, refreshments, and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.
>
> **Example 2:** N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which include banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2 percent of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgment of the sponsorship. However, because the fair market value of the dinner exceeds 2 percent of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.
>
> **Example 3:** O coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. O recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament as well as on signs, scoreboards and other printed material. The auto manufacturer receives complimentary admission passes and pro-am playing spots for each tournament that have a combined fair market value in excess of 2 percent of the total payment. Additionally, O displays the latest models of the manufacturer's premier luxury cars at each tournament. O's use of the manufacturer's name and logo and display of cars in the tournament area constitute acknowledgment of the sponsorship. However, the admission passes and pro-am playing spots are a substantial return benefit. Only that portion of the payment, if any, that O can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.
>
> **Example 4:** P conducts an annual college football bowl game. P sells to commercial broadcasters the right to broadcast the bowl game on television and radio. A major corporation agrees to be the exclusive sponsor of the bowl game. The detailed

[63]See § 2.2(d).
[64]Treas. Reg. § 1.513–4(f).

contract between P and the corporation provides that in exchange for a $1 million payment, the name of the bowl game will include the name of the corporation. In addition, the contract provides that the corporation's name and established logo will appear on player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. P also agrees to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes is $6,000, and the fair market value of the program advertising is $10,000. The agreement is contingent upon the game being broadcast on television and radio, but the amount of the payment is not contingent upon the number of people attending the game or the television ratings. The contract provides that television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. P's use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. The exclusive sponsorship arrangement is not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) does not exceed 2 percent of the total payment (2 percent of $1 million is $20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 5: Q organizes an amateur sports team. A major pizza chain gives uniforms to players on Q's team, and also pays some of the team's operational expenses. The uniforms bear the name and established logo of the pizza chain. During the final tournament series, Q distributes free of charge souvenir flags bearing Q's name to employees of the pizza chain who come out to support the team. The flags are valued at less than 2 percent of the combined fair market value of the uniforms and operational expenses paid. Q's use of the name and logo of the pizza chain in connection with the tournament constitutes acknowledgment of the sponsorship. Because the fair market value of the flags does not exceed 2 percent of the total payment, the entire amount of the funding and supplied uniforms are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 6: R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2 percent of the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.

Example 7: S is a noncommercial broadcast station that airs a program funded by a local music store. In exchange for the funding, S broadcasts the following message: ''This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555–1234. This

station is proud to have the Music Shop as a sponsor.'' Because this single broadcast message contains both advertising and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2 percent of the total payment. Thus, the advertising is a substantial return benefit. Unless S establishes that the amount of the payment exceeds the fair market value of the advertising, none of the payment is a qualified sponsorship payment.

Example 8: T, a symphony orchestra, performs a series of concerts. A program guide that contains notes on guest conductors and other information concerning the evening's program is distributed by T at each concert. The Music Shop makes a $1,000 payment to T in support of the concert series. As a supporter of the event, the Music Shop receives complimentary concert tickets with a fair market value of $85, and is recognized in the program guide and on a poster in the lobby of the concert hall. The lobby poster states that, ''The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555–1234.'' The program guide contains the same information and also states, ''Visit the Music Shop today for the finest selection of music CDs and cassette tapes.'' The fair market value of the advertisement in the program guide is $15. T's use of the Music Shop's name, address, and telephone number in the lobby poster constitutes acknowledgment of the sponsorship. However, the combined fair market value of the advertisement in the program guide and complimentary tickets is $100 ($15 + $85), which exceeds 2 percent of the total payment (2 percent of $1,000 is $20). The fair market value of the advertising and complimentary tickets, therefore, constitutes a substantial return benefit and only that portion of the payment, or $900, that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.

Example 9: U, a national charity dedicated to promoting health, organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, U sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to U to fund U's booth at a health fair. U places a sign in the booth displaying the pharmaceutical company's name and slogan, ''Better Research, Better Health,'' which is an established part of the company's identity. In addition, U grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2 percent of the total payment received from the company. U's display of the pharmaceutical company's name and slogan constitutes acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

Example 10: V, a trade association, publishes a monthly scientific magazine for its members containing information about current issues and developments in the field. A textbook publisher makes a large payment to V to have its name displayed on the inside cover of the magazine each month. Because the monthly magazine is a periodical within the meaning of paragraph (b) of this section, the section 513(i) safe harbor does not apply.

Example 11: W, a symphony orchestra, maintains a web site containing pertinent information and its performance schedule. The Music Shop makes a payment to W to fund a concert series, and W posts a list of its sponsors on its web site, including the Music Shop's name and Internet address. W's web site does not promote the Music Shop or advertise its merchandise. The Music Shop's Internet address appears as a hyperlink from W's web site to the Music Shop's web site. W's posting of the Music Shop's name and Internet address on its web site constitutes acknowledgment of the sponsorship. The entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 12: X, a health-based charity, sponsors a yearlong initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's web site. X's web site contains a hyperlink to the pharmaceutical company's web site. On the pharmaceutical company's web site, the statement appears, ''X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition.'' X reviewed the endorsement before it was posted on the pharmaceutical company's web site and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2 percent of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's web site is a qualified sponsorship payment.

The final two examples, which were not included in the proposed regulations, illustrate whether payments received by an organization in return for placing on its web site a hyperlink to the sponsor company's web site will be treated as a tax-free acknowledgment or taxable advertising. In the first example, the organization posts on its web site the name of a corporate sponsor with its Internet address appearing as a hyperlink to the company's web site. The example concludes that the posting of the address will be treated as a tax-free acknowledgment, even though it contains a hyperlink. The second example involves an organization that includes on its web site a hyperlink to a company sponsor's web site on which the organization's endorsement of the sponsor's product appears. In this situation, the regulations conclude that the hyperlink that leads to the endorsement is taxable advertising, because the statute provides that an endorsement cannot qualify under section 513(i).[65]

The IRS also issued an example in the regulations dealing with the ''exploitation of exempt function rules'' under section 512 and how the corporate sponsorship provisions interact with these rules.[66] The IRS said that the ability to offset related activity excess expenses against unrelated activity expenses will be permitted only when the exempt activity and the

[65]For an additional discussion of Website material and the unrelated business income tax, see § 3.22.
[66]Treas. Reg. § 1.512(a)-1(d).

unrelated activity are ''closely connected,'' such that a taxable entity pursuing the same business activity would also normally conduct the exempt activity. This concept is illustrated with the following example:

> P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of $100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and an essay by the curator of M's department of photography. For purposes of this example, assume that none of the $100,000 is a qualified sponsorship payment within the meaning of section 513(i) and section 1.513–4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (i.e., direct advertising costs) total $25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total $110,000. M receives $60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total $500,000.
> The computation of unrelated business taxable income is as follows:
>
> **(A)** Unrelated trade or business (sale of advertising):

Income	$ 100,000	
Directly connected expenses	(25,000)	
Subtotal	75,000	75,000

> **(B)** Exempt function (publication of exhibition catalog):

Income (from catalog sales)	60,000	
Directly connected expenses	(110,000)	
Net exempt function income (loss)	(50,000)	(50,000)
Unrelated business taxable income	25,000	

Expenses related to publication of the exhibition catalog exceed revenues by $50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity. Consequently, the $500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of $25,000.

In this example, the sale of the advertising exploits the exempt activity of publishing editorial material. Because this type of publishing is an activity normally carried on by taxable entities that sell advertising, the net loss relating to the museum's publication of its exhibition catalog may be applied to offset any net unrelated business income from the sale of advertising in the catalog. In contrast, however, expenses related to the cost of the exhibition itself are not directly related to the advertising activity and cannot be used to offset advertising income.

§ 3.5 HOTEL AND RESTAURANT OPERATIONS

Some colleges and universities operate a hotel or a restaurant (or both) on or near campus for the purpose of housing families of students, prospective students, visiting groups or individuals, trustees, guest lecturers, visiting participants in athletic and other events, spectators at those athletic or other events, tourists, and other members of the general public. From an unrelated business income tax perspective, the issue is whether, and to what extent, the net income derived from the hotel and restaurant operations is subject to tax.

At the outset, if the school can demonstrate that the hotel or restaurant is used as an integral part of its educational activities, for example, as a training laboratory for a hotel management or cooking school, a strong argument can be made that the activity is substantially related to the conduct of the school's educational purposes.[67] Absent such a showing, however, it is difficult to convince the IRS that a hotel and restaurant operation conducted by a college or university should be treated as a substantially related activity.[68]

Two IRS General Counsel Memoranda issued in the late 1970s provide an interesting window on what appeared to be a strong disagreement between the IRS Exempt Organizations Division and the chief counsel's office on the hotel/restaurant issue. The controversy began with a proposed revenue ruling drafted by the Division and sent to the chief counsel's office. This proposed revenue ruling involved a college that operated a hotel and restaurant that was open to the general public and charged prices similar to those charged by commercial establishments.[69] The Division proposed to rule that, to the extent that the hotel/restaurant served individuals having a ''demonstrable connection'' to the exempt purposes of the school, the operation of the hotel/restaurant was related. The Division broadly defined the group of persons having such a demonstrable connection, which included students' families and friends,

[67] Gen. Couns. Mem. 36,321(June 29, 1978).

[68] *See*, *however*, Tech. Adv. Mem. 9847002 (Apr. 29, 1998), in which the IRS concluded that income from a motel owned and operated by a tax-exempt hospital was not subject to the unrelated business income tax to the extent that the income was derived from patients or their relatives and friends. Income from the general public, however, was subject to tax.

[69] Gen. Couns. Mem. 37,591 (Aug. 31, 1978).

prospective students and their families, participants in school functions and activities, and persons having business with the school. Those individuals who did not have the requisite demonstrable connection, according to the Division, were tourists, spectators at sporting events, and the general public.

In its initial review of the proposed revenue ruling, the chief counsel's office generally agreed with the Division's recommendations, except that it did not agree with including within the related group those individuals having business with the school. Only where the school was located in a geographically remote area did chief counsel's office believe that these individuals should be included.[70]

About a year later, the chief counsel's office reconsidered the issue and reversed its earlier approval.[71] The situation presented in the second case was described by the chief counsel's office as follows:

> The college is an educational organization described in section 501(c)(3). The college operates a hotel and restaurant which are located adjacent to the school's campus. Both the hotel and restaurant are operated year round and the patronage of the general public is actively solicited through advertising in magazines, brochures and official meeting guides. The prices charged at the facilities are comparable to those charged by commercial establishments in the area. Individuals staying at the hotel include members of the families of students, persons visiting students, prospective students and their families, trustees, invited entertainers, athletes, guest lecturers, participants at school sponsored conferences or events, tourists, spectators at athletic events, and other members of the general public. The hotel and restaurant are not operated for the purpose of providing practical, on-the job training to students as part of their course of instruction.

In its second consideration of the issue, the chief counsel's office said that it saw no substantial causal connection between the operation of the hotel and restaurant and the college's educational activities. Specifically, the IRS attorneys said that

> it is not apparent to us, in the ordinary case, how the provision of food and lodging to members of the families of students, persons visiting students, prospective students and their families, and other participants in school operations and functions, particularly where other commercial facilities are readily available, ''contribute importantly'' to the accomplishment of the school's educational purposes.

Although agreeing that the different groups of individuals identified in the proposed ruling have a demonstrable connection to the educational purposes of the college, the chief counsel's office noted that other commercial facilities were available in the community, and under these circumstances, the nexus between the use of the hotel/restaurant and the school's educational purposes is ''questionable.'' The office said that

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[70] *Id.*

[71] Gen. Couns. Mem. 38,060 (Aug. 22, 1979).

> there is no evidence that the mere proximity of the college-operated facility would, in any clear-cut manner, encourage or facilitate visits by persons who further the college's exempt purposes. Those individuals who participate in and contribute to the educational activities of the college would, no doubt, do so whether or not they are able to stay at a college-operated facility.

The chief counsel's office went on to say that the rental income exclusion did not apply because the school provided maid and other hotel-type services.

Nevertheless, the chief counsel's office did concede that where a school is ''comparatively isolated and lacking in reasonably available food and lodging facilities,'' the provision of lodging and food service to those individuals having a demonstrable connection to the students, faculty, or staff can escape taxation under the ''convenience exception.''[72] In reaching this conclusion, the chief counsel's office recognized that the types of services provided by a hotel/restaurant in a geographically isolated situation are not as directly related to the students, faculty, and staff as other more typical ''convenience'' services (campus laundry and bookstore items); however, the office said that an extension of the normal convenience exception rules was appropriate in order to reach a ''realistic result'' under the facts of the case.

Notwithstanding the fairly strict position that the IRS has taken over the years, a technical advice memorandum issued in 1998 suggests that the IRS may be relaxing this earlier strict interpretation of what type of hotel stays are related.[73] The ruling involved a section 501(c)(3) organization that was organized and operated to support a hospital, and one of its activities involved the operation of a motel located a short distance from the hospital. Without any explanation as to how this situation might be the same as or different from the situation addressed in 1979 by the chief counsel's office, the IRS ruled that the operation of the motel furthered the organization's exempt purposes to the extent that the guests were either patients or relatives or friends of patients. Income derived from members of the general public, however, was subject to tax. Whether this ruling reflects a softening of the IRS position with respect to hotels and motels operated by colleges and universities remains to be seen, but it certainly suggests that if the same facts that were presented to the chief counsel's office in 1979 were presented today, the IRS might reach a different result. In addition, a 2006 private letter ruling dealing with dormitory rentals likewise suggests that the IRS views this issue differently today.[74]

§ 3.6 TRAVEL TOURS

On many occasions, IRS officials have publicly stated that they consider the income derived by colleges, universities, and their related alumni associations

[72] *See* § 2.2(h).
[73] Tech. Adv. Mem. 9847002 (Apr. 29, 1998).
[74] Priv. Ltr. Rul. 200625035 (Mar. 28, 2006). See a discussion of this ruling at § 3.2.

and foundations from the conduct of travel tours as one of the major areas that agents should review during the course of an audit examination. This strong reaction on the part of the IRS to travel tour programs is no doubt based on fundamental tax policy concerns (primarily, the obvious potential for the recreational and social aspects of these tours to outweigh any educational benefits), but is also no doubt driven by the position forcefully expressed by the commercial travel industry that these tours are not educational but constitute direct competition by nonprofit organizations that do not have to pay tax on their travel tour income.

The travel tour issue arises in one of two ways—either as an exemption issue involving an organization that conducts travel tours as its primary or sole activity and is attempting to obtain tax-exempt status, or as an unrelated business income issue involving an existing tax-exempt organization that conducts travel tours as an adjunct to its regular charitable or educational activities. Even though the issue obviously arises for colleges and universities in the latter context, court cases and IRS rulings in the exemption area are helpful in determining whether a particular tour activity should be treated as an unrelated business income activity.[75]

In making an unrelated business income determination with respect to a travel tour program, the first two issues are whether the program constitutes a trade or business and is regularly carried on. Because the ''fragmentation rule'' allows the IRS to carve out the travel tour activity and treat it as a separate trade or business,[76] the first test is usually always met. Although it is possible that a college or university may conduct travel tours with insufficient frequency and continuity as to fail to meet the regularly carried on requirement, it is probably safe to say that most travel tour programs conducted by colleges and universities are properly treated as ''regularly carried on.''

The primary issue is whether the particular travel tour is substantially related to the college or university's exempt educational purposes. The IRS makes this determination on a tour-by-tour basis, looking at the specific facts and circumstances of the particular tour.[77] It is entirely possible, for example, that a college or university could have a travel tour program consisting of 10 different tours during the year, with 6 of them generating unrelated business income and the remaining 4 treated as nontaxable, related activities. There have been a number of IRS rulings and court cases analyzing different types of tour programs, and the best way to understand how to apply the facts and circumstances test is to review how it has been applied in specific cases.

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[75] *See, e.g., International Postgraduate Med. Found. v. Commissioner*, 56 T.C.M. (CCH) 1140 (1989).
[76] *See* § 2.1(a)(ii).
[77] There is a logical inconsistency here that the IRS has never explained. If each tour is analyzed as a separate and individual trade or business, how can it be regularly carried on?

A 1978 ruling involved travel tours sponsored by a university alumni association for the association's members and their families.[78] The association worked with several commercial travel agencies to schedule tours to destinations around the world, mailed out the promotional material, and accepted the reservations. An association employee served as the tour leader and was paid a fee by the travel agencies based on the number of participants in the tour. The tours had no formal educational programs and did not differ in any substantial manner from commercially operated tours. The IRS found, not surprisingly, that the provision of these travel tours was not an inherently educational activity and that the association was furnishing its members with a commercial service not substantially related to its otherwise exempt purposes.

An IRS General Counsel Memorandum (GCM) issued five years later reached the opposite conclusion in another case.[79] That situation involved a membership organization that conducted travel tours to all parts of the world for the purpose of providing participants with exposure to the art, history, science, and culture of the particular area. Before agreeing to conduct a particular tour, the organization reviewed the proposal to determine (1) the relationship to the organization's exempt purposes, (2) the availability of qualified study leaders and lecturers, (3) whether the organization had sufficient contacts in the area to broaden the educational value of the trip, and (4) any connections that might exist between the proposed tour and any of the organization's prior tours or other educational events. The tours were handled by a professional tour operator; they were open to both the general public and the organization's members; participants received advance reading lists and other tour-related materials; the tours were led by professional staff members of the organization with expertise on the tour's subject matter; scholars from other organizations and lecturers from the locations of the tours participated in certain tours; some tours were conducted in conjunction with educational classes offered by the organization; and, in some cases, participants received college-level academic credits.

These two cases represent the extremes on both sides of the substantially related issue—the 1978 ruling involved a purely recreational tour program with virtually no attempt to cloak the tour with any educational attributes, while the educational aspects of the tours described in the later GCM obviously outweighed any recreational aspects.

Most tour programs, however, fall somewhere in between, and this ''gray area'' is nicely illustrated in a 1990 technical advice memorandum,[80] which involved the following three different travel tour programs, only one of which was held to be related to the organization's exempt purposes.

[78]Rev. Rul. 78–43, 1978-1 C.B. 164.
[79]Gen. Couns. Mem. 38,949 (Jan. 6, 1983).
[80]Tech. Adv. Mem. 9027003 (Mar. 21, 1990). *See also* Tech. Adv. Mem. 9702004 (Aug. 29, 1996).

Tour 1: *A 7-day tour, which included planned time for shopping, cultural events, receptions, and arranged meals*. Out of the 7 days, a total of 6 hours was devoted to lectures, while 21 hours were spent touring. Participation in the lectures was not mandatory.

Tour 2: *A 16-day tour, with 7 hours devoted to lectures and 72 hours to touring*. There was a 2-day predeparture lecture series, and the organization provided a reading list to participants. Participation in the lectures was not mandatory.

Tour 3: *A 15-day tour, conducted in cooperation with a local college and advertised as a study tour focusing on a specific topic*. Each topic was the subject of a $2\frac{1}{2}$-day session at the college, following 2 days of trips to sites illustrating the subject matter. Participants received a reading list and course books, and the instructors were college faculty members. Of the 15 days of the tour, $6\frac{1}{2}$ days were spent in lectures, and there were 4 days of field trips at which the faculty members were in attendance.

The IRS determined that Tour 1 and Tour 2 were both unrelated activities, primarily because only 22 percent and 5 percent, respectively, of the total time was devoted to formal lectures. Tour 3, however, was found to be related because it included a number of educational attributes—formal and organized programs with study lists, books supplied in advance, and classroom study with field trips conducted by qualified instructors. Even though Tour 3 included some recreational activities, no time was specifically set aside for shopping or leisure. Of particular importance, a significant part of the program consisted of formal instruction. Of the 15-day tour, about 40 percent was devoted to formal lectures, and the IRS assumed for purposes of this ruling that attendance at these lectures was required.

Based on its analysis of the three tour programs in this ruling, the IRS has indicated in a 1995 training manual that the following factors are of primary importance in determining whether a tour program is sufficiently educational to be considered related to a college or university's exempt purposes:[81]

- *Bona fide educational methodology*. The manner in which the tour is conducted is examined to determine whether there is a deliberate plan to educate the participants. Helpful factors include (1) a formal educational program that includes organized study, reports by participants, lectures, library access, reading lists, and reference materials, (2) mandatory attendance at the classes and in the study aspects of the program, and (3) the administration of examinations and the grading of students.
- *Structure and design of the tour*. Ideally, the tour should include daily lectures and related classroom studies. The absence of this type of

[81] *1995 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 232–235, 19th ed. (1995). *See also 2002 Exempt Organizations Continuing Professional Education Technical Instruction Program* 195, 24th ed. (2001).

educational framework, particularly when coupled with substantial amounts of free time for social and recreational activities, weighs heavily against the IRS's treating the tour as a related activity. The length of the tour is not a controlling factor, although it may be more difficult from a practical standpoint to maintain the requisite level of educational activities for a tour consisting of several weeks. Also irrelevant is whether the tour is limited to a particular group of students or is open to the general public, so long as all participants must participate in the tour's structured study programs. Finally, the fact that the college or university conducts the tour in cooperation with a for-profit travel agency is not determinative; rather, the IRS looks to whether the organization had an educational purpose in choosing a particular tour and the extent of the educational considerations in developing the tour's itinerary.

- *Intensive study of the subject of the tour*. As the IRS made clear in the 1990 ruling, the amount of time spent during the tour is crucial to an educational determination. The more time that is devoted to organized study, preparation of required reports, lectures, and instruction, the greater the chance the IRS will find the tour to be educational. Also helpful are pre- and post-tour classes, and formal classes provided in conjunction with the tour, such as a college or university course.
- *Academic credit*. The fact that a tour participant can earn academic credits at a college or university is a strong factor in favor of an educational finding.
- *Selection of tour for educational value*. A nexus between the educational focus of the tour and the tour's location is a strong factor in favor of treating the tour as educational. The fact that the location could also be visited by using a commercial tour agency is not determinative; what is important is the educational component of the tour itself. The tour's marketing brochures and information should emphasize and provide a detailed description of the educational components of the tour, as opposed to the social and recreational benefits.
- *Certified teachers and tour guides*. The presence of certified teachers and tour guides who have an expertise in the particular field of study is quite helpful in making an educational finding.

In the late 1990s, IRS officials announced in a series of different speeches that the IRS would undertake a sample review of approximately 100 different travel tours conducted by colleges, universities, alumni associations, or similar organizations to see whether the tour was related to the organization's exempt purposes or whether it was primarily recreational. In conjunction with this new audit focus, the IRS also issued proposed regulations in an attempt to

clarify when a travel tour program would be treated as a related ''educational'' activity and when it would be viewed as an unrelated ''recreational'' activity.[82] The preamble to the regulations is interesting in that it summarized prior IRS rulings involving travel tour programs and said that the new regulation was not meant to replace but to ''augment'' these rulings.[83] The preamble also noted that the IRS would rely heavily on a review of an organization's records to determine whether the travel tour should be treated as educational or recreational, and the IRS specifically asked for public comments with respect to the types of records that organizations should be required to maintain in order to establish the travel tour's primary purpose.

In early 2000, the IRS published final regulations relating to travel tours.[84] As in the proposed regulations, the IRS opted to use a facts-and-circumstances test to determine whether a particular travel tour is related or unrelated to the organization's exempt purposes. Also, like the proposed regulations, the final regulations consist primarily of examples that illustrate application of the facts-and-circumstances test in different situations.

In the preamble to the final regulations, the IRS addressed several comments that had been submitted in connection with the proposed regulations, and these statements in the preamble are helpful in understanding the approach the IRS is taking in the travel tour area. First, the IRS says that it added in the final regulations new factors relating to how the tour is developed, promoted, and operated and included new examples to illustrate the relevance of these new factors. In addition, the final regulations clarify that the number of hours spent on any educational travel tour activity is only one factor in determining the relatedness of the tour and is not, in and of itself, determinative. The examples in the final regulations make it clear that the nature of the educational activities, and the practicalities of engaging in such educational activities (for example, by looking at the time of day during which the activity is conducted), must also be taken into account in addition to the number of hours.

The IRS purposefully did not address in the final regulations the issue of whether income from a tour activity can qualify as an exempt royalty when the organization itself does not operate the tour but instead permits the tour operator to use its name and provides the operator with the names of potential customers in return for a fee. In this potential royalty situation, the

[82]Prop. Treas. Reg. § 1.513–7.

[83]These rulings are Rev. Rul. 67–327, 1967-2 C.B. 187 (overseas tours for students and faculty of university treated as unrelated activity similar to the operation of commercial travel agency activity); Rev. Rul. 69-400, 1969-2 C.B. 114 (on-site tours conducted by local scholars and as part of enrollment at foreign university are educational); Rev. Rul. 70-534, 1970-2 C.B. 113 (tour involved significant amounts of mandatory study and treated as educational); Rev. Rul. 77-366, 1977-2 C.B. 192 (ocean cruises for ministers and church members involved some study but permitted extensive social activities and was noneducational in nature); Rev. Rul. 77-430, 1977-2 C.B. 194 (weekend retreats with little free time for recreation served to advance religious purposes and were not recreational); and Rev. Rul. 78-43, 1978-1 C.B. 164.

[84]Treas. Reg. § 1.513–7.

IRS said that ''the question of what constitutes a royalty is beyond the scope of these regulations,'' referring the reader to other IRS regulations and the *Sierra Club* case.[85]

The IRS also included in the final regulations a clear statement that whether the tour is in competition with for-profit tour operators is immaterial in making the relatedness determination. If all of the facts and circumstances suggest that the tour is a related activity, the fact that it may be in competition with for-profit businesses will not change the result; likewise, the fact that there may be no local travel tour competition will not convert an unrelated tour into a related one.

Finally, the IRS noted in the preamble that clear and contemporaneous documentation and record keeping are essential to demonstrate the relatedness of the tour, but did not impose in the final regulations any special travel tour recordkeeping requirements. Instead, organizations must follow the general recordkeeping requirements set forth in the Code[86]; however, examples in the final regulations illustrate how contemporaneous documentation and record keeping that show how an organization develops, promotes, and operates the tour are essential in making the facts and circumstances analysis. As noted earlier, the regulations primarily consist of examples illustrating the application of the facts and circumstances test. These examples are as follows:

> **Example 1:** O, a university alumni association, is exempt from federal income tax under section 501(a) as an educational organization described in section 501(c)(3). As part of its activities, O operates a travel tour program. The program is open to all current members of O and their guests. O works with travel agencies to schedule approximately 10 tours annually to various destinations around the world. Members of O pay $X to the organizing travel agency to participate in a tour. The travel agency pays O a per person fee for each participant. Although the literature advertising the tours encourages O's members to continue their lifelong learning by joining the tours, and a faculty member of O's related university frequently joins the tour as a guest of the alumni association, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited. The travel tours made available to O's members do not contribute importantly to the accomplishment of O's educational purpose. Rather, O's program is designed to generate revenues for O by regularly offering its members travel services. Accordingly, O's tour program is an unrelated trade or business within the meaning of section 513(a).
>
> **Example 2:** N is an organization formed for the purpose of educating individuals about the geography and culture of the United States. It is exempt from federal income tax under section 501(a) as an educational and cultural organization described in section 501(c)(3). N engages in a number of activities to accomplish its purposes, including offering courses and publishing periodicals and books. As one of its activities, N conducts study tours to national parks and other locations within the United States. The study tours are conducted by teachers and other

[85] *See* § 2.2(d) for a discussion of whether a royalty is exempt from the unrelated business income tax.
[86] IRC §§ 6001, 6033.

personnel certified by the Board of Education of the State of P. The tours are directed toward students enrolled in degree programs at educational institutions in P, as reflected in the promotional materials, but are open to all who agree to participate in the required study program. Each tour's study program consists of instruction on subjects related to the location being visited on the tour. During the tour, five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction, and recitation by the students. Each tour group brings along a library of material related to the subject being studied on the tour. Examinations are given at the end of each tour and the P State Board of Education awards academic credit for tour participation. Because the tours offered by N include a substantial amount of required study, lectures, report preparation, and examinations and qualify for academic credit, the tours are substantially related to N's educational purpose. Accordingly, N's tour program is not an unrelated trade or business within the meaning of section 513(a).

Example 3: R is a section 501(c)(4) social welfare organization devoted to advocacy on a particular issue. On a regular basis throughout the year, R organizes travel tours for its members to Washington, D.C. While in Washington, the members follow a schedule according to which they spend substantially all of their time during normal business hours over several days attending meetings with legislators and government officials and receiving briefings on policy developments related to the issue that is R's focus. Members do have some time on their own in the evenings to engage in recreational or social activities of their own choosing. Bringing members to Washington to participate in advocacy on behalf of the organization and learn about developments relating to the organization's principal focus is substantially related to R's social welfare purpose. Therefore, R's operation of the travel tours does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 4: S is a membership organization formed to foster cultural unity and to educate X Americans about X, their country of origin. It is exempt from federal income tax under section 501(a) and is described in section 501(c)(3) as an educational and cultural organization. Membership in S is open to all Americans interested in the X heritage. As part of its activities, S sponsors a program of travel tours to X. The tours are divided into two categories. Category A tours are trips to X that are designed to immerse participants in the X history, culture, and language. The itinerary is designed to have participants spend substantially all of their time while in X receiving instruction on the X language, history, and cultural heritage. Destinations are selected because of their historical or cultural significance or because of instructional resources they offer. Category B tours are also trips to X, but rather than offering scheduled instruction, participants are given the option of taking guided tours of various X locations included in their itinerary. Other than the optional guided tours, Category B tours offer no instruction or curriculum. Destinations of principally recreational interest, rather than historical or cultural interest, are regularly included on Category B tour itineraries. Based on the facts and circumstances, sponsoring Category A tours is an activity substantially related to S's exempt purposes, and does not constitute an unrelated trade or business within the meaning of section 513(a). However, sponsoring Category B tours does not contribute importantly to S's accomplishment of its exempt purposes and, thus, constitutes an unrelated trade or business within the meaning of section 513(a).

Example 5: T is a scientific organization engaged in environmental research. T is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). T is engaged in a long-term study of how agricultural pesticide and fertilizer use affects the populations of various bird species. T collects data at several bases located in an important agricultural region of country U. The minutes of a meeting of T's board of directors state that, after study, the board has determined that nonscientists can reliably perform needed data collection in the field, under supervision of T's biologists. The board minutes reflect that the board approved offering one-week trips to T's bases in U, where participants will assist T's biologists in collecting data for the study. Tour participants collect data during the same hours as T's biologists. Normally, data collection occurs during the early morning and evening hours, although the work schedule varies by season. Each base has rustic accommodations and few amenities, but country U is renowned for its beautiful scenery and abundant wildlife. T promotes the trips in its newsletter and on its Internet site and through various conservation organizations. The promotional materials describe the work schedule and emphasize the valuable contribution made by trip participants to T's research activities. Based on the facts and circumstances, sponsoring trips to T's bases in country U is an activity substantially related to T's exempt purpose, and, thus, does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 6: V is an educational organization devoted to the study of ancient history and cultures and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, V conducts archaeological expeditions around the world, including in the Y region of country Z. In cooperation with the National Museum of Z, V recently presented an exhibit on ancient civilizations of the Y region of Z, including artifacts from the collection of the Z National Museum. V instituted a program of travel tours to V's archaeological sites located in the Y region. The tours were initially proposed by V staff members as a means of educating the public about ongoing field research conducted by V. V engaged a travel agency to handle logistics such as accommodations and transportation arrangements. In preparation for the tours, V developed educational materials relating to each archaeological site to be visited on the tour, describing in detail the layout of the site, the methods used by V's researchers in exploring the site, the discoveries made at the site, and their historical significance. V also arranged special guided tours of its exhibit on the Y region for individuals registered for the travel tours. Two archaeologists from V (both of whom had participated in prior archaeological expeditions in the Y region) accompanied the tours. These experts led guided tours of each site and explained the significance of the sites to tour participants. At several of the sites, tour participants also met with a working team of archaeologists from V and the National Museum of Z, who shared their experiences. V prepared promotional materials describing the educational nature of the tours, including the daily trips to V's archaeological sites and the educational background of the tour leaders, and provided a recommended reading list. The promotional materials do not refer to any particular recreational or sightseeing activities. Based on the facts and circumstances, sponsoring trips to the Y region is an activity substantially related to V's exempt purposes. The scheduled activities, which include tours of archaeological sites led by experts, are part of a coordinated educational program designed to educate tour participants about the

ancient history of the Y region of Z and V's ongoing field research. Therefore, V's tour program does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 7: W is an educational organization devoted to the study of the performing arts and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, W presents public performances of musical and theatrical works. Individuals become members of W by making an annual contribution to W of q dollars. Each year, W offers members an opportunity to travel as a group to one or more major cities in the United States or abroad. In each city, tour participants are provided tickets to attend a public performance of a play, concert, or dance program each evening. W also arranges a sightseeing tour of each city and provides evening receptions for tour participants. W views its tour program as an important means to develop and strengthen bonds between W and its members, and to increase their financial and volunteer support of W. W engaged a travel agency to handle logistics such as accommodations and transportation arrangements. No educational materials are prepared by W or provided to tour participants in connection with the tours. Apart from attendance at the evening cultural events, the tours offer no scheduled instruction, organized study, or group discussion. Although several members of W's administrative staff accompany each tour group, their role is to facilitate member interaction. The staff members have no special expertise in the performing arts and play no educational role in the tours. W prepared promotional materials describing the sightseeing opportunities on the tours and emphasizing the opportunity for members to socialize informally and interact with one another and with W staff members, while pursuing shared interests. Although W's tour program may foster goodwill among W members, it does not contribute importantly to W's educational purposes. W's tour program is primarily social and recreational in nature. The scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program. Therefore, W's tour program is an unrelated trade or business within the meaning of section 513(a).[87]

Based on these examples, it appears that the most significant aspects of a tour are whether credit is given, the presence or absence of lectures or seminars, the percentage of time spent on instruction as compared to recreation, whether written reports are required of participants, and the qualifications of the instructors. Also, one open question is whether, when the IRS says that ''substantially all'' of the tour's activities must relate to the organization's exempt purposes, does it mean 85 percent? If so, what method will the IRS use to quantify the educational versus the recreational activities in making its determination?

Finally, it is interesting, and perhaps instructive, to note that in Example 4 in the previously issued proposed regulations, the IRS included as one of the underlying facts a statement that all of the organization's tours are priced to return a profit to the tax-exempt organization. This statement is missing, however, from Example 4 in the final regulations, which in all other substantive

[87]Treas. Reg. § 1.513–7(b).

respects is virtually identical to the example in the proposed regulations. Thus, it is now unclear whether consciously pricing a tour so that it will return a profit will cause an otherwise related tour to be treated as unrelated.

Although the primary issue faced by a college or university that conducts travel tours involves determining whether the net income is subject to the unrelated business tax, other collateral tax issues can sometimes arise.

(a) Application of the Royalty Exclusion

In some cases, a for-profit travel agency conducts the tour and pays the college or university a fee for the use of its name and mailing lists of students, faculty, staff, and alumni. Whether the payment for use of the name and the mailing list can be excluded from unrelated business income under the royalty exception is closely tied to the extent of services provided by the college or university as part of the arrangement with the travel agency.[88] The greater the extent of the involvement by the institution in the tour, the greater the chance that the IRS will challenge tax-free royalty treatment.

(b) Mandatory Travel Tour ''Contributions''

Some travel tours conducted by tax-exempt organizations advertise that participants can make a ''mandatory contribution'' in connection with the program and that the payment is deductible as a charitable contribution. In one ruling, the IRS said that, as a general matter, ''that sort of solicitation is problematic and the deduction will be disallowed.''[89]

(c) Room and Board Provided to Employees

If a college or university employee functions as a tour guide or instructor and, as part of that employment, receives free room and board during the tour, the value of the room and board is generally excludable from the employee's income under the exclusion for meals and lodging.[90] If, however, the employee's spouse or children also participate in the tour and receive free room and board, the value of their room and board will generally be includable in the employee's income.

§ 3.7 OPERATION OF PARKING LOTS

Notwithstanding the lack of parking space that seems so prevalent on many college and university campuses, a number of schools have excess parking space that they lease to local businesses or members of the general public.

[88] *See* § 2.2(d).
[89] Tech. Adv. Mem. 9027003 (Mar. 21, 1990).
[90] IRC § 119.

For example, a 1987 private letter ruling described a university that owned a parking deck, which was bordered on two sides by the university and on the other two sides by an unrelated entity, and the university rented a portion of the parking deck to the unrelated entity with the resulting income subject to the unrelated business income tax.[91] While these situations are not the norm, they do occur occasionally and, when they do, they raise unrelated business income tax issues.

Parking lot operations figured prominently in the legislative history underlying both the initial passage of the unrelated business income tax legislation in 1950, as well as the expansion by Congress of the unrelated business income activities in 1969. In both instances, the operation of a parking lot was cited as an example of a business activity conducted by tax-exempt organizations that should be subject to the unrelated business income tax. The regulations, reflecting this legislative history, take a strong position in favor of treating parking lot revenue as unrelated business income.[92] Notwithstanding this legislative history, and the strong statement in the regulations, there are clearly situations in which income derived from parking lot operations is not subject to the unrelated business income tax. For example, the IRS takes the position that income derived from providing parking to faculty, staff, and students is nontaxable under the convenience exception,[93] and in IRS audits, agents have determined that the conduct of parking lot operations at a related event, such as parking at intercollegiate athletic events, is likewise a related activity. Along these lines, the IRS has ruled that a hospital's operation of a parking lot for the use of its patients and visitors contributes to the accomplishment of its exempt purposes and is not subject to the unrelated business income tax.[94] At the same time, the IRS, not surprisingly, takes the position that parking provided at an unrelated event (e.g., a commercially promoted rock concert held in the school's auditorium) will likewise be an unrelated activity.[95]

The major issue that arises in those situations in which the college or university leases parking space to a business or members of the general public is whether the parking-related services that the school provides are of a sufficient scope and degree so as to cause the rental income exclusion to be

[91] Priv. Ltr. Rul. 8720005 (Feb. 20, 1987). But see Priv. Ltr. Rul. 200124022 (Mar. 13, 2001), where the IRS ruled that a parking lot operated by a charitable organization was substantially related to the charity's exempt purposes of assisting in the economic development of a downtown area and that the parking income was, therefore, related business income.

[92] Treas. Reg. § 1.512(b)-1(c)(5).

[93] Priv. Ltr. Rul. 199949045 (Sept. 14, 1999).

[94] Rev. Rul. 69–269, 1969-1 C.B. 160. See also Tech. Adv. Mem. 8735004 (May 14, 1987), in which the National Office ruled that the convenience exception did not apply to income received by a museum from the operation of its parking lot during hours that the museum was not open.

[95] *See* Priv. Ltr. Rul. 7852007 (Sept. 13, 1978), in which the IRS ruled that income derived by a school from the public's use of its parking lots for events held at a nearby stadium and auditorium was unrelated business income.

inapplicable.[96] The IRS national office has been somewhat schizophrenic on this question, holding in some rulings that certain services were insufficient to disqualify the rental exclusion, and in others that much the same services caused the rental exclusion to be inapplicable.[97]

The issue was laid to rest, at least as far as the IRS is concerned, in a 1990 GCM.[98] This GCM acknowledged these prior inconsistent rulings and arrived at a new definition of how the IRS should apply the rental income exclusion in the case of those parking lot operations that are not related to the organization's exempt purposes. First, the GCM rejected the argument that, because of the legislative history's mention of parking lot operations as a model unrelated business income activity and the strong language in the regulations, parking lot operations should be treated as a per se unrelated business income activity. The GCM stated that a tax-exempt organization that engages in the actual operation of a parking lot for an unrelated use (for example, providing parking to businesses or the general public) will never qualify for the rental income exclusion because of the strong statement in the regulations that tracks the legislation history underlying the passage of the unrelated business income tax statute. By contrast, if the organization ''net leases'' the parking lot to a third-party parking lot operator, the income derived by the organization can qualify for the rental income exclusion, provided that the organization provides only minimal services as part of the arrangement. If services are provided, the facts and circumstances must be examined to determine whether the services are sufficient to disqualify the application of rental income exclusion.

Finally, if a school is successfully able to argue that one of its exempt purposes is to further the development of the local community,[99] it might be able to treat parking revenue as nontaxable under the authority of a 2001 private letter ruling where the IRS ruled that a parking lot operated by a charitable organization was substantially related to the charity's exempt purposes of assisting in the economic development of a downtown area and that the parking income was, therefore, related income.[100]

§ 3.8 PARTICIPATION IN PARTNERSHIPS

In connection with either its educational or its unrelated income-producing activities, it is not unusual for a college or university to become a partner in

[96] *See* § 2.2(c).

[97] Compare Tech. Adv. Mem. 8904002 (Oct. 24, 1988) and Tech. Adv. Mem. 7852007 (Sept. 13, 1978) (holding parking lot revenues not to qualify as ''rent'') with Tech. Adv. Mem. 8445005 (July 11, 1984) (holding that parking lot revenues can qualify as ''rent''). *See also* Priv. Ltr. Rul. 8342056 (July 19, 1983); Priv. Ltr. Rul. 9301024 (Oct. 15, 1992).

[98] Gen. Couns. Mem. 39,825 (Aug. 17, 1990).

[99] *See* § 3.25.

[100] Priv. Ltr. Rul. 200124022 (Mar. 13, 2001).

a partnership. This could involve a joint venture entered into with another nonprofit educational organization to conduct an educational activity, or it could involve an investment by the school in, for example, a real estate partnership. It could also involve the formation of a limited liability company (LLC). An LLC is a for-profit legal entity that is classified as a partnership for tax purposes but gives the partners the limited liability protection of corporate shareholders.[101]

The Code sets forth special rules that apply when a tax-exempt organization becomes a partner in a partnership.[102] This statute generally requires the organization to include in its unrelated business income its share of the gross income from any activity conducted by the partnership that would not be a related activity if the organization conducted the activity itself. Therefore, if a college enters into a partnership with another organization to provide joint seminar programs, the tuition paid by participants to attend these programs would not be included in the school's unrelated business income because the activity, if conducted by the school itself, would be related.[103] If, however, the activity conducted by the college and the other organization is unrelated to the school's exempt purposes, the income allocable to the school must be included in unrelated business income (whether or not actually distributed), and the school is permitted to take as deductions against the income its share of the partnership's deductions directly attributable to the activity. These same rules regarding partnership participation seem to apply when the tax-exempt organization enters into a partnership with an entity located overseas.[104]

Any income that is included in the organization's unrelated business income under these special partnership rules is still subject to the other unrelated business income modifications. For example, if the partnership received interest income from an activity that would be unrelated if conducted directly by it, the interest income allocable to the exempt organization would be excluded from its unrelated business income under the exclusion for interest. The regulations illustrate the operation of the special partnership rules with an example in which an exempt educational institution is a partner in a partnership that operates a factory and also owns stock in a corporation. The institution must include in its unrelated business income the income derived from the operation of the facility, but not its share of any dividends received by the partnership from the corporation.[105]

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[101] *See* Priv. Ltr. Rul. 9718036 (Feb. 7, 1997), in which the IRS ruled that an IRC § 501(c)(3) organization can form a LLC to conduct its charitable activities.

[102] IRC § 512(c).

[103] Along these same lines, the IRS has ruled in Tech. Adv. Mem. 9739001 (June 1, 1996) that a tax-exempt hospital's share of ordinary income from a limited partnership that provided purchasing services for its limited partner members was not subject to unrelated business income tax because the activities of the partnership were substantially related to the organization's exempt purposes.

[104] Priv. Ltr. Rul. 9839039 (July 1, 1998).

[105] Treas. Reg. § 1.512(c)-1.

An issue that has arisen in this area is whether the partnership rules should apply to an investment by a tax-exempt organization in a limited partnership. The rationale for not applying these rules to limited partnership investments is, because the organization cannot participate in the active management of the partnership's activities, a limited partnership is a totally passive investment. Thus, so the argument goes, a limited partnership distribution is more akin to the payment of a dividend, interest, or other type of passive investment income that is generally excluded from unrelated business income. This argument was firmly rejected by the Tax Court, however, which held that the statute drew no distinction between general and limited partnership interests.[106]

Prior to 1994, stricter rules applied if the organization was a partner in a publicly traded partnership. In these cases, other unrelated business income modifications did not apply, and the organization could be taxed on, for example, its allocable share of the interest or dividend income earned by the publicly traded partnership. These stricter rules for publicly traded partnerships were eliminated as part of the Revenue Reconciliation Act of 1993, effective for partnership years beginning after 1993.[107]

In early 1998, the IRS issued a major ruling setting forth guidelines on the extent to which a tax-exempt organization can enter into a partnership with a for-profit entity.[108] This ruling requires the partnership to be engaged exclusively in section 501(c)(3) activities and also requires that the tax-exempt organization be in control of the partnership to ensure that the partnership will always be operated for such purposes. Failure to meet these requirements can result in loss of the organization's section 501(c)(3) status on the ground that it is operating for the private interest of the for-profit partner and not exclusively for exempt purposes. These rules as they relate to exemption issues are discussed elsewhere in this book,[109] but this ruling also has potential unrelated business income tax ramifications for colleges and universities.

IRS officials have stated in public presentations that where the partnership arrangement with the for-profit entity violates the ''control'' requirements, but the facts are insufficient to support revocation of an organization's section 501(c)(3) status, the IRS will treat the partnership distribution as unrelated business income. It is unclear how the IRS plans to coordinate any such positions with the statutory rules of section 512(c). In other words, if a university enters into a partnership with a for-profit entity to conduct an

[106] *Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner*, 78 T.C. 812, 819 (1982), *aff'd*, 724 F.2d 519 (6th Cir. 1983).

[107] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13145(b), 107 Stat. 416, 443 (1993). For a detailed discussion and analysis of the involvement of tax-exempt organizations in partnerships and joint ventures, see Michael I. Sanders, *Partnerships and Joint Ventures Involving Tax-Exempt Organizations*, 2nd ed. (New York: John Wiley & Sons, 1999).

[108] Rev. Rul. 98–15, 1998-12 I.R.B. 6. The ruling applies equally to joint ventures and limited liability companies where a for-profit entity is involved.

[109] *See* § 9.1.

activity that if conducted by the university itself would be a related activity (e.g., operate a distance-learning program), but the university is not in control of the partnership, will the IRS nevertheless treat any partnership distributions as unrelated business income? If so, it is difficult to understand the theory upon which any such position would be based.

In late 1999, the IRS national office published a training manual for its field agents, in which it set forth an excellent summary and analysis of the IRS position over the years on whether participation by a tax-exempt organization in a partnership results in unrelated business income, including a detailed analysis of several court cases raising this issue.[110]

Finally, colleges and universities should keep in mind that all of the previously described special rules that pertain to participation in partnerships also will apply to those transactions (e.g., license, lease, employment contract) that are not denominated by the parties as a partnership, but which the IRS recharacterizes as such.[111]

§ 3.9 PROFESSIONAL ENTERTAINMENT EVENTS

Entertainment events conducted by a college or university in which the school's own students put on the event (e.g., a play, concert recital, or ballet) are treated as related activities, even if a substantial portion of the audience and revenue comes from the general public. The IRS views these events as an integral part of the school's educational activities. The fact that they may involve admission fees, advertisements in the community, and concession sales, and may even earn a profit does not detract from their essentially educational nature.[112]

The types of college- and university-sponsored entertainment events that raise a problem with the IRS are those involving professional entertainers. These events can run the gamut from rock concerts and tractor pulls to string quartets and poetry readings; however, the distinguishing characteristic in the IRS's view is not the ''cultural'' nature of the event (or lack thereof) but rather whether it is a professional performance involving paid entertainers. The IRS does not seem to accept the broad position that by sponsoring professional entertainment events on campus the school promotes the education-related function of providing its students with entertainment and recreational outlets. Rather, the IRS position is that these professional entertainment activities are

[110]*2000 Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000*, 22nd ed., at 163–175 (1999).

[111]See § 2.2(d). *See also* Field Service Advice 200144005 (Nov. 2, 2001) in which an IRS field agent asked the IRS Chief Counsel's office to determine whether an exclusive distributorship agreement should be recharacterized as a partnership. The IRS attorneys determined that they needed more information to make this determination, but the Field Service Advice provides some insight on how this determination is made.

[112]Treas. Reg. § 1.513–1(d)(4), Example 1.

related to a school's educational purposes only if they are ''operated primarily as an integral part of the educational program of the university, but [they are] unrelated if operated in substantially the same manner as a commercial operation.''[113]

The approach that the IRS takes in distinguishing related professional entertainment events from unrelated ones is set forth in a 1991 technical advice memorandum and 1991 GCM.[114] The situation involved a state university that owned and operated a multipurpose auditorium on campus at which a number of school-related activities were conducted, such as class registration, intercollegiate athletic events, and commencement exercises. During the course of the academic year, the university also conducted 45 different ''ticket events'' in the facility, including rock concerts, performances by contemporary professional entertainers, closed-circuit professional boxing matches, and professional basketball games. The issue before the IRS was whether these professional entertainment events constituted unrelated business income.

In its analysis, the IRS first reviewed the different factors that it and the courts have taken into account in determining whether certain activities conducted by a tax-exempt organization are conducted with a nonexempt purpose. These ''nonexempt'' factors included the following:

- The fees charged to the general public are comparable to those charged by commercial facilities.
- Only those individuals who purchase the goods or services benefit from the activity, and the benefits they receive are in direct proportion to the fees charged.
- The organization furnishes the facilities and conducts the activity with its own employees, who perform substantial services in conducting the event.
- The organization's reputation as an educational institution is secondary, if a factor at all, in attracting attendees.
- The predominant motivation underlying the organization's conduct of the activities is revenue maximization.

Applying these factors to the facts of the specific case, the IRS found the following facts of primary importance in concluding that the ''ticket events'' were unrelated:

- The auditorium facility was managed by a director with more than 30 years of experience in promoting commercial events.

[113]Tech. Adv. Mem. 9147008 (Aug. 19, 1991).
[114]*Id.;* Gen. Couns. Mem. 39,863 (Nov. 26, 1991).

- While the university had a fine arts department, the department had no involvement in the selection of the professional events or in their presentation.
- During the year in question, more than 25 percent of the tickets were sold off campus.
- As a general rule, the university did not discriminate between students and the general public in its ticket pricing, and students received discounts at only three events.
- The university did not maintain records identifying ticket purchasers or classifying them as either students or members of the general public.
- The events were generally ''indistinguishable by price or type of performance from similar events provided by commercial promoters.''
- The entertainers received essentially the same remuneration as they would have received at a for-profit entertainment facility.
- The university negotiated with the performers for the amount of their compensation.
- The university and the entertainer jointly negotiated the ticket prices.
- Tickets were sold through a commercial ticket service.
- The university included in its standard contract a noncompete clause, forbidding artists from performing within a 75-mile radius of the university 60 days before or after the performance.

The university argued that the IRS would not have reached the same result had the events consisted of ballet, opera, or classical music, and that the IRS was improperly discriminating against contemporary entertainers. The IRS disagreed, stating:

> However, the failure to meet the ''substantially related test'' in this instance is based on the manner in which the activity is conducted and not necessarily on the nature of the entertainment itself. Thus, it is unnecessary to reach the question of whether events performed by contemporary musical artists contribute importantly to [the university's] educational purposes. Rather, the focus is on the manner in which [the university] decides to secure performers and the business considerations that [the university] uses as the foundations for its decisions. In short, the only apparent criterion utilized by [the university] in its sponsorship of professional entertainment events is profitability. The emphasis on revenue maximization to the exclusion of other considerations indicates that the trade or business is not operated as an integral part of [the university's] educational programs and that the activity, therefore, fails the substantially related test.[115]

Although the IRS set forth the specific factors that led it to conclude that the events were unrelated, there is no clue as to whether a different result would

[115]Gen. Couns. Mem. 39,863 (Nov. 26, 1991).

be reached if some of the factors were not present. For example, if there were no noncompete clause and the facility was not operated by the business office, would the IRS have reached a different result? Also unresolved is whether the nature of the activity itself might make a difference. It is interesting, and perhaps important, to note that the IRS states that its related determination is ''not necessarily'' based on the nature of the event and that it reserves this issue to a later date.

Professional entertainment events also raise an interesting application of the fragmentation rule.[116] The IRS has taken the position in several audits of colleges and universities that each individual entertainment event should be examined to determine whether it is a trade or business, regularly carried on, and unrelated to the school's exempt purposes.[117] This does not seem to be the approach taken in the 1991 technical advice memorandum where all 45 events were reviewed and analyzed as a group. Nevertheless, given the broad scope of the fragmentation rule, it is certainly an arguable position and, while such an approach might be beneficial to the college or university in some situations, more often than not, it works to the school's disadvantage. This is because some events are not profitable, and the IRS refuses to view the unprofitable events as a trade or business because they lack a profit motive, thereby denying the school the ability to use these losses to offset the income from the profitable events.[118]

Finally, the form of the arrangement between the school and the concert manager can be important. In a 1997 technical advice memorandum, the IRS refused to apply the royalty income exclusion when an organization contracted with a manager to conduct the concerts and paid the organization a fee based on the net profits. The IRS ruled that the manager acted as the organization's agent, and the organization's involvement with the concert activities was more than passive.[119]

§ 3.10 USE OF RECREATIONAL FACILITIES BY THE GENERAL PUBLIC

Most colleges and universities have athletic facilities (tennis courts, gymnasiums) that are used in physical education programs and intercollegiate athletic events. Obviously, such use is related to the school's exempt educational purpose. Often, the school allows the general public to use these facilities for a fee, and usually also allows students, faculty, staff, and alumni to use these facilities for recreational purposes, either for free or at a reduced or

[116] *See* § 2.1(a)(ii).

[117] Although it is difficult to see how the regularly carried on test can be met if each event is analyzed as a separate trade or business.

[118] *See* § 2.6(e)(i).

[119] Tech. Adv. Mem. 9721001 (Oct. 17, 1997).

discounted fee.[120] Just as use of these facilities by the students for recreational purposes is a related use, use by faculty and staff is also related; however, if the faculty and staff are permitted to pay a fee substantially less than that offered to the general public, the value of the discount provided to the employee may be treated as additional compensation by the IRS.[121]

The unrelated business income issue arises in connection with charging alumni or members of the general public a fee to use the facilities. While there is an IRS ruling holding that alumni use may be a related activity because giving such individuals a discount is ''an inducement for them to provide continuing support to [the university],''[122] the current position of the IRS is clear that alumni will be treated as members of the general public for these purposes.[123]

The basic position of the IRS in this area is perhaps best illustrated by a 1978 ruling involving a school that operated a ski facility located several miles from the campus.[124] The facility was used in connection with the school's physical education program and, in addition, was used to a substantial extent for purely recreational purposes by both students and members of the general public. Except for the use of the facility as part of the school's physical education program, the operation of the facility was substantially similar to that of commercial ski facilities, and persons using the facility were required to pay fees comparable to those charged by nearby commercial ski resorts.

The IRS ruled that the recreational use of the ski facility by the students was substantially related to the school's exempt educational purposes and did not constitute an unrelated business income activity. By contrast, the IRS concluded that providing recreational facilities to the general public was not related to the school's exempt purposes and that the income from those rentals was subject to the unrelated business income tax. The IRS reached identical conclusions in rulings involving the operation of a health club for the general public where the organization charged fees comparable to commercial establishments,[125] the sale by a university of memberships in a recreational

[120]For a discussion of the business aspects of operating a college or university golf course, see Julie L. Nicklin, ''Financing the Green on the Fairway,'' *Chronicle of Higher Education*, July 5, 1996, at A37.

[121]The fact that the activity may be related does not eliminate potential income recognition problems to the faculty and staff. *See* Chap. 5.

[122]Priv. Ltr. Rul. 8340102 (July 11, 1983).

[123]Tech. Adv. Mem. 9645004 (July 17, 1996). *See also* Priv. Ltr. Rul. 9720035 (Feb. 19, 1997), in which the IRS ruled that income derived by a state university from the use of its golf course by alumni, spouses, children, and guests of students, faculty, and staff is unrelated business income. *See also* the discussion of alumni in § 2.2(h).

[124]Rev. Rul. 78–98, 1978-1 C.B. 167.

[125]Rev. Rul. 79–360, 1979-2 C.B. 236.

facility to the general public and alumni,[126] and the rental to members of the general public of ice time in the school's hockey rink.[127]

There is some question, however, as to whether the operation of a health club/fitness center will be regarded as a related activity. Because of prior inconsistent rulings in this area, in 1999 the IRS issued a training manual for its agents focusing on the health club/fitness center area.[128] Another reason for the publication of this guidance was what the IRS called the ''increasing commercial character of fitness centers'' operated by colleges, universities, and other tax-exempt organizations, and the fact that in 1999 Congress requested that the IRS ''review the standards that it applies to fitness activities conducted by educational and healthcare organizations.''[129]

The IRS began its discussion of the health club/fitness center area by briefly describing cases and revenue rulings over the past several decades, which concluded that providing recreational facilities can be a charitable activity, provided the facilities are available to the general public.[130] It then discussed the only published IRS revenue ruling focusing on health clubs and unrelated business income.[131] This ruling involved a health club that was organized for the purpose of providing for the welfare of young people, but was operated with a ''two-tier'' fee structure, with one fee level for the general public and a second, higher fee level comparable to commercial health clubs in the area. In the guidelines, the IRS cited this ruling as authority for a general rule to follow in determining whether the operation of a health club is an exempt activity. The first step in the analysis is to determine whether the operation of the club furthers the organization's exempt purposes; if it does, the analysis then moves to the fee structure. If the fee structure is so high as to ''prevent the general community from obtaining the benefits [of the club], the activity cannot be deemed charitable and related to the exempt purposes of the organization.''

The IRS next discussed the criteria that can be used to determine whether the fee structure is at a level that is within the reach of the community as a whole. As an example, it described the data submitted by an organization involved

[126]Tech. Adv. Mem. 8020010 (n.d.).

[127]Gen. Couns. Mem. 38,339 (Apr. 8, 1980); Priv. Ltr. Rul. 7921005 (Jan. 24, 1979).

[128]*2000 Exempt Organizations Continuing Professional Education Technical Instruction Program*, 1–21, 22 ed. (1999). Two years after the publication of this article, the IRS included in another training manual several more cases that illustrate the principles in the original article. *2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002*, 24th ed., at 163 (2001).

[129]House Conference Report, Treasury and General Government Appropriations Bill for Fiscal Year 1999 at H11512 (Oct. 19, 1998).

[130]*Peters v. Commissioner*, 21 T.C. 55 (1953); *Estate of Thayer v. Commissioner*, 24 T.C. 384 (1995); *People's Educ. Camp Soc'y, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir. 1963); *Eden Hall Farm v. United States*, 389 F.Supp. 858 (W.D. Pa. 1975); *Schoger Found. v. Commissioner*, 76 T.C. 380 (1981); *Columbia Park & Recreation Ass'n v. Commissioner*, 88 T.C. 1 (1987); Rev. Rul. 59–310, 1959-2 C.B. 146; Rev. Rul. 67-325, 1967-2 C.B. 113.

[131]Rev. Rul. 79–360, 1979-2 C.B. 236.

in a 1985 technical advice memorandum.[132] This organization demonstrated that its fee structure was within the financial range of the local community by comparing the average annual incomes of the club members with U.S. Census income data for members of the community, showing what the average American family spent on discretionary recreational activities for a year, and showing that its dues were within that range. The IRS noted in the training manual, with seeming disapproval of its own 1985 ruling, that the ruling did not address the fact that the fees were comparable to those of commercial clubs in the area and that the organization had no special provisions for needy or low-income persons.

The training manual then discussed the concept of treating health clubs and fitness centers as exempt under the theory that they are either promoting health or are part of an overall educational program. With respect to the former, it said that these clubs are normally treated as recreational in nature and not health promoting. With respect to the educational character of the clubs, the IRS said that this will normally be true only when a club's activities are limited to educating youth in athletic activities. It then discussed the 1980 ruling involving a university's recreational facility that was open to students, faculty, staff, alumni, and the general public, and noted with approval the conclusion in that ruling that use of the facility by the students, faculty, and staff was related but that use by alumni and members of the general public was not.[133]

One final point that the IRS makes in this training manual is interesting with respect not only to health clubs but also to all potentially unrelated activities conducted by colleges and universities. The IRS says that whether the health club is in competition with a commercial counterpart is immaterial in making the unrelated business income determination. It is ''the purposes served by the [health club's] activities, not the possible impact of those activities on commercial competitors or providing an otherwise unavailable service'' that determines whether the health club activity is related or unrelated.

The IRS has issued other health club/fitness center rulings subsequent to the publication of the training manual. In a 2001 ruling, the IRS said that a hospital's operation of a fitness center is a related activity because it furthers the organization's exempt purposes of serving the health care needs of the community.[134] The members of the fitness center consisted of the general public, the hospital's employees, and former cardiac rehabilitation patients, all of whom pay a fee to join. The IRS ruled that the operation of the fitness center was an exempt activity and that the fact that members of the general public can join does not change this result because the fees are set at an amount that permits an ''economic cross-section'' of the community to join. In addition,

[132]Tech. Adv. Mem. 8505002 (Aug. 5, 1984).
[133]Tech. Adv. Mem. 8020010 (n.d.).
[134]Priv. Ltr. Rul. 200203070 (Oct. 22, 2001).

the IRS ruled that rental income received from leasing space to a chiropractor and a physical therapist was not taxable as debt-financed income because the leasing activity was also related to the hospital's exempt purposes. Again, it may be that the theory and rationale of this ruling could be applied in the college and university area, at least where a school sees benefiting the local community as one of its exempt purposes.

In another ruling involving a fitness center, the IRS said that a center used by the general public can further a charitable purpose if it is available to a significant segment of the general public and charges fees that are affordable to the community it serves.[135] The IRS determined that the fitness center in question (which was operated by a hospital) furthered charitable purposes because it had a scholarship program for low-income community residents, the indoor pool was free for local students, and it offered special programs for senior citizens and low- or no-cost health screenings for the community. In addition, it charged fees that were affordable by a cross-section of the local community.

§ 3.11 SUMMER SPORTS CAMPS

Many colleges and universities conduct basketball, tennis, or other sports camps, usually during the summer months. Sometimes the camp is conducted by the college or university itself using its own facilities and employees. In other instances, the school leases its facilities to a third party (often a coach who is employed by the school or the coach's wholly owned corporation). Under either scenario, the issue is whether the income derived by the college or university from the operation of the summer camp is subject to the unrelated business income tax.

In 1980, the IRS issued a ruling that addressed both types of summer sports camp operations.[136] Under one situation described in the ruling, a school used its tennis facilities (consisting of tennis courts and dressing rooms) for 10 weeks during the summer to conduct a tennis club that the general public was invited to attend for a fee. Two school employees operated the summer tennis club, collecting fees and scheduling court time. In the second situation, the facts were the same, except the school made its facilities available to an unrelated individual for a fixed fee that was not dependent on the income or profit from the individual's operation of the club. The individual, together with two employees whom he hired, operated the club.

The IRS ruled that the first situation resulted in unrelated business income, finding that ''the school furnishes more than just its facilities'' and ''operates the tennis club through its own employees, who perform substantial services

[135]Priv. Ltr. Rul. 200444030 (Aug. 5, 2004).
[136]Rev. Rul. 80–297, 1980-2 C.B. 196.

for the participants in the tennis club.'' In the second situation, the IRS ruled that the activity was an unrelated trade or business but the income was exempt under the rental income exclusion because (1) the rental income was not dependent, in whole or in part, on the income or profit from the operation of the club; and (2) the school did not provide any services to the third-party individual.[137]

That is not to say that a summer camp will always be treated as an unrelated business income activity. If the camp is conducted as an educational or charitable activity, it will be treated as related. For example, in one ruling, the IRS concluded that a summer sports camp operated by a university for disadvantaged youths was related to the university's exempt purposes.[138] The summer camp offered lessons and instruction in various sports such as tennis, swimming, and basketball.

In another ruling, the IRS found that the operation by a college of a summer hockey camp was a related activity because it was conducted as ''an integral part of the educational program of the college.''[139] The summer hockey camp was conducted directly by the college and provided athletic instruction for children up to high school age. The same college, however, also permitted a corporation that was wholly owned by the college's nationally recognized athletic coach to conduct a summer sports camp using the college's athletic facilities. The college intentionally billed the coach's corporation for less than the costs of operating the camp. The school's stated reason for underbilling the corporation was to provide the coach with additional compensation which the school felt was necessary to make his compensation competitive with that commanded by other coaches of the same national reputation. The IRS ruled that the income derived by the college from the operation of the summer camp was unrelated to the school's exempt purposes because the camp ''was not part of the educational program offered by the school.'' The IRS also ruled, however, that the arrangement between the college and the coach's corporation did not result in private inurement because the underbilling was part of the coach's compensation and the total amount of compensation paid by the college to the coach was reasonable.[140]

§ 3.12 PUBLISHING ACTIVITIES

Many college and universities publish and sell books, journals, and other similar publications as part of their overall educational activities. Because publishing is also a commercial activity that is conducted on a for-profit basis in the business world, there is an issue as to whether the publication and sale

[137] *See* § 2.2(c).
[138] Tech. Adv. Mem. 8020010 (n.d.).
[139] Tech. Adv. Mem. 8151005 (n.d.).
[140] *See* § 9.1(b).

of these items by a college or university should be classified as an unrelated trade or business.

The IRS uses a four-part test to determine whether an organization's publication activities are educational. This test is met if all the facts and circumstances surrounding the publication activity demonstrate that (1) the content of the publication is educational in nature, (2) the preparation of the materials follows methods generally thought to be educational in character, (3) the distribution of the material is necessary or valuable in achieving the organization's educational purposes, and (4) the manner is which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.[141]

Whether publication activities are sufficiently educational to constitute a substantially related business activity usually arises in those situations where publication is the organization's sole or primary activity, and the issue is whether the organization is entitled to tax-exempt status under section 501(c)(3).[142] The issue of publishing as unrelated business income activity hardly ever arises in the college and university context, presumably because most schools clearly conduct their publication activities in a manner that meets the IRS's four-part test. For example, in a 1979 ruling, the IRS held that the publication and sale by a university of foreign language books and a scholarly magazine were both substantially related to the school's exempt purposes using the four-part test described above.[143] One year later, the IRS issued a similar ruling holding that the publication by a university's business administration department of a bimonthly journal consisting of scholarly business articles was likewise a substantially related activity.[144] In so holding, the IRS was influenced by the fact that the content was scholarly and educational; the journal was controlled by an editorial board composed entirely of faculty members; contributing authors were only paid nominal fees; faculty members assisted in the publication as part of their teaching duties; and the readership of the journal was composed primarily of persons with an educational background in business administration. This describes most of the books, journals, and other publications typically published and sold by colleges and universities, which is why publishing rarely raises unrelated business income tax concerns.

But this lenient approach by the IRS may be changing. In a 1996 technical advice memorandum, the IRS ruled that a Christian school that, in addition to providing preschool through college educational instruction, published and sold textbooks was subject to unrelated business income tax on the

[141]Rev. Rul. 67–4, 1967-1 C.B. 121.
[142]*See, e.g., Scripture Press Found. v. United States*, 285 F.2d 800 (Ct. Cl. 1961); *Fides Publishers Ass'n v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967).
[143]Priv. Ltr. Rul. 7902019 (Sept. 29, 1979).
[144]Priv. Ltr. Rul. 8035007 (n.d.).

income from the textbook sales activities.[145] The facts of this ruling, however, are distinguishable from most college and university situations because the school's publishing income amounted to more than 50 percent of its total receipts.

In addition, the IRS has suggested in a 1998 training manual that a university press may generate unrelated business income (or may be disqualified for tax-exempt status under section 501(c)(3) if separately incorporated) if it publishes a large number of different books each year, has more than a nominal per-book press run, and pays normal commercial royalties to authors.[146] This training manual sets forth a case study in which an author enters into a publishing contract with a university press, which is not part of its affiliated university but rather is a separate legal entity with its own section 501(c)(3) status. Under the facts of this case, the university press obtained the exclusive right to produce and distribute up to 25,000 hardcover copies of the book for a specified period of time; agreed to pay the author a 15 percent royalty plus an advance royalty; obtained an option to publish another 25,000 copies; and received a right of first refusal to purchase the copyright to the book if and when the author decided to sell it. The IRS concluded that this university press is ''not acting like a typical university press'' because, according to the IRS, a university press that is entitled to tax-exempt status typically publishes three to four books a year; has a per-book press run of about 500 books; pays a royalty of only about 5 percent; and does not pay authors advance royalties. Therefore, the IRS may argue that those university presses that fall outside these guidelines should be subject to unrelated business income tax, and if separately organized, are not entitled to section 501(c)(3) status.

§ 3.13 AFFINITY CREDIT CARDS

So-called ''affinity credit card'' agreements entered into with commercial banks are increasingly popular, both as a fund-raising device for colleges and universities and as new business ventures for the banks offering credit card services. Under the typical affinity credit card arrangement, the institution grants to the bank the right to market the bank's credit card using the institution's name and logo. The institution also provides the bank with one or more of its mailing lists of individuals who have a close relationship with or a strong interest in the institution. In the marketing of the credit card, the bank emphasizes this close relationship (or ''affinity''), stating that the

[145]Tech. Adv. Mem. 9636001(Sept. 6, 1996). See also Andre Schiffer, ''Payback Time: University Presses as Profit Centers,'' *Chronicle of Higher Education*, June 18, 1999, at B4; Liz McMillen, ''University Presses See Opportunities in Shakeup in the Publishing World,'' *Chronicle of Higher Education*, June 13, 1997, at A15; Marj Charlier, ''Seeking Profits, College Presses Publish Novels,'' *Wall Street Journal*, Sept. 20, 1994, at B6.

[146]*1999 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 21–54 (21st ed. 1998).

college or university will derive financial benefits when the individual uses the card.

The leading case in the affinity credit card area involved an affinity credit card agreement between a bank and the Sierra Club,[147] and the terms of this agreement are typical of the type of business relationships normally established. In that case, the Sierra Club entered into an agreement with a bank credit card company for marketing of credit cards to its members. Under the agreement, the Sierra Club agreed to cooperate with the bank card company in its solicitation of members to utilize credit cards bearing the Sierra Club's name and logo. All the costs of materials used in the solicitation programs were borne by the bank card company, but the Club retained the right to approve of the content of the programs.

A percentage of the fee paid by a member for each use of the card was collected by the bank card company, and a portion of that fee was passed on to the Sierra Club. The fee paid to the Sierra Club was designated as a ''royalty.'' Under the contract, the Sierra Club's duties included selection of the card-issuing bank, approval of any use of its name and logo on promotional materials, and choosing whether to pay certain production and mailing costs associated with the marketing of the card. Although a donor mailing list was provided to the bank card company to facilitate the marketing of the cards to members, the Sierra Club was not required to do so under the agreement.

The issue raised in affinity credit card situations is the same as in any case in which an institution permits a commercial enterprise to use its name, logo, and mailing list to market a product or service and, in return, receives royalty payments.[148] In the Sierra Club's case, the IRS argued that the royalty paid to the Sierra Club was taxable on several different grounds. First, the IRS said that the royalty exclusion is only applicable to passive royalty income and, because the Sierra Club was actively involved in the affinity credit card program, its income was active and therefore taxable. Alternatively, the IRS argued that the arrangement was not that of a licensor-licensee involving a royalty payment, but rather constituted a joint venture between the Sierra Club and the bank, with the income received by the Sierra Club representing a distribution of the joint venture's profits. And, if the Tax Court refused to accept joint venture characterization of the arrangement, the IRS offered yet another alternative—the Sierra Club was in the credit card business itself, with a bank acting as an agent in assisting the Sierra Club to earn sole proprietorship income.

The Tax Court rejected all these theories and held that the agreement created a true licensor-licensee relationship because it found that what the

[147] *Sierra Club, Inc. v. Commissioner*, 103 T.C 307 (1994), *rev'd and remanded*, 86 F.3d 1526 (9th Cir. 1996).
[148] *See* § 2.2(d).

Club gave the bank in return for the payments was the right to use its intangible property, namely, its name, logo, and mailing lists. Therefore, the Tax Court held the payment was a royalty and was excludable under the royalty exclusion provision.[149] The IRS disagreed with this decision and appealed it to the Ninth Circuit Court of Appeals. The Ninth Circuit reversed and remanded the case to the Tax Court to determine whether the payments instead represented compensation for services rendered.

In considering the case upon remand from the Ninth Circuit, the Tax Court addressed the government's argument that the Sierra Club was compensated through the ''royalty'' payment for performing the following services:

- Controlling the marketing plan
- Offering the affinity credit card as a member service
- Placing advertisements for the affinity credit card in its magazines and local publications
- Allowing solicitations to be made using its nonprofit mail permit
- Actively endorsing and sponsoring the acquisition of the affinity credit card through brochures and letters from its officers
- Guaranteeing refunds of the annual fee if the bank imposed such a charge
- Attempting to persuade the bank to relax its credit tolerances so that additional affinity credit cards could be issued and higher profits realized[150]

The Court rejected each of these arguments, finding that none of the payments received by the Sierra Club was in return for services rendered and holding that all amounts received by the Club were royalties exempt from the unrelated business income tax. The IRS defeat was swiftly followed by Ninth Circuit decisions in two additional cases in which that court likewise rejected the IRS position.[151] As a result of these losses, Marcus Owens, director of the IRS Exempt Organizations Division, publicly stated that the IRS will not appeal the *Sierra Club* case and will abandon the various legal positions that it had advanced to find affinity credit card income taxable. Instead, he said that the IRS will follow a ''services'' approach under which IRS agents will attempt to determine whether the tax-exempt organization performed any services in

[149] *Sierra Club, Inc. v. Commissioner*, 103 T.C. at 344. The Tax Court reached the same conclusion in three subsequent cases, *Oregon State University Alumni Ass'n, Inc. v. Commissioner*, 71 T.C.M. (CCH) 1935 (1996), Alumni Ass'n of the University of Oregon, Inc. v. Commissioner, 71T.C.M. (CCH) 2093 (1996), and *Mississippi State Alumni Ass'n v. Commissioner*, T.C. Memo 1997–397 (Aug. 28, 1997).

[150] *Sierra Club v. Commissioner*, T.C. Memo 1999–86, 77 T.C.M. (CCH) 1569 (1999).

[151] *Oregon State Univ. Alumni Ass'n, Inc. v. Commissioner; Alumni Ass'n of University of Oregon, Inc. v. Commissioner*, 193 F.3d 1098 (9th Cir. 1999).

connection with the credit card activity.[152] If so, the IRS will allocate some or all of the royalties received to the value of the services rendered. Any amount so allocated would be treated as unrelated business income, but the remainder would be treated as an exempt royalty.

Notwithstanding the Tax Court's and Ninth Circuit's rejection of many of the positions asserted by the IRS, there remain some potential pitfalls for colleges and universities that enter into these arrangements with banks. Even though the courts have decisively rejected the IRS's joint venture and agency positions, the Tax Court certainly implied in its decision that either of these theories could have some validity under a different set of facts. To avoid such a result, colleges and universities should take care in structuring any affinity credit card arrangements to avoid or minimize any services (e.g., preparing labels, handling correspondence and telephone inquiries from customers, assisting in advertising and promotion) that it might perform under the agreement. Also, to the extent possible, the agreement should limit the institution's control over the credit card activity, and any rights retained by the institution should be limited to those activities designed to protect the institution's name and goodwill, such as reviewing marketing material for matters of good taste and ensuring the quality of the product and services being provided.[153]

In addition to tax considerations, the affinity credit card arrangements that colleges and universities enter into with banks also raise potential issues with the U.S. Postal Service.

Nonprofit organizations are permitted to mail letters and other material using specially reduced nonprofit standard mail rates. If, however, the mailing is used to promote a third party's business activities, the mailing cannot be made at the reduced rates but instead must be made at normal postage rates. Schools should carefully review the rules regarding mailings by nonprofit organizations where the mailing contains something other than its own matter, including information relating to credit cards, insurance policies, and travel opportunities.[154]

In 1997, the Postal Service issued a ruling that describes the extent to which a college, university, or other nonprofit organization that is advising its members, alumni, or others about an affinity credit card arrangement can do

[152]This new position was confirmed in a December 16, 1999, memorandum from Jay Rotz, a senior official at the time in the IRS Exempt Organizations Division, to field personnel instructing them to stop litigating affinity credit card cases because of the recent losses in the courts. It is significant to note, however, that the memorandum does not retreat from the IRS's substantive position; rather, it takes a more practical position that future litigation is simply not worth the effort because of the number of court defeats. For a history of the affinity credit card issue as told from the IRS perspective, see *2002 Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002*, 24th ed., at 200, (2001).

[153]Priv. Ltr. Rul. 7841001 (n.d.).

[154]U.S. Postal Service Domestic Mail Manual, § 703.

so using the reduced nonprofit mailing rates.[155] The ruling makes it clear that no promotional material concerning the affinity credit card can be included in such a mailing (for example, ''benefits include a 13.5 percent interest rate and no annual fee for six months'') as well as no language describing either the card (''low-cost'') or the issuer (''well-known national corporation''). In addition, the ruling clarifies that the mere use of the word ''Visa'' or ''Mastercard'' will be considered to be promotional so as to disqualify a mailing for the reduced rates.

§ 3.14 SALE, RENTAL, OR EXCHANGE OF MAILING LISTS

When the institution grants a business a license to sell products or services to its students, faculty, staff, alumni, or donors, one of the most important intangible property rights that the licensee receives is the institution's various mailing lists that are provided to the business as part of the arrangement. The ability to use the school's name and logo is of little value unless the business is assured that the product or service is marketed to those individuals who have a strong interest in and relationship to the institution. This can usually only be achieved through the use of mailing lists that have been developed over the years by the institution.

In a 1981 case, the court held that income received by the Disabled American Veterans from the rental of its donor lists to certain nonprofit organizations and commercial businesses did not qualify for the royalty exclusion because the rentals were the product of ''extensive business activities'' and did ''not fit within the types of 'passive income''' that the court determined was required by the royalty exclusion.[156] As part of the Tax Reform Act of 1986, however, Congress expressly overruled this decision, at least as it relates to rentals of mailing lists to other nonprofit organizations, by enacting a new provision that provides that a tax-exempt charitable or educational organization will not be treated as engaged in an unrelated trade or business if it rents or exchanges its mailing lists with another tax-exempt charitable or educational organization.[157] The problem with this provision, however, is that it is silent as to the tax treatment of rentals or exchanges of mailing lists by tax-exempt organizations to commercial users or other noncharitable/educational organizations. In the legislative history to this new provision, Congress said ''no inference'' should be drawn as to whether any mailing list activities other than between nonprofit organizations constitute unrelated business income activities.[158] This

[155] Letter dated Feb. 1997, from Anita Bizzotto, Manager, Customer Support Ruling, Business Mail Acceptance, U.S. Postal Service, Washington, D.C.

[156] *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1189 (Ct. Cl. 1981).

[157] IRC § 513(h)(1)(B). The provision also applies to war veterans organizations described in IRC § 170(c)(3).

[158] 132 Cong. Rec. H26208 (daily ed., Sept. 25, 1986) (statement by Mr. Rostenkowski).

''no inference'' statement, however, did not prevent the IRS from attempting to draw a negative inference in a later case also involving the Disabled American Veterans.[159] In that case, the IRS argued that, by limiting favorable treatment to rentals made by one nonprofit organization to another, Congress intended that any mailing list rentals to commercial users should be treated as an unrelated business income activity. The Tax Court rejected the IRS position, holding that a mailing list constitutes intangible property and that a payment for the right to use intangible property is excludable from unrelated business income as a royalty.[160] The IRS reasserted this position in the *Sierra Club* case, and the Tax Court again rejected it.[161] In this appeal of *Sierra Club*, the Ninth Circuit agreed with the Tax Court and held that the payments received from the mailing list rentals were true royalties.[162] The decision was based on the court's finding that the Club ''did not itself perform the services relating to the rental of the mailing lists.''[163] Specifically, the court said that the Club ''did not market the lists, sort the lists on the labels, or provide any other service to the list users.''[164] Instead, the Club contracted with others to perform those activities.

The Tax Court subsequently decided two additional cases involving payments received by a tax-exempt organization from the sale of mailing lists. In both cases, the Court held that the income received by the organization was a royalty and therefore not subject to the unrelated business income tax.[165] These two opinions, which were decided and issued by the Court at the same time, contain a detailed description of how the mailing list rental business is conducted, including a description of the business activities of the outside mailer, list brokers, and list managers. The court divided these mailing list activities into two categories: those that exploit or protect the mailing list and those that do not. To the extent that an activity falls into the first category, the court said that any income received by the organization that is attributable to that activity is part of the royalty payment and exempt from tax. If, however, the organization receives income that is properly attributable to an activity that does not exploit or protect the mailing list, such income may be taxable as unrelated business income.

With the exception of the list broker activities, the court found that all of the activities conducted by the two organizations were royalty-related activities, and that any income attributable to them was part of the exempt royalty. With respect to the list broker activities, the court determined that, although they were not royalty-related activities, they were conducted by a third party who

[159] *Disabled Am. Veterans v. Commissioner*, 94 T.C. 60 (1990).
[160] *Id*. at 71.
[161] *Sierra Club, Inc. v. Commissioner* 65 T.C.M. (CCH) 2582 (1993).
[162] *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996).
[163] *Id*.
[164] *Id*. at 1536.
[165] *Planned Parenthood Fed'n v. Commissioner*, T.C. Memo 1999–206, 77 T.C.M. (CCH) 2227 (1999); *Common Cause v. Commissioner*, 112 T.C. 332 (1999).

was not an agent of the two organizations; therefore, any income allocable to these activities could not be attributed to the organizations and was not taxable to them.

Notwithstanding all these adverse court decisions, the IRS nevertheless issued several rulings and one GCM making it clear that it disagreed with the Tax Court and that it would continue to take the position that the rental of mailing lists by an exempt organization to commercial users is an unrelated business income activity.[166] In one ruling, in which there was no express license by the organization of the right to use its mailing lists, the IRS went so far as to conclude that, because the organization itself engaged in repeated and extensive mailings of promotional literature to its members, it was ''indirectly'' providing the commercial enterprise with access to its member mailing list.[167] The IRS also took the position that where the agreement provides for a single royalty payment in return for the right to use the organization's name, logo, and mailing lists, all of the income will be treated as from the mailing list rental and therefore taxable.[168]

But it now appears that the IRS has conceded that mailing list income can qualify for the royalty income exception in the same manner as income related to the use of the school's name and logo. In other words, as long as the institution does not provide more than de minimis services as part of the agreement, the IRS will agree that the mailing list income qualifies for the royalty income exception.[169]

§ 3.15 CONCESSION SALES

The rule in the concession sales area (e.g., sale of food sales, novelty items, T-shirts) is pretty clear—first, if a college or university makes concession sales to students, faculty, and staff, the activity falls within the convenience exception and is not treated as an unrelated trade or business.[170] Also, if the concessions are sold to anyone (students, faculty, members of the general public) at a related event, such as a football game or a student play, the concession sales are treated as an integral part of the event and not subject to the unrelated business income tax.[171] However, if the concessions are sold to members of the general public or to anyone else in connection with an unrelated event, the concession activity will not be treated as related, and the net income will be subject to tax.

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[166] *See* Tech. Adv. Mem 9635001 (Apr. 6, 1994); Tech. Adv. Mem. 9441001 (Aug. 9, 1993); Tech. Adv. Mem. 9404003 (Sept. 30, 1993); Tech. Adv. Mem. 9404004 (Sept. 30, 1993); Gen. Couns. Mem. 39,827 (Oct. 5, 1989).

[167] Tech. Adv. Mem. 9441001 (Aug. 9, 1993).

[168] *See* Priv. Ltr. Rul. 9306030 (Nov. 18, 1992).

[169] Priv. Ltr. Rul. 200149043 (Aug. 1, 2001); Priv. Ltr. Rul. 200601033 (Oct. 14, 2005).

[170] *See* § 2.2(h).

[171] Priv. Ltr. Rul. 8623081 (Mar. 17, 1986).

§ 3.16 CATERING ACTIVITIES

Many colleges and universities provide their own catering services for events sponsored by the school or by a group affiliated with the school. For example, departments may have monthly luncheons or the alumni association may have periodic dinners that are catered by the school's dining room staff. In addition, a department within the school may invite a group not affiliated with the school to use the school's facilities for a breakfast, luncheon, or dinner meeting; for example, the business school may invite the local chamber of commerce to hold a luncheon meeting at the school. Also, it is not unusual for a college or university to grant a request from a nonaffiliated group (e.g., the local heart association) to use the school's dining facilities in connection with a meeting. In all of these situations, the school often charges the group for the catering services provided, which, of course, raises the issue whether the net income derived from the catering activities constitutes unrelated trade or business income.

In a 1980 ruling, the IRS determined that all the above types of catering activities were related to the school's exempt educational purposes. The IRS found that the activities were not educational in nature, but were ''traditional and commonplace functions of colleges and universities nationwide.''[172]

It is also possible that a school's catering activities include serving other types of groups whose meetings at the school are not so easily classified as ''traditional and commonplace functions'' of a college or university. For example, the school may cater wedding receptions, graduation and birthday parties, or private parties for the president or other senior school officials. The school may even go so far as to actually have a catering department or division that holds itself out to the local community as being available to provide catering services to any member of the general public, regardless of any affiliation with the school. In all likelihood, and certainly in those cases where the catering activities are advertised and provided to the general public, the IRS will treat the activities as unrelated.

In some cases, however, the school may be able to demonstrate that the activity is not regularly carried on. For example, in the ruling mentioned above, the school conducted a total of approximately 200 events, of which 6 or 7 were wedding receptions held on campus. The IRS concluded the wedding receptions were conducted so infrequently as to fail the regularly carried on test. Also, the ruling only treated as a ''traditional and commonplace function'' those catering services provided to other charitable and educational organizations. What about providing catering services to nonprofit organizations that are not charitable or educational, such as the local chamber of commerce? Does it make a difference if the business school invites the chamber of commerce to have its luncheon at the school, with business school professors participating

[172]Tech. Adv. Mem. 8020010 (n.d.).

in the event, as opposed to the school's simply serving as the location where the chamber's meeting is held? The IRS ruling would suggest that the two situations might be treated differently. To be safe, a school should consider limiting availability of its meeting and catering facilities to charitable or educational organizations.

§ 3.17 TREATMENT OF ALUMNI

A determination as to whether an income-producing activity is treated as related or unrelated often depends on the status of the individual for whom the particular activity is performed. For example, the sale of an item in the bookstore to a student may be related, while the sale of the same item by the bookstore to a member of the general public may not. Likewise, permitting a faculty member to use the school's golf course for a fee will not result in unrelated business income, but greens fees paid by members of the general public may.

Alumni are not easily placed in any clearly identified category. On the one hand, they could be included in the student classification because they were students at one time, but they could also be treated as members of the general public who happen to have an interest in the school because of their former status as a student.

The IRS has provided schools with a mixed message regarding the status of alumni. In a 1980 ruling, the IRS said that income derived from alumni use of a school's recreational facilities was unrelated business income,[173] while three years later, the IRS held such use to be related on the ground that alumni use was ''an inducement for them to provide continuing support.''[174] The current position of the IRS, however, is that alumni should be treated in the same manner as the general public and not as part of the school's community like students, faculty, and staff. The IRS made this point quite clearly in a 1997 private letter ruling stating:

> The status of Golf Course members as alumni of [the university] does not transform the golf activity into a related trade or business. These individuals are not sufficiently distinguishable from members of the general public for purposes of determining whether their use of [the university's] facilities is substantially related to [the university's] exempt educational purposes. We have considered the substantial donations made to [the university] by alumni who use the Golf Course. But this fact does not suffice to establish that their Golf Course membership advances exempt educational purposes. Further, we are of the opinion that the alumni in question would make substantial contributions to [the university] regardless of the existence of the Golf Course.[175]

[173]Tech. Adv. Mem. 8020010 (n.d.).
[174]Priv. Ltr. Rul. 8340102 (July 11, 1983).
[175]Priv. Ltr. Rul. 9720035 (Feb. 19, 1997). *See also* Priv. Ltr. Rul. 9645004 (July 17, 1996).

Thus, for purposes of the unrelated business income tax rules, the convenience exception rules, and all other issues relating to college and university tax, the IRS will treat alumni in the same manner as the general public and not accord them the special status granted to students, faculty, and staff. Whether this position could be successfully challenged in court is something that we will have to wait to see.

§ 3.18 CONFERENCES, MEETINGS, AND TRAINING PROGRAMS

Many colleges and universities have a conference center or meeting facilities at which institution-related meetings and conferences are conducted. In addition, some schools also rent these conference and meeting facilities to other entities, both nonprofit and for-profit. Along the same lines, some schools enter into contracts with other entities (again, both nonprofit and for-profit) to provide special training programs and classes for their employees. The issue raised by all of these different activities is whether the income derived is subject to the unrelated business income tax.

Obviously, the conduct of internal meetings at these conference centers raises no problems, but an issue does arise when the rental is to an outside group. A strong argument can be made that the rental of conference and meeting facilities to another nonprofit, section 501(c)(3) organization is related to the school's educational purposes, and IRS agents have generally agreed with this position in college and university audits.[176] A more difficult question, however, relates to rentals to nonprofit organizations that are not exempt under section 501(c)(3), such as trade associations or social clubs. The IRS could contend that these are unrelated activities on the theory that it is not in furtherance of the school's educational purposes to assist non-charitable/educational organizations, even if the organization is organized on a nonprofit basis. Obviously, the same conclusion pertains if the school rents the facilities to a for-profit company. If the IRS were to reach an ''unrelated'' conclusion with respect to either group, it still may be possible to exclude the income under the rental income exclusion.[177] Whether this exclusion will apply, however, depends on the degree and extent of the services provided by the school as part of the rental activity. If, for example, food service is provided to the meeting participants, the IRS will likely conclude that the rental exclusion is not applicable.

[176] But see the discussion of the *Airlie Foundation* case in footnote 180. In this case, the government argued that these conferences must be conducted at substantially below the Foundation's cost in order to qualify under section 501(c)(3); however, the court did not address this argument. *See* Rev. Rul. 72–369, 1972-2 C.B. 245 closing bracket(holding that the provision of managerial and consulting services to other nonprofit organizations was not an exempt activity because the services were only provided at cost.

[177] *See* § 2.2(c).

What if the institution contracts with a for-profit company to conduct a special training program for a particular company's employees? Should this be treated as an educational activity conducted by the school or instead as an unrelated activity designed to further the private interests of the company? The IRS addressed such a situation in a 1991 ruling.[178] This ruling involved a state university that entered into a contract with a for-profit company to conduct a training program for the company's employees. Under this contract, no aspect of the program could be disclosed to persons not approved by the company, and all findings, reports, questionnaires, training media, and other material prepared in connection with the program became the exclusive property of the company. The company provided some of the instructional materials and the classroom space, while the university provided other instructional materials as well as the professors, teaching assistants, and a secretary. The teaching of these courses was treated by the university as part of the professor's regular course load. The training courses were taught eight hours a day for two weeks to more than 300 participants, who came from all over the country. The university awarded undergraduate credit to those participants who requested it.

The IRS, relying on a 1968 ruling that concluded that an organization that conducted an education program for a bank's employees qualified for exemption under section 501(c)(3),[179] ruled that conducting the courses for the company's employees was substantially related to the university's educational purposes. Specifically, the IRS said that, while the courses were restricted to the company's employees, the courses ''nevertheless followed the educational curriculum in place at the university, utilized university professors and teaching assistants, and academic credit was awarded to participants.''

While the IRS will generally find that the institution is involved in a related activity if its own professors and teaching assistants are involved in the educational instruction, what if the school is simply allowing a third party to use its facilities to put on a conference? A 2003 district court case suggests that these situations may raise unrelated business income tax concerns.[180] This case involved a foundation that was organized and operated for the primary purpose of sponsoring educational conferences for governmental, nonprofit, and for-profit entities. After having its tax-exempt status revoked in the late 1980s, it tried to regain its section 501(c)(3) status in 1998 and filed an exemption application with the IRS. The IRS concluded the foundation's conference activities were conducted in a commercial manner and denied the foundation's application for tax-exempt status. The foundation filed a declaratory judgment action in the U.S. district court for the District of Columbia.

[178]Tech. Adv. Mem. 9137002 (Apr. 29, 1991).
[179]Rev. Rul. 68–504, 1968–2 C.B. 211.
[180]*Airlie Foundation v. Internal Revenue Service*, 92 AFTR 2d 2003–6206 (D.D.D.C. Sept. 24, 2003).

The court found that the foundation conducts conferences for about 600 groups a year, including governmental entities (20 percent), nonprofit and/or educational organizations (50 percent), and either corporate clients or organizations using the facilities for weddings and similar events for private individuals (30 percent). The court said that whether conferences of this type should be treated as an educational or a commercial activity depends on all of the facts and circumstances, including:

- Whether and to what extent the foundation is in competition with local for-profit commercial entities
- The extent and degree to which the conferences are provided on a ''below cost'' basis
- Whether the foundation's pricing policies are generally in conformance with for-profit providers of similar services
- Whether the foundation has financial reserves that could be used to supplement the conference costs
- The extent to which the foundation advertises the conferences in a commercial manner
- The extent to which the foundation receives charitable donations

The court held against the foundation, notwithstanding the fact its reduced fee structure and its practice of subsidizing certain conferences were legitimate noncommercial factors. The court agreed with the IRS that the foundation was ''operated in a manner not significantly distinguishable from a commercial endeavor,'' primarily because of the fact that 30 percent of its clients were noneducational/governmental entities, the existence of competition with for-profit conference centers what the court felt were substantial advertising expenditures, and the significant revenues that the foundation earned from weddings and special events. In short, when looking at all of the facts and circumstances, the court found that ''there is a substantial 'commercial hue' to the way [the foundation] carries out its business.''

The issue in this case was whether the foundation was entitled to section 501(c)(3) status, not whether these activities generated unrelated business income, and it is not clear from the decision whether the court concluded that the conferences conducted for the governmental and nonprofit organizations were acceptable under section 501(c)(3). But it is clear that in other contexts that the IRS takes the position that the provision of services by one section 501(c)(3) to another is not a charitable activity unless such services are provided at substantially below the organization's cost.[181]

[181] Rev. Rul. 72–369, 1972–2 C.B. 245.

§ 3.19 ATHLETIC EVENTS/TELEVISION AND BROADCAST RIGHTS

A question that sometimes arises is whether income derived from admissions to a college or university's athletic events and the sale of television and broadcast rights to games is taxable. Congress resolved this question, at least with respect to admissions, when it enacted the unrelated business income tax rules in 1950. The committee reports clearly provide that income from admission charges is not income from an unrelated trade or business because the athletic activities are substantially related to a college or university's exempt educational purposes.[182] The IRS has expanded on this concept and ruled that income derived from the sale of radio and television rights is likewise not subject to the unrelated business income tax on the theory that this is simply another way of exhibiting the game to the general public.[183]

Events in 2006 brought these long-standing positions into some doubt. In late 2006, the chairman of the House Ways and Means Committee sent a letter to the president of the National Collegiate Athletic Association (NCAA) for the stated purpose of requesting that the NCAA provide the Committee with ''information on whether major intercollegiate athletics further the exempt purpose of the NCAA and, more generally, educational institutions.'' The clear purpose of this inquiry was for Congress to be able to determine not only whether the NCAA deserves to retain its section 501(c)(3) tax-exempt status, but also the more universal question whether major intercollegiate athletics furthers a college or university's exempt educational purposes.

This letter, while styled as a ''request for information,'' strongly suggested that at least some members of the Committee had concluded that major intercollegiate athletic programs as currently conducted by colleges and universities do not further the institutions' exempt educational purposes and that, at the very least, the net income from these athletic events should be subject to the unrelated business income tax. Looking at the questions in the letter that were directed at Division I-A major sports programs generally, the Committee wanted to know:

- Why should the federal government subsidize the athletic activities of educational institutions ''when that subsidy is being used to help pay for escalating coaches' salaries, costly chartered travel, and state-of-the-art athletic facilities?''
- Since the manner in which an organization uses funds from an activity has no bearing on the exempt/nonexempt nature of the activity itself, ''how does playing major college football or men's basketball in a highly

[182]Revenue Act of 1950, H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37, 109 (1950).
[183]Priv. Ltr. Rul. 7948113 (Aug. 31, 1979); Rev. Rul. 80–296, 1980–2 C.B. 195.

commercialized, profit-seeking, entertainment environment further the educational purposes of your member institutions?''

- In light of the fact that colleges and universities outside Division I-A spend a fraction of the amount that Division I-A schools spend on football and men's basketball programs, ''what educational value is received by participation in Division I-A athletics beyond that which is received by participation in other division or intramural athletics,'' and, if there is additional educational value, ''does the additional educational value justify the higher expenditures?''
- How much revenue does college sports generate each year?
- How much do colleges and universities spend each year on college sports?
- How much profit do member institutions generate from the operation of their athletic departments?
- For those schools that generate a profit, how much is used for nonathletic department purposes?
- How does the reported spending by public institutions of as much as $600,000 per men's basketball player in the 2004–2005 school year further the educational mission of the university?

About a month later, the president of the NCAA responded, making the following major points in support of the NCAA's position that major sports intercollegiate athletics furthers the general educational tax-exempt purpose of colleges and universities:

- Higher education imparts many skills outside of the traditional classroom, lecture hall, and library, such as participation in a symphony orchestra, working on a student newspaper, and participating in a theater production. Participation in intercollegiate athletics is simply ''another key way in which young men and women enrich their educational experience beyond the classroom.''
- Intercollegiate athletics differs markedly from professional sports in that (1) the purpose of professional sports is to entertain and earn a profit, while the purpose of intercollegiate athletics to enhance the educational development of the student athlete; (2) professional athletes are employees who are traded from team to team, while varsity athletes are students, not employees, and are not traded from school to school; and (3) professional teams are aligned with the local community only so long as the community supports the team, while collegiate teams are embedded in the school and cannot leave if dissatisfied with the level of support.

- Athletic coaches teach developmental athletic skills in the same manner as other faculty members impart academic knowledge.
- The compensation paid to major sports athletic coaches is, in many cases, commensurate with other highly paid and highly recruited faculty and staff. In addition, many of these coaches earn additional income from speaking engagements, sports camps, and so on, which amounts do not come from an institution's tax-exempt dollars.
- The fact that some major sports programs earn substantial net revenue that is used to defray other educational programs does not detract from the inherent educational nature of the sports programs. This simply reflects the ''business model for higher education'' where, for example, revenue from Psychology 101 classes (because of their number and size) is typically much greater than the revenue generated by philosophy classes and, in effect, the Psychology 101 classes subsidize the school's philosophy classes.
- The fact that Division I-A schools pay substantially more for their intercollegiate athletic programs than the amount paid by smaller schools simply reflects the size of the respective programs—for example, the budget for the mathematics department at Ohio State is significantly larger than the mathematics department budget at Defiance College in Ohio.

Where this issue goes from here (if anywhere) remains to be seen, but there is clearly interest in Congress in reviewing the nature and scope of major sports intercollegiate athletics, and it is possible that Congress and/or the IRS could one day bring these activities within the scope of the unrelated business income tax regime.

§ 3.20 RETIREMENT HOMES

Some colleges and universities form retirement home communities either close to or on campus.[184] The reasons for doing so include having a living laboratory for students studying gerontology, attracting alumni who may thereby increase donations to the school, and earning a profit. While setting up a living laboratory to teach students and helping to increase alumni donations are already within a college or university's traditional mission, if the primary motive in setting up and operating the retirement home is that of earning a profit, there are potential unrelated business income tax problems.

[184] ''Retirees Going Back to School to Live,'' *Washington Post*, Nov. 9, 1998, at A-1; CNN Interactive Website, dated Feb. 1, 1999.

§ 3.21 INTELLECTUAL PROPERTY ISSUES

When a college licenses its intellectual property to a third party, particularly a private individual or a for-profit enterprise, a number of tax issues are raised, including whether the resulting income will be treated as unrelated business income. The IRS has addressed a number of these issues in a 1999 training manual.[185] The training manual begins with a helpful overview of the legal basis for intellectual property rights, including those rights that exist under common law and those that exist under federal patent, copyright, and trademark/service mark statutes. This is followed by a discussion of the tax treatment of patent-related activities, such as the tax credits and deductions for research activities, how research income is treated under the unrelated business income tax rules, and the impact of the section 501(c)(3) ''scientific'' regulations.

The manual then moves to the heart of the inquiry—how intellectual property rights are exploited by tax-exempt organizations and the tax impact of these exploitative activities. The IRS recognizes that, in most situations, exploitation involves collaboration between the tax-exempt entity and individuals or for-profit companies, and it is in this context that all the tax issues arise. The IRS chooses to illustrate these tax issues by way of four different case studies, all of which the IRS says pose the ultimate issue of ''whether private individuals are unjustly enriched through the medium of an exempt organization.''

Case Study 1. This case involves a fairly complex set of facts, one element of which is that an author enters into a publishing contract with a university press. The university press is not part of its affiliated university but rather is a separate legal entity with its own section 501(c)(3) status. What is interesting about this case study is that it provides a window on the IRS thinking about book-publishing activities by university presses. Under the facts of this case, the university press obtains the exclusive right to produce and distribute up to 25,000 hardcover copies of the book for a specified period of time; agrees to pay the author a 15 percent royalty plus an advance royalty; obtains an option to publish another 25,000 copies; and receives a right of first refusal to purchase the copyright to the book if and when the author decides to sell it. The IRS concludes that this university press is ''not acting like a typical university press'' because, according to the IRS, a university press that is entitled to tax-exempt status typically publishes three to four books a year; has a per-book press run of about 500 books; pays a royalty of only about 5 percent; and does not pay advance

[185] *1999 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook*, 21st ed., at 21–54 (1998).

royalties to authors. Therefore, one can infer that this university press would have had its section 501(c)(3) status revoked.[186]

Case Study 2. This case involves a tax-exempt fraternal lodge organization that owns a popular trademark and licenses that trademark to a for-profit company. The organization's subordinate organizations (the lodges) assist in the marketing and sale of the products. The for-profit company pays the organization a 5 percent royalty based on sales of items bearing the trademark, and the organization takes the position that these payments are not unrelated business income under the section 512(b)(2) royalty exception. The IRS asserts the same position that it had asserted in a number of other cases prior to the issuance of the 1999 training manual—that is, where an organization shares in the net sales proceeds by way of a percentage royalty and also provides services related to the sales activity, the arrangement ''is characteristic of a joint venture rather than a royalty arrangement.'' Today, the IRS would most likely not take such an inflexible position on the joint venture issue but would examine additional facts and circumstances in making its final determination.

Case Study 3. This case involves a state university that has an affiliated tax-exempt research institute. A particular scientist, who is jointly employed by both the university and the research institute, has assisted the research institute in the development of a patent. The research institute proposes to enter into a license agreement with a for-profit company to commercially exploit the patent, and also proposes to pay the scientist an annual salary of $20,000 plus a 5 percent interest in any royalties received by the institute. The IRS says that the issue in this case ''boils down to one of reasonableness of compensation'' and that, in order to decide this issue, ''it is important to determine if similar institutes engage in comparable arrangements with their employees.'' In looking at these other institutes, the IRS concludes that it was reasonable to provide key employees with an equity interest in the royalties to ensure that the persons will not ''bolt'' to set up their own company to conduct the research necessary to bring the product to market. The IRS goes on to say that a tax-exempt organization can offer its employees a share in royalties or profits from the exploitation of intellectual property, provided that the compensation is reasonable taking into account the norms of the industry. Any such arrangements should be decided in advance, contain arm's-length terms and conditions, and be reflected in a written agreement.

Case Study 4. The facts involve a section 501(c)(3) private foundation that entered into a ''sweetheart'' exclusive trade secret license agreement

[186] *See* § 9.1.

> with a related party, and the IRS said that, while the royalty payments would be exempt from unrelated business income, the transaction would be an act of self-dealing and therefore subject to the penalty excise taxes imposed under Chapter 42 of the Code. The IRS also says that if the section 501(c)(3) organization were not a private foundation, the transaction would raise ''private benefit'' issues, unless the organization could show that the exclusive license was the only practical way to exploit and maintain the value of the trade secret. In such a case, the IRS today would also consider imposing the ''intermediate sanctions'' penalty excise taxes called for under section 4958 of the Code.[187]

In 2003, the IRS ruled favorably with respect to a situation where a section 501(c)(3) organization proposed to enter into an agreement with a for-profit company under which the company will commercialize the organization's intellectual property.[188] Under the proposed arrangement, the organization will exclusively license its intellectual property to the company and transfer to the company the right to a royalty interest in the intellectual property in return for an amount equal to its technology transfer costs plus 50 percent of any net income generated by the intellectual property. The exclusive license will provide that all intellectual property derived from the organization's research efforts will be licensed to the company automatically upon the property's creation, subject to the organization's retention of ultimate ownership of the intellectual property and a 50 percent royalty interest in any net income generated by the intellectual property.

The IRS ruled that the organization's exempt purposes will not change by having an exclusive license with the company because it will continue to engage in bona fide scientific research and otherwise meet the ''scientific'' requirements under section 501(c)(3). It said that scientific research can be regarded as carried on in the public interest even when a commercial sponsor has the right to obtain ownership or control of the intellectual property resulting from the research if the results of the research are published without reasonable delay other than delay needed to secure patent rights arising from the research.[189] The IRS also noted that under the exclusive license with the company, neither the company nor any of its sublicensees would have control over the direction of the organization's research; rather, the company would only have the right to receive progress reports and access to the research results to know when the intellectual property was ready to be marketed.

Thus, the IRS determined that the organization's arrangement with the company would not result in more than incidental private benefit to the for-profit company and would not adversely affect the organization's exempt

[187]See § 9.1(d).
[188]Priv. Ltr. Rul. 200326035 (Apr. 4, 2003).
[189]See Rev. Rul. 76–296, 1976-2 C.B. 141.

status. Moreover, the IRS said that the royalties paid by the company would not result in unrelated business income under the exception for royalties set forth in section 512(b)(2).[190]

§ 3.22 INTERNET FUND-RAISING AND ADVERTISING ISSUES

In a 2000 training manual for its field agents, the IRS national office issued guidance relating to use of the Internet to raise funds and engage in advertising activities.[191] This guidance begins with a reminder that use of the Internet to accomplish a particular task does not necessarily change how the tax laws apply to that task, or, as the IRS puts it: ''Advertising is still advertising and fund raising is still fund raising.'' Nevertheless, the IRS noted that the nature of the Internet can change the manner in which these tasks are accomplished and that such changes can affect the resulting tax treatment.

The IRS first set forth a brief description of how the World Wide Web works, including a discussion of how web pages are created, how links operate, security issues, and how credit card purchases work. It then looked at tax-exempt organization fundraising practices using the Internet and noted that some organizations use their web pages to raise funds. The IRS said that contributions made to an organization in this manner ''raise no novel tax issues.'' But the IRS noted that fund raising in this manner may raise state and local law concerns if a state or local jurisdiction concludes that anyone within its jurisdiction accessing the web site is being solicited; in such a situation, the organization for which the site is soliciting would have to register with the state or local jurisdiction. The IRS also briefly discussed e-mail fund-raising solicitations and noted that such solicitations ''present, in general, the same legal issues as any direct mail solicitations.''

The IRS then turned to Internet advertising/merchandising and began with a statement that it ''has yet to consider many of the questions raised by web advertising, merchandising, and publishing; however, it is reasonable to assume that as the Service develops positions it will remain consistent with our position with respect to advertising and merchandising and publishing in the off-line world.'' The IRS went on to discuss different methods of Internet advertising payments, including flat fee, pay-per-view, click-through charges, and link/banner exchanges. It noted that a moving banner is more likely to be classified as a taxable advertisement (as opposed to a nontaxable corporate sponsorship) and that it is presently unclear whether the IRS will treat a link or banner exchange in the same manner as a mailing list exchange or ''whether

[190]See § 2.2(d).

[191]*2000 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2000*, 23rd ed., at 119–140 (1999). For another analysis of the impact of the Internet on activities conducted by tax-exempt organizations, see Nooney, ''Tax-Exempt Organizations and the Internet,'' *Exempt Organization Tax Review*, Jan. 2000, at 33.

an organization that participates in such a program may incur liability for unrelated business income.'' The IRS went on to say that, in analyzing these exchanges, one must determine whether the exchange is ''an exchange of advertising'' as opposed to an attempt to refer the site visitor to additional information in furtherance of the organization's exempt purposes.

The IRS next discussed the advertising-versus-corporate-sponsorship issue and how these rules apply to messages on the Internet.[192] The IRS mentioned the issue of whether the presence of a hypertext link in a message that otherwise meets the corporate sponsorship guidelines will cause the message to be taxable advertising, but did not set forth a conclusion; rather, it simply said ''that a link will retain the passive character of a corporate sponsorship while a moving banner is more likely to be considered to be advertising.''

The IRS then addressed the question of whether web site material prepared by the organization will be treated under the special and favorable unrelated business income computational methods relating to the publication of ''periodicals.''[193] In this connection, the IRS said that most of the material on tax-exempt organization web sites is prepared in a manner that is distinguishable from the methods used to prepare periodicals, but that it may be possible for an online publication to be treated as a periodical. It assumes that a periodical will exist when the organization has online editions and print publications that are ''sufficiently segregated from the other traditional web site materials so that the production and distribution methods are clearly ascertainable and the periodical income and costs can be independently and appropriately determined.''

Finally, the IRS addressed the use of on-line storefronts and merchant affiliation programs. With respect to the storefronts, the IRS said, though it ''has yet to address any cases specifically addressing on-line merchandising issues,'' it is useful to look at how the IRS has treated sales activities of organizations such as museums, where the IRS applies a ''primary purpose'' test, looking at the nature, scope, and motivation for the particular sales activities.[194] Thus, the IRS concluded that, ''in addressing Internet merchandising cases it is reasonable to use the same analysis that the Service would apply in sales made through stores, catalogues, or other traditional vehicles.'' Internet sales will be evaluated on an item-by-item basis to determine whether the sales activity furthers the accomplishment of the organization's mission or is simply a way to increase revenues.

The 2000 training manual was the first IRS salvo on Internet-related issues. In that same year, the IRS issued a formal request for public comments on a

[192]For a discussion of the corporate sponsorship rules, *see* § 3.4.
[193]For a discussion of how periodicals are treated under the unrelated business income tax rules, *see* § 3.4.
[194]*See* Rev. Rul. 73–104, 1973-1 C.B. 263; Rev. Rul. 73–105, 1973-1 C.B. 264.

wide range of different Internet-related tax issues.[195] The specific issues raised by the IRS provide some insight into the evolution of the agency's thinking as to the possible impact of the Internet on different areas of the tax law. The issues on which the IRS requested comments are as follows:

General Issues

1. Is a web site a single publication or communication, and if not, how should it be separated?
2. What is the proper method to allocate expenses to the operation of a web site?
3. Given that some web sites are constantly changing, to what extent and how should an organization maintain records of previous web pages?
4. Should comments made by members of listservs or other discussion groups be attributable to the organization that maintains the web site?

Political and Lobbying Activities

1. Should the normal guidelines regarding intervention in political campaigns be equally applied to candidate information on web sites?
2. Does a hyperlink from the organization's web site to a political or lobbying organization's web site result in lobbying or political intervention?
3. What are the factors to take into account to determine whether lobbying communications made on a web site are a substantial part of an organization's activities?
4. For those organizations that have made a section 501(h) lobbying election, (a) what facts and circumstances should be taken into account to determine whether an organization's web site constitutes a ''call to action''; (b) does the publication of a web page constitute an appearance in mass media; and (c) to what extent is an organization's Internet communication treated as made directly or indirectly with its members?

Advertising and Other Business Activities

1. What are the facts and circumstances that should be used to determine whether an organization's business activities on the Internet are ''regularly carried on''?
2. Are there any circumstances under which the payment of a percentage of sales from customers referred by the organization to another web site should be treated as ''substantially related''?

[195]I.R.S. Announcement 2000–84, 2000–42 I.R.B. 385.

3. Can a ''virtual trade show'' be treated as a ''traditionally conducted trade show'' under section 513(d)?

Solicitation of Contributions

1. Are solicitations on the Internet (either on a web site or in e-mail form) in ''written or printed form'' for purposes of the section 6113 disclosure requirements, and if so, what factors should be taken into account to determine if the disclosure is in a ''conspicuous and easily recognizable format?''
2. Can an organization meet the section 6115 ''quid pro quo'' requirements, and can a donor meet the section 170(f)(8) substantiation requirements, with a web page confirmation that can be printed out by the donor or by sending an e-mail confirmation?

In connection with what the IRS calls ''individual merchant affiliate programs'' conducted on the Internet, the IRS analogized these programs to the well-known ''affinity credit card'' rules. Accordingly, the IRS will most likely concede that payments under these programs are royalties unless the organization is providing significant services as part of the arrangement.[196]

In 2002, the IRS issued the final corporate sponsorship regulations, which contain two new examples illustrating whether payments received by an organization in return for placing on its web site a hyperlink to the sponsor company's web site will be treated as a tax-free acknowledgment or taxable advertising.[197] In the first example, the organization posts on its web site the name of a corporate sponsor with its Internet address that appears as a hyperlink to the company's web site. The example concludes that the posting of the address will be treated as a tax-free acknowledgment even though it contains a hyperlink. The second example involves an organization that includes on its web site a hyperlink to a company sponsor's web site on which the organization's endorsement of the sponsor's product appears. In this situation, the regulations conclude that the hyperlink that leads to the endorsement is taxable advertising because the statute provides that an endorsement cannot qualify as a corporate sponsorship activity.[198]

Then, in 2002 the IRS issued a ruling that provides further guidance on how it will treat web site advertising activities.[199] The ruling involved a section 501(c)(5) agricultural organization that entered into agreements with various service providers to provide special or discounted benefits to its members at a reduced cost. The organization also licensed its name and logo to

[196]For a discussion of affinity credit card programs, *see* § 3.13.
[197]Treas. Reg. § 1.513–4(f), Examples 11 and 12.
[198]IRC § 513(i)(2)(A).
[199]Priv. Ltr. Rul. 2003303061 (Oct. 21, 2002).

certain insurance companies that sold insurance products to the organization's members. The organization listed the names of the service providers and the benefits they provide in its publications and on its web site, without any endorsement or promotion of the business activity. The organization also included a link to the service providers on its web site. Against these background facts, the IRS held that:

- The organization's listing of information about third-party service providers in the organization's publications and brochures and on its web site is not a trade or business for unrelated business income purposes. It is unclear why the IRS reached this conclusion; it may have been based on the fact that the organization did not charge any fees for these activities.
- The organization's provision of a link from its web site to the web sites of third-party service providers, as part of its listing of information about such service providers, was likewise not a trade or business. Here, it is interesting to note that the IRS did not distinguish between a general home page web site and web sites from which products can be ordered, thereby suggesting that the IRS may not assert a position that income derived from links to ''product'' web sites is taxable.
- The organization's listing of information about the two insurance companies in its publications and brochures and on its web site, and its provision of a link to the companies' web sites as part of the web site listing, will not cause any portion of the organization's licensing revenues from those companies to fail to be treated as nontaxable royalties under section 512(b)(2).
- The organization's income from the sale of periodical and banner advertising to third-party service providers at its customary rates, including to the two insurance companies on an exclusive basis, constitutes unrelated business taxable income; however, the sale of such advertising will not disqualify any portion of the licensing revenues received from such service providers as royalties because they were paid pursuant to separate agreements and each was at a fair market value rate. The organization itself treated the banner advertising as unrelated business income; therefore, the IRS did not make any independent determination in this regard.
- The organization's sale of banner advertising on its web site was not periodical advertising under section 513(i); however, the IRS said that if the online material qualified as a ''periodical,'' the income would be taxable.[200]

[200] *See* § 3.4.

- No allocation between periodical and nonperiodical advertising (including online periodical advertising) need be made where (1) an advertiser pays the organization an amount that is attributable only to periodical advertising, and (2) the entire amount is taxable. An allocation between periodical and nonperiodical advertising must be made, however, when an advertiser pays the organization an amount attributable to periodical advertising and advertising that appears on the organization's web site generally.
- The organization's provision of a link to a sponsor's web site in connection with an acknowledgment of a sponsorship payment is an unrelated trade or business but is not treated as taxable advertising under the acknowledgement rules of section 513(i). Again, it is interesting that the IRS imposed no restrictions on the types of web sites to which the link can be made.

§ 3.23 OWNERSHIP OF S CORPORATION STOCK

An S corporation is a special type of corporation that is treated as a corporation for limited liability purposes but is taxed as a partnership.[201] At one time, a tax-exempt organization could not own stock in an S corporation, but this restriction was lifted in 1996.[202] Nevertheless, the ownership by a tax-exempt organization of stock in an S corporation is treated as an interest in an unrelated trade or business, and any items of income, loss, or deduction that flow through an S corporation to a tax-exempt shareholder, or any gain or loss on the sale of the S corporation stock, is taken into account in determining the organization's unrelated business taxable income.[203]

§ 3.24 SALE OF PRODUCTS DERIVED FROM CONDUCT OF RELATED ACTIVITY

If a tax-exempt organization sells a product that is derived from the performance by the organization of an exempt activity, the IRS says that the sales activity will be treated as ''substantially related,'' provided that the product is sold in substantially the same state it was in upon completion of the exempt activity.[204] For example, assume that a section 501(c)(3) university with a large agricultural research program maintains an experimental dairy herd and sells milk and cream produced by the herd. Under this rule, the sale of the

[201]IRC §§ 1361–1363.
[202]IRC § 1361(c)(7), which was added by the Small Business Job Protection Act of 1996, Pub. L. No. 104–188.
[203]IRC § 512(e)(1)(B)(i),(ii). *See also* Hoyt, ''Subchapter S Stock Owned by Tax-Exempt Organizations: Solutions to Legal Issues,'' *Exempt Organization Law Review*, No. 1, at 25 (1998).
[204]Treas. Reg. § 1.513–1(d)(4)(ii).

milk and cream would be treated as a substantially related activity; however, if the university were to utilize the milk and cream in the further manufacture of food items such as ice cream and pastries, the sale of such products would not be a substantially related activity and the income would be taxable.[205]

§ 3.25 BUSINESS INCUBATOR ACTIVITIES

A ''business incubator'' is an organization (or an activity conducted by an existing college or university) designed to reduce the high failure rate of new businesses by assisting the businesses in getting organized and providing support until the business in ready to operate on its own. In most cases, the incubator gives a variety of different types of businesses (high-tech, office, light manufacturing, etc.) the opportunity to work out of a single facility that provides them with low-rent space, shared support services and facilities, and consulting advice. While incubators have the common goal of assisting small businesses, they types of businesses that they support, as well as the scope and nature of the services provided, can vary widely.

Colleges and universities typically offer business incubator services by making the intellectual and physical resources of the university available to the assisted businesses, often, but not always, in connection with a business school that uses the incubator as a learning laboratory. These businesses are normally able to use the institution's libraries and equipment to conduct research, and they often hire students and staff to assist them. In many cases, the incubator's clients commercialize the technology developed in the universities' research facilities.

If a college or university operates an incubator as a part of its activities, the initial question is whether the activity qualifies as charitable or educational under section 501(c)(3). If not, the activity will be treated as an unrelated business activity with any profit subject to tax. If, however, the incubator is primarily used by the college or university as a learning vehicle with substantial involvement by students and is incorporated into the ongoing curriculum, a good argument can be made that the activity is part of the school's overall educational mission and is a related activity on that basis. If this is not the case, however, the question will be whether the incubator is operated in accordance with the ''exempt incubator'' guidelines developed by the IRS over the years.

In a 1992 legal memorandum, the IRS explained that a business incubator may be either taxable or tax-exempt depending on the method and manner in which it is operated.[206] As a general rule, an incubator activity will be an

[205] *See* Priv. Ltr. Rul. 200512025 (Dec. 28, 2004), in which the IRS ruled that income earned by a charitable organization from its sales of produce grown on site is not taxable, but income from sales of produce grown offsite is taxable.

[206] Gen. Couns. Mem. 39883 (Oct. 16, 1992).

exempt activity if it qualifies as a community development organization.[207] These are organizations created to help revitalize depressed economic areas by assisting business operation in these areas. Because the services provided are often quite similar to services provided by for-profit entities, a community development organization must demonstrate that it is operated for charitable purposes, not profit or gain, and must show that it is not primarily serving the private interests of its business clients.[208] After reviewing the numerous cases and rulings in this area, the memorandum concluded that a determination of whether a community development business incubator furthers a charitable purpose requires an analysis of three factors:

1. Whether assistance is being provided to help local businesses or to attract new local facilities of established outside businesses
2. Whether the type of assistance provided by the community development organization has noncommercial terms and the potential to revitalize the disadvantaged area
3. Whether there is a nexus between the business entities assisted and relieving the problems of the disadvantaged area, or between the businesses and a disadvantaged group, like a minority, in the area

The IRS said that the first factor determines how specific the assistance must be. For example, any assistance, such as favorable rent or loans or grants, provided to the local facility of an outside business must be limited to the local facility.

Looking at the second factor, the IRS that varies types of assistance are acceptable, including loans, grants, the purchase of equity business interests, technical assistance, counseling, favorable leases, advertising and otherwise publicizing businesses in a deteriorated area, and constructing a retail center in a depressed area. This assistance must be provided in a noncommercial manner such as offering low-interest loans and low rental rates, and all forms of assistance must have the potential to promote revitalization of businesses in the disadvantaged area.[209] In addition, the assisted businesses should not be otherwise able to obtain the assistance because of the depressed area or the business's affiliation with a minority or other disadvantaged group.

[207]It is also possible that the activity could qualify under section 501(c)(3) under the ''lessening the burdens of government'' standard under Treas. Reg. § 1.501(c)(3)-1(d)(ii) or as scientific research, although the IRS rejected the scientific research argument under the facts presented in Gen. Couns. Mem. 39883.

[208]Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); Rev. Rul. 74–587, 1974-2 C.B. 162; Rev. Rul. 76–419, 1976-2 C.B. 146.

[209]In Priv. Ltr. Rul. 200614030 (Jan. 13, 2006), the IRS said that providing businesses with ''pre-seed capital'' to assist the businesses in the very early stages of technological development was an acceptable part of the total incubator package of services.

With respect to the final requirement that there be a nexus between the businesses that are assisted and relieving the problems in the area, the IRS said that there are three characteristics that demonstrate such a nexus:

1. Assistance recipients conducting their business in the economically disadvantaged area
2. Recipients not being otherwise able to obtain assistance from conventional sources because of the depressed nature of the area or affiliation of business participants with minority or other disadvantaged groups
3. Assistance recipient selection based on which recipients will offer the greatest potential community benefit by virtue of either their current operations or their promises to take certain actions benefiting the depressed area

If these factors are met, the college or university that is not able to show that its business incubator activity is primarily used as a learning vehicle, but rather is intended to foster community development, should be able to operate the incubator activity within the scope of its section 501(c)(3) mission.

CHAPTER FOUR

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§ 4.1 INTRODUCTION

The Internal Revenue Code imposes a number of different types of taxes, including income taxes, excise taxes, and estate and gift taxes, to name just a few of the most common. There is also a category of employment taxes, which consists of Social Security taxes, unemployment taxes, and wage withholding taxes. While colleges and universities are exempt from federal income taxes, they have no such exemption from these other federal taxes and are subject to employment taxes just as any for-profit corporation.

The first of these employment taxes, the Social Security tax (sometimes known as Federal Insurance Contributions Act, or FICA, tax), is imposed on both employers and employees. This tax is measured by the amount of wages paid with respect to employment, and the terms *employer, employee, wages*, and *employment* have special definitions for purposes of the Social Security tax. It is safe to say that most salary payments made by colleges and universities to individuals whom the school has classified as employees are subject to Social Security taxes. The Social Security tax is computed by applying the tax rate in effect (currently 7.65 percent for both the employer and the employee portions of the tax) to the amount of wages paid to the employee, and employers are required to collect the employee portion of the tax by deducting it from the wages paid to the employee at the time of payment and later paying both the employee's and the employer's portion of the tax to the IRS.[1]

The federal unemployment tax (FUTA) is part of a joint federal-state governmental program designed to provide benefits to employees during periods of temporary unemployment. Both the federal and the state governments impose a tax on employers to help finance this program, and certain states require that employees contribute to the program as well. The federal unemployment tax is imposed in the same manner as the Social Security tax—as a percentage of the wages paid to the employee, and as under the Social Security tax, certain types of employment are excepted from application of the

[1] *See* I.R.C. §§ 3101–3128, Ch. 21. The social security tax is actually composed of two different elements: old age, survivor, and disability insurance, which has a tax rate of 6.2 percent, and hospital and Medicare insurance, with a tax rate of 1.45 percent.

tax. Unlike the Social Security tax, however, the federal unemployment tax is reduced by the amount of state unemployment tax paid by the employer.[2]

The final category of employment taxes is wage withholding taxes, which are employees' income taxes that are withheld by employers from the wages paid to their employees.[3]

An important aspect of each of these taxes is that the employer is liable for the taxes that it does not pay over to the IRS, even if the taxes that should be withheld are actually tax liabilities of the employee, such as the employee's portion of the Social Security taxes and the wage withholding taxes. Although there are mechanisms by which the employer can obtain a subsequent credit if the taxes are ultimately paid by the employee,[4] the IRS is able to assert some significantly high-dollar deficiencies against employers, including colleges and universities, in the employment tax area in large part because the employer is held liable for taxes that are substantively imposed on its employees.

This chapter discusses the employment tax issues most commonly faced by colleges and universities during the course of making payments to their employees and other workers. In addition, readers might want to consult a training manual issued by the IRS national office in late 1999, focusing on employment tax issues facing educational institutions.[5]

§ 4.2 EMPLOYEE VERSUS INDEPENDENT CONTRACTOR CLASSIFICATION

Unlike many college and university tax issues that apply to some schools but not to others, the task of determining whether a worker should be classified as an employee or an independent contractor has an impact on each and every educational institution. Moreover, if the IRS initiates an audit of a college or university, while some tax areas may go unexamined, the IRS undoubtedly will examine, and examine in great detail, the employee/independent contractor classification area.

The reason that a college or university is required to make this classification arises from the withholding tax requirement that every employer must withhold income tax from the ''wages'' it pays.[6] The Code defines the term *wages* as remuneration for ''services performed by an employee,'' thereby raising the basic question of whether the worker is, in fact, an employee.[7] If a worker

[2]*See* I.R.C. §§ 3301–3311, Ch. 23.
[3]*See* I.R.C. §§ 3401–3406, Ch. 24.
[4]IRC §§ 3402(d) (income taxes), 6402 (Social Security taxes).
[5]Internal Revenue Service, *2000 Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000*, 22nd ed., at 177–185 (1999).
[6]IRC § 3402(a)(1).
[7]IRC § 3401(a). The issue from a Social Security tax withholding perspective arises from IRC § 3102(a), which requires employers to deduct Social Security tax from ''wages,'' which is defined

is not an employee, the worker is an ''independent contractor.'' There are no other alternatives.

Significant ramifications result from classifying the worker as either an employee or an independent contractor. If the worker is classified as an independent contractor, the entity making the payment to the worker has only the obligation to file Form 1099 with the IRS; this form reports the amount paid to the individual, but only if the payment exceeded $600.[8] By contrast, if the worker is classified as an employee, the college or university making the payment must (1) withhold the employee's share of income and Social Security taxes, (2) pay the employer's share of Social Security taxes, and (3) pay federal unemployment taxes. There may be other ramifications as well, such as having to take employees into account in determining whether a qualified retirement plan is discriminatory.[9]

The basic test used in making the employee/independent contractor classification is derived from the common law definition of an *employee*. This definition states that a worker is an employee if the person for whom the services are performed has the right to direct and control the worker, not only as to the result to be accomplished by the work but also as to the details by which the work is accomplished.[10] Although this test sounds simple, the application of the ''direction-and-control'' requirement is made by using a facts and circumstances test that is one of the most difficult tests in the tax law to apply.

Literally hundreds of court cases have wrestled with the different direction-and-control factors that should be taken into account, as well as the relative weight to be given to each. A 1992 Supreme Court case is representative of the cases outlining factors that go into making this determination.[11] In this case, the Supreme Court considered the skill required of the worker; whether the worker supplied his or her own tools; the location of the work; the duration of the relationship between the parties; whether the hiring party had the right to assign additional projects to the worker; the extent of the worker's discretion over when and how long to work; the method by which the worker was paid; the worker's role in hiring and paying assistants; whether the work was part of the regular business of the hiring party; whether the hiring party provided employee benefits to the worker; and how the hiring party classified the worker. The Court reiterated the three common themes that run through all of these cases—no shorthand formula can be applied,

in IRC § 3121(a) as remuneration from ''employment.'' To close the loop, IRC § 3121(b) defines *employment* as services, of whatever nature, performed by an ''employee.''

[8]IRC § 6041(a).

[9]IRC § 401(a)(4).

[10]*See* Treas. Reg. § 31.3401(c)-1(b).

[11]*Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).

all of the aspects of the relationship must be assessed, and no single factor is decisive.[12]

(a) IRS Position on Employee/Independent Contractor Classification

The IRS has issued two significant documents—one in 1987 and the other in 1996—that together set forth the agency's basic position on how the employee/independent contractor classification should be made. Each of these two documents is discussed below.

(i) The 20-Factors Test. In an effort to provide guidance and assistance in making employee/independent contractor classifications, the IRS reviewed the factors that the courts have analyzed in making these classifications and identified 20 factors that it found to be the most significant. These now-famous ''20 factors'' were published in 1987[13] and since that time have served as one of the primary bases on which the IRS makes its employee/independent contractor classifications, again following the well-established principle that no one factor or group of factors is necessarily determinative. Thus, it is quite important that any school making its own employee/independent contractor classification be aware of and understand the factors that the IRS uses.

The specific 20 factors are as follows:

1. *Instructions*. The IRS says that a worker who is required to comply with a college or university's instructions about when, where, and how to work is ordinarily an employee, and that this control factor exists if the school has the right to require compliance with instructions.[14]

   Comment: Instructions do reflect supervisory control, but the problem with this factor is that many contractual relationships that are obviously not employer-employee relationships include clearly delineated instructions on what is to be done. For example, if a school retains a computer consultant to install new software, it is likely that the consultant will be given a detailed list of instructions; however, that does not mean that the person is an employee. Conversely, hospitals and universities routinely employ doctors and lawyers in an employee capacity, but the employer seldom gives them instructions as to what they are supposed to do.

2. *Training*. If a college or university trains a worker by requiring an experienced employee to work with the worker, corresponding with the worker, requiring the worker to attend meetings, or using other similar training methods, this is an indication to the IRS that the school wants

[12]Other leading cases in the worker classification area are *United States v. Silk*, 331 U.S. 704 (1947), and *Bartels v. Birmingham*, 332 U.S. 126 (1947). For a more recent summary of the various judicial opinions in this area, see *Jones v. Commissioner*, T.C. Summary Opinion 2003-61.

[13]Rev. Rul. 87-41, 1987-1 C.B. 296.

[14]Rev. Rul. 68-598, 1968-2 C.B. 464; Rev. Rul. 66-381, 1966-2 C.B. 449.

the services performed in a particular method or manner and that the worker is an employee.[15]

Comment: Training, like instructions, is a form of supervisory control, but the lack of training does not necessarily indicate that the employer does not control the individual.[16] And the fact that the school may provide some training to the worker does not mean that the person is an employee.[17]

3. *Integration*. The IRS believes that integration of a worker's services into a college or university's educational or other activities generally shows that the worker is subject to the school's direction and control. If the success or continuation of an activity depends to an appreciable degree upon the performance of certain services, the IRS generally concludes that the worker who performs these services must necessarily be subject to a certain amount of control by the college or university.[18]

   Comment: One court found the integration factor to be the ''most important'' in making the employee/independent contractor determination,[19] while another court, recognizing that independent contractors can likewise be an integral part of the company's business, found this factor to be relevant but ''not determinative.''[20]

4. *Services Rendered Personally*. If a school requires that an individual's services be rendered personally, it is an indication to the IRS that the school is interested in the methods used to accomplish the work as well as in the results and that the worker is an employee.[21]

   Comment: In other words, if the worker does not have the right to delegate the work to others, it is evidence that the worker is an employee. While at least one court has found this factor significant,[22] it is relatively unusual for a college or university that retains the services of any particular person, whether an employee or an independent contractor, to give the person the right to delegate to a third party the obligation to perform the expected work. So it is difficult to see how this factor should be of any great significance.

5. *Hiring, Supervising, and Paying Assistants*. If a college or university hires, supervises, and pays assistants for a worker, this generally shows the IRS an element of control over the worker on the job. If, however, the

[15] Rev. Rul. 70-630, 1970-2 C.B. 229.
[16] *Titanium Ores Corp. v. United States*, 205 F. Supp. 606, 611 (D. Md. 1962).
[17] *See, generally, Radio City Music Hall Corp. v. United States*, 135 F.2 d 715 (2 d Cir. 1943).
[18] *United States v. Silk*, 331 U.S. 704 (1947).
[19] *Gilmore v. United States, Civil No*. K-25-754 (D. Md. 1977).
[20] *Rayhill v. United States*, 364 F.2 d 347, 355 (Ct. Cl. 1966).
[21] Rev. Rul. 55-695, 1955-2 C.B. 410.
[22] *Service Trucking Co. v. United States*, 347 F.2 d 671 (4th Cir. 1965).

worker hires, supervises, and pays his or her own assistants under a contract which provides that the worker is to supply materials and labor and is responsible only for the attainment of a result, the IRS generally concludes that the worker is an independent contractor.[23]

Comment: Interestingly, in the two cited rulings, both of which involved the status of truck unloaders who worked under the supervision of drivers for a trucking company, the IRS assumed that the unloaders were employees either of the trucking company or of the drivers, but in neither case did the IRS use the status of the unloaders to determine the status of the drivers.

6. *Continuing Relationship*. A continuing relationship between a college or university and a worker indicates to the IRS that an employer-employee relationship exists. The IRS usually finds the requisite ''continuing relationship'' where the work is performed at frequently recurring intervals, even though the intervals may be irregular.[24]

Comment: In applying this factor, it is also important to take into account the length of time that the person works and whether he or she is paid by the job or by the time spent. Thus, even if there is a continuing relationship between the school and the worker, if the duration of the work is short and the person is paid by the job, the worker should probably still be classified as an independent contractor.

7. *Set Hours of Work*. If the IRS finds that a school sets the hours of work for a worker, it shows to the IRS the school's control over the worker.[25]

Comment: But there are many clearly independent contractor situations where a college or university will set the hours of work, for example, requiring that an entertainer perform at certain times; requiring that the services be performed during business hours; or requiring that the services be performed during nonbusiness hours so as not to disturb the workplace.

8. *Full-Time Required*. If a worker must work full-time for a college or university, the IRS normally concludes that the school has control over the amount of time the worker spends working, thereby restricting the worker from doing other gainful work. The IRS contrasts this with an independent contractor, who is free to work when and for whom he or she chooses.[26]

Comment: Although this is certainly an important factor, it is interesting to note that in the cited ruling there is no discussion of the ''full-time''

[23] *Compare* Rev. Rul. 63-115, 1963-1 C.B. 178, *with* Rev. Rul. 55-593, 1955-2 C.B. 610.
[24] *Silk, 331 U.S. at 704*.
[25] Rev. Rul. 73-591, 1973-2 C.B. 337.
[26] Rev. Rul. 56-694, 1956-2 C.B. 694.

factor; rather, the fact that the person is engaged on a full-time basis is simply mentioned in the ruling's factual summary.

9. *Doing Work on Employer's Premises*. If a college or university requires that the work be performed on campus or another location that is part of the school, it suggests to the IRS that the school exercises control over the worker, especially if the work could be done elsewhere.[27] When the work is done off-campus, such as at the worker's office, this indicates some freedom from control. The IRS notes, however, that the importance of this factor depends on the nature of the services involved and the extent to which an employer generally would require employees to perform similar services on the employer's premises. As examples in the for-profit context, the IRS says that there is control when a business has the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.[28]

Comment: In analyzing this factor, the IRS omits to mention a 1973 ruling in which it held that, while furnishing a place to work and supplies are factors showing an employer-employee relationship, ''the existence of those factors alone is not sufficient to establish such a relationship for federal employment tax purposes.''[29]

10. *Order or Sequence Set*. If a worker must perform services in the order or sequence set by the college or university, it shows to the IRS that the school is in control of the worker because the worker is not free to follow his or her own pattern of work but must follow the school's established routines and schedules. The IRS notes that, depending on the nature of a particular occupation, an entity often does not set the order of the services, or may set the order infrequently. The IRS considers that the requisite control exists, however, if the entity retains the right to set the order.[30]

Comment: The IRS fails to note that it is also not unusual to set forth ''order or sequence'' type instructions as part of independent contractor relationships.

11. *Oral or Written Reports*. A requirement that a worker submit regular written reports to the college or university indicates to the IRS a degree of control over the worker.[31]

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[27] Rev. Rul. 56-660, 1956-2 C.B. 693.
[28] Rev. Rul. 56-694, 1956-2 C.B. 694.
[29] Rev. Rul. 73-592, 1973-2 C.B. 338.
[30] *Id*.
[31] Rev. Rul. 70-309, 1970-1 C.B. 199; Rev. Rul. 68-248, 1968-1 C.B. 431.

Comment: Probably because the requirement to submit these reports is equally prevalent in independent contractor situations, the IRS says that this factor evidences only a ''degree of control.''

12. *Payment by Hour, Week, Month*. The IRS believes that payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight-commission basis generally indicates to the IRS that the worker is an independent contractor.[32]

Comment: This factor was given significant weight by the Restatement (Second) of Agency in making employee/independent contractor determinations.[33]

13. *Payment of Business and/or Traveling Expenses*. If a college or university ordinarily pays a worker's business and/or traveling expenses, the IRS generally concludes that the worker is an employee on the ground that the school, in order to be able to control expenses, retains the right to regulate and direct the worker's business activities.[34]

Comment: The IRS position ignores the common practice of many independent contractors (e.g., attorneys) to charge the client for the business and/or traveling expenses that they incur in connection with the services rendered.

14. *Furnishing of Tools and Materials*. The fact that a college or university furnishes tools, materials, and other equipment to the worker tends to show to the IRS the existence of an employer-employee relationship.[35]

Comment: It is also probably fair to say that there is a quantitative aspect to this factor—that is, the more tools and materials furnished, the greater likelihood that the person is an employee on the theory that increased tools and material lead to increased direction and control.[36]

15. *Significant Investment*. If a worker invests in facilities used by the worker in performing services and such facilities are not typically maintained by employees (e.g., the maintenance of an outside office rented at fair value from an unrelated party), it indicates to the IRS that the worker is an independent contractor. By contrast, the IRS believes that a worker's lack of investment in facilities shows dependence on the college or

[32]Rev. Rul. 74-389, 1974-2 C.B. 330.
[33]*Restatement (Second) of Agency* § § 220, at 485–486, 490.
[34]Rev. Rul. 55-144, 1955-1 C.B. 483.
[35]Rev. Rul. 71-524, 1971-2 C.B. 346.
[36]*Restatement (Second) of Agency* § 220, at 485–486, 490.

university for the facilities and, accordingly, indicates the existence of an employer-employee relationship. The IRS notes that special scrutiny is required for certain types of facilities, such as home offices.[37]

Comment: Although the presence of a significant financial investment by a worker is strong evidence of independent contractor status, the fact that there is little or no investment is a fairly weak factor in favor of finding employee status.

16. *Realization of Profit or Loss*. The IRS generally regards a worker to be an independent contractor if the worker can realize a profit or suffer a loss from performing services, while a worker who cannot realize a profit or loss is generally regarded as an employee.[38] The IRS says, for example, that if a worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, this indicates that the worker is an independent contractor, but the mere risk that a worker will not receive payment for services, which is common to both independent contractors and employees, is not a sufficient economic risk to support treatment as an independent contractor.

Comment: The IRS concludes that the employee's risk of not getting paid for the services rendered is on the same level with that of an independent contractor and that the existence of this risk should therefore not be taken into account in making the determination. It is hard to see how the IRS can reach this conclusion since the chance that an independent contractor will not get paid seems significantly greater than the risk that an employee will not receive a paycheck.

17. *Working for More Than One Business at a Time*. If a worker performs more than minimal services for a number of other unrelated nonprofit or for-profit organizations at the same time, it generally indicates to the IRS that the worker is an independent contractor.[39] But the IRS notes that a worker who performs services for more than one entity may be an employee of each.

Comment: This is obviously an important factor in favor of independent contractor classification, and while it is certainly possible, as the IRS suggests, that a person can be employed concurrently for different entities, these are fairly rare situations.

18. *Making Services Available to the General Public*. The fact that a worker makes his or her services available to the general public on a regular

[37] *Id*.
[38] Rev. Rul. 70-309, 1970-1 C.B. 199.
[39] Rev. Rul. 70-572, 1970-2 C.B. 221.

basis indicates to the IRS the existence of an independent contractor relationship.[40]

Comment: This is another very important factor in favor of independent contractor status. In fact, when this factor is present together with ''less than full-time required'' and ''working for more than one firm at a time,'' there is an almost irrebutable presumption that the person is an independent contractor.[41]

19. *Right to Discharge*. A college or university's right to discharge a worker is a factor indicating to the IRS that the worker is an employee. The IRS states that an employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions, while an independent contractor cannot be fired so long as he or she produces a result that meets contractual specifications.[42]

Comment: This factor ignores the fact that many employees cannot be discharged because of contractual or collective bargaining provisions, and at least one court has failed to give this factor a great deal of weight.[43]

20. *Right to Terminate*. The IRS believes that if a worker has the right to end his or her relationship with a college or university at any time without incurring liability, this indicates an employer-employee relationship.[44]

Comment: This is the converse of the right to discharge and is considered by the IRS to be an important factor in making the employee/independent contractor determination.

While there are certain types of workers who are more apt to work for higher education institutions,[45] as a general rule the worker classification issues faced by colleges and universities do not vary in any significant respect from those faced by for-profit corporations. Thus, while the IRS obviously drafted its ''20 factors'' with for-profit businesses in mind, the factors are equally applicable to colleges, universities, and other nonprofit organizations.

Although situations vary from case to case, as a general rule all employers (including colleges and universities) have an interest in classifying a worker as an independent contractor so as to avoid Social Security, unemployment, and wage withholding taxes, as well as the requirement to pay fringe benefits such as medical and life insurance and pension plan coverage. At the same time, many workers tend to favor independent contractor classification because

[40] Rev. Rul. 56-660, 1956-2 C.B. 693.
[41] *Restatement (Second) of Agency* § 220, at 485.
[42] Rev. Rul. 75-41, 1975-1 C.B. 323.
[43] *Rayhill v. United States*, 364 F.2 d 347, 354 (Ct. Cl. 1966).
[44] Rev. Rul. 70-309, 1970-1 C.B. 199.
[45] *See* § 4.2(f).

it eliminates any wage and Social Security/unemployment tax withholding. Thus, there is often a motivation on both sides to make an independent contractor classification. In relatively large organizations, this bias can usually be corrected by assigning to the payroll or accounting office the task of objectively applying the applicable criteria to new hires. In many college and university settings, however, this centralized control factor often does not work as well as it should because many schools tend to hire individuals on a decentralized basis, with the initial classification decisions often made, for example, by the chair of the chemistry department or other official within that department. When the classification decision filters back to the payroll or accounting office, there is often neither expertise nor the political clout to give the initial decision the proper review and, if necessary, to reverse it.

(ii) Training Manual Tests. Following its 1987 publication of the ''20 factors'' ruling, the IRS issued little guidance to help taxpayers make worker classification determinations, except for dozens of private letter rulings, most of which concluded that the worker in question should be classified as an employee and not an independent contractor. As a result, the IRS was criticized, particularly by the small business community, about the ''pro-employee'' position that it regularly took during audit examinations and in rulings, and about its failure to provide any additional guidance as to how the common law ''direction and control'' factors should be applied.

The cumulative effect of this criticism eventually had an impact on the IRS. In 1996, it issued a training manual designed to give IRS employment tax agents additional guidance on how the worker classification decisions should be made.[46] It is fairly obvious that the IRS intended that this training manual, in addition to helping train its employment tax agents, also serve as a guide to taxpayers regarding the IRS's position on how employee/independent contractor determinations should be made.[47] The IRS initially published the training manual in proposed form, with the request that comments be submitted by both IRS agents and the general public. The IRS reviewed and analyzed these comments and published the final version of the manual later in 1996.[48] The IRS made several significant changes in the final version to reflect some of the comments received. These included (1) requiring the agents to give taxpayers about to be examined a plain-language summary of the section 530 relief provisions,[49] (2) advising the agents to focus on unreimbursed expenses, not reimbursed expenses, and (3) telling the agents that workers who receive hourly wages are not necessarily employees.

[46]I.R.S. News Release 96-7 (Mar. 5, 1996).
[47]The training manual is another example of a technique that the IRS finds so popular these days of issuing guidance to taxpayers disguised as guidance to the IRS agents.
[48]*Independent Contractor or Employee?*, IRS Training Materials, Training 3320-102 (Rev. 10/96). This training manual can be found on the IRS web site at *www.irs.gov/pub/irs-utl/emporind.pdf*.
[49]*See* § 4.2(b).

The training manual focuses on the common law ''direction and control'' test as the primary vehicle in making employee/independent contractor determinations but emphasizes the evidence that the agent must develop in order to support the final result. It divides the type of evidence that should be developed into three categories—evidence showing behavioral control, evidence showing financial control, and evidence demonstrating the relationship between the parties.

According to the IRS, behavioral control primarily involves training and providing instructions to the worker. Training is the ''classic means'' of explaining the methods and procedures to perform a task, and providing instructions is strong evidence that the employer not only has the right to direct and control the worker, but also actually exercises that right. The training manual includes a detailed description of the different types of instruction that can constitute appropriate evidence that behavior-related direction and control is present. For example, if a worker is instructed to obtain approval before taking certain actions, he or she is likely to be classified as an employee. But the manual distinguishes between instruction as to what is to be done and instruction as to how it is to be done, with only the latter type of instruction reflecting employee situations. For example, assume that an independent truck driver receives a call from a manufacturing company to make a delivery in a certain part of the United States. When he picks up the cargo for delivery, the company gives him an address at which the cargo should be delivered and tells him that the delivery must be completed within two days. This is an instruction as to what is to be done, rather than how it is to be done, and is consistent with independent contractor status.

The second type of evidence of direction and control—financial control over the worker—relates to the business aspects of the relationship, and the question to be asked is: ''Does the recipient have the right to direct and control business-related means and details of the worker's performance?'' Evidentiary aspects that are important include whether the worker (1) has made a significant financial investment in the business activity (indication of independent contractor); (2) receives reimbursement for the business expenses incurred (indication of employee); (3) provides the same or similar services to other members of the general public (indication of independent contractor); (4) receives a salary, flat fee, or commission (salary indicates employee; flat fee/commission indicates independent contractor); and (5) has the opportunity for personal profit or loss from the activity (indicates independent contractor).

The final category of direction and control evidence is the relationship between the parties. This factor relates to how the two parties perceive their own relationship and includes such items as whether (1) the employee receives employee-type benefits, such as vacation days, sick days, and health insurance; (2) a written contract exists and sets forth the worker's duties and the terms and

conditions of the contract; (3) the relationship is expected to be a permanent one; (4) the worker can be discharged at any time without incurring a penalty; and (5) the worker's activities are part of the regular business activities of the employer. All these factors indicate an employee relationship, except perhaps for the written contract, which could equally pertain to independent contractors.

The training manual also sets forth various factors that have been used in other cases and rulings but that the IRS views as less important in making worker classifications. These include whether the individual works part-time or full-time, whether the employment is temporary, the location where the worker conducts his or her activities, and the hours that the individual is required to work.

In 2003, the IRS issued guidance to its exempt organization agents in which it discusses the process of making employee/independent contractor determinations using the training manual guidelines. This guidance also analyzes recent case law in the area.[50]

(b) Section 530 Relief

During the late 1960s and into the 1970s, the IRS significantly increased its enforcement of the employment tax laws, and a substantial number of controversies developed between the IRS and taxpayers as to whether businesses had correctly classified workers as independent contractors. Because of its belief that the IRS was acting unfairly in many situations, Congress enacted section 530 of the Revenue Act of 1978.[51] One of the most important aspects of section 530 was a provision that allowed an employer to treat a worker as a nonemployee for employment tax purposes, regardless of the worker's actual status under the common law direction and control test, if the employer (1) had a reasonable basis for such treatment, (2) treated all similar workers as independent contractors, and (3) filed all required federal tax returns on a basis consistent with independent contractor classification. While the courts have generally interpreted the provisions of section 530 quite liberally to provide pro-taxpayer relief,[52] one court has held that a university hospital's medical residents could not rely on section 530 to receive refunds of FICA tax withheld from their stipends because section 530 relief is available only for employers.[53]

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[50] *2003 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook for FY 2003*, at D-1 (2002).

[51] Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2885 (1978).

[52] See, e.g., *Lambert's Nursery & Landscaping, Inc. v. United States*, 894 F.2 d 154 (5th Cir. 1990); *General Investment Corp. v. United States*, 823 F.2 d 337 (9th Cir. 1987); *Ridgewell's Inc. v. United States*, 655 F.2 d 1098 (Ct. Cl. 1981); *North Louisiana Rehabilitation Center, Inc. v. United States*, 179 F. Supp. 2 d 658 (W.D. La. 2001).

[53] *Ahmed v. United States*, 147 F.3 d 791 (8th Cir. 1998).

Although initially passed in 1978 as a temporary relief measure, this rule was made a permanent part of the tax law by Congress in 1982.[54] In 1986, Congress modified the rule to provide that section 530 relief will not be granted in the case of a worker who provides services as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[55] Therefore, these types of workers are not eligible for the general relief provisions of section 530 and will be treated as employees if they meet the general common law tests. In 1996, Congress made further modifications to section 530, which, for the most part, liberalized the provision, making it easier for employees to obtain relief.[56]

(i) The ''Reasonable Basis'' Test. The ''reasonable basis'' component of section 530 provides that a reasonable basis for treating the worker as an independent contractor exists if the employer reasonably relied on any of the following:

- Judicial precedent, published rulings, or a technical advice memorandum or private letter ruling issued with respect to the taxpayer;
- A past IRS audit of the taxpayer in which there was no employment tax assessment attributable to the treatment of individuals holding positions substantially similar to the position held by the individuals in question
- A long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

These factors are a safe harbor, not necessarily the exclusive means of meeting the reasonable basis requirement. Therefore, as discussed in more detail below, whether a particular classification meets the reasonable basis test sometimes turns on whether the employer can show some ''other reasonable basis'' for treating the individual as an independent contractor outside the specific safe harbor.

With respect to the judicial precedent/public rulings safe harbor, there is little guidance as to the degree of similarity of the facts that must be demonstrated in order for an employer to be able to rely on this provision. The IRS has ruled that the precedent need not necessarily be related to the employer's particular business or industry[57]; and, in a 1991 ruling, the IRS permitted an employer to rely on precedent that presented facts that were

[54]Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 92-248, § 269(c), 96 Stat. 342, 552 (1982).
[55]Tax Reform Act of 1986, Pub. L. No. 99-514, § 1706, 100 Stat. 2085, 2781 (1986).
[56]Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1122, slip copy, 110 Stat. 1755, 1766–68 (1996).
[57]I.R.S. Litigation Guideline Memorandum, The Effect of Section 530 the Revenue Act of 1978 on Employment Tax Litigation at TL-9 (Mar. 1, 1990).

''generally similar'' to those present in the employer's situation.[58] In later rulings, however, the IRS seems to have taken a stricter approach, requiring a closer similarity of facts in the relied-upon precedential case or ruling.[59] Also, the IRS has said that an employer is not permitted to rely on judicial precedent if the case was decided after the years at issue in the audit.[60]

With respect to the safe harbor for private letter rulings and technical advice memoranda, the courts have held that an employer cannot meet this safe harbor unless the employer itself was the subject of the particular letter ruling or technical advice memorandum.[61] Nevertheless, the fact that the IRS issued a private letter ruling or technical advice memorandum to another taxpayer could support an ''other reasonable basis'' for the employer's classification.[62]

Looking next at the prior IRS audit safe harbor, although the IRS had held that it can apply even if the prior audit was not an employment tax audit,[63] in 1996 Congress amended section 530 to require that the prior audit be an employment examination of the same worker or the same class of worker involved.[64] In order to constitute an ''audit,'' there must be an official IRS examination of the taxpayer's books and records, but the IRS has ruled that a ''compliance review'' does not constitute an audit for these purposes.[65] The IRS also takes the position that audits conducted by other governmental agencies do not constitute prior audits for section 530 relief purposes and that the audit of another employer engaged in the same industry likewise does not qualify for this safe harbor provision.[66]

With respect to the industry practice safe harbor, the employer must demonstrate that the classification was made based on a long-standing recognized practice of a significant segment of the particular industry. This safe harbor provision raises a number of difficult questions. First, what constitutes a ''recognized practice'' within the industry? At one time, the IRS argued that the practice of treating workers as independent contractors must be recognized nationwide,[67] but the IRS now appears to take the position that the relevant area for evaluating the industry is the geographic region where the employer

[58]Priv. Ltr. Rul. 9243001 (Dec. 19, 1991).
[59]Priv. Ltr. Rul. 9443002 (Dec. 3, 1993); Priv. Ltr. Rul. 9420002(Jan. 6, 1994); Priv. Ltr. Rul. 9330007 (Apr. 28, 1993).
[60]I.R.S. Litigation Guideline Memorandum, supra footnote 57; Priv. Ltr. Rul. 9443002 (Dec. 3, 1993); Priv. Ltr. Rul. 9350002 (Sept. 2, 1993); Priv. Ltr. Rul. 9321001 (Feb. 1, 1993).
[61]*Darrell Harris, Inc. v. United States*, 770 F. Supp. 1492(W.D. Okla. 1991).
[62]*Ridgewell's, Inc. v. United States*, 655 F.2 d 1098, 1105 (Ct. Cl. 1981).
[63]I.R.S. Litigation Guideline Memorandum; see footnote 57; Priv. Ltr. Rul. 9402001 (Jan. 25, 1993); Priv. Ltr. Rul. 9236006 (June 8, 1992).
[64]Small Business Job Protection Act of 1996; see footnote 56, § 1103.
[65]Priv. Ltr. Rul. 9033003 (Aug. 17, 1990).
[66]Hospital Resource Personnel, Inc. v. United States, 860 F. Supp. 1557 (S.D. Ga. 1994), aff'd in part, vacated in part, 68 F.3 d 421 (11th Cir. 1995).
[67]General Inv. Corp. v. United States, 823 F.2 d 337 (9th Cir. 1987).

is located.[68] Second, what constitutes a ''significant segment'' of the particular industry? Prior to 1996, the guidance on this question was quite inconsistent,[69] but in a 1996 amendment to section 530, Congress stated that more than 25 percent is sufficient to constitute a ''significant segment'' of the industry.[70] Finally, has the industry practice been ''long-standing''? The IRS has stated that there is no fixed time period that necessarily meets this test,[71] and one court has held that seven years is a sufficient length of time to constitute a ''long-standing'' practice.[72] In 1996, Congress stated that less than 10 years may be sufficient, depending on the facts and circumstances.[73]

With respect to all of the reasonable basis safe harbors, the IRS requires the taxpayer to demonstrate that it actually relied on the industry practice in determining to treat its workers as independent contractors.[74]

Even if the employee fails to satisfy the three specific ''reasonable basis'' safe harbors, it can meet the ''reasonable basis'' requirement of section 530 in other ways.[75] For example, the IRS has ruled that reliance on legal advice constituted a reasonable basis for not treating certain workers as employees.[76] The case law in this area, however, has been less than instructive, and the courts have gone in a number of different directions in determining whether some ''other reasonable basis'' exists. Some courts have permitted the employee to meet the ''other reasonable basis'' test by looking at the same type of evidence that would be introduced outside the context of the section 530. In other words, given all the facts and circumstances, did the employer have a reasonable basis for classifying the individual as an independent contractor?[77] Another case required only that the employer show that it took reasonable steps to determine the classification of its workers and held that this can be demonstrated through

[68]Priv. Ltr. Rul. 9443002 (Dec. 3, 1993); Priv. Ltr. Rul. 9442002 (Jan. 6, 1994).

[69]One IRS official publicly stated that this requirement is satisfied when at least 80 percent of the businesses in the relevant industry treat similarly situated workers as independent contractors. See ''Service Hopes to Issue Guidance on Classification of Workers,'' *Tax Notes*, May 21, 1992, at 1541. In a court case, however, the IRS argued that the ''significant segment'' of the industry test means that more than 50 percent of the members of the industry treat the workers at issue as independent contractors. *In re Bentley*, No., 93-30510, 1994 W.L. 171200, at * 4 (Bankr. E.D. Tenn. Feb. 25, 1994). The courts have reached varying conclusions on this issue, with one indicating that an amount below 75 percent qualifies, *REAG, Inc. v. United States*, 801 F. Supp. 494 (W.D. Okla. 1992), and another stating that less than a majority meets the test, *In re Bentley*, 175 B.R. 652 (Bankr. E.D. Tenn. 1994). Yet another case held that 39 percent could constitute a ''significant segment'' of the industry. *Hospital Resource Personnel, Inc.*, 860 F. Supp. at 1561.

[70]Small Business Job Protection Act of 1996, § 1103.

[71]Priv. Ltr. Rul. 8749001 (Feb. 10, 1987).

[72]*REAG, Inc.*, 801 F. Supp. at 499.

[73]Small Business Job Protection Act of 1996, § 1103.

[74]Priv. Ltr. Rul. 9420002 (Jan. 6, 1994); IRM 4015.3(1) (Aug. 2, 1996).

[75]Rev. Proc. 85-18, 1985-1 C.B. 518.

[76]Tech. Adv. Mem. 9801001 (May 6, 1997).

[77]*Henderson v. United States*, No. 1:90-CV-1064, 1992 WL 104326, at *3 (W.D. Mich. Feb. 18, 1992); *Hospital Resource Personnel, Inc.*, 860 F. Supp. at 1561; *REAG, Inc.*, 801 F. Supp. at 495. *But see Boles Trucking, Inc. v. United States*, 77 F.3 d 236 (8th Cir. 1996) (calling these cases into question).

evidence of the employer's subjective intent at the time of the classification and its reliance on the advice of attorneys and accountants in treating the workers as independent contractors.[78] It appears that the IRS may agree with this approach.[79] Finally, other cases have held that an employee can satisfy the ''other reasonable basis'' test by showing reliance on the audit of another taxpayer in the same industry or on private letter rulings issued to other taxpayers.[80]

(ii) The ''Substantive Consistency'' Requirement. The second component of section 530—whether the employer treated all similar workers as independent contractors—also raises a number of difficult issues. For example, what if an employer initially treated its workers as independent contractors but subsequently reclassified such workers as employees? In these situations, the IRS holds that section 530 relief will be allowed for any periods prior to the period in which the individuals were treated as employees.[81] For example, if a university treated a certain class of workers as independent contractors for all periods prior to 2007, but began treating these workers as employees in 2007, it could obtain section 530 relief for all similarly situated workers for taxable years before 2007 but not for 2007 or later years.[82]

Another issue is what constitutes ''treating'' the worker as an employee for purposes of section 530. The IRS takes the position that the withholding of income or Social Security taxes from the individual's wages constitutes ''treatment'' of the worker as an employee and that the filing of an employment tax return with respect to the worker is also ''treatment'' as an employee.[83] Another issue is whether the workers who were treated as independent contractors were in ''substantially similar positions'' as bona fide independent contractors. Whether workers are ''similarly situated'' raises yet another facts and circumstances test[84] and, according to the IRS, the day-to-day services provided by the workers, the method by which they perform those services, and the similarity of job functions are all important factors in making this determination.[85]

Also, in 2000 the IRS chief counsel's office determined that the substantive consistency test of section 530 is not applied on a consolidated basis but rather on an entity-by-entity basis.[86] The case involved a large health care

[78]Smokey Mountain Secrets, Inc. v. United States, 910 F. Supp. 1316, 1324 (E.D. Tenn. 1995).
[79]IRM 4015.3(1) (Aug. 2, 1996).
[80]*Hospital Resource Personnel, Inc.*, 860 F. Supp. at 1561; *Ridgewell's, Inc.*, 655 F.2 d at 1105.
[81]Rev. Proc. 85-18, 1985-1 C.B. 518.
[82]For a case in which the court held that an employer failed the ''substantial consistency test,'' see *Kentfield Med. Hosp. Corp. v. United States*, 215 F. Supp. 2 d 1064 (N.D. Cal. 2002).
[83]Rev. Proc. 85-18, 1985-1 C.B. 518.
[84]Rev. Rul. 87-41, 1987-1 C.B. 296.
[85]*Independent Contractor or Employee?*, IRS Training Materials, Training 3320-102 (Rev. 10/96).
[86]Field Service Advice 200129008 (Dec. 15, 2000).

organization that filed a consolidated return with its subsidiaries. In determining whether the safe harbor rules of section 530 applied, the IRS said that a subsidiary corporation could not rely on the fact that the IRS had conducted an employment examination of its parent and that a parent could likewise not rely on a prior audit of a subsidiary.

(iii) The ''Return Filing Consistency'' Requirement. The final section 530 requirement is that the employer must have filed all federal tax returns consistent with treating the workers as independent contractors in a timely manner.[87]

(iv) Issues Relating to Employee Status. The nature of the individual's employee status can impact the application of section 530 relief. For example, the IRS has said that section 530 relief is available for income tax withholding purposes with respect to state and local government workers who are treated as employees under a so-called section 218 agreement between a state and the Department of Health and Human Resources, but that no section 530 relief is available for FICA tax purposes.[88]

The Tax Court, on the other hand, has held that section 530 relief is available only where a worker's status as employee is determined under the common-law rules, rather than under a statutory definition of employee. Thus, the court ruled that section 530 relief is unavailable, for purposes of *any* employment taxes, to workers who are statutorily classified as employees as corporate officers under section 3121(d)(1) or as ''statutory employees'' under section 3121(d)(3). In addition, the Tax Court extended this ruling also hold that section 530 relief is not available to state and local government employees who are treated as employees under section 218 agreements.[89]

(v) Burden of Proof. With respect to worker classification suits arising in 1997 and later years, Congress modified the burden of proof in section 530 cases by providing that if the employer can establish a prima facie case that it was reasonable to treat the worker as a nonemployee, the burden of proving that the worker is an employee shifts to the IRS.[90] The burden shifts, however, only with respect to the three safe harbor tests; the burden remains on the taxpayer to prove any other aspect of section 530 that may be at issue.[91] And in order for

[87]For situations applying this test, see Rev. Rul. 83-16, 1983-1 C.B. 235 (where relief was denied to a medical corporation that changed its treatment of doctors as employees); Rev. Rul. 81-224, 1981-2 C.B. 197 (where relief was denied because the Forms 1099 were not timely filed); and Chief Counsel Advice 199950035 (Dec. 17, 1999) (where relief was granted even though the employer did not report certain constructive payments).
[88]Field Service Advice 1998-368.
[89]*Grey v. Commissioner*, 119 T.C. 121 (2002).
[90]Small Business Job Protection Act of 1996, § 1122.
[91]*See* H.R. Rep. No. 737, 104th Cong., 2 d Sess. 28–29 (1996).

the burden to shift on these three tests, the taxpayer must fully cooperate with respect to all reasonable requests made by the IRS for information necessary to make the worker classification.[92]

(vi) Benefits of Section 530 Relief. If a college or university meets all three tests and qualifies for section 530 relief, the benefits can be quite substantial. If, for example, the IRS were to audit an educational institution and find that different classifications of workers whom the institution had treated as independent contractors were, in fact, employees, a substantial tax deficiency could be asserted. Even if the institution was incorrect in its classifications, if it were able to qualify for section 530 relief, the tax deficiency could not be assessed. Because of the substantial benefits available to taxpayers under section 530, the IRS, not expectedly, often takes a narrow view of the section 530 relief provisions, and it is often difficult to convince the IRS agent that section 530 relief should be available.

(c) IRS Classification Settlement Program

In early 1996, the IRS implemented a new classification settlement program (CSP) that was designed to help resolve worker classification issues as early as possible in the administrative process.[93] This CSP was implemented for a two-year test period, but because of its success, the IRS extended the program indefinitely.[94] Under the CSP, if an agent audits a taxpayer and determines that there exist worker classification issues, the agent and the group manager must determine whether the taxpayer is eligible for a CSP settlement offer. If so, the settlement offer will be made.

The settlement offer is based on whether and to what extent the taxpayer meets the section 530 relief provisions discussed above. If the taxpayer meets the return filing consistency requirement, but clearly does not meet either the substantive consistency or the reasonable basis requirements, the CSP offer will be a full employment tax assessment for the one year under examination. If, however, the taxpayer meets the return filing consistency requirement and has a colorable argument of meeting the other two requirements, the CSP offer will be an amount equal to 25 percent of the employment tax deficiency for that year. Finally, if the taxpayer clearly meets all three of the section 530 requirements, no employment tax deficiency will be assessed, and the taxpayer can choose to continue treating the workers as independent contractors, or may instead choose to treat the workers as employees on a prospective basis. The IRS may make different CSP settlement offers to reflect different categories of workers who may be at issue.

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[92] *Id*. at 29.
[93] IRM § 4.23.6 (Classification Settlement Program), rev. Mar. 1, 2003.
[94] IRS Notice 98-21, 1998-13 I.R.B 14.

Whether a taxpayer wishes to participate in the CSP is entirely up to the taxpayer, and a CSP offer can be accepted at any time during the examination process. If the offer is accepted, the taxpayer signs a closing agreement with the IRS reflecting the agreed-upon terms and conditions; if rejected, the audit will proceed on its normal course, and the taxpayer does not lose its right to administrative appeals or its right to litigate the issue in the courts.

(d) Section 3402(d) Relief Procedures

The Code clearly provides that the employer is liable for the federal income tax that is required to be withheld from an employee's wages.[95] Therefore, when the IRS determines that a college or university misclassified an employee as an independent contractor, it asserts a claim against the institution for the amount of the income tax that should have been withheld from the payments made to the person. If, however, that person reported the payment on his or her personal tax return and paid the applicable federal income tax with respect to the payment, the government would receive a windfall if it were to also collect the withholding tax from the employer.

For this reason, section 3402(d) of the Code provides that if an employer was required to withhold income tax from wages paid to an employee, but failed to do so, any income tax that was ultimately paid by the employee will be credited against the employer's withholding tax liability. In a typical audit of a college or university, the IRS identifies a number of workers whom it says the school misclassified as independent contractors and asserts a withholding tax liability against the school for the amount of the income tax that should have been withheld from the payments made to these individuals.

Under the IRS's formal ''section 3402(d) relief'' procedure, the institution can contact the persons to whom it made the compensation payments in question and obtain from them statements that they paid the applicable income taxes with respect to such payments. This statement is set forth on Form 4669 (Statement of Payments Received). When it receives these Forms 4669, the school then files Form 4670 (Request for Relief from Income Tax Withholding) with the applicable IRS Service Center together with a copy of all the Forms 4669 received from the employees. Once the IRS receives this information, it will normally abate any withholding tax liability previously asserted against the college or university with respect to these payments.

(e) Can an Individual Be Classified as an Employee and Independent Contractor at the Same Time?

It is not unusual in the college and university world for an employee of one department to be hired by a second department to perform other work

[95]IRC § 3403.

on an independent contractor basis. If we assume that the individual would otherwise be classified as an independent contractor with respect to the work performed for the second department, the issue is whether the person can simultaneously be an employee and an independent contractor for the same employer.

While the IRS looks at such arrangements quite closely, and more often than not finds it inappropriate for an individual to serve simultaneously in both capacities for the same institution, the IRS clearly recognizes that such a dual status relationship is possible, given the right circumstances. In a 1958 ruling,[96] the IRS held that an individual who worked for an insurance company both as its president and as a salesman was properly classified as an employee with respect to his presidential duties and as an independent contractor with respect to his sales activities. The critical aspect to this conclusion was that the two services that he performed were not interrelated. Specifically, the IRS said that if ''the services in the two capacities are separate and distinct, that is, if there is no interrelation as to either duties or remuneration in the two capacities, then the status of each type of service must be considered separately.'' More recently, the IRS confirmed the fact that an individual can serve in such a dual-status capacity. The training manual states that ''a worker may perform services for a single business in two or more separate capacities. A dual status worker performs one type of service for a business as an independent contractor, but performs a different type of service for the business as an employee.''[97]

In addition, the Tax Court has held that a worker may simultaneously wear both an employee hat and an independent contractor hat. In a 1992 case,[98] the Court held that a University of Michigan professor, who was obviously an employee with respect to his teaching duties, could also work as an instructor in the University's continuing education department on an independent contractor basis. In so holding, the Court said that ''the fact that [the professor] is an employee of the University in one capacity does not foreclose the possibility that he may independently contract with the University in another capacity.''[99] The key distinction, according to the Tax Court, was whether the professor was treated in the same manner as nonemployee instructors in the continuing education program. Since he was, the Court found that he, too, was an independent contractor.

A related issue was addressed in a technical advice memorandum involving university physician faculty members who taught at the medical school and also received income from a faculty practice plan with respect to their

[96] Rev. Rul. 58-505, 1958-2 C.B. 728.
[97] *Independent Contractor or Employee?*, IRS Training Materials, Training 3320-102 (Rev. 10/96).
[98] *Reece v. Commissioner*, 63 T.C.M. (CCH) 3129 (1992).
[99] *Id*. at 3131.

private medical practice.[100] The issue was whether they were employees of the university so that the private practice income was wages or whether they were independent contractors so that the payments were income from self-employment. The IRS held that the income was wages because (1) the faculty practice plan was not a separate entity, (2) there was a close interrelationship between the physicians' work for the university and the pay they received from the plan, and (3) the university had substantial economic control over the physicians.

In summary, it is certainly possible that an individual can be treated as an employee and an independent contractor with respect to the same school. The key factors are whether there is any interrelation between the duties and/or remuneration in the two positions and whether the person is being treated in the same manner as a nonemployee retained to do the same work. Note, however, that the IRS will closely examine all these dual-status situations and that the institution will have to overcome a strong presumption that the individual should be treated as an employee in both positions.

(f) Classification of Workers Commonly Hired by Colleges and Universities

While colleges and universities are apt to hire a wide variety of workers to perform certain tasks, educational institutions more typically retain certain categories of workers. This section briefly describes how the IRS and the courts have treated these workers. While the existence of a ruling or court case with respect to a particular occupation will not necessarily control a subsequent case, prior authorities are of some assistance in determining how the worker should be classified.

(i) Instructors and Adjunct Faculty. Colleges and universities commonly hire instructors and adjunct faculty members on a part-time basis to teach one or more courses. Should these instructors and adjunct faculty be classified as employees or independent contractors? In at least one audit, the IRS agents asserted that, because instruction is such a basic and fundamental component of a college or university, individuals who are hired to provide instruction should always be treated as employees because the school is so interested and involved in what they do that it will always exercise significant direction and control over their activities.

The IRS has ruled that substitute teachers who are required to observe regular school hours and are subject to the rules and regulations of the school are employees, even if they run an independent business as a private tutor when not engaged in substitute teaching.[101] The IRS reached the same result

[100]Tech. Adv. Mem. 9808001 (Sept. 22, 1997).
[101]Rev. Rul. 55-206, 1955-1 C.B. 485. See also Rev. Rul. 55-583, 1955-2 C.B. 405.

in the case of part-time instructors who were hired to teach courses at times that did not conflict with their regular jobs.[102] By contrast, tutors who use an agency to arrange the initial contact with the client are generally considered to be independent contractors.[103]

An IRS ruling issued in 1970 provides a good illustration of how the distinction between an employee and independent contractor is applied with respect to instructors. The ruling involved two groups of music instructors. The first group, who taught classes for normal remuneration, was required to spend certain designated hours in the music conservatory performing their duties and were treated as employees. The second group was treated as independent contractors because they gave private lessons in a studio furnished by the conservatory, agreed not to teach elsewhere without the conservatory's consent, and permitted the conservatory to retain a certain percentage of the tuition charged by the instructor.[104]

Another 1970 IRS ruling involved attorneys who worked full-time in private practice but also taught as adjunct members of a law school's faculty.[105] In holding that the attorneys be classified as employees, the IRS said:

> Although the instructors of the law college are outstanding members of the legal profession, the contracts for their services as instructors are with reference to the regular business of the college, and the instructors, insofar as their relationship to the college is concerned, are not engaged in an independent calling. On the contrary, the facts show that the college retains the right to control and direct the instructors and the substitute instructors to an extent sufficient to establish the legal relationship of the employer and the employee.

In a 1989 private letter ruling, the IRS addressed the issue of how the common-law principles used in making employee/independent contractor classifications apply in determining whether adjunct faculty at a university are employees or independent contractors.[106] This ruling involved a private university that provided undergraduate and graduate educational courses and had both regular faculty and adjunct faculty. While the regular faculty members were engaged for an indefinite period under a written contract, the adjunct faculty members were hired for a particular course and for a specific term under a verbal contract. The regular faculty viewed higher education as their primary career, but the adjunct faculty were engaged in other business activities. After a lengthy discussion of the various similarities and differences between the manner in which the regular faculty and the adjunct faculty

[102]Rev. Rul. 70-308, 1970-1 C.B. 199. See also Priv. Ltr. Rul. 9821053 (Feb. 24, 1998), which involved a part-time teacher in a public school system who was ruled to be an employee.
[103]Rev. Rul. 59-104, 1959-1 C.B. 251.
[104]Rev. Rul. 70-338, 1970-1 C.B. 200. See also Priv. Ltr. Rul. 9337022 (June 18, 1993), in which the IRS ruled that a music tutor who tutored for a county school board was an independent contractor.
[105]Rev. Rul. 70-363, 1970-2 C.B. 207.
[106]Priv. Ltr. Rul. 8925001 (June 23, 1989).

operated, the IRS concluded that the adjunct faculty members were employees and not independent contractors, primarily because of the degree of control exercised by the school over their teaching activities.

Another 1989 private letter ruling involved a worker who was hired under a written employment agreement by a state university as a part-time instructor in mathematics.[107] The worker prepared and presented mathematics lectures, graded homework, prepared, administered and graded tests, and met with students for tutorial purposes. Although there was some disagreement as to the extent of the training provided by the university, it was clear that the university did not have the right to change the teaching methods used by the individual or to direct him on how to do his work. The university selected the textbooks to be used and the method of reporting the final grades, but the methods used in the preparation of the lectures, the lecture methods, and the testing methods were at the worker's discretion and under his control. He was engaged for a particular job and was required to work for 14 weeks for a three-hour credit class; he was expected to lecture at each class; and he was required to provide final examinations and grades for students. The university furnished the classroom equipment, while the individual furnished his own office, telephone, and computer, and paid all expenses for textbooks, office and test supplies, and handout materials. After a lengthy analysis, relying heavily on a 1970 ruling involving instructors hired by the airline industry,[108] the IRS ruled that because the university ''exercises, and has the right to exercise, the degree of direction and control necessary to establish the relationship of employer and employee under the common law rules,'' the part-time instructors were employees.

In a 1993 ruling, a worker, pursuant to a written contract with a public community college, was hired to teach courses offered at the college.[109] The worker was required to follow a routine established by the college; the college provided the equipment and supplies necessary for the performance of his services; the college retained the right to discharge the worker and the worker retained the right to terminate his services without either party's incurring any liability; the college paid the worker a specified rate based on the number of credit hours taught per quarter; and the college did not provide the worker with any benefits. The IRS held that the worker was an employee.[110]

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[107]Priv. Ltr. Rul. 8901042 (Jan. 6, 1989).

[108]Rev. Rul. 70-308, 1970-1 C.B. 199.

[109]Priv. Ltr. Rul. 9345046 (Aug. 17, 1993).

[110]For additional cases and rulings in which part-time and adjunct professors were held to be employees, see *Bilenas v. Commissioner*, 47 T.C.M. (CCH) 217 (1983) (adjunct professor who taught one class each semester in engineering school); *Potter v. Commissioner*, 68 T.C.M. (CCH) 248 (1994) (''gypsy professor'' hired on a class-by-class basis); Priv. Ltr. Rul. 9105007 (Feb. 1, 1991); Priv. Ltr. Rul. 9146040 (Aug. 19, 1991); Priv. Ltr. Rul. 9224045 (Mar. 17, 1992); Priv. Ltr. Rul. 9248020 (Aug. 31, 1992).

In 2001, the Tax Court addressed this issue in connection with an adjunct faculty member who challenged in court the IRS treatment of him as an employee.[111] In this case, the individual had a full-time job as an engineer and also worked as an adjunct faculty member at Idaho University and Idaho State University. The facts of the case indicated that (1) the adjunct faculty member was compensated for his work on a per-course basis; (2) the classes were conducted in classrooms provided by the two universities, (3) he prepared for his classes and reviewed student assignments at home, and (4) his communications with his students were primarily by e-mail from his home. The contracts that he entered into with both universities specified the course to be taught, set forth the duration of his assignment as an adjunct faculty member, outlined the amount of his payment and the method by which he would be paid, and said that he would be treated as an employee. Both universities treated him as an employee, withheld income and FICA taxes from his payments, and filed a Form W-2 with respect to these payments.

In holding him to be an employee, the Tax Court rejected the adjunct faculty member's argument that the universities did not exercise sufficient control over his teaching activities to render him an employee, saying that a lesser degree of control is required with respect to professional employees such as university professors. In addition, the Court based its decision on the fact that (1) his services as an adjunct professor were consistent with the regular business of each university; (2) he bore no risk of loss as to possible underenrollment in his classes; (3) he had regularly taught at the universities since 1991; and (4) both written contracts said he would be treated as an employee and both universities so treated him for income and FICA tax purposes.

(ii) Proctors. As a general rule, the IRS treats individuals hired as proctors to conduct and oversee examinations as employees because the employer normally prescribes and sets forth the details as to how they are to perform their functions. The IRS reached this conclusion in two rulings, one involving proctors hired by a national association to give uniform examinations to candidates throughout the country,[112] and the other involving a federal agency that hired proctors to oversee an employment test.[113]

(iii) Researchers. Whether the IRS treats a researcher as an employee or an independent contractor depends primarily on whether the organization hiring the researcher has the right to control his or her activities or, instead, whether the researcher is able to conduct his or her research activities with no (or minimal) direction and control. For example, a 1957 ruling involved a

[111] *Beitel v. Commissioner*, T.C. Summary Opinion (July 5, 2001).
[112] Rev. Rul. 72-270, 1972-1 C.B. 325.
[113] Rev. Rul. 75-243, 1975-2 C.B. 402. *See also* Priv. Ltr. Rul. 8601030 (Oct. 7, 1985), involving a person hired to test students enrolled in a self-instruction foreign language program.

biologist who received a grant from a governmental scientific foundation.[114] The nature of the research and the place and manner of its performance were under the full control of the biologist, not the foundation, and the IRS concluded that the biologist was an independent contractor. The IRS ruled to the contrary, however, in another case involving a ''research associate'' who conducted scientific research for a trade association using research facilities at the National Bureau of Standards.[115] The association involved in the ruling received approval from the National Bureau of Standards to use its facilities, and engaged a research associate to conduct the research. The research associate became subject to the rules and regulations of the National Bureau of Standards and was entitled to some of its employees' rights and privileges. The IRS held that the individual was an employee, and not an independent contractor. A similar conclusion was reached in a 1977 Tax Court case involving a research coordinator, primarily because of the control that was exercised by the state agencies over the individual and the fact that both the agencies and the individual considered the individual an employee.[116]

In a 1955 ruling, a professor was hired by a college to carry out a research project funded by a foundation grant.[117] In addition to his regular salary, the professor received from the college additional remuneration that was paid from the grant funds. A stenographer engaged by the professor to work on the research project performed services under his direct supervision and was also remunerated by the college out of funds from the grant. The IRS held that both the professor and the stenographer were employees of the college.

A 1994 ruling involved a state university that received a grant from a federal agency to fund a summer internship program involving students who came from all over the country to work.[118] The interns conducted various research projects on the university's premises, were assigned to work with a university employee, and performed services on a full-time basis over the summer. The IRS ruled that the workers were employees of the university. In addition, the IRS has ruled that a laboratory researcher paid a fixed amount per job as well as a researcher hired to perform a specific research project were both employees.[119] Also, the IRS has held that a scientist who provided research services to a federal agency should be treated as an employee of the agency and not an independent contractor.[120]

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[114]Rev. Rul. 57-127, 1957-1 C.B. 275.
[115]Rev. Rul. 71-292, 1971-2 C.B. 344.
[116]*Harris v. Commissioner*, 36 T.C.M. (CCH) 1426 (1977).
[117]Rev. Rul. 55-583, 1955-2 C.B. 405.
[118]Priv. Ltr. Rul. 9439004 (Sept. 30, 1994). See also Priv. Ltr. Rul. 9302030 (Oct. 21, 1992) in which the IRS ruled that a worker who was hired by a research and development laboratory affiliated with a university to conduct research was an employee of the laboratory.
[119]Priv. Ltr. Rul. 8909046 (Dec. 7, 1988); Priv. Ltr. Rul. 9238032 (June 22, 1992).
[120]Priv. Ltr. Rul. 200505005 (September 30, 2004).

Finally, while most of the issues involving researchers arise in the employee versus independent contractor context, there is also an issue whether the payment made to the researcher is an independent contractor payment or a fellowship. This issue also arose in a Tax Court case that involved an individual who held a doctoral degree in geology and geophysics, and who applied for and received a one-year fellowship from Columbia University.[121] The fellowship was a privately funded, competitive award, and the fellows received funds and office space to allow them to conduct independent scientific research at a geological observatory located at Columbia. Under the fellowship program, the fellows chose their own subjects and determined how best to conduct their research; they had no teaching or other responsibilities; Columbia University had no right to, or interest in, the result of the fellows' activities; the fellows were not required to observe office hours; and they were not required to report to a supervisor. The IRS argued that the fellowship payments constituted self-employment income derived by the fellow from the operation of a trade or business. The fellow who litigated this issue, however, took the position that the amount constituted a fellowship and therefore was not subject to self-employment tax.

The case contains an excellent historical review of the taxation of scholarships and fellowships from 1954 to the present and is worth reading in that regard alone. On the issue presented, the Court held that the grant, although not excludable from gross income as a ''qualified scholarship,'' was nevertheless a scholarship or fellowship grant, not compensation income. The rationale underlying this conclusion was that the funds were not provided to the fellow as compensation for research services; the individual's efforts did not economically benefit Columbia University; and the individual performed his own research and studies primarily to further his own education and training. While the Court reached the correct result, the decision is disturbing in that the IRS chose to litigate a case in which the facts seem to so clearly indicate that the grant funds were not awarded in return for compensation of services. The fact that the IRS chose to litigate this case may indicate an uncompromising position that it will take in other independent contractor versus fellowship issues.

(iv) Accountants. This classification issue arises with respect to accountants that a school may hire to augment its normal accounting staff. In a 1957 ruling, the IRS concluded that a person providing part-time bookkeeping services, tax services, and accounting advice to a corporation was an independent contractor, not an employee.[122] Although the services were performed on the corporation's premises, the individual was not required to maintain any

[121] *Spiegelman v. Commissioner*, 102 T.C. 394 (1994).
[122] Rev. Rul. 57-109, 1957-1 C.B. 328. But see Rev. Rul 58-504, 1958-2 C.B. 727, and Priv. Ltr. Rul. 8616002 (June 17, 1985).

particular hours, and provided all of his own materials and paid all of his own expenses. He was not supervised and was compensated on the basis of the services he performed. He had a home business office, advertised in the newspapers, and had his own regular clientele.

(v) Consultants. College and universities often hire consultants to perform a variety of different tasks, and based on some old cases and IRS rulings, the classification of consultants seems to hinge on whether the individual has more than one client, holds himself or herself out to the public as being available to provide consulting services, and maintains an independent office.[123] When these factors are present, the consultant is generally classified as an independent contractor; however, when absent, the consultant has been found to be an employee.[124] In a 1993 ruling, the IRS found that a computer data manager who was hired by a state government was an independent contractor when he worked six to eight hours a day for about six months, sometimes in his home and sometimes in the agency's office.[125] He provided his own equipment and held himself out to the general public as engaged in an independent trade or business. The IRS appeared to be influenced by the relatively short duration of the work and the fact that he provided his own materials.

Another common consulting situation involves employees who retire but are subsequently rehired on a consulting basis. In a 1993 ruling, the IRS held that certain individuals who fell into this category were independent contractors where they entered into consulting contracts, had no set work schedule, had no restrictions on their ability to do work for others, and were not under the company's supervision.[126] However, a regular employee who retired but came back to work as a consultant to train his replacement was classified as an employee, notwithstanding the fact that the company and the individual had designated the relationship as one of an independent contractor.[127]

(vi) Corporate Officers/Directors and Trustees. As a general rule, corporate officers are treated as employees of the corporation.[128] This clearly applies to officers of nonprofit corporations as well. There may be circumstances, however, where the individual performs only minor services and does not receive any remuneration. In these cases, the IRS regulations provide that the individual may not be treated as an employee.[129] Members

[123] *Fuller v. Commissioner*, 9 B.T.A. 708 (1927); Rev. Rul 54-586, 1954-2 C.B. 345; Priv. Ltr. Rul. 9609047 (Dec. 5, 1995).
[124] Rev. Rul. 55-466, 1955-2 C.B. 397.
[125] Priv. Ltr. Rul. 9334027 (June 1, 1993). *See also* Priv. Ltr. Rul. 9337013 (June 17, 1993) involving a project coordinator hired by a state agency for a year.
[126] Priv. Ltr. Rul. 9345002(July 13, 1993).
[127] Rev. Rul. 59-104, 1959-1 C.B. 251.
[128] IRC § 3121(d)(1) (Social Security taxes) and § 3306(i) (federal unemployment taxes).
[129] Treas. Reg. § 31.3121(d)-1(b).

of the board of trustees or directors, however, are treated as independent contractors.[130]

(vii) State Elected and Appointed Officials. State institutions are subject to the same rules that are used to distinguish employees from independent contractors.[131] In this connection, the IRS has ruled that elected state officials should always be treated as state employees because they can be removed from office by a supervisor or the general public, while appointed state officials can be either state employees or independent contractors, depending on the facts and circumstances.[132]

(viii) Psychologists Working in a Hospital. In a California district court case, the court held that psychologists working in a hospital were properly treated as employees, not independent contractors, because the hospital exercised significant control over the means and methods by which they performed their job.[133]

(g) Other College and University Classification Cases and Rulings

Over the years, the IRS and the courts have decided several other cases involving college and university workers and whether they should be classified as employees or independent contractors.

- *Professor teaching in a university executive education center*. A 1992 Tax Court case involved a professor at the University of Michigan who, in addition to serving as a tenured university faculty member, designed and led short seminars on corporate finance for business executives in the university's Executive Education Program. The court held that he was an independent contractor and not an employee.[134] The executive education work was done on a contract basis with a division of the university that offered noncredit seminars and other programs for business executives throughout the year at the Executive Education Center. The professor was not retained on an ongoing basis, and he contracted for each seminar and received a set fee. He prepared the syllabus and all course materials and received no fringe benefits. The IRS argued that the professor's employment relationship with the university as a tenured professor should be extended to cover his seminar services for the division. The Tax Court, however, disagreed, stating that

[130] *Id*.
[131] See § 9.7.
[132] CCA 200113024 (Jan. 29, 2001).
[133] *Kentfield Med. Hosp. Corp. v. U.S*., 215 F. Supp 2 d 1064 (N.D. CA. 2002).
[134] *Reece v. Commissioner*, 63 T.C.M. (CCH) 3129 (1992).

> the weakness of [the IRS's] position is revealed when [the professor's] relationship with [the division] is compared with that of other individuals who are not otherwise employees of the University. Surely an individual who independently contracts with the [division] on a per seminar basis is not an employee of the University. The fact that the [division] provides facilities in support to such an individual does not result in the creation of an employee-employer relationship. We conclude that [the professor's] relationship with [the division] should not be treated any differently than that of the seminar providers for [the division] who are not University employees. Simply stated, the fact that [the professor] is an employee of the University in one capacity does not foreclose the possibility that he may independently contract with the University in another capacity. While a few facts, such as the manner in which [the professor] receives his compensation from the [division] reveal differences in the way [the professor] is treated by the [division] from the non-university employees, such differences are incidental at most and have proved to be inconsequential in our overall evaluation of this record in its entirety.[135]

- *University hair stylist*. In a 1994 ruling, a worker performed services for a state university as a hair stylist.[136] The individual worked in a barber shop owned by the university and followed a routine established by the university. She was required to pay the costs of her own tools, license, and insurance; she performed services on a full-time basis for approximately six months; and she received a specified percentage of the gross receipts that she generated. A written agreement between the parties provided that the agreement was not assignable; that all services and supplies offered for sale were subject to prior approval of the university; that no price changes could be made without the university's prior approval; and that her hours of operation were set by the university and could not be changed without prior approval. The IRS concluded that the worker was an employee of the university. Although this case involved a relatively unusual occupation in the college and university world, its principles are equally applicable to other occupations.
- *Special assistant to the president*. In a 1993 ruling, a worker performed services for a state university as a special assistant to the university president.[137] He was hired to analyze certain effects on budgeting, staffing, and teaching, and to draft a proposal for the funding and construction of a research laboratory. His work was performed on the university premises; he was instructed by the university; and the university provided the office, secretarial support, equipment, materials, and supplies

[135] *Id*. at 3131.
[136] Priv. Ltr. Rul. 9405015 (Nov. 4, 1993). See also Priv. Ltr. Rul. 9424049 (Mar. 22, 1994), involving workers in a university-operated barber salon who were held to be employees.
[137] Priv. Ltr. Rul. 9351025 (Sept. 27, 1993).

that he needed to perform the services. The IRS ruled that the worker was an employee.

- *Student newspaper reporter and editor*. In another 1993 ruling, the worker performed services for a state university as a reporter and editor on the student newspaper.[138] She was given training by the university; her work was subject to revision by her supervisor; and the university furnished all of the equipment, materials, and supplies that she needed to perform her services. The IRS concluded that she was an employee.
- *Computer consultant*. In a 1993 ruling, a worker performed services for a university as a computer consultant who was hired to set up programs for statistical analysis. The work was performed at the worker's business location pursuant to a written agreement; the worker was not given training or instructions by the university in the way the work was to be done; the work was not supervised or controlled in the performance of his services; the university provided the data necessary for analysis, but the worker provided his own equipment, materials, and supplies needed to perform the services; the worker represented himself to the public as being in the business of performing the same or similar services; and he advertised his availability to do so. The IRS ruled that the worker was an independent contractor.[139]
- *Student body official*. In a 1993 ruling, a student was elected secretary of the union board. The university had the right to direct the student in the performance of her duties and provided the equipment that she used. The IRS concluded that the student was an employee.[140]
- *Study center director*. In a 1992 ruling, an individual served as the assistant director of a university's center for international studies. She performed her work in a foreign country under a written agreement with the university. The university provided all her equipment, and she performed services in the university's name and did not perform similar services for others. The IRS ruled that she was an employee.[141]
- *Student worker*. In a 1999 ruling, the IRS determined that a college student hired by a federal agency was an employee of the agency and not an independent contractor, because the facts indicated that the agency exercised sufficient direction and control over the student's day-to-day activities to qualify her as an employee.[142]

[138]Priv. Ltr. Rul. 9348056 (Sept. 8, 1993).
[139]Priv. Ltr. Rul. 9320020 (May 21, 1993).
[140]Priv. Ltr. Rul. 9350005 (Sept. 10, 1993).
[141]Priv. Ltr. Rul. 9207012 (Nov. 20, 1992).
[142]Priv. Ltr. Rul. 199917076 (Jan. 28, 1999).

- *Intern funded by third party*. In a 1994 ruling, the IRS held that a student intern who was funded by a federal agency to work and train at a university was an employee of the federal agency, not the university.[143] The IRS reached this conclusion based on the direction and control exercised by the federal agency. However, because the university made the actual wage payments to the individuals, the IRS said that it was required to withhold income taxes and file wage reporting forms with the IRS.

§ 4.3 SOCIAL SECURITY TAX EXEMPTION FOR STUDENTS

(a) The Student FICA Exception

The Social Security tax is imposed on ''wages'' paid to employees, and the term *wages* is defined as remuneration received from ''employment.''[144] The Code carves out a number of different types of services that are specifically exempted from ''employment,'' and therefore from imposition of the Social Security tax. These exceptions run the gamut from services performed as the president or vice president of the United States[145] to services performed by federal prison inmates.[146] There is also a deceptively simple provision that exempts ''service performed in the employ of a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university.''[147] This seemingly straightforward provision, however, has created a storm of controversy between the IRS and higher-education institutions.[148]

(i) History of the Student FICA Exemption. The history behind this so-called ''student FICA exception'' is interesting and helps put the issue into better perspective. Up until 1939, remuneration received from all services rendered by a student or nonstudent to an exempt organization was exempt from the social security tax.[149] In 1939, Congress replaced this general exception with a number of specific exceptions, including one that is virtually identical to the current provision quoted above. That same year, Congress enacted a second narrower exception applicable to student employees of non-tax-exempt colleges and universities. Although this exception also required the student/employees

[143]Priv. Ltr. Rul. 9439004 (June 27, 1994).
[144]IRC § 3101.
[145]IRC § 3121(b)(5)(C).
[146]IRC § 3121(b)(6)(A).
[147]IRC § 3121(b)(10).
[148]The same statutory language is contained in IRC § 3306(c)(10)(B) to carve out an identical exemption from the federal unemployment tax.
[149]Social Security Act of 1935, Pub. L. No. 74-271, §§ 210(b)(7), 907(c)(7), 49 Stat. 620, 625, 643 (1935).

to be enrolled and regularly attending classes, it limited the exception to wages not exceeding $45 per quarter (exclusive of room, board, and tuition).[150] The 1939 legislative history provided the following rationale for these two exceptions:

> The intent of the amendment is to exclude those persons and those organizations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, and the payment of the tax is inconsequential or a nuisance. The benefit rights built up are also inconsequential. Many of those affected, such as students . . . , will have other employment which will enable them to develop insurance benefits. This amendment, therefore, should simplify the administration for the worker, the employer and government.[151]

In 1950, Congress removed the wage cap applicable to students working for non-tax-exempt educational institutions, leaving the unrestricted student FICA exception applying to both exempt and nonexempt educational institutions.[152] The 1950 legislative history again identified administrative simplification as the principal policy objective underlying this exception:

> The bill would continue to exclude . . . services performed by students in the employ of colleges and universities. These exclusions simplify administration without depriving any significant number of people of needed protection.[153]

In 1972, Congress expanded the student FICA exception to include employment by related exempt organizations[154] but, except for this amendment, the provision has not been substantively changed since 1950. In 1987, however, the Reagan administration proposed repealing the student FICA exception, and provided the following rationale for repeal:

> The reason for excluding certain student services from the definition of covered employment was that the small amount of protection that the students would gain would not be proportionate to the wage reporting tax payment burden imposed on their employers. However, because in most instances the employer is now required to withhold income taxes from such earnings because payroll practices have become more sophisticated, the administrative burden placed on employers by the proposal is not unreasonable.
>
> Furthermore, students employed by their educational institutions need the protection of the Social Security program as much as other workers. Because of this exclusion, students may not gain any Social Security protection or may have gaps in their protections. This is important because features have been added to Social Security that are particularly desirable for younger workers (e.g., disability benefits

[150]Social Security Act Amendments of 1939, Pub. L. No. 76-379, §§ 201, 209, 53 Stat. 1360, 1362, 1373 (1939).
[151]H. Rep. No. 728, 75th Cong., 1st Sess. 18 (1939).
[152]Social Security Act Amendments of 1950, Pub. L. No. 81-734, §§ 104(a), 204(a), 64 Stat. 477, 497, 531 (1950).
[153]H. Rep. No. 1300, 81st Cong., 1st Sess. 12 (1949).
[154]Social Security Amendments of 1972, Pub. L. No. 92-603, § 129(a)(2), 86 Stat. 1329, 1359 (1972).

> and Medicare for the disabled). Finally, changes in the student population itself have increased the students' need for protection—students today are older, stay in school longer and are more likely to be married and have children.[155]

In the ensuing hearings, a number of witnesses for higher education took issue with the proposal, one of whom said ''that the burden is no longer administrative; it is financial.''[156] The written statement of the American Council on Education elaborated on this point:

> Students and schools unquestionably enjoy some benefit from the fact that these jobs are not subject to the same FICA tax as virtually all other jobs. But the law has always considered that, for nonprofit educational institutions and needy students, the short-term benefit is by no means an unfair advantage. To impose a tax of nearly 15 percent on these jobs would seriously burden needy students and reduce financial aid and fellowship and scholarship programs throughout the nation. Most students who hold these jobs work because they cannot otherwise afford to pay for their education. A reduction of at least 7 to 15 percent in their income would be a heavy blow. Similarly, the Administration proposal would have the effect of slashing college and university operating funds as well as financial aid resources by big amounts. To implement this proposal together with the administration's recommendations to curtail federal financial aid to students would necessarily deny educational opportunity to hundreds of thousands of students.[157]

Based on these hearings, Congress decided to retain the student FICA exception without any modification. In 1990, the Bush administration proposed repealing the exception with respect to state colleges and universities, but the proposal was rejected by the Subcommittee on Social Security of the Committee on Ways and Means for the same reasons it rejected the administration's proposal in 1987.

(ii) Prior IRS Position. In a 1978 ruling, the IRS considered whether the student FICA exception was applicable in three factual situations involving graduate students employed by a university.[158] In Situation 1, a nondissertation

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[155] *Overview of the President's Budget for Fiscal Year 1988: Hearings Before the House Comm. on Ways and Means*, 100th Cong., 1st Sess. 50–89 (1987) (statement of J. Roger Mentz, Assistant Secretary for Tax Policy, U.S. Department of the Treasury).

[156] Social Security and Railroad Retirement Proposals Contained in the President's Fiscal Year 1988 Budget: Hearings Before the Subcomm. on Social Security of the House Comm. on Ways and Means, 100th Cong., 1st Sess. 37–40 (1987) (statement of Thomas Butts, Assistant to the Vice President for Academic Affairs, University of Michigan).

[157] *Id*. at 39. Fourteen prominent organizations joined in this statement: U.S. Student Association, National Student Roundtable, Association of American Community and Junior Colleges, Association of American State Colleges and Universities, Association of American Universities, Association of Catholic Colleges and Universities, Association of Urban Universities, Council of Independent Colleges, National Association for Equal Opportunity in Higher Education, National Association of College and University Business Officers, National Association of Independent Colleges and Universities, National Association of State Universities and Land Grant Colleges, National Association of Schools and Colleges of the United Methodist Church, and National Association of Student Financial Aid Administrators.

[158] Rev. Rul. 78-17, 1978-1 C.B. 306.

graduate student took 12 credit hours and was employed 15 hours per week; in Situation 2, a nondissertation graduate candidate took 6 credit hours and was employed 40 hours per week; and in Situation 3, a dissertation graduate student was registered for dissertation advisement with zero credit hours and was employed 6 hours per week. The IRS concluded that only Situations 1 and 3 qualified for the exception and premised its conclusion on two legal arguments. The first was that employment is ''incident to and for the purpose of pursuing a course of study'' within the meaning of the applicable regulations[159] only if the individual is taking a ''substantial course load.''[160] The second argument was that the exception applies only to part-time employment, citing the following language from the 1939 legislative history:

> The intent of the amendments is to exclude those persons and those organizations in which the employment is part-time or intermittent and the total amount of earnings is only nominal and the payment of the tax is inconsequential and a nuisance.[161]

In a 1993 technical advice memorandum, the IRS used the principles established in the 1978 ruling on graduate students to arrive at another rule for undergraduate students. In this technical advice memorandum, the IRS created a safe harbor under which an undergraduate student who was taking 12 credit hours (i.e., a ''full-time student'') and working no more than 20 hours per week (i.e., a ''part-time employee'') could qualify for the exception.[162] The IRS also said that part-time students (i.e., students taking 6 hours or less per semester) would not qualify for the exception ''because their scholarly pursuits represent a less than substantial endeavor.'' Technically speaking, the so-called ''12/20 rule'' was only a safe harbor, and students who did not meet the 12/20 test were able independently to prove their entitlement to the student FICA exception. As a practical matter, however, IRS agents refused to permit students who failed the 12/20 test to qualify for the student FICA exception.

Another issue that arose in this area was whether the student FICA exemption applied to summer school students. In one ruling, the IRS held that graduate students and research assistants who worked for a university during the summer months to conduct research related to their doctoral dissertations did not qualify for the student FICA exception because they were not registered for courses and did not attend classes.[163] The IRS reached this conclusion notwithstanding the fact that the students were considered by the

[159]Treas. Reg. § 31.3121(b)(10)-2(c).

[160]Rev. Rul. 78-17, 1978-1 C.B. at 307. In Rev. Rul. 78-17, the IRS interpreted the statute as exempting a graduate student working on his or her dissertation even though the student has concluded the classroom component of the doctoral program. The IRS regarded the preparation of a dissertation as satisfying the ''substantial course load'' requirement.

[161]*Id*.

[162]Tech. Adv. Mem. 9332005 (May 3, 1993).

[163]Rev. Rul. 72-142, 1972-1 C.B. 317. *See also* Priv. Ltr. Rul. 8911051 (Dec. 20, 1988).

university to be engaged full-time in independent study and research that was an integral part of their degree programs. Another ruling involved a student who was enrolled and regularly attending classes at a university and was also employed by the school.[164] His work for the university, however, was not limited to the academic year but continued through the summer vacation when he did not attend classes. Based on the fact that the individual was not ''enrolled and regularly attending classes'' during the summer vacation period, the IRS ruled that the student FICA exception was inapplicable. One court, however, has held to the contrary.[165]

In early 1998, the IRS issued new student FICA guidelines, replacing the previous informal 12/20 rule.[166] Essentially, these guidelines adopted a ''half-time enrollment'' standard and, perhaps more importantly, eliminated altogether the maximum work hour requirement. The guidelines, however, were only a ''safe harbor,'' which meant that if a school followed the guidelines, the IRS would agree that the student FICA exception applies. The IRS said that determinations with respect to any situations that fell outside these new safe harbor guidelines would be decided on a facts and circumstances basis.

(iii) Current IRS Position. In late 2004, the IRS issued final regulations under section 3121(b)(10), as well as an updated set of safe harbor guidelines, which replaced the early safe harbor guidelines published in 1998.[167]

The final regulations set forth a broad facts and circumstances test to be used in making student FICA exception determinations. The approach taken under this test is to compare the ''educational aspects'' of the relationship between the student-employee and the university with the ''services aspects'' of this relationship to determine which of the two is predominant. If the educational aspects predominate over the services aspects, the student is eligible for the student FICA exception; however, if the reverse is true, the student is not eligible for the exception.

The regulations set forth a myriad of different factors and tests to take into account in making this subjectively difficult educational versus services determination, but this cumbersome task can be avoided if the student-employee meets the safe harbor guidelines. If the student-employee is unable to meet these guidelines, he may still be able to qualify for the student FICA exception under the subjective facts and circumstances test set forth in the final regulations, although this may be an uphill battle because the IRS generally gives substantial weight to safe harbors and only rarely will conclude that a facts and circumstances test is met when the safe harbor is not. Some colleges and

[164]Priv. Ltr. Rul. 7302090180A (Feb. 9, 1973).
[165]*Swan v. Califano*, No. C 78-0560 CFP (N.D. Cal. Jan. 3, 1980), *aff'd*, No. 80-4080 (9th Cir. Oct. 19, 1981).
[166]Rev. Proc. 98-16, 1998-5 I.R.B. 19.
[167]Treas. Reg. § 31.3121(b)(10)-2; Rev. Proc. 2005-11, 2005-2 I.R.B. 307.

universities, for administrative reasons, have a policy of allowing only those student-employees who meet the safe harbor guidelines to qualify for the student FICA exception because they do not want to get into the business of trying to apply the general facts and circumstances tests to individual situations.

Under the safe harbor rules, if the student-employee is enrolled on at least a half-time basis as an undergraduate or graduate/professional student, the person is potentially eligible for the student FICA exception if the following four tests are met:[168]

1. *Individual Must Be Employed by a School, College, or University*. In its regulations, the IRS makes it clear that in order for a student employee to be eligible for the student FICA exception, he or she must be employed by a ''school, college, or university'' (SCU), which is defined as an institution that has as its primary function the presentation of formal instruction; normally maintains a regular faculty and curriculum; and normally has a regularly enrolled body of students in attendance where its educational activities are regularly carried on.[169] In addition, in order to qualify under the safe harbor, the institution must qualify as an ''institution of higher education'' under regulations published by the Department of Education.[170] In promulgating its final regulations, the IRS considered, but rejected, the argument that a SCU includes an organization, such as a teaching hospital, that has embedded within it a division or function that carries on educational activities. Thus, this SCU requirement may cause the student FICA exception to be unavailable to students who are employed by certain organizations, such as hospitals and museums that carry on educational activities.
2. *Individual Cannot Be a Full-time Employee*. A full-time employee is not eligible for the student FICA exception. The regulations say that whether an individual is a full-time employee is based on the employer's standards and practices, except that an employee whose normal work schedule is 40 hours or more a week is always considered a full-time employee.[171]

   The regulations also provide that whether an employee is a full-time employee should be determined by the employer at the start of an academic term, thus reducing instances where an employee shifts from student to non-student status during the term. An employee's normal work schedule is not affected by increases in hours worked caused by work demands unforeseen at the start of the academic term. However, whether an employee is a full-time employee is reevaluated for the

[168]Rev. Proc. 2005-11, § 7. The term *half-time student* has the same meaning attributed to that term in the Department of Education regulations at 34 C.F. R. § 674.2. Rev. Proc. 2005-11, § 8.02.
[169]Treas. Reg. § 31.3121(b)(10)-2(c).
[170]Rev. Proc. 2005-11, § 5.01.
[171]Treas. Reg. § 31.3121(b)(10)-2(d)(3)(iii).

remainder of the academic term if the employee changes employment positions with the employer. An employee's work schedule during an academic break though is not considered in determining whether the employee's normal work schedule is 40 hours or more per week.[172]

3. *Individual Is Not a Professional Employee*. The safe harbor is unavailable with respect to the services of a *professional employee*, as that term is defined in the regulations. The regulations define a professional employee as one:

- Whose primary duties consists of work requiring knowledge of an advanced type in a field of science or learning,
- Whose work requires consistent exercise of discretion and judgment, and
- Whose work is predominantly intellectual and varied in character.[173]

4. *Individual Is Not Eligible for Certain Employment Benefits*. The safe harbor in not available to a student-employee if the individual is:

- Eligible for vacation, sick leave, or paid holiday benefits;
- Eligible to participate in any retirement plan described in section 401(a) or would be eligible if to participate if age and service requirements are met;
- Eligible to receive an allocation of employer contributions other than contributions described in section 402(g) under an arrangement described in section 403(b), or would be eligible to receive such allocations if age and service requirements were met, or if contributions described in 402(g) were made by the employer.
- Eligible to receive an annual deferral of nonelective employer contributions under an eligible deferred compensation plan described in section 457(b), or would be eligible for such annual deferrals if plan requirements were met, or if contributions by salary reduction were made by the employee to a 457(b) plan.
- Eligible for reduced tuition (other than qualified tuition reduction under section 117(d)(5) provided to a teaching or research assistant who is a graduate student) because of the individual's employment relationship with the institution; or
- Eligible to receive one or more of the employment benefits described under sections 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), and 137 (adoption

[172] *Id*. Rev. Proc. 2005-11, however, retains the rule under the 1998 safe harbor provisions that the student FICA exception does not apply to services performed by an individual during school breaks of more than five weeks, including summer breaks of more than five weeks.
[173] Treas. Reg. § 31.3121(b)(10)-2(d)(3)(v)(B).

assistance) because of the individual's employment relationship with the institution.[174]

Receipt of or eligibility for one of the employment benefits described above that is mandated by state or local law will not cause an employee to be ineligible for the safe harbor.

The regulations illustrate the application of the student FICA provisions with a series of helpful examples:

Example 1: (i) Employee C is employed by State University T to provide services as a clerk in T's administrative offices, and is enrolled and regularly attending classes at T in pursuit of a BS degree in biology. C has a course workload during the academic term which constitutes a full-time course workload at T. C is considered a part-time employee by T during the academic term, and C's normal work schedule is 20 hours per week, but occasionally due to work demands unforeseen at the start of the academic term C works 40 hours or more during a week. C is compensated by hourly wages, and receives no other compensation or employment benefits.

(ii) In this example, C is employed by T, a school, college, or university within the meaning of paragraph (c) of this section. C is enrolled and regularly attending classes at T in pursuit of a course of study. C is not a full-time employee based on T's standards, and C's normal work schedule does not cause C to have the status of a full-time employee, even though C may occasionally work 40 hours or more during a week due to unforeseen work demands. C's part-time employment relative to C's full-time course workload indicates that the educational aspect of C's relationship with T is predominant. Additional facts supporting this conclusion are that C is not a professional employee, and C does not receive any employment benefits. Thus, C's services are incident to and for the purpose of pursuing a course of study. Accordingly, C's services are excepted from employment under section 3121(b)(10).

Example 2: (i) Employee D is employed in the accounting department of University U, and is enrolled and regularly attending classes at U in pursuit of an, MBA degree. D has a course workload which constitutes a half-time course workload at U. D is considered a full-time employee by U under U's standards and practices.

(ii) In this example, D is employed by U, a school, college, or university within the meaning of paragraph (c) of this section. In addition, D is enrolled and regularly attending classes at U in pursuit of a course of study. However, because D is considered a full-time employee by U under its standards and practices, D's services are

[174]Treas. Reg. § 31.3121(b)(10)-2(d)(3)(v)(C).

not incident to and for the purpose of pursuing a course of study. Accordingly, D's services are not excepted from employment under section 3121(b)(10).

Example 3: (i) The facts are the same as in Example 2, except that D is not considered a full-time employee by U, and D's normal work schedule is 32 hours per week. In addition, D's work is repetitive in nature and does not require the consistent exercise of discretion and judgment, and is not predominantly intellectual and varied in character. However, D receives vacation, sick leave, and paid holiday employment benefits, and D is eligible to participate in a retirement plan maintained by U described in section 401(a).

(ii) In this example, D's half-time course workload relative to D's hours worked and eligibility for employment benefits indicates that the service aspect of D's relationship with U is predominant, and thus D's services are not incident to and for the purpose of pursuing a course of study. Accordingly, D's services are not excepted from employment under section 3121(b)(10).

Example 4: (i) Employee E is employed by University V to provide patient care services at a teaching hospital that is an unincorporated division of V. These services are performed as part of a medical residency program in a medical specialty sponsored by V. The residency program in which E participates is accredited by the Accreditation Counsel for Graduate Medical Education. Upon completion of the program; E will receive a certificate of completion and be eligible to sit for an examination required to be certified by a recognized organization in the medical specialty. E's normal work schedule, which includes services having an educational, instructional, or training aspect, is 40 hours or more per week.

(ii) In this example, E is employed by V, a school, college, or university within the meaning of paragraph (c) of this section. However, E's normal work schedule calls for E to perform services 40 or more hours per week. E is therefore a full-time employee, and the fact that some of E's services have an educational, instructional, or training aspect does not affect that conclusion. Thus, E's services are not incident to and for the purpose of pursuing a course of study. Accordingly, E's services are not excepted from employment under section 3121(b)(10) and there is no need to consider other relevant factors, such as whether E is a professional employee or whether E is eligible for employment benefits.

Example 5: (i) Employee F is employed in the facilities management department of University W. F has a BS degree in engineering, and is completing the work experience required to sit for an examination

to become a professional engineer eligible for licensure under state or local law. F is not attending classes at W.

(ii) In this example, F is employed by W, a school, college, or university within the meaning of paragraph (c) of this section. However, F is not enrolled and regularly attending classes at W in pursuit of a course of study. F's work experience required to sit for the examination is not a course of study for purposes of paragraph (d)(2) of this section. Accordingly, F's services are not excepted from employment under section 3121(b)(10).

Example 6: (i) Employee G is employed by Employer X as an apprentice in a skilled trade. X is a subcontractor providing services in the field in which G wishes to specialize. G is pursuing a certificate in the skilled trade from Community College C. G is performing services for X pursuant to an internship program sponsored by C under which its students gain experience, and receive credit toward a certificate in the trade.

(ii) In this example, G is employed by X. X is not a school, college or university within the meaning of paragraph (c) of this section. Thus, the exception from employment under section 3121(b)(10) is not available with respect to G's services for X.

Example 7: (i) Employee H is employed by a cosmetology school Y at which H is enrolled and regularly attending classes in pursuit of a certificate of completion. Y's primary function is to carry on educational activities to prepare its students to work in the field of cosmetology. Prior to issuing a certificate, Y requires that its students gain experience in cosmetology services by performing services for the general public on Y's premises. H is scheduled to work and in fact works significantly less than 30 hours per week. H's work does not require knowledge of an advanced type in a field of science or learning, nor is it predominantly intellectual and varied in character. H receives remuneration, in the form of hourly compensation from Y for providing cosmetology services to clients of Y, and does not receive any other compensation and is not eligible for employment benefits provided by Y.

(ii) In this example, H is employed by Y, a school, college or university within the meaning of paragraph (c) of this section, and is enrolled and regularly attending classes at Y in pursuit of a course of study. Factors indicating the educational aspect of H's relationship with Y is predominant are that H's hours worked are significantly less than 30 per week, H is not a professional employee, and H is not eligible for employment benefits. Based on the relevant facts and circumstances, the educational aspect of H's relationship with Y is predominant. Thus, H's services are incident to and for the purpose of pursuing a course of

study. Accordingly, H's services are excepted from employment under section 3121(b)(10).

Example 8: (i) Employee J is a graduate teaching assistant at University Z. J is enrolled and regularly attending classes at Z in pursuit of a graduate degree. J has a course workload which constitutes a full-time course workload at Z. J's normal work schedule is 20 hours per week, but occasionally due to work demands unforeseen at the start of the academic term J works more than 40 hours during a week. J's duties include grading quizzes and exams pursuant to guidelines set forth by the professor, providing class and laboratory instruction pursuant to a lesson plan developed by the professor, and preparing laboratory equipment for demonstrations. J receives a cash stipend and employment benefits in the form of eligibility to make elective employee contributions to an arrangement described in section 403(b). In addition, J receives qualified tuition reduction benefits within the meaning of section 117(d)(5) with respect to the tuition charged for the credits earned for being a graduate teaching assistant.

(ii) In this example, J is employed by Z, a school, college, or university within the meaning of paragraph (c) of this section, and is enrolled and regularly attending classes at Z in pursuit of a course of study. J's full-time course workload relative to J's normal work schedule of 20 hours per week indicates that the educational aspect of J's relationship with Z is predominant. In addition, J is not a professional employee because J's work does not require the consistent exercise of discretion and judgment in its performance. However, the fact that J receives employment benefits in the form of eligibility to make elective employee contributions to an arrangement described in section 403(b) indicates that the employment aspect of J's relationship with Z is predominant. Balancing the relevant facts and circumstances, the educational aspect of J's relationship with Z is predominant. Thus, J's services are incident to and for the purpose of pursuing a course of study. Accordingly, J's services are excepted from employment under section 3121(b)(10).[175]

The safe harbor guidelines also contain a broad ''anti-abuse rule.'' Under this rule, the IRS has broad authority to ignore the safe harbor tests if it appears that the institution is ''inappropriately'' applying the guidelines so as to ''manipulate'' or ''mischaracterize'' the relationship between the school and the student/employee.[176] This antiabuse rule would come into play, for example, if a school attempted to avoid FICA tax by purposefully converting research laboratory workers from career to noncareer status and requiring

[175]Treas. Reg. § 31.3121(b)(10)-2(e).
[176]Rev. Proc. 2005-11, § 9.

them to enroll in a six-hour certificate program granting them academic credit for their work in the laboratory. In this example or in similar situations, the IRS has the authority to ignore the guidelines and make a determination based on all of the facts and circumstances of the case.

The publication of the final section 3121(b)(10) regulations and the related safe harbor provisions resolved, for the most part, the issues that had surrounded the student FICA exception for many years. But some issues still remain.

1. *Student-Employees Who Receive Certain Employment Benefits*. Some institutions have policies under which their student-employees are eligible to receive certain types of fringe benefits such as vacation or sick leave and holiday pay. This would disqualify the student-employee under the safe harbor; however, it would seem that the overall facts and circumstances could still be met if the student employee (1) is classified by the institution as a non-career employee; (2) works on a part-time basis; (3) is enrolled on at least a half-time basis; and (4) does not fail any other of the safe harbor provisions.
2. *Graduate Student Teachers and Researchers*. The safe harbor is unavailable with respect to the services provided by a *professional employee*, as that term is defined in the regulations. At many schools, graduate student teachers and researchers (TAs and RAs) exhibit a number of characteristics that could lead them to be considered professional employees. This is because their work often requires knowledge of an advanced type in a field of science or learning, involves some exercise of discretion and judgment, and has a substantial intellectual component. At the same time, however, their work is predominantly educational training rather than the provision of services, and all of their work is generally overseen and supervised by a faculty member.

   There is an example in the regulations that concludes that a graduate teaching assistant qualifies for the student FICA exception.[177] Under this example, the TA's duties include grading quizzes and exams pursuant to guidelines set forth by the professor, providing class and laboratory instruction pursuant to a lesson plan developed by the professor, and preparing laboratory equipment for demonstrations. The example concludes that the TA is not a professional employee because the TA's work does not require the consistent exercise of discretion and judgment in its performance. The problem with this example, however, is that it assigns fairly mundane duties to the TA and leaves open the question of whether the IRS might reach a different conclusion if the TA or RA had more substantial or significant duties, as many do.

[177] Treas. Reg. § 31.3121(b)(10)-2(e), Example 8.

3. *Treatment of PhD Candidates*. In a 1978 ruling,[178] the IRS seemed to recognize that special treatment should be accorded PhD students, but the safe harbor guidelines do not contain any special provisions with respect to PhD candidates. As it currently stands, a PhD candidate who qualifies as a ''half-time student'' can qualify under the safe harbor guidelines, but this means that the person must be carrying at least a half-time academic workload as determined by that institution according to its own standards and practices. If the PhD student cannot qualify under this test, the determination must be made outside the safe harbor of the guidelines and under the facts and circumstances test.
4. *Definition of Enrolled*. In a 1998 private letter ruling, the issue before the IRS was whether a student was ''enrolled'' in a university for purposes of determining whether the student's parents could claim a dependency deduction for him or her under section 151.[179] The precise issue was whether the student should be treated as enrolled during the period of time between the date that he or she registered for classes in August and the date that classes began in September. This issue was important because the section 151 regulations say that the person must be an enrolled student for at least five calendar months in order to qualify as a dependent, and if August counted, she would qualify.[180] The IRS ruled that the term *enrolled* as used in the regulations should be interpreted broadly enough to include the period of time the person was registered but had not yet attended classes. There is no reason why this same rationale should not be applicable in determining ''enrollment'' status for purposes of the student FICA exception.

(iv) Treatment of Medical Residents. The treatment of medical residents under the student FICA exception has generated much controversy, largely as a result of a case brought by the University of Minnesota in the 1990s in which it successfully argued that its medical residents were students and therefore exempt from FICA tax.

- *The University of Minnesota case*. This case involved stipends paid during 1985 and 1986 by the University to its medical residents.[181] In 1990, the Social Security Administration (SSA) determined that these stipends were subject to Social Security tax and assessed the University approximately $4 million in Social Security contributions for each of

[178]Rev. Rul. 78-17, 1978-1 C.B. 307. In this ruling, the IRS interpreted the statute as exempting a graduate student working on his or her dissertation even though the student has concluded the classroom component of the doctoral program. The IRS regarded the preparation of a dissertation as satisfying the ''substantial course load'' requirement in effect at that time.
[179]Priv. Ltr. Rul. 9838027 (June 23, 1998).
[180]Treas. Reg. § 1.151-3(b).
[181]*Minnesota v. Chater*, Civil No. 4-96-756 (D. Minn. May 21, 1997).

the two years. In 1994, this assessment was confirmed by the commissioner of the SSA, and the university appealed the SSA commissioner's determination to the local federal district court.

The district court held that the stipends paid to the medical residents were not subject to FICA tax and based its decision on two different grounds. First, the court found that the medical residents were not ''employees'' under the State of Minnesota's section 218 agreement.[182] In 1958, the state had modified its section 218 agreement to include ''employees'' at the University of Minnesota. The court determined that at the time this modification was entered into the state did not consider medical residents to be ''employees,'' and therefore the modification did not apply to them. The court recognized that case law as well as various IRS and SSA rulings since 1958 held medical residents to be employees for employment tax purposes but said that the modification to the section 218 agreement should be interpreted in accordance with the parties' intentions at the time it was entered into. Because there were valid legal authorities in 1958 for not considering medical residents to be ''employees,'' the court held that this interpretation of the section 218 agreement should remain unchanged.

The court went on to say that even assuming that the medical residents are ''employees'' under the section 218 agreement, they are still excluded from coverage because the section 218 agreement exempts services performed by a ''student,'' and the medical residents qualify as ''students'' under section 410(a)(10) of the Social Security Act. This statute is identical to its companion provision in the Internal Revenue Code[183] and exempts from FICA coverage service ''performed by a student who is enrolled and regularly attending classes at [a] school, college or university.'' The court looked for guidance to the regulations under section 410(a)(10), which state that if the person's ''main purpose'' is pursuing a course of study rather than earning a livelihood, the person is a ''student'' and the work is not considered ''employment.''[184]

Even though the stipends paid to these medical residents ranged from $20,000 to $28,000, the court found that the main purpose of the services provided by the medical residents was educational because

- Like regular students at the university, the medical residents were enrolled at the university, paid student tuition, and were registered for course work amounting to approximately 15 credit hours per quarter.

[182]See § 4.5.
[183]IRC § 3121(b)(10).
[184]20 C.F.R. § 404.1028(c).

- They were not entrusted with sole responsibility for patients but were given significant supervision and were evaluated on their performance.
- They were provided educational instruction on their daily rounds and through lectures and formal courses of study.
- Also like regular students, they could be dismissed if they performed poorly.

The court also found that under different aspects of Minnesota law (physician licensing, workers' compensation, and unemployment insurance coverage), medical residents were classified as students. For these reasons, the court found that the medical residents were ''students'' under the Social Security Act and therefore excluded from Social Security coverage.

The Eighth Circuit Court of Appeals affirmed the decision of the Minnesota district court.[185] In its opinion, the Eighth Circuit said that in determining whether the student FICA exception is applicable, the proper test is to look at the relationship between the student/employee and the university, not the nature of the payments made to the person. Even though the payments were clearly wages paid in return for patient-related services provided, the court held that the student FICA exception applied because the relationship between the medical residents and the university was primarily educational.

- *FICA tax refund claims*. As a result of the Eighth Circuit's decision in the *University of Minnesota* case, there have reportedly been over 7,000 claims with the IRS filed seeking more than $1.35 billion of social security taxes paid by residents and hospitals.[186] Well over 100 institutions filed claims requesting refunds of FICA taxes that had been withheld on wages paid to medical residents. After much deliberation as to how to handle these refund claims, in 2000 the IRS issued a Chief Counsel Advice Memorandum[187] in which it said that there are two fundamental issues that must be addressed in determining whether wages paid to a medical resident are eligible for the student FICA exception. First, the medical resident must be employed by a ''school, college, or university.'' Therefore, if the medical resident is employed by a hospital (a common situation), the IRS says that the resident will not qualify for the student FICA exception because a hospital is not a school, college, or university. The second issue is whether the medical resident qualifies as a ''student.''

[185] *Minnesota v. Apfel*, 151 F.3 d 742 (8th Cir. 1998).
[186] *U.S. v. Mt. Sinai Medical Center of Florida, Inc.*, 97 AFTR 2 d 2006-1408 (S.D. Fla. 2006).
[187] CCA 200029030 (July 21, 2000). *See also* FSA 200041002 (Jan. 24, 2000), which addresses the medical resident FICA refund issue but was issued prior to CCA 200029030.

Both the ''employer'' and the ''student'' determinations are based on a facts and circumstances test, and the Chief Counsel Advice Memorandum sets forth a detailed description of the applicable facts and circumstances that must be taken into account in making both such determinations.

- *Subsequent IRS and judicial developments*. In 2001, the IRS issued detailed instructions to its agents on how to review and analyze the medical resident FICA refund claims based on the *University of Minnesota* case.[188] Following the issuance of this legal memorandum, chief counsel's office issued a second memorandum holding that a hospital that sponsors a medical residency program cannot qualify as a ''school, college, or university'' for purposes of the student FICA exception, unless the hospital is part of the same legal entity as a university.[189] The IRS further amplified on the ability of hospitals to be treated as a qualifying employer in yet another legal memorandum in which it explained the circumstances under which a hospital might be treated as a section 509(a)(3) supporting organization with respect to a university even if the hospital was not originally formed as a supporting organization for the university and does not have official section 509(a)(3) status.[190] This is an important memorandum because an entity that is not a school, college, or university can nevertheless be a qualifying employer for section 3121(b)(10) purposes if it is a section 509(a)(3) supporting organization with respect to a school, college, or university.

  In 2002, the IRS issued yet another legal memorandum saying that, except in those cases located in the Eighth Circuit with facts that are identical to the *University of Minnesota* case, IRS agents should deny the refund claims on the ground that the residents are not ''students.''[191] In this memorandum, the IRS first analyzed the University of Minnesota case and concluded that the decision was based on three primary facts: the residents were (1) enrolled in the university, (2) paid tuition, and (3) were registered for approximately 15 hours per semester. The IRS suggests that there may be few (if any) other residency programs

[188]2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002, 24th ed., at 1 (2001).
[189]CCA 200145040 (Aug. 23, 2001).
[190]CCA 200215048 (Jan. 29, 2002). In this memorandum, the IRS said that the hospital can qualify under IRC § 509(a)(3) if (1) the university exercises control over the hospital as evidenced by the right to appoint at least a majority of the hospital's directors; (2) the hospital and the university share a number of common purposes, and the purposes of the hospital are no broader than those of the university (IRS agents are advised not to pursue the argument that the operation of a hospital might be considered a purpose beyond that of the university because of substantial doubt that a court would ever support such a position); and (3) there exists a historic and continuous relationship between the hospital and the university.
[191]CCA 200212029 (Jan. 24, 2002).

with these characteristics. The memorandum goes on to identify those factors that, in its opinion, cause the residents to be treated as employees, not students. They include that patient care, not education, is the primary focus of the residents' activities; the lack of a structured medical residency educational program or curriculum; the indicia of the employer-employee relationship between the hospital and the resident, including employment contracts, performance appraisals, fringe benefits, and so on; the distinction between the work activities of the residents and the educational activities of medical students; and the clear economic benefit received by the hospital from the activities of the medical residents.

In 2003, another court rejected the government's position in the medical resident student FICA area.[192] This case, which involved the Mayo Foundation, not only affirmed many of the principles articulated in the Eighth Circuit's *University of Minnesota* decision but also resolved other issues in favor of medical schools and hospitals that sponsor residency programs. Of particular interest is the court's determination that the residents were ''employees'' of the Foundation, not the separate hospitals at which they trained because of numerous examples showing that the hospitals had little or no control over the residents' activities. For example, the hospitals could not hire or fire the residents and discipline problems were resolved by the supervising staff physician or the Foundation, not the hospitals. Also, the court found that the Foundation qualified as a ''school, college, or university'' even though over 90 percent of its expenditures related to providing patient care and less than 5 percent related to providing education. The court rejected the government's argument that an organization should be classified as a ''school, college, or university'' only if education is its ''primary purpose.'' Instead, the court said that the proper test is whether the Foundation is a ''school, college, or university'' under the commonly and generally accepted sense of that term.

Then, in 2004, in an effort to overturn these judicial decisions through the issuance of regulations, the IRS released the final regulations under section 3121(b)(10), which contain an example that states as follows:

> (i) Employee E is employed by University V to provide patient care services at a teaching hospital that is an unincorporated division of V. These services are performed as part of a medical residency program in a medical specialty sponsored by V. The residency program in which E participates is accredited by the Accreditation Counsel for Graduate Medical Education. Upon completion of the program; E will receive a ''certificate of completion'' and

[192] *U.S. v. Mayo Foundation for Medical Education and Research and Mayo Foundation*, 92 AFTR 2 d 2003-5774 (D.C. Minn. 2003).

> be eligible to sit for an examination required to be certified by a recognized organization in the medical specialty. E's normal work schedule, which includes services having an educational, instructional, or training aspect, is 40 hours or more per week.
>
> (ii) In this example, E is employed by V, a school, college, or university within the meaning of paragraph (c) of this section. However, E's normal work schedule calls for E to perform services 40 or more hours per week. E is therefore a full-time employee, and the fact that some of E's services have an educational, instructional, or training aspect does not affect that conclusion. Thus, E's services are not incident to and for the purpose of pursuing a course of study. Accordingly, E's services are not excepted from employment under section 3121(b)(10) and there is no need to consider other relevant factors, such as whether E is a professional employee or whether E is eligible for employment benefits.[193]

These regulations were effective for services rendered on or after April 1, 2005; therefore, the issue remained in court cases involving years prior to that date. In early 2005, a federal district court in Florida upheld the government's position that medical residents are ineligible for the student FICA exception and are subject to FICA tax on the wages they receive.[194] This court case involved medical residents who worked and trained at the Mt. Sinai Medical Center located in Miami Beach. The Mt. Sinai medical residency program was a traditional medical resident program in that education and training was provided under the Accreditation Counsel on Graduate Medical Education (ACGME) guidelines, the residents conducted clinical examinations together with Mt. Sinai clinical and attending physicians and attended daily conferences and weekly grand round sessions, and the program involved textbook readings, graded examinations, and participation in journal clubs. The residents did not pay tuition and they received annual salaries ranging from $28,000 to $44,000.

In reaching its conclusion, the court did not address that the residents worked for a ''hospital'' and not a ''school, college, or university'' as required by section 3121(b)(10). The court did address, however, the long-standing position of the IRS that medical residents, because of the substantial patient care services they provide, are primarily ''employees'' and that they do not qualify for the student FICA exception for that reason. Here, the court disagreed with the IRS and found that the ''focus of the [medical residents'] service was educational'' in nature.

The court based its opinion on the medical residents not qualifying for the student FICA exception on its interpretation of the legislative

[193]Treas. Reg. § 31.3121(b)(10)-2(e), Example 4.
[194]*U.S. v. Mt. Sinai Medical Center of Florida, Inc.*, 97 AFTR 2 d 2006-1408 (S.D. Fla. 2006).

history to section 3121(b)(10) and particularly on an analysis of the many modifications to the student FICA exception statute since its original enactment in 1939. Based on its reading of this legislative history, the court determined that Congress has always intended that medical residents be subject to FICA tax and that the statute should be so construed today.

The *Mt. Sinai* case was appealed to the Eleventh Circuit, and that court reversed the district court on the ground that the underlying statute was not ambiguous, and therefore it was improper for the court to have taken into account the statute's legislative history in reaching its decision.[195] The court remanded the case to the district court ''for further proceedings consistent with this opinion.'' Thus, it is expected that the district court will issue another decision on the issue and that this decision will again be appealed to the Eleventh Circuit.

In 2006, prior to the Eleventh Circuit's decision in the *Mt. Sinai* case, a federal district court in Ohio decided a case in which the employer-hospital raised two arguments in connection with stipends paid to its medical residents[196]:

1. The payments were fellowships, not wages; and
2. The payments were exempt from FICA tax under the section 3121(b)(10) student FICA exception.

The government filed a summary judgment motion with the court arguing that, as a matter law, the stipends were wages and the student FICA exception was inapplicable. Thus, the government argued, the court need not make any factual determinations on either issue, and both issues should be decided in the government's favor without a trial. The court rejected the government's motion with respect to both issues.

With respect to the fellowship/wages issue, the court noted the long history of cases and rulings that have uniformly held that ''advanced medical personnel are employees and that all payments to them are subject to taxation.''[197] But the court noted that, in order for a purported fellowship the payment to be treated as in return for services, the services have to be ''substantial,'' and said that only by developing facts at a trial could the court determine whether the services performed by the hospital's medical residents were substantial. Also, the court noted that section 117(b)(1) says that the scholarship/fellowship recipient is entitled to ''establish'' that the payment he/she receives is a scholarship/fellowship. A trial, the court felt, would be required to give the

[195] *U.S. v. Mount Sinai Medical Center of Florida, Inc.*, 99 AFTR 2 d 2007-2800 (11th Cir. 2007).
[196] *U.S. v. University Hospital*, 98 AFTR 2 d 2006- 6057(S.D. OH 2006).
[197] *Parr v. U.S.*, 469 F.2 d 1156, 1159 (5th Cir. 1972).

hospital the right to establish its position. Therefore, while the court rejected the government's motion for summary judgment, the tenor of the court's opinion suggested that the hospital may have a difficult time showing that the stipends paid to the medical residents were not wages.

Turning to the student FICA issue, the court first noted that even if the stipends are treated as wages, they still may be exempt from FICA tax under the section 3121(b)(10) student FICA exception. In support of its denial of the government's motion, the court first said that the plain language of the statute could be interpreted as allowing medical residents at hospitals to qualify for the FICA tax exemption. The court then went on to review several cases cited by the government in support of its position (including the previously cited *Mt. Sinai* case) and said that these cases were either inapplicable here or were not cases that the court was bound to follow. For these reasons, the court said that the student FICA issue should proceed to trial.

There were three other significant court decisions in 2006. In the first case, the court denied the government's motion for summary judgment saying that any determination as to whether medical residents are exempt as ''students'' from paying FICA tax ''must be done through a case-by-case examination of the residents' relationship with their schools.'' Thus, the court said that the taxpayer must be allowed to present to the court the factual basis for its position that its medical residents are more in the nature of ''students'' than ''employees.''[198]

The second case involved the University of Chicago Hospitals (UCH), which administers medical education programs for residents in a variety of specialties.[199] UCH filed a claim for over $5 million in FICA taxes for 1995 and 1996, and after six months elapsed with no response from the IRS, UCH filed a petition with an Illinois federal district court asking that the refund claims be granted. In the government's motion for summary judgment, it argued that UCH's medical residents are not eligible for the section 3121(b)(10) student FICA exception based on the legislative history rationale of the Florida district court's *Mt. Sinai* case. The court denied the motion, saying that it is only appropriate to look at a statute's legislative history if the statute and the applicable Treasury regulations are unclear. Here, the court said that while ''the plain language of section 3121(b)(10) does not clearly indicate whether medical residents are eligible for the student exclusion, the applicable Treasury regulation provides guidance on how to make the determination.'' Thus, the court rejected and refused to follow the legislative history approach of the *Mt. Sinai* district court. The court also rejected the government's

[198] *Center for Family Medicine v. U.S*, 98 AFTR 2 d 6340 (D.C. SD 2006).
[199] *University of Chicago Hospitals v. U.S.*, 98 AFTR 2 d 2006-6657 (D.C. Ill. 2006).

argument that the student FICA exception is only available to student employees who earn a ''nominal amount'' of income, saying that it found no such requirement, either explicit or implicit, in the section 3121(b)(10) regulations.

The final decision, rendered by a federal district court in Michigan, held that medical residents, as a matter of law, do not qualify for the section 3121(b)(10) student FICA exception and, as such, are subject to FICA taxes on the wages paid to them by the hospital at which they work and train.[200] Importantly for those who believe that medical residents should be exempt from FICA tax under the student FICA exception, the basis for the court's decision was *not* that medical residents are primarily engaged in ''employment'' activities as opposed to ''educational'' activities. Rather, the court followed the same rationale as followed by the Florida district court in the subsequently reversed *Mt. Sinai* case—that is, the legislative history of the Social Security Act supports the government's position that medical residents should not qualify under the student FICA exception.

(b) Students Performing Domestic Services

If a student provides domestic services for a local college club or local chapter of a college fraternity or sorority, the services are exempt from social security tax if the student is enrolled in and regularly attending classes at the school, college, or university. Likewise, such domestic services are exempt from the federal unemployment tax (whether or not performed by a student), unless the cash amount paid for all such services is $1,000 or more in any calendar quarter during the calendar year. The types of domestic services that fall within the scope of this provision include services rendered by cooks, waiters, butlers, janitors, laundresses, handymen, gardeners, housekeepers, and housemothers. These services are not excepted from Social Security tax, however, if the local club or fraternal organization is used primarily for the purpose of supplying room and board to students or to the public as a business activity. A local college club is defined as one whose membership is made up primarily of students enrolled in the college and does not include an alumni club or chapter or clubs that may be organized for the institution's faculty or administrative staff.

(c) Students Employed at Hospitals

Wages paid in connection with services performed by student employees of federal hospitals, as well as services performed as student nurses in the employ of a hospital or nurses training school, are exempt from social security

[200] *U.S. v. Detroit Medical Center*, 98 AFTR 2 d 2006-7995 (DC MI 2006).

and federal unemployment tax, if the individual is enrolled and regularly attending classes at a nurses training school chartered and approved by state law.[201] In order to qualify for this exemption, however, the employment must be substantially less than full-time, the total amount of earnings must be nominal, and the services performed must be incidental to the student's training.[202]

(d) Students in ''Work Study'' Programs

Full-time students who work for an employer in a ''work study'' program are not subject to federal unemployment tax if the institution at which the student is enrolled has certified to the employer that the service is an integral part of the program.[203] This exclusion applies to students at both public and private education institutions but does not apply to employee education or training programs that are established for or on behalf of an employer or group of employers.

§ 4.4 THE NONRESIDENT ALIEN EXCEPTION

(a) General Rules

Another exception from ''employment'' for Social Security tax purposes pertains to services performed by nonresident alien employees who hold an F, J, M, or Q visa.[204] Again, the statutory provision seems quite simple and straightforward but contains some hidden problems. The statute provides that the term *employment* does not include

> service which is performed by a nonresident alien individual for the period he is temporarily present in the U.S. as a nonimmigrant under subparagraph (F), (J), (M), or (Q) of section 101(a)(15) of the Immigration and Nationality Act, as amended, and which is performed to carry out the purpose specified in subparagraph (F), (J), (M), or (Q), as the case may be.

Thus, when this statute is divided into its component parts, in order to qualify for the exemption, the individual must be (1) a nonresident alien; (2) an F, J, M, or Q visa holder; and (3) performing services to carry out the purpose of his or her visa.

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[201]IRC §§ 3121(b)(13), 3306(c)(13).

[202]Rev. Rul. 85-74, 1985-1 C.B. 331; *Johnson City Med. Ctr. Hosp. v. United States*, 783 F. Supp. 1048 (E.D. Tenn.), *aff'd*, 999 F.2 d 973 (6th Cir. 1993).

[203]IRC § 3306(c)(10)(C).

[204]IRC § 3121(b)(19). An F visa pertains to students; a J visa pertains to a variety of different types of individuals, the most common of whom at colleges and universities are students, scholars, and trainees; an M visa pertains to vocational students; and a Q visa pertains to individuals in the United States under an international cultural exchange program. All these visa holders are eligible to work, but with certain restrictions.

Looking at the first test—whether the individual is a nonresident alien—the institution must apply the green card and substantial presence test to see whether the foreign national employee is classified as a nonresident alien or as a resident alien for U.S. tax purposes.[205] If, after application of these tests, the individual is classified as a resident alien, the exception is not applicable.

This was not always the case, however. In 1967, the IRS issued a ruling holding that a nonimmigrant alien present in the United States under an F or J[206] visa can be classified as a nonresident alien for Social Security tax purposes even though the individual may be a resident alien for income tax purposes.[207] In 1986, however, the IRS issued proposed regulations that reversed this position and permitted a Social Security tax exemption for F and J visa holders only if they were also classified as nonresident aliens for income tax purposes. These proposed regulations were finalized in 1992; therefore, the current position of the IRS is that the nonresident/resident alien tests are the same for both income and Social Security purposes, and an individual does not qualify for this Social Security tax exception if the individual is a ''resident alien'' for income tax purposes.[208]

The second component of the test—that the individual bean F, J, M, or Q visa holder—simply requires that the individual be in the United States under one of these visa categories while working. Even if the individual has been misclassified by the U.S. immigration authorities and incorrectly issued an F, J, M, or Q visa, it is the current visa status that controls for tax purposes, even if it is wrong. A change in the individual's visa status to a non-F, -J, -M, or -Q category causes the exemption to be inapplicable on the date of change.

The final requirement is that the individual be working in furtherance of the purpose specified in the F, J, M, or Q visa. This requirement is not, in most cases, a problem because most of these individuals are only permitted to work and earn income for activities directly related to the primary purpose of the issuance of their particular visa. The provision does come into play, however, with respect to spouse and children dependents of the primary visa holder (who usually hold an F-2, J-2, M-2, or Q-2 visa). They are not eligible for the exemption because the purpose for their visit to the United States is to accompany the primary (or ''-1'') visa holder, not to work. Therefore, individuals holding F-2, J-2, M-2, or Q-2 visas are not eligible for the exemption.

This issue is further complicated by the fact that, under the U.S. residency rules, once an individual is classified as a resident alien (and therefore no

[205] *See* Chapter 8.
[206] The M and Q visa categories were added at a later date.
[207] Rev. Rul. 67-159, 1967-1 C.B. 280.
[208] Treas. Reg. § 31.3121(b)(19)-1(a)(1).

longer eligible for the exemption), the classification is effective on a retroactive basis to the first day of the tax year, thereby causing the Social Security tax to be applied retroactively as well. To illustrate:

> Assume that an individual arrives in the United States on December 1, 2006, on a J-1 visa to teach. In determining the individual's U.S. residency status for tax purposes, the individual will be a nonresident alien eligible for the exemption for 2006 and 2007, and will be exempt from Social Security tax during those two calendar years. Beginning on January 1, 2008, however, the individual must begin to count days under the substantial presence test to determine his U.S. residency status, and once the person has been in the United States for 183 days during 2008, the individual will become a ''resident alien'' retroactively to January 1, 2008. Because the status is effective retroactively, the individual is subject to Social Security tax retroactively to January 1, 2008.

The college or university in this situation has two choices: it can either wait until the individual meets the 183-day test in 2008 (which occurs in early July) and then withhold the Social Security tax retroactively to January 1, or begin withholding Social Security tax on January 1 under the assumption that the 183-day test will be met for that year. Because of the administrative burden of retroactive tax withholding, most institutions follow the latter course of action and begin social security tax withholding on the first day of the year, unless they have a good reason to believe that the individual will leave the United States before the 183-day test is met.[209]

(b) Income Tax Treaties

One other aspect relating to the imposition of the social security tax on foreign nationals deserves mention. The United States has entered into income tax treaties with more than 50 different countries, and the question is often asked whether a tax treaty can operate to exempt nationals of that country from the social security tax. The specific taxes covered by the treaties are usually described as ''federal income taxes''; therefore, in order for a tax treaty to provide an exemption from social security tax, the social security tax must qualify as a ''federal income tax.'' There is some conflicting authority,

[209]There is an argument that the FICA tax determination should be made at the time of the wage payment, and that if the person was a nonresident alien at the time that the payment was made, the nonresident alien FICA tax exclusion applies, even if the person eventually meets the 183-day test. Assume, for example, that a foreign national's two-year J visa–holder exemption expires on December 31, 2006, and that he or she has to begin counting days toward the substantial presence test on January 1, 2007. Assume further that the foreign national stays in the United States for the requisite 183-day period during 2007. Under this theory, a wage payment made to the person on, say, April 1, 2007, would be eligible for the nonresident alien FICA tax exemption because on the date that the payment was made, the person was a nonresident alien. The IRS does not agree with this theory, however, and it has yet to be tested in court.

however, as to whether the Social Security tax so qualifies.[210] Given this conflicting authority, a nonresident alien is on somewhat shaky ground in attempting to argue that an income tax exemption under a tax treaty should be extended to cover the Social Security tax. Also, a tax treaty exemption, if it applies, only pertains to the employee's portion of the social security tax—the employer's portion would not be exempt.

If, however, a tax treaty specifically refers to Social Security taxes, these specific references control. Some tax treaties expressly exclude social security taxes from the taxes covered by the treaty.[211] In others, the actual tax treaty is silent, but the Treasury Department's technical explanation that describes the treaty's provisions states that the U.S. Social Security tax was intended to be excluded from the taxes covered under the treaty.[212] In still others, both the tax treaty and the Treasury Department's technical explanation are silent.[213] In summary, without tax treaty language specifically covering the social security tax, it is difficult to argue that the social security tax is exempt under an income tax treaty, and a nonresident alien can expect the IRS to challenge any such assertion.

(c) Social Security Totalization Agreements

A discussion of the impact of the Social Security tax on nonresident aliens would not be complete without mentioning social security ''totalization agreements.'' These are executive agreements entered into by the United States with various foreign countries. Executive agreements are different from treaties in that the executive agreements do not require formal approval by Congress. The purpose of a ''totalization agreement'' is (1) to relieve the employer and employee from double social security tax with respect to the same employment, and (2) to ''totalize'' the employee's Social Security tax paid to both countries in order to receive the combined benefits in only one country.

A totalization agreement does not permit an employee to avoid social security tax in both countries; rather, it merely allows the employee to pay tax to either one country or the other. In order to use the totalization agreement as an exemption from U.S. Social Security tax, the foreign employee must prove that Social Security tax is being paid to his or her home country for

[210] *See* IRC §§ 3101 and 275(a)(1), which refer to the social security tax on employees as an income tax. Also, in *Helvering v. Davis*, 301 U.S. 619, 635 (1937), the Supreme Court described the social security tax as an ''income tax on employees.'' *But see* Rev. Rul. 66-77, 1966-1 C.B. 242, and *Chatterji v. Commissioner*, 54 T.C. 1402, 1404 (1970).

[211] For example, the U.S. tax treaties with Barbados, China, Cyprus, New Zealand, Poland, and Romania.

[212] For example, the U.S. tax treaties with Australia, Canada, Jamaica, Morocco, and the Philippines.

[213] Most treaties that were ratified prior to 1970 and are still in effect fall into this category.

the income earned while working in the United States. This burden of proof rests with the foreign employee who must obtain a ''coverage certificate'' from the home-country Social Security authorities.[214] The coverage certificate must be presented to the U.S. employer, who may then cease Social Security tax withholding.[215]

§ 4.5 STATE COLLEGE AND UNIVERSITY EMPLOYEES

As a general rule, individuals who are employed by a state or any political subdivision of a state are exempt from Social Security coverage.[216] One exception to this rule relates to those state and local government employees who are not covered by a state retirement system.[217] They are automatically included in the Social Security system and their wages are subject to Social Security taxes. A second exception relates to employees who are subject to voluntary coverage agreements executed between their state and the federal government. These agreements (known as ''section 218 agreements'' because they stem from section 218 of the Social Security Act) are administered by the SSA, not the IRS. Each state decides which categories of employees are to be covered under the agreement, and they generally include those state or local employees whose positions are not covered by a state or local retirement system.

The section 218 agreements generally mirror the federal Social Security provisions and usually contain, for example, the same exemptions for student employees and nonresident alien employees. But this is not always the case, and certain states do not have a student FICA exception as part of their section 218 agreement. Regulations issued by the SSA provide that section 218 agreements cannot cover ''services other than agricultural labor or student services that would be excluded if performed for a private employer.''[218] This means that services performed by nonresident aliens on F, J, M, and Q visas cannot be covered under a section 218 agreement, even if the agreement is silent with regard to such individuals.

There is virtually no guidance or legal authority on how section 218 agreements are to be interpreted and applied, and there are even reported situations in which a state has been unable to find a copy of its section 218 agreement.

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[214]Rev. Proc. 80-56, 1980-2 C.B. 851; Rev. Proc. 84-54, 1984-2 C.B. 489.

[215]As of this writing, the United States has entered into social security totalization agreements with Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom.

[216]IRC § 3121(b)(7). For a more detailed discussion of these rules, *see* § 9.7.

[217]IRC § 3121(b)(7)(F), effective for services performed after July 1, 1991.

[218]SSA Federal Old-Age, Survivors and Disability Insurance Rule, 20 C.F.R. § 404.1209(e).

§ 4.6 CLASSIFICATION OF SIGNING BONUSES AND TERMINATION, EARLY RETIREMENT, ROYALTY, AND SETTLEMENT PAYMENTS

When an employer makes a payment to an employee for a stated reason other than wages for services rendered, a question arises as to whether the payment should be treated for tax purposes in accordance with the stated reason for the payment or should instead be treated as additional wages subject to ordinary income and FICA tax withholding. This section deals with termination, early retirement, royalty, and settlement payments made to employees and discusses the extent to which such payments are respected as such for tax purposes or are instead treated as wage income.[219]

(a) Termination Payments

A district court in Texas held in 1994 that an amount paid to a tenured professor at Texas A&M University in settlement of a dispute over the termination of the professor's employment did not constitute ''wages'' subject to withholding.[220] The court took issue with an earlier IRS ruling in which similar payments were held to be subject to wage withholding because they were made in return for the performance of prior services.[221] The district court called this IRS ruling ''highly questionable'' and held that, although under the university's guidelines a faculty member may not be eligible for tenure until a certain number of years have passed, the offer of tenure should be considered an offer for a contract of more stable future employment, not as a payment for past services. The court held that when the tenured contract is breached, the professor's damages are for lost future employment, not for the loss of remuneration for services already performed. Therefore, the tenure payments were not wages paid to an employee.

The IRS does not agree with this rationale as evidenced in a legal memorandum in which the chief counsel's office reviewed several court cases that were decided in 1999 and 2000, all of which supported the IRS's position that termination payments represent additional wage income.[222] The arguments

[219]For a discussion of the IRS position on various cases in this area of the law, see 2003 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook for FY 2003, at D-23 (2002).

[220]*Slotta v. Texas A&M University Systems*, 1994 U.S. Dist. LEXIS 21205, No. Civ. G-93-92 (S.D. Tex. August 10, 1994).

[221]Priv. Ltr. Rul. 8648027 (Aug. 28, 1986). The IRS also addressed this issue in two prior rulings. In Rev. Rul. 58-301, 1958-1 C.B. 23, the IRS ruled that a termination payment made to an employee was not wages because it was made in return for the employee's relinquishment of his contract rights, while in Rev. Rul. 75-44, 1975-1 C.B. 15, the IRS ruled that the termination payment was wages because it was paid in consideration of past services.

[222]ILM 200033043 (June 13, 2000).

raised by the taxpayers in these cases fell into three categories: (1) the payments were made with respect to a period of time in which the person was not employed and therefore could not be wages; (2) the payments were made on account of personal injury or sickness and were therefore excludable under section 104(a)(2); or (3) where the payments were spread out over a period of years, the FICA tax should be computed with reference to the years that the compensation was earned, not the year it was paid.

The IRS memorandum cites and discusses a 1999 Court of Federal Claims case, which rejected this first argument on the ground that service provided for an employer includes not only work actually done for the employer but also payments made in connection with the employer-employee relationship.[223] Thus, a termination payment that included an extra year's compensation was treated as wage income even though the employee did not perform services for that year. With respect to the second argument, the memorandum cites a number of cases that rejected the taxpayer's section 104(a)(2) argument on the ground that these payments were not, as the statute requires, ''received on account of personal injuries.'' Instead, the courts found that the payments were based on salary and years of service, factors that typically measure employee compensation.[224] The final argument is that termination payments paid out over several years should be taxed with reference to the year that the entire payment was earned, not each year that it is paid out. Thus, the employee would only be subject to FICA tax up to the FICA tax wage limit of the year that the income was earned. The legal memorandum cites a California district court case that rejected this argument and held that payments made in consideration for early retirement were wages in each year in which they were paid.[225]

The IRS attempted to clarify its position on the termination payment issue in a 2004 revenue ruling.[226] In this ruling, an individual was hired under an employment contract that ran for a specified term of years. Before the end of the contract period, the employer and the employee agreed to cancel the contract with the employer making a cash payment to the employee in consideration for the employee's relinquishment of his contract rights. The IRS said that the definition of *employment* is quite broad and ''encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the terms and conditions thereof.'' For an employee to be able to assert successfully that a termination payment

[223]Associated Elec. Coop., Inc. v. United States, 42 Fed. Cl. 867 (1999).

[224]The primary case that the IRS relied on was *Commissioner v. Schleier*, 515 U.S. 323 (1995). *See also Ndirika v. Commissioner*, T.C. Memo 2004-250, in which the Tax Court found that the full amount of the severance payment made by an employer to a former employee was taxable as a salary continuation severance payment, not as a payment for the employee's alleged physical injury. In reaching this conclusion, the Court looked to the language of the separation agreement, which clearly indicated that the employee's payments were intended to compensate the employee for loss of wages.

[225]*Cohen v. United States*, 63 F. Supp. 2 d 1131 (C.D. Cal. 1999).

[226]Rev. Rul. 2004-110, 2004-50 I.R.B. 960.

is not ''wages,'' the employee must be able to provide ''clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions.''

In this ruling, the IRS held that, though the employee did receive the payment in return for relinquishing his contract rights, ''the payment is part of the compensation the employer pays as remuneration for employment'' and was dependent on the employer-employee relationship and its component terms and conditions. Therefore, the contract termination payment represented wages subject to FICA and other employment taxes. Because it recognized that this ruling revoked or substantially modified earlier rulings on which taxpayers had properly relied, the IRS said that the ruling will not apply to any payment made by an employer to an employee or former employee before January 12, 2005.

Finally, it is important to distinguish a termination or severance payment from a deferred compensation payment because the latter type of payment triggers the rules of section 457.[227] The IRS said in a 1999 technical advice memorandum that a termination or severance payment is one made at the termination of employment due to an unanticipated set of circumstances, while a deferred compensation payment is structured to postpone the receipt of income to delay the payment of taxes until a later date, such as when the person retires or separates from service.[228] In addition, this memorandum sets forth numerous other factors that the IRS says must be taken into account in distinguishing a bona fide severance payment from a payment of deferred compensation.

(b) Early Retirement Payments

A North Dakota federal district court held in 1999 that early retirement payments made by North Dakota State University to its tenured faculty were not ''wages'' and therefore were exempt from FICA tax.[229] In this case, the court agreed with the university that the payments made to tenured faculty members were not compensation for services rendered but rather were payments for the purchase of a property right—tenure—owned by the faculty member. The court cited as authority for its position a 1958 IRS revenue ruling, which held that a payment made by an employer to an employee in consideration for the cancellation of an employment contract was a payment in return for a property right and therefore was not wages subject to FICA.[230] The court dismissed

[227] *See* § 9.3(m).

[228] Tech. Adv. Mem. 199903032 (Oct. 2, 1998).

[229] *North Dakota State Univ. v. United States*, No. A3-98-50 (D.N.D. Nov. 19, 1999).

[230] Rev. Rul. 58-301, 1958-1 C.B. 23. This ruling, while still valid, was significantly limited by two later rulings. In Rev. Rul. 74-252, 1974-1 C.B. 287, the IRS said that the ''payment in return for property rights'' rule does not apply when the provision for the payment is set forth in the contract itself. In Rev. Rul. 75-44, 1975-1 C.B. 15, the IRS said that the rule does not apply if the termination payment was made due to the employee's long years of service.

the government's argument that tenure should be treated as simply another type of ''employment right,'' such as ERISA (Employee Retirement Income Security Act of 1974) settlement awards, downsizing payments, and ''early out'' payments, which the courts have consistently held are wages subject to FICA tax. The court, after setting forth a detailed history and description of the concept of tenure, rejected this argument because it found that a payment for tenure was ''something more'' than a mere payment for an employment right.

The court also decided another issue involving the same early retirement payments, except these payments were made by the university to its nonfaculty administrators. Because these persons did not have tenure, the court compared the situation to earlier court cases holding that payments made by an employer to an employee in return for the relinquishment by the employee of ''employment rights'' are taxable wages.[231] Under these cases, when payments to employees are based on length of service and rate of pay, they are deemed to be wages for FICA tax purposes; because the university's early retirement payments to the administrators were based on these factors, these payments were held to be wages subject to FICA tax.

The government appealed the district court decision to the Eighth Circuit, and in 2001, the appellate court affirmed the district court, with respect to the payments made to the tenured faculty members as well as those made to the nonfaculty administrators.[232] The IRS subsequently announced that it does not agree with the Eighth Circuit's decision with respect to the tenured faculty members.[233] The Eighth Circuit, for the most part, relied on the district court's rationale for both conclusions, but said that the university never attempted to prove its position that the nonfaculty administrators had tenure. Thus, because the Eighth Circuit did not specifically rule that the nonfaculty administrators were prohibited as a matter of law from claiming nonwage treatment, a college or university that could demonstrate that its nonfaculty administrators had tenure (or the equivalent thereof) might also be able to treat the payments to these officials as nonwages.

In addition, in a case that arose outside of the Eighth Circuit, a Pennsylvania federal district court handed the University of Pittsburgh a major victory where the university made early retirement payments to certain faculty and administrators holding faculty tenure.[234] The case involved several early

[231] *Abrahamsen v. United States*, 44 Fed. Cl. 260, 272–73 (1999) (holding that ''downsizing'' payments are wages);*Associated Elec. Coop. v. United States*, 42 Fed. Cl. 867, 876 (1999) (holding that ''early out'' payments are wages); *Mayberry v. United States*, 151 F.3 d 855, 860 (8th Cir. Aug. 10, 1998) (holding that an ERISA class action settlement award is wages);*Lane Processing Trust v. United States*, 25 F.3 d 662, 665 (8th Cir. 1994) (holding that trust distributions made to employees are wages).

[232] *North Dakota State University v. United States*, 255 F.3 d 599 (8th Cir. 2001).

[233] 2001-53 I.R.B. 1. *See also* Service Center Advice Memorandum 200235029 (July 28, 2002), which directs Service Center officials to reject all refund claims filed by taxpayers outside the jurisdiction of the Eighth Circuit.

[234] *University of Pittsburgh v. U.S*, 96 AFTR 2 d 7412 (W.D. Pa. 2005).

retirement plans established by the university between 1982 and 1999 as an incentive to its faculty members and certain other employees to retire early. The plans were available for (1) full-time and part-time faculty members with tenure, (2) full-time administrators holding faculty tenure, and (3) full-time and part-time librarians who, while not holding tenure, had a contractual expectation of continued employment.

The plans provided that the employees would receive a specific payment in return for the individual's release of his or her tenure or contract rights. The university withheld FICA tax on these payments but later changed its mind as to the proper tax treatment and filed refund claims totaling more than $2 million. The IRS disallowed the refunds, and the university filed suit in district court.

The government argued that because the university's payments to all of the plan participants arose from the employment relationship and were earned through their services to the university, the payments constituted ''remuneration for employment'' or ''wages'' and were, therefore subject to FICA tax. The university, however, asserted that its payments were made to purchase a protected property interest, namely, its faculty and administrators' tenure and the contractual rights held by the librarians, and that the payments did not constitute ''wages'' because they were made in exchange for the relinquishment of these tenure and contractual rights.

The district court followed the Eighth Circuit's position in the *North Dakota State University* case and held that the payments made to the faculty members and administrators holding tenure were not wages because they were paid in return for the individuals' relinquishment of their ''contractually and constitutionally protected property interest in continued employment.''

The court considered several arguments raised by the government to distinguish the *North Dakota State University* case, namely, the payments made under the plan constituted wages because (1) they were based on each employee's salary and length of service; (2) they were in consideration for past employment and not in exchange for property rights; (3) they arose from the employment relationship between the university and its employees so as to constitute ''remuneration for employment''; and (4) the payments were not limited to tenured faculty, but were also available to nontenured faculty librarians.

The court rejected all of these arguments except for the last one and held that the payments made to the nontenured librarians were wages because there was no showing that their contracts provided lifetime employment similar to a tenure right.

In 2006, however, the Sixth Circuit held that early retirement payments made to certain tenured public school teachers were wages and refused to follow the *North Dakota State University* rationale that the payments were in consideration for the teachers' release of their tenure rights.[235] The Sixth Circuit

[235] *Appoloni v. United States*, 97 AFTR 2 d 2006-2828 (6th Cir. 2006).

cited four reasons in support of its conclusion that that the early retirement payments made to the public school teachers were wages:

1. Eligibility for a payment was conditioned on the person serving as an employee for a certain period of time, which the court felt was indicative of a wage payment.
2. The teacher earned tenure by providing service to the school, which again is indicative of a wage payment.
3. The decision was in accord with a 1975 IRS revenue ruling,[236] which held that a similar payment was properly classified as wages.
4. The court recognized that its decision was at variance with the Eighth Circuit's *North Dakota State University* case, but said that it simply disagreed with the court's reasoning in that case.

The taxpayer in the Sixth Circuit case appealed the decision to the Supreme Court, and many observers believed that the Court would agree to hear the case because of what appeared to be a clear split between the Sixth and Eighth Circuits. But in early 2007 the Supreme Court announced that it would not hear an appeal of the Sixth Circuit decision.

The Supreme Court's refusal to resolve what appears to be a conflict between the two circuits could mean that it believes that the issue should be further litigated to allow other courts of appeal to analyze the issue before it steps into the fray. Or the Court might be of the view that there really is no conflict between the two circuit decisions because of the substantive difference in the tenure rights granted to the North Dakota State University faculty members versus the less substantive rights granted to the public school teachers in the Sixth Circuit case. In this regard, it is interesting to note that the government itself, in a brief filed with the Supreme Court arguing against Supreme Court review, strongly suggested such a distinction, saying:

> While expressing disagreement with the reasoning of the Eighth Circuit in *North Dakota*, the Sixth Circuit also noted that ''*North Dakota* is factually distinguishable.'' The court explained that ''the tenure rights in *North Dakota* were created by a single contract made at the onset of the tenure relationship,'' and that tenure for North Dakota professors was not automatic after a specified period of service but depended on a variety of factors. Although the government does not believe that the correct application of 26 U.S.C. 3121(a) turns on those factual distinctions, the Sixth and Eighth Circuits each attached significant weight to facts that were not present in the other case. For that reason, no square conflict between the two decisions exists. [Citations to the record omitted.]

Shortly after the Supreme Court announced that it would not hear the Sixth Circuit case, the IRS announced that it would no longer follow the

[236]Rev. Rul. 75-44, 1975-1 C.B. 271.

Eighth Circuit's *North Dakota State University* case in the geographical area of the Eighth Circuit.[237] In this announcement, the IRS said that it is modifying its litigating position involving early retirement payments made to tenured faculty members within the Eighth Circuit on the theory that the Eighth Circuit relied on a 1958 revenue ruling in reaching is conclusion,[238] and that in late 2004 the IRS issued Rev. Rul. 2004-110, which superseded this 1958 ruling.[239] Therefore, the IRS said that it will follow the *North Dakota State University* holding within the Eighth Circuit only for cases that have the ''exact same facts'' as that case and where the payments at issue are made before January 12, 2005. For cases with different facts, the IRS will contest the issue within the Eighth Circuit no matter when the payments are made.

To summarize where things currently stand, the future fate of early retirement payments made to college and university faculty members is unclear. The IRS will no doubt continue to assert deficiencies where it finds nonwage treatment (both within and without the states covered by the Eighth Circuit), and it will be interesting to see how these other courts interpret the Supreme Court's refusal to hear the Sixth Circuit case. On the one hand, a court may believe that the Supreme Court is looking for additional analyses by different courts and will decide the case based on its reading of the Eighth and Sixth Circuit decisions. On the other hand, the court may conclude that the Supreme Court implicitly said that the type of tenure held by college and university faculty members is so substantial as to cause the early retirement payments to be treated as payments made in return for a release of those rights, and not as wages.

(c) Royalty Payments

Many colleges and universities make payments to faculty and staff in consideration of the faculty or staff member's transferring to the school the patent rights to an invention that the employee created during the course of his or her employment. An issue that arises in these situations is whether the payment of patent royalties to the employee should be treated as either (1) nonemployee compensation of the type reported on Form 1099, or (2) additional employee wage compensation that is subject to income tax withholding and reportable on Form W-2.[240]

Under most state laws, an employee who creates an invention while acting within the scope of his or her employment is vested with an ownership right in

[237] Action on Decision 2007-1, which can be found on the IRS web site at *www.irs.gov/pub/irs-aod/aod200701.pdf*.

[238] Rev. Rul. 58-301, 1958-1 C.B. 23.

[239] 2004-50, I.R.B. 960.

[240] For an interesting article exploring the tension between the technology licensing office of a major university and a former student over income earned from a patent that had been developed by the student during the period he was obtaining his PhD, see Marcus, ''MIT Seeds Inventions but Wants a Nice Cut of Profits They Yield,'' *Wall Street Journal*, July 20, 1999, at 1.

the invention. Many institutions, however, require the employee to assign all the employee's ownership rights in the patent to the school in return for certain consideration. In return for this transfer of ownership, the employee/inventor receives a share of the net income earned by the school from the invention, which is paid by way of a royalty.

(i) Section 1235 Analysis. One way to analyze the issue of whether a royalty payment made by the employer to an employee should be treated as additional employee compensation or as a bona fide payment for the employee's transfer of his or her patent rights in the invention is to examine those cases involving section 1235 of the Code. Section 1235 generally provides that an inventor can obtain long-term capital gains treatment on royalties he or she receives for the patent if the inventor transfers to a third party ''all substantial rights'' in the patent that the inventor owns.[241]

The specific issue in these employer-employee section 1235 cases is whether the royalty payment should be treated as additional wages paid to the employee and taxed as ordinary income or, instead, whether the payment was in return for a bona fide transfer to the employer of all of the employee's rights in the invention, thereby qualifying the royalty for capital gains treatment under section 1235. Thus, if under these section 1235 cases a payment is properly classified as additional employee compensation, the payment would be subject to the income tax withholding and reported on Form W-2; however, if the royalty qualifies for capital gains treatment under section 1235, no withholding is required, and any reporting would be on Form 1099.[242]

The first principle that these section 1235 cases establish is that if the employee/inventor was ''hired to invent,'' the payments made to him or her by the employer will be additional employee compensation because, in these situations, the payment is clearly for the employee's services, not for the invention.[243]

For those employee/inventors who are not hired to invent, whether the payments they receive should be treated as additional wage income or as a payment in return for the transfer of the employee's patent rights is based on

[241]But there must be a clear transfer of the patent rights by the employee to the employer. For example, in *Vision Information Services v. Commissioner*, 419 F.3 d 554 (6th Cir. 2005), the court rejected the taxpayer's argument that the license agreement should be recharacterized as a sale of the patent rights and know-how because the court found that the agreement between the parties, which referred to the payments as license fees, was clear and unambiguous. In addition, the court said that the payments would not qualify for capital gains treatment under IRC § 1235 because the taxpayer did not part with all substantial rights to the patents and know-how.

[242]It could reasonably be argued that any payment that is treated as a capital gains distribution does not have to be reported at all because an employer is not required to report a capital gains transaction with an employee. But most colleges and universities report these payments on Form 1099.

[243]*Chilton v. Commissioner*, 40 T.C. 552, 562 (1963); *Blum v. Commissioner*, 11 T.C. 101 (1948); *Karrar v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957).

all the facts and circumstances of the case. Perhaps the leading case in this area involved an IBM employee who transferred all of his interest in his invention to IBM, for which he received a lump-sum payment of $30,000.[244] Under the terms of his employment agreement, the employee was required to transfer all rights to his invention to IBM, but that agreement did not specify what consideration, if any, IBM would pay to the employee in return for the transfer. The court held that this payment should not be treated as made in return for the transfer of the employee's right to the invention but rather as additional employee compensation.

After noting that a determination of whether employer-to-employee royalty payments should be treated as payments for the transfer of the employee's rights to the invention or as additional wages is based on all the facts and circumstances of the case, the court said that the presence of the following factors indicate a bona fide transfer of property rights:

- *Fixed royalty payment*. The employment agreement should require the employer to pay a royalty to the employee/inventor for the transferred rights to the invention. Also, the royalty should be paid at a specific rate, with no opportunity for the employer to later vary the amount of the royalty. The thinking of the court is that if the employer retains discretion over whether or how much to pay the employee/inventor, then the payment by the employer can be more readily construed as compensatory in nature because the employer can base the amount of the payment on the quality of the employee's work or other employment-related criteria. (In *Lehman*, the court interpreted the employment agreement in that case as not requiring such a payment by IBM, and this was arguably the primary reason that the court held the payment to be additional wages.)
- *Royalty dependent on benefit to employer*. The amount of the royalty paid to the employee/inventor should depend on the extent of the use and income received by the employer from the invention rather than constitute a lump-sum payment or other payment that has no relationship to the benefit received by the employer.
- *Continuation of royalty after termination or change in policy*. If the employer retains the right to terminate or change its general policy to make royalty payments to employees in return for the transfer of the invention rights, an employee whose right to receive royalties existed prior to such termination or change should continue to receive his or her royalties under the original agreement.
- *Continuation of royalties after termination of employment or death*. The employee/inventor should continue to receive the royalty even after

[244] *Lehman v. Commissioner*, 835 F.2 d 431 (2 d Cir. 1987), *aff'g* 53 T.C.M. 429 (1987).

termination of his or her employment, and if the employee/inventor dies while receiving the royalty, the employee's heirs should continue to receive the payments.

Therefore, to the extent that a college's or university's policies reflect most or all of these factors, a royalty payment made by the school to an employee/inventor who was not ''hired to invent'' should be treated as a royalty payment for a bona fide transfer of the employee's property rights in the invention and not as additional employee compensation subject to income tax withholding and Form W-2 reporting.

If, however, the employee/inventor is not initially vested with an ownership interest in the patent under the applicable state law, this section 1235 analysis may not apply because there would never be a ''transfer'' from the employee to the school, and a transfer is required in order to obtain section 1235 treatment.

The IRS addressed these issues in a technical advice memorandum involving a professor who developed a patentable invention within the scope of his employment and transferred all of his rights in the invention to the university.[245] The university licensed the invention to a third party who paid royalties to the university, and the university paid a share of these royalties to the professor. The professor reported the royalties as capital gains under section 1235 and was audited by the IRS. The issue was sent to the national office under the technical advice procedures, and the national office first held that the payments in question were true royalties (not additional compensation) because the professor was not ''hired to invent'' and the invention was a natural by-product of his normal research services. Turning next to the application of the capital gains provisions of section 1235 to the royalty payment, it concluded that the professor had made a ''transfer'' of his rights in the patent to the university upon the execution of his employment contract, even though the actual invention was created much later. Next, the national office found that the professor had transferred ''all substantial rights'' in the patent to the university. For these reasons, the national office concluded that the professor was entitled to capital gains treatment under section 1235 with respect to the royalty payments that he received.

(ii) Royalties Paid by Issuance of Capital Stock. Most of the royalty payment issues discussed above arise when a college or university licenses employee-created technology and pays to the employee/inventor a percentage of the net royalty received by the school. For example, a university's policies may say that when it licenses an employee/inventor's patent to a third party, it will pay the employee/inventor 25 percent of the royalty that the school receives from the licensor, less applicable expenses. But some colleges

[245]Tech. Adv. Mem. 200249002 (Aug. 8, 2002).

and universities also accept shares of stock in the licensed company in addition to (or in lieu of) the normal cash royalty payment. In these situations, they normally provide for the same split with the employee/inventor because the shares of stock also constitute a ''royalty,'' albeit in a different form. Using the above example, if the university received 100 shares of Company X stock under the license agreement, it would distribute 25 shares of stock to the employee/inventor.

The payment of a royalty in equity shares raises some issues that do not arise when the royalty is paid in cash. First, colleges and universities must watch out for constructive receipt issues. Some schools' policies give the employee/inventor the choice either to receive the stock or have the school hold the stock for later distribution to the employee/inventor. Under the long-established ''constructive receipt'' principle that a person is taxed on income when she has the unqualified right to receive it and cannot avoid taxation by choosing not to take possession of the income, the employee/inventor in these situations is taxed at the time that she has the choice to take the stock, whether she chooses to take the stock or leave it with the school.[246] If the employee/inventor chooses not to take the stock, she gets the worst of all worlds—she does not have possession or the financial benefit of the stock, but she has to pay tax on its value.

The second issue relates to the fact that the value of the stock should be treated as a royalty in the same manner as if the payment had been made in cash. This means that the college or university should file a Form 1099 with respect to the stock distribution just as it would if the payment had been made in cash, and the amount that is reported on the Form 1099 should reflect the fair market value of the stock. But what is the date on which the value of the stock should be determined? This seemingly simple question has quite a complex answer.

In the first place, while one might think that a cash-basis employee/inventor is taxable on the value of the stock that he receives on the date that he receives his stock certificates, this is not the case. One taxpayer tried to argue that he should be taxed on the value of his shares of stock on the date that he received the stock certificates just as he would be taxed on the value of his dividend on the date that he received his dividend check. The Tax Court, however, rejected this approach, saying:

While it may be true that a division or distribution by a corporation is not taxable to a stockholder who is on the cash receipts and disbursements basis until the amount of the distribution is made available to him, this does not mean that, when stock of one corporation is distributed by another, the certificate itself must actually be received before there can be taxable gain. Since a person may be a stockholder in a corporation without ever having

[246]Rev. Rul. 60-31, 1960-1 C.B. 174.

received a stock certificate, the time of the actual receipt of the stock certificate is immaterial.[247]

If the date of taxation (and therefore valuation) is not the date that the stock certificate is received, what is it? The Tax Court answered this question in a case in which securities held in the name of a liquidating corporation were transferred to a securities broker with instructions that new securities be issued in the name of the liquidating corporation's shareholders.[248] The securities and the transfer instructions were delivered to the broker in 1963, but the taxpayer did not receive his stock certificates until early 1964. The Court held that the taxpayer ''received'' the stock in 1963, not 1964, saying:

> Accordingly, where, as here, a transferor of fully endorsed stock certificates delivers such certificates to a broker with the intent that such securities are to become the property of the transferee, we believe that such act is sufficient to divest the transferor of all dominion and control over the certificates and to vest in the transferee a beneficial interest in the certificates coextensive with that formerly held by the transferor.[249]

The IRS addressed this same issue in a case involving the determination of the proper date that a taxpayer received a distribution of shares of stock from a stock bonus plan.[250] In this ruling, the trustee of the plan delivered to the company's transfer agent stock certificates previously issued in the trustee's name together with written instructions to reissue the certificates in the name of the taxpayer. Following the rationale of the Tax Court, the IRS ruled that ''[t]he date the trustee made delivery to the transfer agent was the date on which the distributee became vested in both the legal and equitable interest in the corporation.''

Thus, it appears that the position of both the Tax Court and the IRS is that where stock is transferred by one party to another, the date that the transferor delivers to the company or the company's agent the instructions, stock certificates, and other information necessary to effect the transfer of the shares to the transferee is the date that the transferee becomes vested with an ownership interest in the stock and is the date on which such stock must be valued for federal income tax purposes.[251]

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[247]Young v. Commissioner, 6 B.T.A. 472(1927). See also Kaufman v. Commissioner, 46 B.T.A. 924 (1942).

[248]*Byrne v. Commissioner*, 54 T.C. 1632(1970),*aff'd*, 449 F.2 d 759 (8th Cir. 1971).

[249]54 T.C. at 1640.

[250]Rev. Rul. 81-158, 1981-1 C.B. 205.

[251]Query whether it is implicit in this ''date of delivery'' rule that the documents and information that the transferor delivers to the company or the transfer agent must be complete and correct in order for the stock transfer to be made. If so, then one could argue that the delivery is not complete until such time as the company or transfer agent makes the determination that it has all the required transfer information. Unless there is specific evidence to the contrary, one might reasonably assume that this is the same date that the company or transfer agent records the transfer on its books. But neither the Tax Court nor the IRS looks to the date of recordation by the

(d) Settlement Payments

It is, of course, not unusual these days for employees to bring (or threaten to bring) lawsuits against their college or university employers based on some type of employment-related discrimination, such as Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1974, the Americans with Disabilities Act, and the Family and Medical Leave Act, to name just a few. These controversies sometimes result in a court-awarded judgment and sometimes are resolved through a settlement agreement in which the institution makes a lump-sum payment to the employee. A question in these situations is whether the school should withhold income, FICA, or other taxes from the payment. In some instances, this issue is raised by the IRS during the course of an audit, but in other cases it is raised by the employee in an action against the institution. For example, in one case a court awarded an employee damages of a certain sum, but the employee refused to accept the check issued by the employer because the employer had withheld income taxes. Instead, the employee brought suit against his employer on the ground that the employer was not required to withhold any taxes from the payment.[252]

The position of the IRS is very clear—to the extent that the payment constitutes pay for past or future services and does not qualify for the gross income exclusion under section 104 for damages received on account of personal physical injury or sickness, the payment falls within the broad scope of ''wages,'' and therefore income and FICA tax withholding is required.[253] The IRS bases this position on the broad definition of wages in the regulations, which provide that wages include ''all remuneration for employment'' regardless of the name by which it is designated and even though the employer-employee relationship

company or the transfer agent; rather, they both look to the rather nebulous ''date of delivery.'' *But see Quantz v. Commissioner*, T.C. Memo 1987-358, wherein the Tax Court used the date that the stock transfer was recorded on the books of the transfer agent as the date of taxation. This case was decided after the promulgation of the ''date of delivery'' rule by the Tax Court and the IRS, but the issue in Quantz was the taxability of the value of the stock, not the date of taxation.

[252] *Redfield v. Insurance Co. of N. Am.*, 940 F.2 d 542 (9th Cir. 1991).

[253] Rev. Rul. 96-65, 1996-2 C.B. 6; Rev. Rul. 78-176, 1978-1 C.B. 303. For a comprehensive discussion and analysis of the IRS position, see Tech. Adv. Mem. 200215001 (Oct. 19, 2001) in which the IRS held that court-awarded damages received by former employees for breach of contract were ''wages'' for income and FICA tax purposes. *See also* Priv. Ltr. Rul. 200303003 (Aug. 30, 2003), in which the IRS ruled that payments made by an employer to its employees pursuant to an agreement settling a class action employment discrimination case were wages subject to employment taxes, because the underlying cause of action was not based on tort or tort-type rights and did not relate to personal injury or sickness; Tech. Adv. Mem. 200244004 (June 19, 2002) where the IRS said that where the agreement covers lost wages and damages for emotional distress, the settlement or award payment must be allocated between the two causes of action; *Allum v. Commissioner*, T.C. Memo. 2005-177, where the Tax Court held that a civil rights-related settlement payment made by a bank to an employee was includable in the employee's gross income. The Court rejected the employee's argument that some of the payments related to personal physical injury.

no longer exists at the time the remuneration is paid.[254] In addition, there are court cases supporting such a broad and inclusive definition of wages.[255] This broad definition of *wages* includes situations where the payment represents a payment of future wages even though the parties agree that the person will not perform any future services. In one of the leading cases in this so-called front pay area, a court, citing an earlier Supreme Court case as supporting authority, held that ''awards representing a loss in wages, both back and future wages, that otherwise would have been paid, reflect compensation paid to the employee because of the employer-employee relationship, regardless of whether the employee actually worked during the time period in question.''[256]

In addition, if the employer pays back wages to an employee, there is an issue as to whether the applicable FICA tax should be computed on the date that the settlement payment is made or as of the date that the wages should have been paid. The Supreme Court resolved this issue in 2001, holding that the FICA tax on back-wage payments must be computed on the date that the payment was made.[257]

There are, however, some recent cases that support a ''no withholding'' conclusion. In one case, an individual had worked for a company for 23 years but left the company's employ and worked elsewhere for 5 years. He applied to the company for a new position but was denied employment. He brought an age discrimination action against the company and was awarded a substantial sum of back pay and front pay. The company tendered a check to the employee net of withholding taxes, and the employee brought an action against the company forcing it to pay the full amount. Even though the person had been an employee of the company for 23 years and even though the payment was specifically denominated as back pay and front pay, the Eighth Circuit held that no withholding was required. The court found that the person was a ''job applicant,'' not an employee, at the time of the litigation and said that it could find no authority for the proposition that withholding was required with respect to a nonemployee, even if the payment was called back pay and front pay.[258]

In another case, an employee sued her former employer under the Family and Medical Leave Act (FMLA), saying that she was wrongfully fired because of a medical condition. A jury awarded her damages of more than $8,000,

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[254]Treas. Reg. § 31.3121(a)-1(c), (i). *See also* CCA 200124019 (May 9, 2001) in which the IRS Chief Counsel's office outlines the tax treatment of settlement payments under a number of different scenarios, including payments to joint, multiple, and insolvent claimants.

[255]*Social Sec. Bd. v. Nierotko*, 327 U.S. 358, 362–70 (1946); *Mayberry v. United States*, 151 F.3 d 855 (8th Cir. 1998).

[256]*Gerbec v. United States*, 164 F.3 d 1015, 1026 (6th Cir. 1999), citing *Social Security Board v. Nierotko*, 327 U.S. 358 (1946).

[257]*United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001), rev'g 215 F.3 d 1325 (6th Cir. 2000).

[258]*Newhouse v. McCormick & Co.*, 157 F.3 d 582 (8th Cir. Oct. 2, 1998).

representing the ''amount of any wages, salary, employment benefits or other compensation denied or lost'' by reason of the FMLA violation. The employer withheld income and FICA taxes from the payment. A district court, however, said that no withholding was required because she had not performed any services for the employer during the time period covered by the FMLA violation.[259]

Another case involved a situation in which an employee had identified alleged environmental violations committed by his employer and was fired for that reason. He appealed his dismissal within the company but never filed a lawsuit. The company paid him more than $300,000 under a ''severance agreement,'' from which it withheld more than $100,000 in taxes. The court concluded that the company's normal severance package would have only been about $50,000 and held that withholding was not required on the remaining amount of the payment since it was not ''wages'' but rather was a payment made in order to ''buy peace'' with the employee, and there was no evidence that any part of this payment was in consideration of prior services rendered.[260]

An interesting development in the settlement payment area occurred in 2006 when the D.C. Circuit Court of Appeals held that section 104(a)(2), which limits the damage-award gross income exclusion to damages received on account of physical injury or sickness is unconstitutional to the extent that it attempts to tax damages received for nonphysical injuries.[261]

The case arose out of a complaint filed by the plaintiff against the New York Air National Guard. In her complaint, she argued that she had suffered both physical and mental injuries after filing complaints about environmental hazards and other problems she found on a National Guard's airbase. She was eventually awarded damages of $45,000 for ''emotional distress and mental anguish'' and $25,000 for ''injury to professional reputation.'' On her income tax return, she chose to report and pay tax on the full $70,000 in nonphysical damage awards, taking the position that the section 104(a)(2) exclusion was inapplicable because it only pertained to the damages received ''on account of personal physical injuries or physical sickness.'' She later filed a refund claim, first arguing that the awards should be treated as paid for physical injuries, and in the alternative, that the monetary damage awards were not ''income'' to her and therefore to tax these amounts would be unconstitutional.

After first dismissing her argument that the awards were on account of ''physical injuries'' as contemplated by section 104(a)(2), the court addressed her argument that nonphysical damage awards are not ''income'' for purposes of the Sixteenth Amendment, which states that ''The Congress shall have power to lay and collect taxes on incomes, from whatever source derived. . . .''

[259] *Churchill v. Star Enters.*, No. 97-3527 (E.D. Pa. Apr. 28, 1998).
[260] *Greer v. United States*, No. 96-117 (E.D. Ky. Sept. 23, 1998).
[261] *Murphy v. Internal Revenue Service*, 98 AFTR 2 d 2006-6088 (D.C. Cir. 2006), *rev'g*, 95 AFTR 2 d 2005- 1505 (D.C. Dist. Col. 2005).

It said that the Supreme Court has long held that ''incomes'' for these purposes means ''gains'' and ''accessions to wealth,'' and that any attempt to tax a financial benefit that does not fit into either category is unconstitutional.

In analyzing the constitutional issue, the court did not rely on the plaintiff's primary argument that the damage awards were a return of her ''human capital,'' which, she argued, should be treated in the same nontaxable manner as a return of financial capital. Instead, it looked to the traditional test used to determine the tax consequences of damage awards – in lieu of what were the damages awarded? If the damages were awarded for an item that is a ''gain'' or an ''accession to wealth'' (e.g., a capital gains transaction or wages), the court said that damages may constitutionally be taxed in the same manner. But here, the court noted, the damages were awarded to make the plaintiff whole for the loss of her emotional well-being and good reputation. These were items ''that she enjoyed before they were diminished by her former employer'' but did not represent taxable income to her at that time. Therefore, the court said that ''the compensation she received in lieu of what she lost cannot be considered income, and hence, it would appear that the Sixteenth Amendment does not empower the Congress to tax her award.''

A few months after the decision was rendered, the D.C. Circuit took the unusual step, on its own motion, of vacating its decision. It ordered the parties to rebrief the issue and to participate in a second oral argument. The court did not explain the reason for this action, but it suggests that the court had second thoughts as to the correctness of its earlier decision. How the court finally resolves this issue will have a major impact on the taxation of damages under section 104(a)(2).

(e) Payment of Plaintiff's Attorneys' Fees

A college or university, either as part of an agreement settling litigation brought against the school or as part of a court order issued in connection with the litigation, commonly pays some or all of the plaintiff's attorneys' fees. The fees may be paid to the plaintiff or paid directly by the school to the attorney. The issue raised by these attorneys' fee payments is whether they represent taxable income to the plaintiff by relieving the plaintiff of a legal obligation, that is, the requirement to pay his attorney.

There was at one time a split of authority among the circuits as to whether legal fees paid directly to the attorney should be treated as gross income to the plaintiff.[262] But in 2005 the Supreme Court resolved this question in

[262]For cases holding that attorneys' fee payments represent gross income to the plaintiff, see *Alexander v. Commissioner*, 72 F.3 d 938 (1st Cir. 1995); *O'Brien v. Commissioner*, 319 F.2 d 532 (3 d Cir. 1963); *Young v. Commissioner*, 240 F.3 d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3 d 881 (7th Cir. 2001); *Sinyard v. Commissioner*, 268 F.3 d 756 (9th Cir. 2001); Hukkanen-*Campbell v. Commissioner*, 274 F.3 d (10th Cir. 2001); *Baylin v. United States*, 43 F.3 d 1451 (Fed. Cir. 1995). For cases holding to the contrary, see *Cotnam v. Commissioner*, 263 F.2 d 119 (5th Cir. 1959); *Clarks v.*

favor of the government.[263] The Court relied on the so-called ''anticipatory assignment of income'' doctrine, which says that income should be taxed to the person that earns it. Where a taxpayer has dominion and control over an income-generating asset, the Court said that he or she will be taxed on the income from that asset and cannot assign that income to a third party. In this case, the Court said that the plaintiff had full dominion and control over the income-generating asset—the lawsuit—throughout the period of the litigation. Therefore, the plaintiff could not assign a portion of the income derived from that lawsuit to his attorney by way of having the defendant pay the attorneys' fees. The Court said that the attorney is an agent who is bound to act only in the interests of the plaintiff, and it is, therefore, appropriate to treat the full amount of the recovery as income to the plaintiff.

The Court said that plaintiffs can theoretically deduct the amount of the attorneys' fees as a miscellaneous itemized deduction, thereby creating a wash for tax purposes, but noted that this deduction was of no benefit to many taxpayers because of the alternative minimum tax rules. The Court said that this problem has been corrected by the enactment of section 61(a)(19) by the American Jobs Creation Act of 2004. This new provision provides that a taxpayer may now deduct ''attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination.''

There is also a reporting issue with respect to these attorneys' fee payments. When the college or university pays the settlement/award and the attorneys' fees by way of a check payable jointly to the plaintiff and the attorney, the school is required to file an information return reporting a payment to the plaintiff equal to the total of the two amounts. The same reporting rule applies if one check is written to the plaintiff for the settlement or award and a separate check is written to the attorney. The IRS illustrates these rules with the following two examples:[264]

> **Example 1:** Attorney P represents client Q in a breach-of-contract action for lost profits against defendant R. R settles the case for $100,000 damages and $40,000 for attorneys' fees. Under applicable law, the full $140,000 is includable in Q's gross taxable income. R issues a check payable to P and Q in the amount of $140,000. R is required to make an information return reporting a payment to Q in the amount of $140,000.
>
> **Example 2:** Assume the same facts as in Example 1, except that R issues a check to Q for $100,000 and a separate check to P for $40,000. R is required to make an information return reporting a payment to Q in the amount of $140,000.

United States, 202 F.3 d 854 (6th Cir. 2000); *Foster v. United States*, 249 F.3 d 1275 (11th Cir. 2001). The Second Circuit has not decided this issue as yet, but a district court in Vermont has followed the non–gross income line of cases. *Raymond v. United States*, (D. Vt. 2003).

[263] *See Commissioner v. Banks*, 95 AFTR 2 d 2005-659 (Jan. 24, 2005).

[264] Treas. Reg.§ 1.6041-1(f)(2).

But what if the attorney's fee payment in question relates to income that is excludable from the plaintiff's gross income, for example, as a payment for personal injury excludable under the provisions of section 104? In a private letter ruling, the IRS said that attorneys' fees allocable to excludable income take on the character of the income to which they relate and are likewise excludable from the plaintiff's gross income.[265]

The IRS is of the view that when the college or university pays the total amount by way of a joint check payable to the plaintiff and the attorney but does not know the amount of the attorney's fees, it must issue an information return for the entire amount to both the plaintiff and the attorney.[266] Furthermore, if the school pays the settlement or award amount to the plaintiff and writes a separate attorneys' fee check to the attorney, the full amount must be reported to the plaintiff and a separate information return must be filed with the attorney to reflect the payment to the attorney.[267]

(f) Signing Bonuses

The IRS has historically sent mixed and confusing signals as to whether signing bonuses paid to future employees payments made to current or future employees should be treated as wages for FICA and other employment tax purposes. In a 1958 ruling, the IRS held that a signing bonus payment made by a baseball team to an individual player would not be wages because it was paid in consideration for signing the contract and was not contingent on the future performance of services.[268]

They had informally backed away from this position over the years, and in 2004 it issued a revenue ruling setting forth a new position with respect to signing bonuses paid to current or future employees.[269] This ruling describes two situations, the first of which involves a baseball club that pays a signing bonus to an individual player if he reports for spring training at the time and place directed by the club; however, the bonus is not contingent on the player's future performance of services for the club. The second situation involves a collective bargaining agreement entered into between an employer and a union under which all employees who are employed as of a specified future date will receive a bonus. Each employee is paid the same amount regardless of compensation and seniority, and the payment is not contingent on the employee's future performance of services.

The ruling begins the analysis by noting that the term *wages* is defined as remuneration for ''employment,'' and that employment ''encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the

[265]Priv. Ltr. Rul. 200403046 (n.d.).
[266]Prop. Treas. Reg. § 1.6045-1(f)(2), Example 1.
[267]Prop. Treas. Reg. § 1.6045-1(f)(2), Example 2.
[268]Rev. Rul. 58-145, 1958-1 C.B. 360.
[269]Rev. Rul. 2004-109, 2004-50 I.R.B. 958.

employer-employee relationship or any of the terms and conditions thereof.'' For an employee to be able to assert successfully that a signing bonus (or other payment received from his employer) is not ''wages,'' the employee must be able to provide ''clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions.'' The IRS said that the employee did not do this in either situation, and the signing bonus was, therefore, properly treated as wages in both cases. Because it recognized that this ruling revoked or substantially modified earlier rulings on which taxpayers had properly relied, the IRS said that the ruling will not apply to any payment made by an employer to an employee or former employee before January 12, 2005.

§ 4.7 STUDENT LOANS FORGIVEN IN RETURN FOR SUBSEQUENT SERVICES

A college or university sometimes will lend students money for tuition or other educational expenses but then forgive the debt if the student agrees to work for the school for a period of time after the completion of his or her studies. As a general rule, the discharge of the student loan debt under these circumstances will constitute taxable income to the student under the general gross income inclusion rules of section 61.[270]

This principle arose in a 2004 private letter ruling involving a hospital that loaned money to nursing students to pay for their nursing school tuition and other educational expenses.[271] If the nursing student worked for the hospital for at least two years after graduation, the hospital agreed to forgive the loan. The IRS ruled that the tuition payments made by the hospital to the nursing school did not represent wage income to the students because they were bona fide loans. If and when the individual works for the hospital for the two-year period and the hospital forgives the loan, the IRS said that the amount of the forgiven loan will constitute taxable wages at that time.

The loan discharge could not qualify under the exception in section 108(f) for discharges of certain student loans conditioned on the performance of future services because the student is required to work for the same entity that discharged the debt.[272] Likewise, the discharged debt cannot qualify under the section 117 scholarship/fellowship exclusion provisions because of the rule that the exclusion does not apply when the grant is conditioned on the performance of services.[273] Thus, the amount of the discharge will constitute

[270]Treas. Reg. § 1.61-12, which provides that, with certain exceptions, the discharge of indebtedness results in the realization of gross income to the individual whose debt is discharged.
[271]Priv. Ltr. Rul. 200452027 (Sept. 2, 2004).
[272]IRC § 108(f)(3). For a discussion of the section 108 student loan discharge provisions, see § 7.7.
[273]IRC § 117(c). *See* § 7.5.

additional wage income to the student-employee on the date of the discharge, and the school will be required to report the amount of the discharge on a Form W-2.[274]

§ 4.8 DEFERRED COMPENSATION PAYMENTS

As part of the American Jobs Creation of 2004,[275] Congress added to the Code new section 409A dealing with deferred compensation payments. Though colleges, universities, and other nonprofit organizations are closely regulated on the manner and extent to which they can make deferred compensation payment to their employees under section 457,[276] the new rules of section 409A are intended to operate in addition to the section 457 rules.[277] Therefore, section 409A adds a new set of deferred compensation requirements that colleges and universities must master.

Under the general framework of section 409A, all compensation that is deferred during a tax year (and in all preceding tax years) is includable in the recipient's gross income if the plan under which the deferred compensation is paid fails to meet certain distribution, acceleration of benefit, and election requirements.[278] In addition, if the plan is structured to meet these requirements, the deferral will be disregarded if the plan is not actually operated in accordance with these requirements.[279] Section 409A does not apply, however, to the extent that the deferred income is subject to a ''substantial risk of forfeiture'' or has previously been included in the recipient's gross income.[280] A ''substantial risk of forfeiture'' is defined for section 409A purposes as a situation where the rights of a person to compensation are conditioned on the future performance of substantial services by any individual.[281]

The definition of a *deferred compensation plan* for purposes of these new rules is broad. It is defined as any ''plan'' that provides for the deferral of compensation, other than a ''qualified employer plan'' (generally, employee retirement and similar type plans) and any *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.[282] The definition of a *plan* is also broad and includes any agreement or arrangement, including an agreement or arrangement that includes one person.[283]

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[274]CCA 200130038 (May 31, 2001).
[275]P.L. 108-357.
[276]*See* § 9.3(m).
[277]Notice 2005-1, 2005-1 I.R.B. 274, Q-6.
[278]IRC § 409A(a)(1)(A).
[279]Notice 2005-1, 2005-1 I.R.B. 274, Q&A-2.
[280]IRC § 409A(a)(1)(A).
[281]Code Sec. 409A(d)(4).
[282]IRC § 409A(d)(1).
[283]IRC § 409A(d)(3).

Though *severance pay plans* are excluded from the deferred compensation rules of section 457,[284] a similar exclusion does not exist in the statutory language of section 409A. But proposed regulations issued by the IRS (on which taxpayers may rely until final regulations are issued[285]) contain a modified exemption for what the regulations call ''separation pay arrangements.''[286] These regulations exempt separation pay arrangements where the payments do not exceed two times the lesser of (i) the service provider's annual compensation for the calender year before the separation from service, or (ii) the annual compensation limit under section 401(a)(17).[287] The regulations also say that the arrangement must require that all payments be made by no later than the end of the second calendar year following the year in which the service provider terminates service.[288]

In addition, the section 409A rules do not apply to annual bonuses, or other annual compensation amounts, paid within two and one-half months after the close of the tax year in which the relevant services required for payment have been performed.[289]

If, as the result of the application of section 409A, compensation is required to be included in the service provider's gross income, that income will be increased by interest on such amount, and (2) a penalty equal to 20 percent of the compensation that is required to be included.[290]

(a) Section 409A Plan Requirements

Section 409A provides that the deferred compensation plan must meet requirements relating to distributions, acceleration of benefits, and elections.

- *Distributions requirement*. The distributions requirement is satisfied if a deferred compensation plan provides that compensation deferred under the plan cannot be distributed earlier than the following:
  - The participant's separation from service
  - The date the participant becomes ''disabled''[291]
  - The participant's death
  - A time specified, or a schedule fixed, under the plan at the date of the deferral of the compensation

[284]IRC 457(e)(11)(A)(i).
[285]*See* Preamble to Prop. Regs, Oct. 4, 2005.
[286]Prop. Reg. § 1.409A-1(b)(9).
[287]Prop. Reg. § 1.409A-1(b)(9)(iii)(A)(1) and (2).
[288]Prop. Reg. § 1.409A-1(b)(9)(iii)(B).
[289]Conf. Rept. No. 108-755, P.L. 108-357, Oct. 22, 2004, p. 721.
[290]IRC § 409A(a)(1)(B).
[291]This term is defined in IRC § 409A(a)(2)(C).

- A change in the ownership or effective control of the organization
- The occurrence of an ''unforeseeable emergency''[292]

- *Prohibition against the acceleration of benefits*. This requirement is met if a deferred compensation plan does not permit the acceleration of the time or schedule of any payment under the plan,[293] and the regulations set forth a number of different rules, and exceptions to the rules, regarding this requirement.[294]
- *Elections*. The plan must contain certain requirements relating to the initial deferral election and any subsequent elections.[295] The initial deferral election requirement is met if the plan provides that compensation may be deferred at the participant's election only if the election is made not later than the close of the preceding tax year; or (2) at another time provided in future IRS regulations.[296] The requirement with respect to subsequent elections is met if the plan requires that the election cannot take effect until at least 12 months after the date on which the election is made.[297]

(b) Effective Date of Section 409A

Section 409A is effective for (1) amounts deferred in tax years beginning after December 31, 2004 and (2) amounts deferred in tax years beginning before January 1, 2005, if the plan under which the deferral is made is ''materially modified'' after October 3, 2004.[298] For purposes of these rules, an amount is considered deferred before January 1, 2005, if the amount is earned and vested before January 1, 2005. An amount meets this ''earned and vested'' test if prior to January 1, 2005, the service provider has a legally binding right to be paid the amount.[299] A service provider will not be treated as having a legally binding right to be paid the amount if the right to the amount is subject to a ''substantial risk of forfeiture'' or to a requirement to perform further services.[300]

(c) Transitional Rules

The IRS has said that a deferred compensation plan adopted before December 31, 2007, will not be treated as violating the section 409A requirements if

[292]IRC § 409A(a)(2); Prop. Reg. § 1.409A-3. An ''unforeseeable emergency is defined in Prop. Reg. § 1.409A-3(g)(3).
[293]IRC § 409A(a)(3).
[294]Prop. Reg. § 1.409A-3(h).
[295]IRC § 409A(a)(4)(A).
[296]IRC § 409A(a)(4)(B).
[297]IRC § 409A(a)(4)(C).
[298]Prop. Reg. § 1.409A-6(a)(1).
[299]Prop. Reg. § 1.409A-6(a)(2).
[300]*Id*.

the plan is operated in ''good faith compliance'' with section 409A through December 31, 2007 and (2) the plan is amended on or before December 31, 2007, to conform to the section 409A requirements.[301]

(d) Reporting Requirements

When Congress enacted section 409A, it amended section 6051 (the provision that requires reporting on wage payments to employees) and section 6041 (the section requiring reporting on payments to independent contractors) requiring the reporting of all the total amount of deferrals under a nonqualified deferred compensation plan as defined in section 409A.[302] In late 2004, the IRS issued Notice 2005-1[303] in which it provided the following additional guidance with respect to these reporting rules:

- An employer must report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2 using code Y.[304]
- An employer must report amounts includable in gross income under section 409A and in wages under section 3401(a) in box 1 of Form W-2 as wages paid to the employee during the year. An employer must also report such amounts in box 12 of Form W-2 using code Z. [305]
- A payer must report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 15a of Form 1099-MISC.[306]
- A payer must report amounts includable in gross income under section 409A and not treated as wages under section 3401(a) as nonemployee compensation in box 7 of Form 1099-MISC. A payer must report such amounts in box 15b of Form 1099-MISC. [307]

However, a year later, the IRS issued Notice 2005-94,[308] in which the agency suspended employers' and payers' reporting and wage withholding requirements for calendar year 2005 with respect to deferrals of compensation within the meaning of section 409A. The IRS said in this notice that future published guidance may require an employer or payer to file a corrected information return and to furnish a corrected payee statement for calendar year 2005 reporting any previously unreported amounts includable in gross

[301] Notice 2006-79, 2006-43 I.R.B. 763.
[302] *See* new IRC §§ 6051(a)(13) and 6041(g).
[303] 2005-2 I.R.B. 274.
[304] Q&A-29.
[305] Q&A-33.
[306] Q&A-30.
[307] Q&A-35.
[308] 2005-52 I.R.B. 1208.

income under section 409A. Though individuals must file a return and pay any taxes due relating to amounts includable in gross income under section 409A for calendar year 2005, the IRS understands that it is likely that these individuals will find it difficult to determine the correct amount and timing of inclusions under section 409A without reporting from the employer or payer. Consequently, the IRS will not assert penalties under sections 6651(a)(1) and (2), 6654, and 6662 with respect to amounts includable in gross income under section 409A for calendar year 2005 if the employee reports and pays any taxes due with respect to such amounts in accordance with future published guidance.

Then, in 2006 the IRS issued Notice 2006-100,[309] which supersedes Notice 2005-94 and modifies Notice 2005-1. Highlights of Notice 2006-100 are as follows:

1. Organizations are not required to report on Form W-2 or Form 1099 amounts deferred during 2005 or 2006 under a nonqualified compensation plan subject to section 409A where the deferred income is not taxable to the service provider.
2. For 2006, an employer is required to treat amounts that are includable in an employee's income under section 409A as wages for both income tax withholding and reporting purposes. Notice 2006-100 contains detailed guidance as to how such amounts are to be calculated for withholding tax purposes.
3. Organizations that relied on the relief provided in Notice 2005-94 to avoid reporting taxable IRC § 409A deferrals for 2005 must file an original or corrected information return (Form W-2 or 1099) for 2005 reporting all previously unreported amounts. These amounts should be calculated under the calculation rules contained in Notice 2006-100. The information returns must be filed no later than the time specified for filing such returns for 2006.

In addition to this withholding and reporting guidance, Notice 2006-100 also provides guidance to both employees and independent contractors who received includable section 409A deferred compensation in 2005 and 2006 as to how they are to calculate the amount to be included in income and the calculation of any additional tax that may be required under the penalty provisions of section 409A.

Notice 2006-100 is effective with respect to both organizations' reporting and wage withholding obligations and as well as service providers' filing requirements and tax payment obligations for calendar years 2005 and 2006.

[309] 2006-51 I.R.B. 1109.

CHAPTER FIVE

Fringe Benefits

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§ 5.1 INTRODUCTION

Like virtually all other nonprofit and for-profit employers, colleges and universities provide fringe benefits to their employees, and a primary focus of any IRS audit is on whether the institution properly withheld income and Social Security taxes on its fringe benefits payments and properly reported these items to the IRS and the employees. In addition, depending on what it finds during the course of the examination, the IRS may institute collateral audits of certain employees to see whether they properly reported and paid tax on the fringe benefits they received.

What is a ''fringe benefit''? Broadly speaking, it is any benefit that is provided by an employer to an employee other than salary or wage payments. While fringe benefits are usually thought of in terms of noncash payments (and most fringe benefits fall into this category), a cash payment can be a fringe benefit as well, for example, a payment into a retirement plan. The list of the different types of nonwage benefits that employers provide their employees is long and is limited only by the imagination of both the employers (which are generally looking for nonwage methods to compensate their employees) and the employees (who are often not shy about suggesting to their employers ways that they might receive nonwage benefits).

The fringe benefits provided by colleges and universities to their employees do not differ markedly from those provided by other employers. They include paying for the employees' moving, education, transportation, legal, medical, meal and lodging, and professional dues expenses. These payments can be made either to a third party on the employee's behalf or directly to the employee as a reimbursement for an expense that the employee incurred. In addition, many colleges and universities provide a service or make a facility available to the employee, and this constitutes a fringe benefit as well. These latter types of fringe benefits include discounts on products or services (e.g., employees at the campus bookstore may receive a 10 percent discount on all merchandise); personal use of automobiles (e.g., the president is provided an institution-owned car that can be used for personal purposes); supper money and taxi fare home from work late at night; use of the institution's dining facilities at either no cost or at a reduced rate; low-interest or interest-free loans for home mortgages or other purposes; employee gifts or awards; free or low-cost financial counseling; and free or discounted use of the school's athletic or other recreational facilities.

Obviously, employees would ideally like fringe benefits to be structured in such a manner so as to be nontaxable. If this cannot be achieved, the second best result is to defer taxation until sometime after the year in which the benefit was received. From the employer's standpoint, colleges and universities are usually less concerned than for-profit employers with how they must account for the fringe benefit for tax purposes. While the for-profit employer wants to be able to deduct the amount or value of the fringe benefit in the year that it is paid or provided, the college or university is generally not concerned with being able to claim a tax deduction because of its tax-exempt status. Of course, if the college or university employee to whom the fringe benefit is provided spends some or all of his or her time working on an unrelated business income activity, the school will want to be able to include the amount or value of the fringe benefit as part of the allocable wage expenses that can be used to reduce the net taxable income from that activity.[1]

[1] *See* § 2.6.

One of the most fundamental principles in the tax law is that all accretions to an individual's wealth constitute gross income, unless the particular income item is specifically excepted under a provision in the Internal Revenue Code.[2] Thus, it is not surprising that the taxation of fringe benefits operates under the same basic principle—that is, the amount or value of the fringe benefit is taxable to the employee in the year in which it is received, unless there is a specific provision in the Code that excludes the fringe benefit from income or defers taxation to a later year.

Thus, the principal inquiry in the fringe benefit area is whether the benefit qualifies for one of the many fringe benefit exclusions that Congress over the years has included in the Code. Some of these exclusions stem from the fact that, because the federal government does not provide the particular benefit, it is good social policy to permit employers to do so on an on taxable basis. An example of a fringe benefit that falls into this category is the exemption for the cost of medical insurance provided by employers to their employees.[3] Another reason for excluding certain fringe benefits is that the administrative difficulty of valuing the benefit and keeping the necessary records is so great, and the revenue from the benefit is so small, that it makes no sense to require taxation. An example of this type of benefit is the de minimis fringe benefit described later in this chapter. Finally, there are some benefits, such as educational assistance, that Congress simply feels are good social policy to encourage.

For whatever motivation, a number of specific provisions in the Code exempt certain types of fringe benefits from the income of the employee. Until 1984, there was no basic statutory framework to determine how fringe benefits should be taxed; over the years, the IRS had determined that some fringe benefits were taxable and others were not, without providing a great deal of thought or rationale to its decisions. This uncertain and sometimes contradictory situation in the fringe benefit area concerned Congress, so much so that in 1984 it enacted a basic statutory framework for fringe benefit taxation, while at the same time still leaving in place a number of the existing special fringe benefit exclusions, such as educational and dependent care assistance programs.

This basic statutory framework is contained in section 132 of the Code, which sets forth six broad categories of fringe benefits that can be excluded from the employee's income. They are (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, (5) qualified transportation fringes, and (6) qualified moving expense reimbursements. In addition, section 132 sets forth special exclusionary rules for certain eating and athletic facilities. Although these various fringe benefit

[2]*Commissioner v .Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).
[3]IRC § 106.

exclusions are of primary interest and concern to the employees, it is important for college and university employers to also know how they operate because the institution must know whether income tax has to be withheld with respect to the fringe benefit provided.

§ 5.2 THE SECTION 132 RULES

(a) No-Additional-Cost Services

This fringe benefit exclusion appears to have its roots in an early IRS ruling that concluded that free travel passes provided by the railroads to their employees were gifts and not income.[4] In addition, over the years many transportation (bus, railroad, and airline) companies routinely provided free travel to their employees without including the value of the travel in the employees' income. Therefore, the prevailing industry practice seems to have had some influence in convincing Congress to include the no-additional-cost service fringe benefit in the list of excludable fringe benefits.

The no-additional-cost service provision is not limited to simply free travel but rather covers a broader array of employer-provided services. The basic rule of the provision is that the value of a service that is provided by an employer to an employee is not includable in the employee's income if (1) the employer does not incur any ''substantial'' cost in providing the service to the employee, and (2) the service is one that the employer offers for sale to customers in the usual course of its business.[5] Free travel provided by transportation companies is the classic example of a no-additional cost service. The cost to an airline company to permit an employee to travel for free in an unsold seat on a flight that is going to the destination anyway is virtually zero and fits nicely in the rationale underlying the rule. The provision also covers railway, bus, and cruise line transportation, as well as hotel and telephone services. It does not, however, extend to ''educational services,'' and a college or university must look to the qualified tuition reduction rules to determine if free or reduced tuition is excludable from the employee's income. The reason for this can be found in section 132(l), which essentially says that if a fringe benefit is provided for in a section of the Code outside of section 132 (e.g., the qualified tuition reduction rules of section 117(d)), the fringe benefit must qualify under that other section, and the taxpayer cannot look to section 132 to exclude the value of the fringe benefit.[6]

In order to fall under the no-additional-cost service exclusion, the employer must show that it does not incur any substantial additional cost in providing the service to the employees. This cost includes not only out-of-pocket hard

[4]I.R.S. Office Decision 946, 1921-4 C.B. 110.
[5]IRC § 132(a)(1), (b).
[6]For a discussion of the qualified tuition reduction rules, *see* § 7.4.

costs, but also the cost of labor in providing the service. The labor cost must be taken into account even if the workers were otherwise underemployed or performed the services outside their normal working hours.[7]

In determining the employer's cost for purposes of making a ''substantial cost'' determination, any revenue that the employer forgoes as a consequence of providing the service to the employee must also be taken into account.[8] For example, while the airline would incur no additional out-of-pocket costs in letting the employee have a free seat on the flight, if the flight were full and the employee's seat could have been purchased by a customer, the airline has incurred a ''cost'' in the form of forgone revenue.

As noted above, in the college and university context, the no-additional-cost service rule does not extend to the primary ''service'' that the college or university provides—education—and any free or reduced tuition must be provided in accordance with the qualified tuition reduction rules in order to be excluded from the employee's income. There are nevertheless many situations in which college and university employees can benefit from this exclusion. For example, if a university provides its athletic department employees with free tickets to all athletic events, the no-additional-cost service rule could operate to exclude the value of the tickets if the event were not sold out.[9] Thus, it may be that a free ticket to the football game does not qualify, but a ticket to the wrestling meet does, assuming that football games routinely sell out and wrestling matches do not.[10] Likewise, if a college with a major computer system that it uses to run the school's operations has excess computer capacity and permits its employees to use its computers for free, the value of the free use could qualify for the exclusion. Virtually any service that a college or university provides (except educational services) is a potential candidate for the no-additional-cost service exclusion, assuming that the school does not incur additional costs or forgo any revenue in permitting employees to use the service.

There are additional rules relating to (1) the definition of an *employer* and an *employee*, (2) the requirement that the service be provided to an employee who works in the same ''line of business'' as the service being provided, and (3) special nondiscrimination rules. These rules apply to other fringe

[7]Treas. Reg. § 1.132-2(a)(5)(ii).
[8]Treas. Reg. § 1.132-2(a)(5)(i).
[9]*See* § 5.3(r).
[10]In some cases, it is possible for members of the general public to obtain tickets to allegedly ''sold out'' football, basketball, or other games immediately before game time. One of several possible reasons for such a situation is that the tickets that the school has set aside for the opposing team's fans were not fully used, thereby freeing up tickets for sale to the general public. In one university audit, the IRS agents accepted the school's representation that visiting team football game tickets were available for sale at all home games and agreed to apply the no-additional-cost service exception where, based on press reports, all the games were sold out.

benefit exclusion provisions as well and are best discussed separately in section 5.2(g).

(b) Qualified Employee Discounts

This provision excludes from the employee's income the value of any discounts on products or services provided by the employer. In order to prevent abuses, however, the rule has certain restrictions and limitations. Prior to the enactment of section 132, there was a great deal of uncertainty surrounding the taxation of employee discounts. Although the IRS regulations had been construed by one court to make all such discounts taxable,[11] the IRS administrative practice seemed to be that the discounts should be nontaxable except in abusive situations.

Under the qualified employee discount rule, all discounts qualify if they stay within certain limitations, depending on whether the discount is provided with respect to a service or a product.[12] For discounts on services, the exclusion cannot exceed 20 percent of the price at which the employer offers the services to nonemployee customers.[13] For example, if a college sells computer time to the general public at a certain price and permits its employees to purchase computer time at a 20 percent discount, the employees do not have to include the value of the computer time in their income. (Note that if the college could demonstrate that it had excess computer time and did not forgo any revenue by permitting the employees to use the computers for free, the value of the computer time could be excluded under the no-additional-cost service provision without regard to any discount).

For products or merchandise, the discount cannot exceed the employer's ''gross profit percentage'' earned on the sale of the product to nonemployee purchasers.[14] For example, if a university bookstore gives its employees a discount on all books and other merchandise sold at the store, the employees do not have to include the value of the discount in their income as long as the discount is equal to or less than the store's gross profit percentage. The gross profit percentage is defined as the excess of the aggregate sales price of all products sold in the relevant line of business over the aggregate cost of the merchandise to the employer divided by the aggregate sales price.[15] To illustrate: Assume that a bookstore's total sales of merchandise for the year were $500,000 and its total cost of merchandise was $250,000. Its gross profit percentage for the year would be 50 percent, and any discount provided to employees that did not exceed 50 percent of the sale price to the bookstore customers for the item would be excludable from the employee's

[11] *Beckert v. Commissioner*, T.C. Summary Opinion 1978-211 (Small Tax Case).
[12] IRC § 132(c).
[13] IRC § 132(c)(1)(B).
[14] IRC § 132(c)(1)(A).
[15] Treas. Reg. § 1.132-3(c).

income. The regulations also contain some special ''deep discount'' rules for situations in which the employer regularly sells at a discount to large customers.[16] If applicable, these rules can increase the allowable discount for the employees.

If the discount exceeds either the 20 percent threshold for services or the gross profit percentage amount for products, it is only the excess amount that is included in income. Also, like the no-additional-cost service provision, special employer and employee definitions apply, and there are ''line of business'' and nondiscrimination rules that come into play as well. These rules are discussed separately in section 5.2(g).

(c) Working Condition Fringe Benefits

Prior to the enactment of section 132, the courts had held that certain fringe benefits provided for the convenience of the employer could be excluded from the employee's income, and the working condition fringe exclusion appears to be derived from this rule.[17] The working condition fringe exclusion applies to any property or service provided by the employer to the employee to the extent that, if the employee had paid for the property or service, the payment would have been deductible by the employee as a business expense deduction.[18] The typical types of benefits that can be excluded under this provision include cars used for business, an office, a secretary, support staff, and office supplies. But the IRS chief counsel's office has advised field agents that an employee who receives from his or her employer free tax preparation services does not receive a working condition fringe benefit even if the employee was required to accept the free services. The IRS attorneys concluded that the benefit primarily benefited the employee, not the employer, even though the employee was working overseas and had difficulty obtaining U.S. tax preparation services in that location.[19]

This fringe benefit exclusion provision brings into play the entire body of cases and rulings dealing with whether expenses incurred by employees are deductible as ordinary and necessary business expenses because, if the expense does not qualify, the working condition fringe rule does not apply. The nature of the expense, not the particular employee's situation, controls the determination. For example, the fact that a business expense deduction could not be claimed by the employee because of the 2 percent floor rule does not prevent the working condition provision from being applicable if the deduction would otherwise be allowed.[20] Therefore, in order to determine whether the working

[16]Treas. Reg. § 1.132-3(b)(2)(iv).
[17]*Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977).
[18]IRC § 132(d). The business expense must be deductible under IRC § 162.
[19]Field Service Advice 200137039 (June 19, 2001).
[20]The 2 percent floor rule generally provides that certain miscellaneous itemized deductions (such as unreimbursed employee expenses and expenses incurred to produce income) are

condition fringe rule applies, college and university personnel must have a sound background and expertise in the employee business expense rules.

The working condition fringe exclusion is available only to current employees and not to their family members, although volunteers providing services for the college or university employer can take advantage of the rule.[21] Also, unlike other section 132 fringe benefit exclusions, the working condition fringe is not subject to the nondiscrimination or line-of-business requirements discussed in section 5.2(g). Under section 117(d), colleges and universities are permitted to provide their employees with tax-free tuition waivers if the waivers meet the section 117(d) requirements.[22] Because section 117(d) tuition waivers must relate only to undergraduate education (except for graduate teaching and research assistants), if a school provides its non-TA/RA employees with tuition waivers for graduate education, the tuition waiver exclusion rules of section 117(d) will not apply. However, when the graduate education is related to the employee's job, many schools take the position that the value of the graduate tuition waiver is excludable from the employee's gross income as a working condition fringe benefit because, had the employee paid for the education he or she could have taken a section 162 business expense deduction.

The IRS, however, has said that non-TA/RA employees cannot exclude the value of job-related graduate tuition waivers as a working condition fringe benefit.[23] The rationale for this position is based on section 132(l), which says that when a fringe benefit does not qualify under a specific fringe benefit exclusion provided for elsewhere in the Code (e.g., section 117(d)), the taxpayer cannot use the rules of section 132 to exclude the benefit even if the benefit would qualify under section 132. Because section 117(d) sets forth special rules that must be met for a college or university employee to receive tax-free tuition waivers, the IRS says that a tuition waiver that does not qualify under section 117(d) because it relates to graduate education cannot qualify as a working condition fringe benefit under section 132(d).

To reach this conclusion, the IRS must deal with a section of the regulations that seems to lead to a contrary result. Specifically, in regulations promulgated under section 132(l), the regulations say:

> Similarly, because section 117(d) applies to tuition reductions, the exclusions under section 132 do not apply to free or discounted tuition provided to an employee by an organization operated by the employer, whether the tuition is for study at or below the graduate level. Of course, if the amounts paid by the employer are for education relating to the employee's trade or business of being an employee of the employer so that, if the employee paid for the education, the amount paid could be

deductible by an individual only to the extent that the aggregate amount of the deductions exceeds 2 percent of the taxpayer's adjusted gross income. *See* IRC § 67.

[21] Treas. Reg. § 1.132-5(r); Joint Comm. on Taxation, 98th Cong., 2 d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 856 (Joint Comm. Print 1985).

[22] *See* § 7.4.

[23] Field Service Advice 200231016 (March 13, 2002).

> deducted under section 162, the costs of the education may be eligible for exclusion as a working condition fringe.[24]

The IRS seems to distinguish this regulation by focusing on the ''paid by the employer'' language; that is, because a college or university waives, and does not ''pay'' for, the tuition, the regulation does not apply. In addition, the IRS attempts to distinguish what appears to be a contrary holding in a 1990 private letter ruling, which said:

> Under section 132 of the Code, a fringe benefit that qualifies as a no-additional-cost service, a qualified employee discount, a working condition fringe, or a de minimis fringe is excludable from gross income. However, section 132(j) [now section 132(l)] prevents the exclusions under section 132 (other than the exclusion for de minimis fringes) from applying to fringe benefits of a type for which the tax treatment is expressly provided elsewhere in the Code. Because section 117(d) provides for the tax treatment of tuition reductions, the exclusions under section 132 generally do not apply to free or discounted tuition provided by an educational institution to its employee, whether the tuition is for study at or below the graduate level. (The exception to this general rule is that if the amounts paid by the employer are for education relating to the employee's trade or business of being an employee of the employer so that, if the employee paid for the education, the amount paid could be deducted under section 162, the costs of the education may be eligible for exclusion as a working condition fringe under section 132(a)(3)). See section 1.132-1(f)(1) of the Federal Income Tax Regulations.[25]

The IRS concludes that this language, when read in context, does not apply to section 117(d) tuition waivers but rather to section 127 educational benefit exclusions under section 127.

Many colleges and universities do not agree with the IRS legal rationale with respect to this issue and are continuing to take the position that tuition waivers can qualify as working condition fringe benefits, provided that the tuition benefit would qualify as a business deduction for the employee. How this issue will finally be resolved remains to be seen.

(d) De Minimis Fringe Benefits

Another specific fringe benefit exclusion category under section 132 relates to de minimis fringe benefits.[26] These are employer-provided products or services that have such a minimal value that accounting for the benefit would be unreasonable or administratively impractical. Congress included this category of excludable fringe benefits in section 132 to reflect the accepted practice prior to 1984 of permitting employees to exclude occasional and low-value benefits provided by the employer.[27]

[24]Treas. Reg. § 1.132-1(f)(1).
[25]Priv. Ltr. Rul. 9040045 (July 10, 1990).
[26]IRC § 132(e).
[27]*See* Rev. Rul. 59-58, 1959-1 C.B. 17, which excluded small employer-provided gifts such as a turkey or ham at Christmas.

In determining whether the value of a particular benefit is small enough to fall into the de minimis category, the regulations provide that, in addition to the actual value to the employee, the frequency by which the employer provides the benefit should also be taken into account.[28] Frequency is measured on an individual employee basis, unless it would be administratively difficult to do so, in which case the appropriate measure is the frequency at which the benefit is provided to the workplace as a whole.[29]

The legislative history underlying the de minimis provision lists several types of typical employer-provided benefits that qualify—typing of personal letters by a secretary working for the employer, occasional use of the employer's copying machine, monthly transit passes not exceeding $15 in value, occasional employer sponsored picnics and cocktail parties, occasional supper money or taxi fare because of overtime work, traditional holiday gifts of property with a low fair market value, occasional theater or sporting event tickets, and coffee and doughnuts provided in the workplace.[30]

The fundamental reason that these benefits are excluded from income is the administrative difficulty in being able to account for them; therefore, the nondiscrimination and line-of-business rules do not apply because of the detailed recordkeeping that would be required to monitor compliance.

The IRS says in its regulations that cash can never be excluded as a de minimis fringe benefit and that this rule also applies to a ''cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card),'' even if ''the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit.''[31] In 2004, the IRS relied on this regulation as support for its position that a $35 employer-provided holiday gift coupon that was redeemable by employees at local grocery stores did not qualify as a de minimis fringe benefit and was includable in the employees' gross income as additional wages.[32] The national office concluded that the coupon was a ''cash equivalent fringe benefit,'' thereby excluding it from de minimis fringe benefit treatment.

Notwithstanding this 2004 ruling, some tax practitioners believe that the IRS position is wrong and that those gift certificates or coupons that qualify as ''tangible personal property'' under IRS regulations and rules pertaining to length-of-service and safety achievement awards should not be treated as a proxy for cash and can qualify as an excludable de minimis fringe benefit. Under these rules, a gift certificate will qualify as tangible personal property if

[28]Treas. Reg. § 1.132-6(a).
[29]Treas. Reg. § 1.132-6(b).
[30]Joint Comm. on Taxation, at 858.
[31]Treas. Reg. § 1.132-6(c).
[32]Tech. Adv. Mem. 200437030 (Apr. 30, 2004).

the certificate (1) is inscribed with the recipient's name, (2) is nontransferable, and (3) cannot be redeemed for cash.[33]

(e) Qualified Transportation Fringe Benefits

This category of excludable fringe benefits was added in 1992 because of Congress's concern that the Code contained insufficient incentives to encourage the use of mass transit, and the IRS has provided guidance on how this provision should be applied.[34]

Under this provision, an employee can exclude, within certain dollar limitations, the following transportation fringe benefits: (1) commuting transportation provided by or for the employer in a commuter highway vehicle, (2) transit passes, and (3) qualified parking.[35] The dollar limits are indexed for inflation, and any amounts over the dollar limitation are taxable to the employee both for income and for Social Security tax purposes. If the value of the benefit exceeds the applicable dollar limitation, the excess cannot be excluded as a working condition fringe benefit or a de minimis fringe.[36] And, in 2006, the IRS provided guidance on the use of smartcards and debit cards to provide qualified transportation fringe benefits.[37]

The commuting transportation benefit must be provided by or for the employer and must involve the use of a commuter highway vehicle (defined as seating at least six adults and 80 percent of the use of which is for commuting to and from work).[38] The value of the commuting benefit must be determined under the automobile lease valuation rule, the cent-per-mile rule, or the commuting valuation rule, all of which are set forth in other IRS regulations.[39] The dollar limitation on this benefit is combined with the transit pass benefit, and the combination of the two cannot exceed the applicable amount.[40]

Transit passes are any pass, token, fare card, voucher, or similar item that permits the holder to use mass transit facilities or ride in a commuter vehicle operated on a for-hire basis.[41]

The qualified parking benefit requires that the employee park at or near the business premises or at a location from which the employee can use mass transit facilities.[42] This benefit permits the employer to pay the parking lot

[33]Prop. Treas. Reg. § 1.274-8(c)(2), and its pre-1987 predecessor Treas. Reg. 1.274-3(b)(2)(iv), which applied a similar definition to pre-1987 years.
[34]I.R.S. Notice 94-3, 1994-1 C.B. 327; Prop. Treas. Reg. § 1.132-9(b), in which the IRS guidance is set forth in question-and-answer format.
[35]IRC § 132(f).
[36]IRC § 132(f)(7).
[37]Rev. Rul. 2006-57, 2006-47 I.R.B. 911.
[38]IRC § 132(f)(5)(B).
[39]Treas. Reg. § 1.61-21.
[40]Treas. Reg. § 1.132-9(b), Q-9 and Q-17.
[41]IRC § 132(f)(5)(A).
[42]IRC § 132(f)(5)(C).

owner directly, reimburse the employee for the parking expense, or provide parking on its own business premises.[43] In determining whether the value of the employer-provided parking exceeds the excludable amount, the value is based on the arm's-length cost for parking at that same site. Additional valuation rules are set forth by the IRS for reserved parking spaces, car and van pool parking, and other valuation issues that arise in this area.[44]

Prior to the passage of the Taxpayer Relief Act of 1997, section 132(f)(4) provided that the qualified transportation fringe benefit was only available if the benefit was provided in addition to, and not in lieu of, any compensation otherwise payable to the employee. This meant that the benefit could not be included as part of any salary reduction–type arrangement, and the IRS ruled that the exclusion did not apply if an employer (1) reduced its employees' compensation in exchange for providing qualified transportation fringe benefits or (2) offered employees the choice of receiving the benefit or receiving a higher salary.[45]

By 1997, however, Congress had come to the conclusion that this restriction on an employer's ability to offer the employee a choice between cash and the ''qualified parking'' portion of the qualified transportation fringe benefit resulted in an overutilization of employer-provided parking as a fringe benefit. Therefore, in order to raise revenue and promote what it believed to be sound environmental and energy policy, Congress decided in 1997 to modify section 132(f)(4) and permit employees to choose between receiving cash and receiving the ''qualified parking'' benefit without that choice causing the benefit to be taxable.[46] Congress subsequently expanded this provision so it applies to all of the qualified transportation fringe benefits.[47] It is interesting to note that Congress made the initial change in the law for the purpose of reducing the amount of employer-provided parking on the theory that many employees would choose cash over the parking benefit. Both changes in the law are effective for tax years beginning after December 31, 1997.

In 2004, IRS identified what it referred to as ''abusive'' arrangements under which an employer reduces an employee's cash compensation by the same amount that it reimburses the employee for parking, and the employer takes the position that the reimbursed amount is not subject to federal income tax withholding or FICA/FUTA tax. In a revenue ruling, the IRS rejected this transaction as ''meritless'' and ruled that the reimbursed amounts represent taxable wage income to the employee.[48]

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[43]I.R.S. Notice 94-3, 1994-1 C.B. 327.

[44]*Id*. For a ruling where the IRS said that a parking arrangement for employees met the qualified parking rules, *see* Priv. Ltr. Rul. 200347003 (July 11, 2003).

[45]IRS Notice 94-3, 1994-1 C.B. 327, Q-4.

[46]Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1072.

[47]Pub. L. No. 105-178, § 9010(a).

[48]Rev. Rul. 2004-98, 2004-42 I.R.B. 664.

(f) Qualified Moving Expense Reimbursements

This exclusion, added by Congress in 1993, covers any amount that an employee receives from an employer as a payment for or a reimbursement of moving expenses that the employee could otherwise deduct if the employee had paid those expenses directly.[49] If the employee deducted the expense in a prior year, the exclusion does not apply.[50]

(g) Special Rules Applicable to Section 132 Exclusions

Section 132 sets forth some special rules regarding who is a permissible recipient of an excludable fringe benefit as well as certain nondiscrimination and so-called ''line of business'' rules.

(i) Permissible Recipients. In order to qualify for any of the different types of section 132 exclusions, the benefit must be provided by an *employer* to its *employee*, and these terms are specially defined in section 132 and the regulations. The common-law definition of the term *employee* is not controlling; rather, there are special definitions that may vary depending on the benefit provided and the exclusion provision involved. Although employees are generally defined as those individuals currently working for the employer, also included for purposes of the no-additional-cost service and qualified employee discount exclusions are (1) former employees who left employment because of retirement or disability, (2) widows/widowers of individuals who died as current or former employees, and (3) spouses and dependent children of employees.[51] Independent contractors are treated as employees but only for purposes of the working condition and de minimis and fringe benefit rules.[52] Likewise, directors or trustees are eligible to claim both of these fringe benefit exclusions.[53] Finally, bona fide volunteers (i.e., individuals performing services who do not have a profit motive for doing so) can exclude working condition fringe benefits from their income.[54]

(ii) Nondiscrimination Rules. In enacting section 132, Congress wanted to ensure that the fringe benefit exclusion provisions not be used as a vehicle to reward highly compensated employees with noncash benefits to the exclusion of the non–highly compensated component of the workforce. Because of the administrative difficulties in applying the nondiscrimination rules to all of the exclusion categories, these rules only apply to the no-additional-cost services,

[49]IRC § 132(g). The moving expense deduction is allowed under IRC § 217.
[50]IRC § 132(g).
[51]Treas. Reg. § 1.132-1(b)(1).
[52]Treas. Reg. § 1.132-1(b)(2)(iv).
[53]Treas. Reg. § 1.132-1(b)(2)(iii).
[54]Treas. Reg. § 1.132-5(r)(1).

the qualified employee discounts, and the special rule for employer-provided cafeterias and dining rooms (described below in section 5.2(n).[55]

Under the nondiscrimination rules, each benefit is tested separately; therefore, a determination that a particular benefit is discriminatory does not taint other benefits provided by the employer.[56] The nondiscrimination rules are set forth in some detail in the regulations and generally require that (1) the benefits be provided either to all employees or to each member of a group of employees that is a reasonable and nondiscriminatory classification of employees, and (2) each benefit be available to employees on substantially the same terms.[57] As a general rule, each fringe benefit plan is separately treated under the nondiscrimination rules.[58] If, however, the plans are ''related,'' the plans are tested together.[59] While the regulations do not define the term *related*, they contain an example wherein a company maintains a 20 percent discount program for all employees and a 15 percent discount for highly compensated employees. The regulations say that the 20 percent discount program is related to the 15 percent program and that each is discriminatory as to highly compensated employees.[60] The definition of a *highly compensated employee* for the purposes of making the nondiscrimination tests is set forth in section 414(q),[61] and it is important to note that the failure of a particular benefit to pass the nondiscrimination rules will cause the value of the benefit to be taxable to the highly compensated employees only—the non–highly compensated employees can continue to exclude the value of the benefit from income, assuming it otherwise qualifies for the exclusion.

(iii) The Line-of-Business Requirement. Both the no-additional-cost service and qualified employee discount exclusions contain what is known as a ''line-of-business'' requirement.[62] The basic purpose of this rule is to ensure that the service or product that the employer is providing for free or at a reduced cost to the employee is a service or product that the employer provides during the course of its ordinary activities, not some unrelated product or service, and that the employee receiving the benefit is one who works in this same line of business. For example, it is perfectly permissible for a store that sells ski equipment and also provides ski vacation travel services to give its employees who work in sales a discount on the purchase of ski equipment, but it would violate the line-of-business rule if these employees received travel services at no cost.

[55]IRC § 132(j)(1).
[56]Treas. Reg. § 1.132-8(a)(2)(i).
[57]Treas. Reg. § 1.132-8.
[58]Treas. Reg. § 1.132-8(a)(2)(i).
[59]Treas. Reg. § 1.132-8(a)(2)(ii)(A).
[60]*Id*.
[61]*See* Treas. Reg. § 1.132-8(f).
[62]IRC § 132(b)(1), (c)(4).

As noted earlier, the no-additional-cost service exclusion allows employees to exclude from their gross income the value of services that are provided by their employer, so long as the employer does not incur substantial additional costs or forgo substantial revenue when providing the services. In order to qualify for the no-additional-cost service exclusion, the service must be one that is ''offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the. . .service performs substantial services.''[63] The ''qualified employee discount'' exclusion allows an employer to provide its employees with a limited discount on goods and services without causing the discounted amount to be included in the employees' income as additional compensation. This exclusion has the same line-of-business requirement.[64] Thus, application of both exclusions is contingent upon a showing that the benefits are provided in the same ''line of business'' in which the employee works. Although this requirement is easily applied in the for-profit world, its application to colleges and universities (and other nonprofit organizations) is quite unclear because educational institutions do not normally conduct ''business'' activities in which they sell products or services to the general public.

The regulations expand on the line-of-business requirement and provide that the test is met if the benefits are (1) the same type of service or property offered for sale to customers in the ordinary course of the employer's business, and (2) the same type of service or property offered for sale in the line of business in which the employee works.[65]

Before analyzing these two components of the line-of-business test in the context of benefits provided by colleges and universities, it is first necessary to ask a broader question: Does the line-of-business requirement effectively prevent employees of nonprofit organizations from taking advantage of these two section 132 exclusions altogether? Although the answer to this question is clearly no, it would be possible to interpret the language used by Congress to define the line-of-business test as an implicit indication that Congress intended to exclude ''nonbusiness'' employers. No statement, however, in either the statute or the legislative history specifically excludes the application of section 132 to nonprofit organizations, and had Congress intended to exclude nonprofits from the application of these provisions, it clearly would have incorporated a specific exclusion to that effect in the Internal Revenue Code.[66] Although it seems clear that the no-additional-cost service and qualified employee discount provisions should apply to all nonprofit organizations that

[63]Treas. Reg. § 1.132-4(a)(1).
[64]IRC § 132(c)(4).
[65]Treas. Reg. § 1.132-4.
[66]As a general rule, provisions of the Internal Revenue Code are construed strictly against the taxing power and liberally in favor of the taxpayer. *See, e.g.*, *Phipps v. Commissioner*, 91F.2 d 627 (10th Cir.), *cert. denied*, 302 U.S. 742 (1937).

meet the requirements necessary for exclusion, the fact that the statute and regulations are drafted in for-profit terms leaves some confusion as to how these provisions should be applied in the case of employees of nonprofit employers.

Turning to an analysis of the line-of-business requirement in the context of nonprofit organizations, the initial step is to look at the first component of that requirement—that the service or property must be offered for sale to customers in the ordinary course of business.[67] Because nonprofit organizations do not provide services or sell property as part of a business operation, if this requirement is to have any meaning to a nonprofit organization, the requirement must be interpreted so as to relate to the business of the nonprofit organization. That is, the no-additional-cost service or the activity generating the qualified employee discount must be one that the nonprofit organization provides as part of its ongoing charitable/educational activities. Without such a modification, employees of charitable and educational organizations could almost never obtain the benefits of these fringe benefit exclusions because (except in unrelated business income tax situations) charitable and educational organizations do not offer services or products ''for sale to customers in the ordinary course of business.''

The second part of the line-of-business'' test provides that only those employees who perform substantial services in the same line of business in which the service is offered are entitled to claim the exclusion. The classic example is the company that operates both a hotel and an airline. Free hotel accommodations are excludable only if provided to hotel employees, while free airline travel is excludable only if provided to the airline employees. It is unclear, however, how this component of the line-of-business requirement should be applied within a nonprofit context. For example, if employees of a university's library can use the university's athletic facilities for free, is the qualified employee discount rule inapplicable because the library employees are in a different line-of-business from those employees working in the athletic department? IRS agents have advanced such an interpretation during audits of colleges and universities, but there are no reported instances of a court's ever agreeing with this interpretation.

A better and more reasonable interpretation, however, is to say that all employees who work in an area that is part of the school's broad section 501(c)(3) educational or scientific mission (e.g., library, research facilities, athletic department, bookstores) are in the same line of business and are

[67]Treas. Reg. § 1.132-4. See also H.R. Rep. No. 432, 98th Cong., 2 d Sess., pt. 2, at 1594–98 (1984). Neither the Code nor the underlying Treasury regulations provide much guidance regarding the determination of whether goods or services are offered ''for sale to customers.'' One provision offers some clarification by stating that a service or property will not be considered to be offered for sale to customers if that service or property ''is primarily provided to employees and not to the employer's customers.'' Treas. Reg. § 1.132-2(a).

therefore eligible for either the no-additional-cost service or qualified employee discount exclusions. Under this interpretation, as long as the activity is one that is in furtherance of the school's section 501(c)(3) mission, all university employees who perform substantial services in furtherance of that activity meet the line-of-business requirement. Thus, the employee who works in the university's research facilities should be entitled to the benefits of the no-additional-cost service and qualified employee discount rules with respect to free or discounted athletic services because the services that the employee provides (scientific research) and the services provided to that employee (free or discounted athletic tickets), even though different, are both part of the school's broad section 501(c)(3) mission.

Direct support for this approach can be found in the regulations. In defining the line-of-business requirement, the regulations require that the two-digit code classification set forth in the Enterprise Standard Industrial Classification (ESIC) Manual be used and that each two-digit business classification set forth in the ESIC Manual must be treated as a separate ''line of business.''[68] In this regard, Code 82 of the ESIC Manual defines *educational services* as a single line of business.[69] The different activities conducted by educational institutions are not further broken down by the ESIC Manual into separate lines of business. Strict application of this regulation seems, therefore, to require classification of all colleges and universities providing ''educational services'' under ESIC Manual Code 82, and the existence of a single ESIC Manual code for educational services supports this interpretation of the line-of-business requirement with respect to colleges and universities.[70]

An alternative analysis provides additional support for treating all operations of a university as a single line of business. Specifically, the regulations provide for an aggregation rule under which two or more lines of business may be treated as a single line of business if one or more of the following requirements are met:

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[68]Treas.Reg.§1.132-4(a)(2)(i). Application of this rule is illustrated by Priv. Ltr. Rul. 8936041 (June 12, 1989), in which the National Office declined to aggregate into a single line of business ''general'' and ''specialty'' retail sale operations because each had a different ESIC Manual two-digit code. Also, in Priv. Ltr. Rul. 9328016 (Apr.16,1993), the Internal Revenue Service refused to aggregate two lines of business with separate ESIC two-digit codes (retail clothing and optical goods sales) into a single line of business for purposes of providing qualified employee discounts to employees under IRC § 132(a)(2).

[69]Executive Office of the President, Office of Management and Budget, Enterprise Standard Industrial Classification Manual, 391 (1987) (Major Group 82). Educational Services includes ''establishments providing academic or technical instruction. Also included are establishments providing educational services such as libraries, student exchange programs, and curriculum development.''

[70]It could be argued that the scientific mission of a college or university is a different ''line of business'' for these purposes since the ESIC Manual lists Noncommercial Research Organizations as a subgroup (No. 8733) under Code 87, which pertains to ''engineering, accounting, research, management, and related services.'' The IRS has never indicated, however, that a school's activities should be bifurcated in this manner.

- It is uncommon in the industry to operate any of the employer's separate lines of business without the others.
- It is common for a substantial number of nonheadquarters employees to perform substantial services in more than one line of business.
- For otherwise separate lines of retail business operations that are located on the same premises, such lines would be considered one line of business if the merchandise were sold in a department store.[71]

For example, a 1986 ruling involved a vertically integrated oil and gas corporation that acted as the common parent of an affiliated group of corporations.[72] The controlled group of corporations offered products and services to customers that were classified under six separate ESIC Manual two-digit codes. Although the activities fell within six separate two-digit codes, the IRS aggregated the taxpayer's activities because it was uncommon in the petroleum industry for any of the activities to be operated without the others. Accordingly, the controlled group's business activities were treated as a *single* line of business for purposes of the qualified employee discount exclusion.[73]

This aggregation rule provides additional authority for the position that all operations of colleges and universities may effectively be treated as a single line of business. Even if multiple lines of business are found to exist, colleges and universities can claim that any activities with separate ESIC Manual two-digit classifications must be aggregated because they represent separate lines of business that are common in the college/university industry to be operated together.[74] Specifically, within the ''educational services'' industry, it is common for colleges and universities to offer a wide range of programs and activities that further their broad overall educational missions. These programs and services include, among many others, formal classroom instruction, library services, computer services, on-campus housing, dining facilities, athletic facilities, athletic events, and cultural events, and it is not only common, but essential, within the educational services industry for an institution to operate each of these ''businesses'' in coordination with one or more of the others. Also, this same argument could be used to counter any IRS assertion that a school's scientific activities should be treated as a separate line of business because it is uncommon for a college or university to provide educational services without also conducting scientific research activities.

[71]Treas. Reg. § 1.132-4(a)(3).

[72]Priv. Ltr. Rul. 8708048 (Nov. 26, 1986).

[73]The ruling actually involved Temp. Reg. § 1.132-4 T(a)(3), which was subsequently finalized as Treas. Reg. § 1.132-4(a)(3). See also Priv. Ltr. Rul. 9025068 (Mar. 27, 1990), in which the IRS aggregated a motor vehicle manufacturing line of business and a financial services line of business, each with a separate ESIC Manual two-digit code, into a single line of business for purposes of the qualified employee discount exclusion because it was uncommon in the automotive industry for one line of business to be operated without the other line of business.

[74]*See, e.g.*, Priv. Ltr. Rul. 9025068 (Mar. 27, 1990).

The line-of-business requirement was obviously drafted with for-profit companies in mind. Neither the Code nor the legislative history indicates that Congress gave any thought whatsoever to nonprofit employers or to the fact that nonprofit organizations do not, as a general rule, offer services or property for sale to customers in the ordinary course of business. The legislative history indicates that these limitations were intended to serve two principal purposes: (1) to prevent employers from providing employees with benefits that are unrelated to any actual ongoing business of those employers,[75] and (2) to maintain the competitive balance between single-line-of-business operations and larger conglomerate enterprises by preventing the larger enterprises from being able to offer a greater variety of tax-free fringe benefits to employees.[76] Clearly, nonprofit employers and their employees should not be denied the benefits of section 132 because of failure to meet the ''for-profit'' tests established by Congress and the IRS; rather, all employees of a university who perform substantial services related to the university's overall section 501(c)(3) mission should qualify for the no-additional-cost service exclusion and the qualified employee discount with respect to the goods or services provided by the university.

§ 5.3 FRINGE BENEFITS TYPICALLY PROVIDED BY COLLEGES AND UNIVERSITIES

This section describes the tax treatment of those fringe benefits typically offered by colleges and universities to their employees.

(a) College- or University-Owned Automobiles

To the extent that a college or university employee uses a school vehicle for employment-related duties, the value of the use of the automobile is excludable as a working-condition fringe benefit. Incidental use of the car for personal purposes is excludable as a de minimis fringe, and the issue that typically arises in this context is what constitutes incidental.[77] Stopping for lunch or running an occasional personal errand qualifies as incidental, but commuting between the individual's personal residence and work does not. To the extent that the employee's use is more than incidental, an allocation of the business/personal use must be made following guidelines set forth in the regulations.[78] Also, it is important to note that the rules requiring that adequate books and records be

[75]H.R. Rep. No. 432, 98th Cong., 2 d Sess., pt. 2, at 1594 (1984). See also Joint Comm. on Taxation, 98th Cong., 2 d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 856 (Joint Comm. Print 1985).
[76]H.R. Rep. No. 432, pt. 2, at 1594–95.
[77]Treas. Reg. § 1.132-6(e)(2).
[78]Treas. Reg. § 1.132-5(b).

maintained to substantiate the business use must be complied with in order to support the working-condition fringe exclusion.[79]

(b) College- or University-Owned Airplanes

For those schools that have their own airplanes, the rules are similar to the rules for automobiles—that is, any employment-related use of the plane is excludable as a working-condition fringe.[80] Unlike the automobile rules, however, it appears that any personal use (even incidental) will be taxable to the employee.[81] The regulations require that special flight-valuation rules be followed for purposes of valuing the personal component of the use of the plane.[82]

(c) Home Computers

To the extent that employer-provided home computers and computer-related equipment meet the tests for qualifying as a business expense deduction and are used by the employee for business purposes, the value can be excludable as a working-condition fringe benefit.

Like the employer-provided automobiles, an allocation between personal and business use must be made, and all business use must meet the substantiation rules. Under section 280F(d)(4), computers and communications equipment, such as fax machines, are so-called listed property, which means that the employee must keep substantiating documentation with respect to business/personal use. Any personal use would constitute gross income and could not be excluded under the de minimis fringe benefit rules.[83]

(d) Professional Dues, Publications, and Meetings

If a college or university pays the professional dues of its employees, pays for publications they use in their work, or pays the cost of attending professional meetings or training sessions, the value is excludable as a working condition fringe benefit.[84]

(e) Educational Assistance

If a college or university provides or pays for education for its employees, the benefit can be excluded as a working condition fringe benefit as long as the

[79]Treas. Reg. § 1.132(c); IRC § 274.
[80]Joint Comm. on Taxation, at 855.
[81]At least this was the law prior to the enactment of IRC § 132. See *Ireland v. United States*, 621 F.2 d 730 (5th Cir. 1980).
[82]Treas. Reg. § 1.132-5(k); Treas. Reg. § 1.61-21(g).
[83]See section 280F(d)(4)(iv), relating to computers, and Treas. Reg. §1.280F-6(b)(3)(i), relating to communications equipment such as fax machines. For a discussion of the de minimis fringe benefit rules, see § 5.2(d).
[84]Joint Comm. on Taxation, at 856.

education is directly related to the employee's job skills and meets the requirements of being deductible as a business-related educational expense.[85] Because of the difficulty of determining which educational expenses are job-related and which are not, many schools have adopted educational assistance plans that qualify under section 127.[86] Apart from these section 127 plans, however, it is possible to exclude job-related educational assistance as a working condition fringe benefit, as long as the business expense deduction requirements are satisfied.

(f) Security Arrangements

Prior to the enactment of section 132, amounts paid by employers for the security of their employees were generally excludable from the employee's income, whether the security was provided at work or at home.[87] The exclusion extended to the employee's family members as well. Section 132 generally continues the prior law rules with respect to employer-provided security arrangements and treats those expenses paid on behalf of an employee as an excludable working condition fringe benefit.[88] If the college or university provides security while the employee is traveling, the regulations contain a detailed set of requirements that must be met in order for the exclusion to apply.[89]

(g) Travel and Entertainment Expense Reimbursements

If a college or university reimburses an employee for expenses incurred in entertaining or traveling on business, the reimbursement is excludable from the employee's income as a working condition fringe benefit. The expense must, however, be deductible under the section 162 business expense deduction rules, and the substantiation rules set forth in the section 274 regulations must be met as well. The section 162 regulations clearly provide that if either of the rules is not met, or if the reimbursement is for an amount greater than the amount expended, the working condition fringe benefit exclusion does not apply.[90]

(h) Outplacement Services

Some colleges and universities offer outplacement services for terminated employees. Because an employee is generally able to deduct job-searching expenses if the search is for employment in the employee's same trade or business, it was generally thought that any outplacement services provided by an employer would qualify as a working condition fringe benefit. In

[85]IRC § 132(j)(8).
[86]*See* § 5.3(p).
[87]*Munson v. Commissioner*, 18 B.T.A.232 (1929), *acq.*, IX-1 C.B.38.
[88]Treas. Reg. § 1.132-5(m).
[89]Treas. Reg. § 1.132-5(m)(2).
[90]Treas. Reg. § 1.162-2; Treas. Reg. § 1.62-25(b).

1988, however, the IRS issued a ruling to the contrary.[91] This ruling was subsequently withdrawn, and the IRS announced that it was going to study the issue further.[92]

As a result of this study, in 1992 the IRS issued a second ruling, stating that outplacement services could qualify as a working condition fringe benefit as long as the employer could show that it derived a substantial business benefit from providing the services, as opposed to the benefit it would receive by simply paying cash to the employee.[93] According to this ruling, ''substantial business benefit'' for these purposes includes creating a positive organizational public image, maintaining the morale of existing employees, and decreasing the likelihood of wrongful termination lawsuits. The ruling goes on to say, however, that the working-condition fringe benefit exclusion does not apply if the employer gives the employee the choice of either severance pay or reduced severance pay and outplacement services.

(i) Reciprocal Arrangements

As part of the no-additional-cost service provision, the regulations permit an otherwise qualifying no-additional-cost benefit to be provided reciprocally by one employer to another's employees if the following three conditions are met:

1. The benefit is provided pursuant to a written agreement between the two employers.
2. Neither employer incurs substantial additional cost or forgone revenue in providing the benefit.
3. The benefit meets the line-of-business requirement.[94]

It would seem on the surface that this reciprocal arrangement provision could apply where one college or university enters into a reciprocal arrangement with another under which employees of each school can send their dependents to the other school on a tuition-free basis. But because the no-additional-cost service provision cannot apply to the provision of educational benefits by a college or university,[95] it is questionable whether such a reciprocal arrangement would be treated as tax-free by the IRS.

(j) Communication Services

To the extent that a college or university provides its employees with free local and long-distance telephone (including cellular), facsimile, and

[91]Priv. Ltr. Rul. 8913008 (Dec. 21, 1988).
[92]Priv. Ltr. Rul. 9040025 (July 6, 1990).
[93]Rev. Rul. 92-69, 1992-2 C.B. 51.
[94]Treas. Reg. § 1.132-2(b). *See* § 5.2(g)(iii).
[95]*See* § 5.2(a).

electronic mail services, the value of the benefit is includable in the employee's income, unless the school can show that the no-additional-cost service exclusion applies.[96] If a school can demonstrate that it is simply using excess capacity that it has already purchased and is not incurring any substantial additional cost in providing the service to the employees, the no-additional-cost service rules will be met. The rapidly changing technology and price structure for these different communications services, however, makes this a potentially difficult issue to analyze, and the tax consequences of providing these services to employees may change from time to time as pricing structures change.

In analyzing the issue of whether the value of a cell phone or other communications equipment provided to an employee to be used outside the office represents a taxable fringe benefit to the employee. For example, if a university provides an employee with a cell phone and cell phone service that she can use for whatever purposes she wants, the presumption is that the value of the cell phone and the service is taxable compensation. To avoid taxation, the university and the employee would be required to show that use of the cell phone by the employee qualifies as a working-condition fringe benefit—that is, the employee could deduct the cost of the phone and the service as an employee business expense deduction if he paid for the phone and the service himself.

In order for an employee to show that use of the cell phone would qualify as an employee business expense deduction (and therefore that the provision of the phone by the university would be a nontaxable working-condition fringe benefit), the employee must provide adequate substantiation under the section 274 rules to show that the phone was used for business purposes.[97] An issue that arises in this area is whether, assuming the employee can show that only a small amount of use was personal, say, less than 15 percent, the value of the personal use could be excluded from income as a de minimis fringe benefit. While some schools reportedly take such a position, discussions with IRS officials indicate that the IRS would treat even a small amount of personal use as taxable income to the employee.

(k) Supper Money and Taxi Fares

It is common for colleges and universities to provide employees who work overtime with supper money and taxi fares. It is clear from the legislative history of section 132 that these types of benefits are intended to qualify for exclusion as de minimis fringe benefits.[98] In order to qualify, three tests must be met:

[96]Treas. Reg. § 1.132-2(a)(6), which literally applies to telephone services only.
[97]IRC § 274(d)(4), which requires that ''listed property'' be substantiated, and IRC § 280F(d)(4), which defines listed property as including computers, cellular telephone and similar equipment.
[98]H.R. Rep. No. 432, 98th Cong., 2 d Sess., pt. 2, at 1604 (1984).

1. The money or taxi fare must be provided on an occasional basis (although the IRS does not provide a definition of *occasional*).
2. The money or taxi fare is provided because the employee is working overtime.
3. The money or taxi fare is provided to enable the employee to work overtime.[99]

   The IRS takes the position that any reimbursement based on the number of overtime hours worked does not qualify as a de minimis fringe benefit and that meal allowances provided to employees on a routine basis to permit them to work overtime likewise does not qualify.[100]

(l) Gifts and Awards

If a college or university traditionally makes holiday or birthday gifts of relatively low-value property items to employees, the benefit qualifies for exclusion as a de minimis fringe,[101] but gifts of cash or gift certificates do not.[102] (See section 5.2(d)for a detailed discussion of the IRS position with respect to ''gift coupons.'') In 1986, Congress added a special provision that excludes as a de minimis fringe benefit employee awards of low value, including traditional more expensive awards (e.g., a gold watch) made to employees upon retirement.[103] The exception for more valuable gifts upon retirement is based on the fact that the gift is not made for any particular achievement and is not compensatory in the sense of being provided to ensure the provision of future services.

Colleges and universities, like most other employers, like to make employee achievement awards to recognize special past or present services provided. As previously mentioned, awards of low value, or gifts of relatively high value if made in connection with retirement, can qualify for exclusion as a de minimis fringe benefit. The Code permits certain other employee achievement awards to be excluded as well.[104] In order to qualify, the award must be an item of tangible personal property that is made to the employee because of length of service or safety achievement, must be awarded as part of a meaningful presentation, and cannot constitute disguised compensation. Gifts of cash, vacation packages, meals, lodging, and tickets do not qualify. If the award is made as part of a written program or plan that does not discriminate in favor of highly compensated employees, the value of the award can be up to $1,600 on a nontaxable basis. Otherwise, the award cannot exceed $400.

[99]Treas. Reg. § 1.132-6(d)(2)(i).
[100]Priv. Ltr. Rul. 9148001 (Feb. 15, 1991).
[101]Treas. Reg. § 1.132-6(e)(1).
[102]Treas. Reg. § 1.132-6(c).
[103]IRC § 274(j).
[104]IRC § 74(c).

(m) Tax Preparation Services

In 1994, the IRS issued a ruling involving an employer that assists its employees in preparing their federal and state tax returns.[105] In this ruling, the IRS held that the value of tax return preparation services provided by an employer under the IRS's Volunteer Income Tax Assistance (VITA) program is an excludable de minimis fringe benefit, but providing the services of a commercial tax return preparer is not. In the same ruling, the IRS concluded that giving employees coupons that they could use to obtain tax return preparation services is a de minimis fringe, as is assistance in helping the employees file their tax returns electronically.

(n) Cafeterias and Dining Rooms

It is not unusual for a college or university to permit employees to use school cafeterias or dining rooms at a no cost or reduced rate that reflects the fact that the school subsidizes the cost of the eating facility. There is a long and well-established rule outside the section 132 fringe benefit area that employer-provided meals on the business premises and for the convenience of the employer are excludable from the employee's income.[106] The issue under section 132 arises with respect to those meals that do not qualify for this broad exclusion.

Under a special rule set forth in section 132, the value of meals provided at an ''employer-operated eating facility'' can be excluded from the employee's income, if (1) the facility is located on or near the employer's business premises, (2) the revenue from the facility normally equals or exceeds the direct operating costs, (3) the facility is owned and operated by the employer (including contracting with a catering service), and (4) meals are served only during or immediately before or after the normal workday.[107]

The regulations contain guidance on how to compute direct operating costs for purposes of determining whether the costs exceed the revenue derived from the facility, as well as how to determine the amount that must be included in the employee's income if the rules are not met.[108] Also, the regulations set forth certain nondiscrimination rules that must be met, even though, as a general rule, the de minimis fringe benefit provision is not subject to any nondiscrimination rules.[109]

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[105]Priv. Ltr. Rul. 9442003 (July 11, 1994). *See also* Priv. Ltr. Rul. 8547003 (July 31, 1985).
[106]IRC § 119.
[107]IRC § 132(e)(2); Treas. Reg. § 1.132-7(a)(2). Note that if the employer does not charge for meals at the facility, and therefore there is no revenue, the facility cannot qualify under this special rule. Tech. Adv. Mem. 9829001 (Mar. 10, 1998).
[108]Treas. Reg. § 1.132-7.
[109]Treas. Reg. § 1.132-7(a)(1)(ii).

(o) Athletic Facilities

Many colleges and universities permit their employees to use the school's athletic facilities for free or at a reduced rate from what they charge the general public. This benefit can often be excluded under the qualified employee discount rules, but there is a special exclusionary provision in section 132 that should be examined first to see whether the benefit can qualify.[110]

Under this rule, the value of the use of a gym or other athletic facility (including swimming pools, tennis courts, golf courses) can be excluded from the employee's income if (1) the facility is located on the employer's premises (not necessarily the ''business premises''), (2) the facility is operated by the employer (including a contract with a professional athletic services provider), and (3) substantially all of the use of the facility is by employees or the spouses and dependents of employees. For these purposes, use by students does not count toward meeting the ''substantially all of the use'' test. It is generally thought that the ''substantially all the use'' test is met if employees or the spouse and dependents use the facility at least 85 percent of the time. The regulations specifically provide that this special exclusion is not applicable if the facility is available to the general public through rental or membership fees.[111] Also, the regulations state that the athletic facility exclusion is not dependent on passing any nondiscrimination rules; therefore, the facility could be made available for highly compensated employees only.[112]

(p) Section 127 Educational Assistance Programs

The history of section 127 educational assistance programs has been checkered to say the least. Prior to the enactment of section 127 as part of the Revenue Act of 1978, employer-provided educational assistance could be excluded from the employee's gross income only if the education was directly related to the employee's job and improved the skills necessary to perform that job.[113] In 1978, however, Congress established a more liberal ''educational assistance program'' statutory scheme for two primary reasons. First, the fact that employees could exclude only job-related training discriminated in favor of higher paying jobs, which were more apt to qualify for this test. Second, the job-related test was a subjective and difficult test to apply in a variety of different factual situations.[114] For these reasons, Congress enacted section 127, which generally provides that amounts paid by an employer for the educational assistance of an employee (whether paid directly to the educational institution or to the employee as a reimbursement) under a ''qualified

[110]IRC § 132(j)(4).
[111]Treas. Reg. § 1.132-1(e)(1).
[112]Treas. Reg. § 1.132-1(e)(5).
[113]Treas. Reg. § 1.162-5; Treas. Reg. § 1.162-17(b)(1).
[114]Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

educational assistance program'' are not includable in the employee's gross income.

For reasons known only to Congress, however, section 127 has never been made a permanent part of the Internal Revenue Code; rather, it has been enacted repeatedly on a temporary basis, usually for two years at a time.[115] But in 2001, Congress extended the section 127 exclusion until the end of 2010.

In 1996, the exclusion for graduate-level courses was dropped from section 127, and the provision became applicable to undergraduate courses only.[116] In 1999, Congress again extended section 127 through December 31, 2001.[117] Again, however, notwithstanding lobbying efforts by the higher-education community, the provision was not expanded to include graduate level courses. For these purposes, the IRS defined *graduate-level courses* as those taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.[118] As part of the 2001 reenactment, however, Congress agreed to permit graduate-level education benefits to be included within the scope of section 127.[119]

The benefits that can be provided under these section 127 programs include tuition, fees, books, supplies, and equipment, as well as the value of education provided to the employee by the employer itself.[120] Allowable benefits do not include (1) supplies that the employee can retain after the courses (except for textbooks); or (2) meals, lodging, and transportation.[121] The types of courses that can be taken are quite broad and generally include any form of instruction

[115]The original provision that was enacted in 1978 expired on Dec. 31, 1983. In 1984, it was extended to Dec. 31, 1985; in 1986, it was extended to Dec. 31, 1987; in 1988, it was extended to Dec. 31, 1988; in 1989, it was extended to Sept. 30, 1990; in 1990, it was extended to Dec. 31, 1991; in 1991, it was extended to June 30, 1992; and in 1993, it was extended to Dec. 31, 1994. It was not reenacted until 1996, when it was made retroactive to January 1, 1995. Under the 1996 reenactment, the provision was extended for undergraduate courses through May 31, 1997, but the exclusion for graduate courses expired for courses beginning after June 30, 1996. In 1997, the provision was again extended for undergraduate courses beginning before June 1, 2000; however, graduate students were again excluded. In 2001, Congress extended the employer-provided educational assistance provision, this time until December 31, 2010, but this time the provision included graduate education.

[116]*See* footnote 116.

[117]Work Incentives Improvement Act of 1999, Pub. L. No. 106-107, § 506, 113 Stat. 1860.

[118]I.R.S. Notice 96-68, 1996-2 C.B. 236.

[119]IRC § 127(c)(1),

[120]Treas. Reg. § 1.127-2(c)(1). Some schools have contemplated operating a student loan forgiveness program (where, for example, the school lends the student money but forgives the loan if the student works for the institution after graduation) through a section 127 plan. The issue is whether the amount of the forgiven principal and interest can be excluded as a section 127 benefit up to the $5,250 maximum amount. While the definition of ''educational assistance'' in this regulation would seem to be broad enough to include the forgiven loan principal and interest, the IRS issued a private letter ruling in 1987 that, while not directly on point, casts some doubt on such treatment. See Priv. Ltr. Rul. 8714035 (Jan. 2, 1987).

[121]Treas. Reg. § 1.127-2(c)(3)(i) to(ii).

or training that improves or develops the capabilities of the individual, except for games, hobbies, or sports not related to the employer's business. Therefore, although a course on how to play tennis would not generally qualify, if the employee who attended was a tennis coach at a college or university, the course would qualify.[122] The maximum amount that can be excluded is $5,250 per year, and any amounts provided in excess of that amount are included in the employee's gross income and subject to income and employment tax withholding.[123]

In order to qualify as an educational assistance program, six different requirements must be met:

1. The program must be set forth in a separate written plan that is not part of another employee benefit plan (although it can be part of a cafeteria plan that gives employees a choice of different nontaxable benefits).[124]
2. The program must be for the exclusive benefit of the employer's employees, retired employees, disabled or laid-off employees, or employees on leave.[125] Benefits may not be provided to the employee's spouse or children.[126]
3. Although not all employees must be eligible for the plan, the plan cannot discriminate with respect to participation in favor of highly compensated employees.[127]
4. Likewise, the plan cannot be discriminatory as to benefits. Nevertheless, the regulations provide that discrimination will not be found simply because certain types of educational assistance are used to a greater extent by the highly compensated employees or because, in order to receive benefits, the employee must successfully complete the course, attain a particular grade, or remain with the institution for a certain period of time.[128] There is a related rule to the effect that no more than 5 percent of the amount paid by the employer for educational assistance is paid to employees who own more than 5 percent of the stock of the employer.[129] When the employer is a nonprofit organization that has no

[122]Treas. Reg. §§ 1.127-2(c)(3)(iii), -2(c)(4).

[123]IRC § 127(a)(2). It is possible that any such excess amount could be excluded from the employee's gross income as a working condition fringe benefit under IRC § 132(d), but the IRS refused to issue a ruling so holding on the ground that the question was too factual in nature. See Priv. Ltr. Rul. 200337004 (June 10, 2003).

[124]Treas. Reg. § 1.127-2(b).

[125]Treas. Reg. §§ 1.127-2(d), -2(h)(1). In Rev. Rul. 96-41, 1996-2 C.B. 8, the IRS held that a plan can qualify under section 127 if eligible participants include former employees, regardless of the reason for their termination.

[126]Treas. Reg. § 1.127-2(d).

[127]Treas. Reg. § 1.127-2(e).

[128]Treas. Reg. § 1.127-2(e)(2)(i), (ii).

[129]Treas. Reg. § 1.127-2(f)(2)(i), (ii).

stock, the regulations offer no guidance as to how this test is met, or indeed if it is even required.

5. The plan cannot offer the employee the choice to receive taxable compensation instead of educational assistance.[130]
6. All employees must receive reasonable notice of the existence of the plan.[131]

If a college or university has any question as to whether a plan qualifies under section 127, it can submit the plan to the IRS for an advance ruling.[132]

In 2003, the IRS ruled that an employer could forgive student loans within the scope of its section 127 educational assistance plan without jeopardizing the plan's status.[133] Under the facts of this case, the employer made loans to its employees to attend school and then forgave a portion of the loans each year. To the extent that the loan forgiveness was less than the $5,250 section 127 cap, the cancellation of indebtedness was not included in the employee's income.

(q) Spousal Travel

Prior to 1994, if a college or university official took his or her spouse on a business trip, the expenses attributable to travel by the employee's spouse were deductible as business expenses if the spouse's participation in the trip served a bona fide business purpose. If the employer paid the expenses directly, it was able to deduct the payment as an ordinary and necessary business expense, and the employee was not required to include this amount as income. If, however, instead of paying the expense directly, the employer reimbursed the employee for the spouse's travel expenses, the employee was able to treat the reimbursement as a working condition fringe benefit on the ground that the amount would have been deductible by the employee if the employee had incurred the expense directly.

All of this changed in 1994, when Congress amended the Code to provide that no deduction will be allowed for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer on business travel unless (1) the spouse, dependent, or other individual is an employee of the taxpayer; (2) travel of the spouse, dependent, or other individual is for a bona fide business purpose; and (3) the expenses would otherwise be deductible by the spouse, dependent, or other individual.[134] This

[130]IRC § 127(b)(4).

[131]IRC § 127(b)(6).

[132]See, for example, Priv. Ltr. Rul. 200245042 (Aug. 6, 2002) in which the IRS ruled that a plan qualified under IRC § 127; Priv. Ltr. Rul. 20037004 (June 10, 2003) where the IRS held that certain amendments to an IRC § 127 plan would not adversely affect the plan's qualification under IRC § 127; and Priv. Ltr. Rul. 200624059 (June 16, 2006) where the IRS ruled that an educational assistance plan established by a IRC § 501(c)(6) organization qualified under IRC § 127.

[133]Priv. Ltr. Rul. 200337004 (June 10, 2003).

[134]IRC § 274(m)(3).

new statute was directed at the employer's ability to deduct the spousal travel payment (usually irrelevant to colleges, universities, and other nonprofit organizations), but had the unintended consequence of also requiring that, unless the spouse was also an employee, the value of the spousal travel was includable in the gross income of the employee. This was because the working condition fringe benefit requires that the employee be able to deduct the reimbursement if he had paid for it himself, and the new statute precluded any deduction unless the spouse was an employee.

In the college and university area, the spousal travel rule usually arises in connection with travel by the school's president or other senior official, and the new statute led to some schools putting the senior official's spouse on the payroll as an employee. Most commentators believed that this structure would work if there was, in fact, substance to the employer-employee relationship. If, however, the spouse was made an employee in name only, the IRS would most likely disregard such an arrangement.

In any event, this ''employee'' fiction ceased being an issue a couple of years later because the IRS took action to address this unintended consequence of the 1994 spousal travel rules.[135] In 1996, the IRS issued regulations providing that the fact that the employer may be denied a deduction for the employer's payment of travel expenses of a spouse, dependent, or other individual accompanying the employee on a business trip (including because the spouse does not qualify as an employee) does not preclude those items from qualifying as working condition fringe benefits if (1) the employer has not treated such amounts as compensation to the employee, (2) the amounts would otherwise be deductible as business expense deductions but were disallowed as deductions because of the new law, and (3) the employee properly substantiates the expenses. An issue of particular concern to nonprofit organizations is the second part of the test because, unlike for-profit entities, nonprofits do not claim a tax deduction for the payment and therefore their deductions are not disallowed. The IRS specifically addressed this issue in the regulations, holding that the reference to the disallowance of a deduction for tax-exempt employers will be interpreted as if the organization was subject to tax.[136]

The upshot of these new regulations was that it is no longer required that the spouse be an employee of the college or university in order for the president or other senior official to be able to exclude the value of the spousal travel from his or her gross income. What is still required, however, is that the spouse served a bona fide business function on the trip and that the claimed expenses are properly substantiated under the rules of section 274.

[135]Treas. Reg. §§ 1.132-5(s), -5(t).
[136]Treas. Reg. § 1.132-5(s)(2).

(r) Free or Discounted Theater or Athletic Tickets

Many colleges and universities provide employees with free or discounted tickets to the school theater or athletic events. Under both the section 132 regulations and the legislative history to section 132, the provision of occasional tickets is excludable as a de minimis fringe benefit.[137] The regulations specifically provide, however, that season tickets do not qualify as a de minimis fringe.[138]

Many colleges and universities provide complimentary football, basketball, and other sporting event tickets to various university employees, usually members of the athletic department staff. Also, free or discounted theater tickets are provided to employees, usually those employees who are involved in the theater or drama activities of the institution. Although these arrangements are typically not reduced to a written contract, it is generally understood that the tickets are not for resale and are to be used by the recipient for either business or personal purposes. In some cases, the tickets are provided at no cost, and in other cases, at a discount from the cost charged to the general public.

The value of free or discounted tickets can be excluded from the employee's gross income either as a no-additional-cost service or as a working-condition fringe benefit. If the college or university attempts to exclude the value under the no-additional-cost service rules, it must be able to show that it did not incur any substantial additional cost in providing the tickets to its employees on the ground that the event would have taken place regardless of the number of individuals attending the event. Also, the institution must be able to demonstrate that any services provided by university employees to the ticket recipients were merely incidental. The biggest hurdle to overcome in justifying the no-additional-cost service rules is the obligation of the college or university to show that it did not forgo any substantial revenue in providing the tickets. The IRS takes the position that if the ticket that is provided is a season ticket, it is similar to an airline company's giving an employee the right to a reserved seat on an airplane, and the no-additional-cost service provision does not apply.[139] If the tickets that are provided are individual tickets and the event was not sold out, the no-additional-cost service rules should apply. The IRS position with respect to season tickets is questionable if the college or university is able to show that there is no restriction or limitation on the number of season tickets sold.

In certain circumstances, the employee may be able to exclude the value of the ticket as a working-condition fringe benefit on the ground that had the individual paid for the ticket him- or herself, it would have been deductible. In some cases, for example, employees of the athletic department (e.g., the

[137]Treas. Reg. § 1.132-5(e)(1).
[138]Treas. Reg. § 1.132-5(e)(2).
[139]Treas. Reg. § 1.132-2(c).

athletic director, assistant athletic directors) are required to attend sporting events and often use the events as a recruiting device. In these or similar cases, the value of the tickets should be excludable as a working-condition fringe benefit.

Finally, if the ticket is provided at a discount, it is possible that the qualified employee discount rules may come into play. In a number of audits, the IRS has taken the position that a ticket is treated as a ''service,'' not a product; therefore, the employee is not required to include in gross income a discount provided by his or her employer if the discount does not exceed 20 percent of the price of which the employer offers the service for sale to nonemployee customers. To the extent that the discount provided to the employee falls within the 20 percent threshold, the value should be deductible as a qualified employee discount.

(s) Free or Subsidized Housing

Some colleges and universities provide faculty and staff with free or discounted on-campus housing, while others provide assistance for off-campus housing.

The Code contains a special exclusion from gross income for the value of lodging furnished to an employee. With respect to employer-provided lodging, the value is excluded if (1) the lodging is furnished for the convenience of the employer; (2) the employee is required to accept the lodging as a condition of his or her employment; and (3) the lodging is on the business premises of the employer.[140] The failure to meet any one of these conditions renders the exclusion inapplicable.[141]

The ''convenience-of-the-employer'' test requires a direct nexus between the lodging that is furnished to the employee and the business interests of the employer.[142] Whether such a direct nexus exists is a question of fact to be resolved by a consideration of all the facts and circumstances of each case.[143] This test, however, is generally met if, due to the nature of the employer's business, it is necessary for the employee to be available for work for longer than normal work hours.[144]

The ''required-as-a-condition-of-employment'' test is met if the lodging is required in order for the employee to properly perform the duties of his or her employment. The employee's acceptance of lodging need not be expressly

[140]IRC § 119(a); Treas. Reg. § 1.119-1(b).
[141]*Dole v. Commissioner*, 43 T.C. 697, 705, aff'd per curiam, 351 F.2 d 308 (1st Cir. 1965).
[142]*McDonald v. Commissioner*, 66 T.C. 223, 232 (1976).
[143]Treas. Reg. § 1.119-1(a)(1); *United States Junior Chamber of Commerce v. United States*, 334 F.2 d 660, 663 (Ct. Cl. 1964). *See also* Tech. Adv. Mem. 9404005 (Sept. 30, 1993), in which the IRS ruled that this test was not met for certain school employees.
[144]*Schwartz v. Commissioner*, 22 T.C.M. (CCH) 835 (1963); *Hatt v. Commissioner*, 28 T.C.M. (CCH) 1194 (1969).

required as a condition of employment (such as pursuant to a written contract), so long as the proper performance of the employee's duties objectively requires, as a practical matter, that the individual live on the business premises.[145] Both the Tax Court and the Court of Claims have stated that there is little, if any, substantive difference between the convenience-of-the-employer test and the ''required-as-a-condition-of-employment test.[146]

The final test is that the lodging must be ''on the business premises'' of the employer.[147] Notwithstanding the statutory language requiring that the lodging be located ''on'' the employer's business premises, the courts have adopted, in some situations, a more liberal standard. If the off-premises lodging either constitutes an integral part of the employer's operations or is a place where the employee performs a meaningful portion of his or her duties, the courts have held that the ''on-the-business-premises'' test will be met.[148] As one court has stated: ''functional rather than spatial unity is determinative of whether lodging is on the employer's business premises.''[149] But the IRS applies a strict interpretation of the ''on the business premises'' test, as evidenced by a 1993 ruling, in which the IRS ruled that the value of lodging received by employees residing on property located one to three miles from campus was not excludable from the employees' gross income.[150] In this same ruling, the IRS held that the value of lodging provided to employees who lived on campus was likewise not excludable because the employees did not perform employment-related duties at their residences.

Whether an off-premises lodging will be treated by the courts as functionally ''on'' the employer's business premises depends on the facts and circumstances involved, and close consideration is given to the employee's duties as well as the nature of the employer's business.[151] No bright-line test can be used to determine whether the scope of the employee's business activities in an off-premises residence will be sufficient to treat the residence as ''on the business premises'' for purposes of the exclusion, but a few examples from court cases, two of which involve educational institutions, may help illustrate this concept:

- An organization furnished an official residence to its president during his term in office, which residence was used at night to conduct staff meetings and for official business entertainment purposes. The residence was located approximately three miles from the organization's

[145] *Adams v. United States*, 585 F.2 d 1060, 1063 (Ct. Cl. 1978*); McDonald*, 66 T.C. at 223.
[146] *Vanicek v. Commissioner*, 85 T.C. 731, 739 (1985); United States Junior Chamber of Commerce, 334 F.2 d at 663.
[147] IRC § 119(a)(2).
[148] *Adams*, 585 F.2 d at 1060.
[149] *Bob Jones Univ. v United States*, 670 F.2 d 167, 176 (Ct. Cl. 1982).
[150] Tech. Adv. Mem. 9404005 (Sept. 30, 1993).
[151] *Lindeman v. Commissioner*, 60 T.C. 609, 615 (1973).

headquarters where the president performed his duties during regular business hours. The court held that the residence qualified as ''on the business premises'' because official activities were conducted in that location.[152]

- A Japanese subsidiary of a U.S. corporation provided its chief executive officer with a residence located three miles from the corporate headquarters. The executive maintained an office in his employer's headquarters, but worked in his residence on evenings and weekends, where he conducted business meetings and made telephone calls that could not be conducted or made during normal business hours. He also conducted regular business entertainment activities in his residence. The court held that this residence qualified as ''on the business premises'' because the company carried on ''some of its business activities'' at the residence.[153]
- A college provided its president with a residence located four miles from the main campus. The president entertained business guests and occasionally held meetings, made telephone calls, or conducted college-related business in the residence. The court held that these occasional activities did not constitute a sufficient quantum of employment-related activity to find that the residence constituted a ''business premises'' for purposes of the exclusion.[154]
- A university housed its faculty and staff in lodging situated one to three blocks away from the campus property. The court held that this housing was not ''on the business premises'' where the only services performed for the university consisted of grading papers, preparation for classes, and occasional meetings with students and their parents. These services were, in the aggregate, too insubstantial to make the premises part of the institution's ''business premises.''[155]

In a technical advice memorandum, the IRS ruled that housing allowance payments made by a hospital to its medical residents did not qualify for the section 119 housing exclusion.[156] The housing, some of which was owned by the hospital, was located within one mile of the hospital, and most units were within a quarter-mile. The IRS ruled that the housing allowances did not qualify under section 119 because no patient care or other hospital business was conducted in the lodging, and therefore, the ''on the business premises''

[152] *United States Junior Chamber of Commerce*, 334 F. 2 d at 664–65.
[153] *Adams*, 585 F.2 d at 1065–1066.
[154] *Winchell v. United States*, 564 F. Supp. 131 (D. Neb. 1983). *See also McDonald v. Commissioner*, 66 T.C. 223 (1976) (the occasional entertainment of business guests or use of a telephone in the residence for business calls does not constitute a sufficient amount of employment-related activity to find that the residence is ''on the business premises'').
[155] *Bob Jones Univ.*, 670 F.2 d at 176.
[156] Tech. Adv. Mem. 9824001 (Feb. 11, 1998).

test of section 119 was not met. Also, some of the allowances were paid as cash reimbursements, and the IRS said that the section 119 exclusion only applies to in-kind housing and does not cover cash reimbursements for lodging expenses.

As the foregoing examples illustrate, the duties performed by the employee at the employer-provided lodging must be significant, not merely incidental, in order for the lodging to be treated as functionally ''on'' the business premises of the employer.

If the basic exclusion is not applicable, benefit may be derived under a special provision for employees of educational institutions.[157] Under this provision, qualified campus lodging provided to an employee will be excluded from the employee's gross income if the employee pays rent that is equal to or in excess of the lesser of (1) 5% of the appraised value of the lodging, or (2) the average of rentals paid by individuals (other than employees or students) during the year for school-provided lodging that is comparable to the qualified campus lodging provided to the employee. If, however, the employee does not pay rent that is equal to or above this amount, the employee must include in income the ''spread'' between the amount paid (if any) and the lesser of the two values.[158]

An employee of an educational institution qualifies for this benefit only if the lodging constitutes ''qualified campus lodging.'' The term *qualified campus lodging* is defined as lodging that (1) does not qualify under 119(a), (2) is ''located on, or in the proximity of,'' the campus, and (3) is furnished to the employee, the employee's spouse, and any of the employee's dependents by, or on behalf of, the institution for use as a residence.[159]

As part of the housing provided by a college or university to the president or other senior official who is required to live on campus, the school may also pay for the cleaning of the residence, including bathroom and kitchen counters, sweeping and mopping, emptying trash cans, vacuuming all rooms and hallways, dusting, and so on. In addition, as part of the cleaning services, the staff may also make beds, cleans linens, and do dishes. The question is whether the value of these cleaning services is taxable to the employee.

The IRS has held that the term *lodging* as used in section 119 ''encompasses items such as heat, electricity, gas, water, and sewerage service'' on the theory that these services ''are necessary to make the lodging habitable.''[160] The Tax Court, presumably on the same ''habitable'' theory, has gone further to say that the value of cleaning of the residence also qualifies under section 119,

[157]IRC § 119(d).

[158]For an excellent summary of cases dealing with housing allowances and exclusions, see Raby & Raby, ''Facts, Circumstances, and Housing Exclusions,'' Tax Notes Today (Tax Analysts), 98 TNT 29-86 (Special Reports) (Oct. 30, 1997).

[159]I.R.C. § 119(d)(3). This provision also applies to housing provided in ''academic health centers.'' See Priv. Ltr. Rul. 9816015 (Jan. 13, 1998).

[160]Rev. Rul. 68-579, 1968-2 C.B. 61.

although the decision does not contain any explanation or rationale for this conclusion.[161] The IRS, however, would likely take the opposite position, because it litigated this issue in the Tax Court and has not indicated that it agrees with the Tax Court's position. In addition, the IRS has said in a 1990 ruling that ''house cleaning'' is a personal expense because it constitutes ''ordinary day-to-day expenses of living.''[162]

Another issue that arises when a college or university provides free housing to a president or other senior official relates to their ability to make some personal use of equipment located in the residence, such as computers and fax machines and whether the value of such use should be treated as taxable income. At the outset, computers and communications equipment, such as fax machines, are so-called listed property under section 280F(d)(4), which means that the employee must keep substantiating documentation with respect to business/personal use.[163] But the Code and the IRS regulations say that if the computer or communications equipment is used exclusively on the employer's regular business establishment and is owned or leased by the employer, the listed property rules do not apply.[164] Therefore, if the president lives in a residence that qualifies for the section 119 exclusion, any computer, fax machines, and other equipment located in the residence would not be listed property because the residence is part of the school's business premises. Therefore, the de minimis fringe benefit rules are potentially applicable to the value of any personal use of this equipment, provided that the other de minimis fringe benefit rules are met.

(t) Meals

In addition to excluding the value of free housing provided to employees, section 119 also excludes the value of meals provided by an employer to an employee if the meals are (1) provided for the convenience of the employer, and (2i) furnished on the employer's business premises. In its regulations under section 119, the IRS says that ''if the employee is required to occupy living quarters on the business premises of his employer as a condition of his employment, . . . the exclusion applies to the value of any meal furnished without charge to the employee on such premises.''[165] Thus, if the value of the housing provided to the university employee (e.g., the president) qualifies for the exclusion, then the value of any meals provided at the residence is likewise not taxable.

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[161] *Anderson v. Commissioner*, 42 T.C. 410 (1964).
[162] Rev. Rul. 90-64, 1990-2 CB 35.
[163] See IRC § 280F(d)(4)(iv), relating to computers, and Treas. Reg. §1.280F-6(b)(3)(i), relating to communications equipment such as fax machines.
[164] IRC § 280F(d)(4)(B), relating to computers, and Treas. Reg. § 1.280F-6(b)(3)(ii) and (iii), relating to communications equipment, such as fax machines.
[165] Treas. Reg. § 1.119–1.

But what if the college or university provides groceries instead of prepared meals? While there is one Third Circuit case holding that the value of in-kind groceries provided by an employer to an employee can qualify for the section 119 exclusion,[166] the Tax Court has held to the contrary,[167] and the IRS has ruled that the meals exclusion applies only to ''prepared meals'' and does not extend to the provision of groceries, either in-kind groceries or the reimbursement of the employee for groceries that he or she may have purchased. And, in those cases where the groceries are not provided in-kind with the employer reimbursing the employee for groceries purchased, the Tax Court has held that this is the equivalent of a cash allowance for meals, which is specifically prohibited under the IRS regulations.[168]

The fact that the value of the prepared meals qualifies for the section 119 exclusion leads to a question of whether the value of the services provided by a chef who works in the residence should be taxable to the employee. There is no authority, IRS or otherwise, on this issue, and it seems that the value of the services provided by the chefs are an integral part of the ''prepared meals'' and therefore should be excludable as part of the meal exclusion. The classic section 119 situation is the hotel manager who is required to live and eat in the hotel, and the hotel employs a chef who is involved in the preparation of the manager's meals. The IRS has never tried to bifurcate the value of those preparation services from the meals themselves and most likely would not do so with respect to situations where the employee lives in a residence that includes the services of a chef.

(u) Club Memberships

When a college or university pays the club dues of its president or other senior official, the issue that arises is whether the payment constitutes additional income to the individual. As with the spousal travel question, the problem arises from the fact that in 1993 Congress specifically made club dues payments nondeductible to the employee.[169] This, in turn, caused the individual to receive taxable income on the amount of the payment because it would no longer be excludable as a working condition fringe benefit, which requires that the employee be able to deduct the expense.

The IRS addressed this issue in regulations that generally provide that the fact that the club dues payment may be nondeductible by the employee does not necessarily mean that it cannot also be treated as excludable as a working-condition fringe benefit by the employee.[170] To be excludable as a

[166] *Jacob v. U.S.*, 493 F.2 d 1294 (3 d Cir. 1974).
[167] *Tougher v. Commissioner*, 51 T.C. 737 (1969), *aff'd per curiam*, 441 F.2 d 1148 (9th Cir. 1971).
[168] *Anderson v. Commissioner*, 42 T.C. 410 (1964), citing Treas. Reg. § 1.119-1(e), which provides that cash allowances for meals cannot qualify under IRC § 119.
[169] IRC § 274(a)(3).
[170] Treas. Reg. § 1.132-5(s).

working condition fringe benefit, however, the regulations clearly provide that the amount must otherwise qualify for a deduction by the employee as a bona fide business expense.[171] The regulations illustrate this with an example under which a company provides an employee with a country club membership valued at $20,000. The individual substantiates that the club was used 40 percent for business purposes. The 40 percent business use of the club is considered a working condition fringe benefit, notwithstanding that the employer's deduction for the dues allocable to the business use is disallowed. Therefore, the individual may exclude from his or her gross income $8,000 (40 percent of $20,000) as a fringe benefit.[172]

(v) Domestic Partners

Many colleges and universities have extended health care coverage to include so-called ''domestic partners,'' which are unmarried couples, either of the same sex or the opposite sex, who live together. The IRS takes the position that the fair market value of the health care benefits provided by the school to the domestic partner is taxable to the employee, unless the domestic partner qualifies as the employee's ''dependent'' under section 152(a).[173]

In addition, the IRS has ruled that an employee's same-sex partner cannot be a ''spouse'' under the Internal Revenue Code but may qualify as a ''dependent'' under sections 152(a)(9) and 152(b)(5) if the person (a) receives more than one-half of his or her support from the employee; (b) lives in and is part of the employee's household; and (c) does not violate local law by engaging in the relationship. If the person meets these tests, any health benefits provided by the school to the domestic partner can be excluded from the person's gross income.[174]

(w) Leave Donation or Sharing Programs

In 2001, the IRS issued interim guidance regarding so-called ''leave-based donation payments,'' involving an employer's payment to section 501(c)(3) organizations in exchange for vacation, sick, or personal leave that the employee elects to forgo.[175] In this guidance, the IRS said that it would, for a period of time, not question whether such payments can be deductible by the employees under section 170 or whether the employee should be taxed on the forgone payment under the assignment of income doctrine. Two years later, however, the IRS said that it had lifted this moratorium and that henceforth it

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[171] *Id*.

[172] Treas. Reg. § 1.132-5(s)(3), Example 1.

[173] Priv. Ltr. Rul. 9034048 (May 29, 1990); Priv. Ltr. Rul. 9231062 (May 7, 1992); FSA 199911012 (Dec. 10, 1998). For a discussion of whether domestic partners can qualify under the IRC § 117(d) ''qualified tuition reduction'' rules, *see* § 7.4.

[174] Priv. Ltr. Rul. 9850011 (Sept. 10, 1998).

[175] Notice 2001-69, 2001-2 C.B. 491.

would begin to question whether these leave-based donation programs should be nondeductible by the employees and result in additional wage income.[176]

Although the IRS in 2005 carved out a limited exception for leave-based donation programs designed to provide relief to victims of Hurricane Katrina,[177] it continued to have a problem with these programs, as evidenced by a ruling issued in early 2006 holding that a leave-based donation program under which state employees donated vacation time to the leave bank of a deceased state correctional guard or highway patrol officer who dies while in service with the state subsequently paying the cash value of donated leave to the survivor is reportable on employee's Form W-2 and is subject to income, Federal Insurance Contributions Act (FICA), and federal unemployment (FUTA) tax withholding.[178]

But later in 2006, expanding in the exception carved out for Hurricane Katrina, the IRS issued guidelines under which employees who donate time off to coworkers who are adversely affected by a major disaster are not taxed on their donated leave.[179] A ''major disaster'' for these purposes is one that is declared by the president under certain statutory authorities.[180] The major disaster leave-sharing program must be set forth in a written plan, which meets following requirements:

- The plan allows a leave donor to deposit accrued leave in an employer-sponsored leave bank for use by other employees who have been adversely affected by a major disaster. For purposes of the plan, an employee is considered to be adversely affected by a major disaster if the disaster has caused severe hardship to the employee or a family member of the employee that requires the employee to be absent from work.
- The plan does not allow a leave donor to deposit leave for transfer to a specific leave recipient.
- The amount of leave that may be donated by a leave donor in any year generally does not exceed the maximum amount of leave that an employee normally accrues during the year.
- A leave recipient may receive paid leave (at his or her normal rate of compensation) from leave deposited in the leave bank. Each leave recipient must use this leave for purposes related to the major disaster.
- The plan adopts a reasonable limit, based on the severity of the disaster, on the period of time after the major disaster occurs during which

[176]Notice 2003-1, 2003-1 CB 257.
[177]Notice 2005-68, 2005-40 IRB 622.
[178]Priv. Ltr. Rul. 200626036 (March 7, 2006).
[179]Notice 2006-59, 2006-28 I.R.B. 60.
[180]42 U.S.C § 5170 or 5 U.S.C. 6391.

a leave donor may deposit the leave in the leave bank, and a leave recipient must use the leave received from the leave bank.

- A leave recipient may not convert leave received under the plan into cash in lieu of using the leave. However, a leave recipient may use leave received under the plan to eliminate a negative leave balance that arose from leave that was advanced to the leave recipient because of the effects of the major disaster. A leave recipient also may substitute leave received under the plan for leave without pay used because of the major disaster.
- The employer must make a reasonable determination, based on need, as to how much leave each approved leave recipient may receive under the leave-sharing plan.
- Leave deposited on account of one major disaster may be used only for employees affected by that major disaster. Except for an amount so small as to make accounting for it unreasonable or administratively impracticable, any leave deposited under a major disaster leave-sharing plan that is not used by leave recipients by the end of the period specified in paragraph 5, above, must be returned within a reasonable period of time to the leave donors (or, at the employer's option, to those leave donors who are still employed by the employer) so that the donor will be able to use the leave. The amount of leave returned to each leave donor must be in the same proportion as the amount of leave donated by the leave donor bears to the total amount of leave donated on account of that major disaster.

The IRS says that a leave donor who deposits leave in an employer-sponsored leave bank under a major disaster leave-sharing plan realizes no wage income with respect to the deposited leave, provided that the plan treats payments made by the employer to the leave recipient as ''wages'' for purposes of income, FICA, and FUTA tax withholding. In addition, a leave donor may not claim an expense, charitable contribution, or loss deduction on account of the deposit of the leave or its use by a leave recipient.

CHAPTER SIX

Charitable Contribution Deductions

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§ 6.1 INTRODUCTION

One of the most fundamental components of the U.S. tax system is the provision that permits taxpayers to claim a tax deduction for contributions that they make to charitable and educational organizations, including, of course, college and universities. This deduction was first introduced by Congress in 1917 and, while modifications have been made over the years to the technical manner in which the deduction operates, the basic principle that taxpayers should be allowed a deduction for gifts to charitable and educational organizations has not been seriously questioned.[1]

The charitable contribution deduction provision, set forth in section 170 of the Code, is subject to a wide variety of restrictions and limitations as to how much can be deducted, what types of contributed property qualify for the

[1]The continued existence of this deduction may be at issue, however, if the United States moves toward a ''flat tax'' system of taxation. Under some of the flat tax proposals, the charitable contribution deduction would be eliminated.

deduction, and what types of organizations qualify as permissible donees. As a general rule, a deduction is only allowed if it meets the following tests:

- There is a bona fide transfer of money or property.
- The recipient organization is a permissible donee.
- The transfer is made without a return receipt of economic consideration or benefit.
- The contribution is made in the proper form.

§ 6.2 BONA FIDE TRANSFER OF MONEY OR PROPERTY

In order for any transfer of money or property to qualify as a gift, the donor must actually part with something, and the donee must actually receive something.[2] For example, a taxpayer who merely segregates funds on his books in the name of, and for the benefit of, a certain charity cannot claim a charitable contribution deduction because he has not actually transferred the funds.[3] And the donor must be able to demonstrate that he or she parted with legal title to the property.[4]

That is not to say, however, that in all cases a bona fide transfer has to involve an actual transfer of funds by the donor. When an individual has the right to receive the income but directs the payor to pay the income to a charitable organization, the transaction is treated as a bona fide transfer by the donor, provided the donor takes the amount into income and then offsets the income by the charitable contribution deduction.[5] For example, if an individual is owed a $25,000 bonus from her company but directs the company to pay it to her alma mater, the individual can claim a $25,000 charitable contribution deduction even though she did not make the actual transfer. She would, however, have to report the $25,000 as gross income for the year as well.

In order to qualify as a bona fide transfer, the money or property must also be delivered so that the donee actually possesses dominion and control over it. For example, in one case the court disallowed a charitable contribution deduction for a gift of a life insurance policy when the donor retained the right to change the charitable beneficiary.[6] In another case, a deduction was denied when the taxpayer deposited funds in a bank account that he opened in the name of his church, but retained full control over all funds deposited in the

[2] *Adler v. Commissioner*, 5 B.T.A. 1063, 1066 (1927).
[3] *See, e.g., Christensen v. Commissioner*, 40 T.C. 563, 576 (1963).
[4] *See Kaplan v. Commissioner*, T.C. Memo. 2006-16, in which the Tax Court held that a limited liability company (LLC) may not deduct as a charitable contribution deduction land donated to a IRC § 501(c)(3) organization because the LLC was unable to demonstrate that it transferred legal title to the land to the organization.
[5] *Ankeny v. Commissioner*, 53 T.C.M. (CCH) 827, 829 (1987).
[6] *Adler*, 5 B.T.A. at 1066.

account.[7] The IRS has, however, allowed a charitable contribution deduction when an individual proposed to make unconditional and irrevocable cash gift to a college while retaining the right to manage the investment of the funds. The right to manage the investments was subject to certain broad restrictions as to the nature of the allowable investments.[8]

This bona fide transfer principle also comes into play in two other situations. The first is when an individual makes a gift, with the caveat that the gift will revert to the donor when a particular event takes place, known as a gift subject to a condition subsequent. The second is when the gift will not take effect until the happening of a specific future event, known as a gift subject to a condition precedent. The regulations provide that a gift made subject to a condition subsequent is treated as a bona fide transfer if the condition ''appears on the date of the gift to be so remote as to be negligible.''[9] In one case, the court held that a gift of land to a university subject to the condition that the university use the land for an athletic field was a bona fide gift because there was little chance that the land would be used for some other purpose.[10] With respect to gifts made subject to a condition precedent, the regulations similarly provide that there is no bona fide transfer until the condition has actually been satisfied, unless the facts indicate that ''the possibility that the charitable transfer will not become effective is so remote as to be negligible.''[11] For example, in one case, a gift made in one year subject to the donor's agreeing to fulfill certain conditions was not a complete gift until the following year, when the donee agreed to the specified conditions.[12] But in another ruling, the IRS held that the contribution of a patent to a university contingent on an individual remaining as a faculty member for an additional 15 years was not a completed gift because the chance that the condition would arise was not considered to be remote.[13]

Not only must there be a transfer, but also if the transfer is of money, there must be a ''payment'' of the money. The transfer must be treated as a payment because section 170 permits the charitable contribution deduction only with respect to a ''payment [that is] made within the taxable year.''[14] Obviously, unrestricted contributions of cash qualify as payments, but questions often arise with respect to noncash payments and whether they will be treated as the equivalent of cash. The most popular form of noncash payment is a payment made by check. These payments are deductible when the check is mailed or delivered with no conditions or restrictions imposed on the donee, assuming that the check is honored in due course with no restrictions on the

[7]*Burwell v. Commissioner*, 89 T.C. 580, 591 (1987).
[8]Priv. Ltr. Ruls. 200445023 and 200445024 (July, 12, 2004).
[9]Treas. Reg. § 1.170A-1(e).
[10]*Fargason v. Commissioner*, 21 B.T.A. 1032, 1037 (1930), acq., X-2 C.B. 22 (1931).
[11]Treas. Reg. § 1.170A-1(e).
[12]*Gagne v. Commissioner*, 16 T.C. 498, 502 (1951).
[13]Rev. Rul. 2003-28, 2003-1 CB 594.
[14]IRC § 170(a)(1).

time and manner of payment.[15] For example, if a check is placed in the mail on December 31, the deduction is allowed in that year, even though the charitable or educational donee does not receive the check, and the check is not deducted from the donor's bank account, until the following year. The fact that the donor has the right to stop payment on the check does not alter this result.

Promissory notes and pledges are generally not deductible until the promised amount has actually been paid,[16] although the IRS has ruled that a donor who executed an irrevocable letter of credit from a bank to a charity was entitled to a deduction for the full amount of the letter of credit on the date it was established.[17] If a donor attempts to make a payment by credit card, the IRS position is that the charged amount is deductible on the date that the charge is made to the card.[18]

Another type of payment that raises the cash equivalency issue is a payment that is made not to the charity but to a third party on the charity's behalf. Clearly, if the payment operates to satisfy a legal obligation of the college or university (e.g., paying legal bills incurred by the school), the donor is allowed to claim the deduction as if the gift were made directly to the institution. Also, a taxpayer is allowed to deduct incidental unreimbursed expenses made during the course of rendering services for the school, although the value of the services rendered is nondeductible.[19] The incidental expenses must be incurred in connection with that benefit the institution receives and not for personal or business reasons.[20] For example, local transportation expenses incurred by a taxpayer in traveling from the taxpayer's residence to the place where the services are rendered are deductible.

In order to be deductible, the payment need not necessarily be in cash or a cash equivalent—contributions or gifts of property also qualify, but the donor must part with full dominion and control over, and ownership of, the property in order for there to be the requisite ''payment.''[21] For example, a gift of stock is considered complete on the date that a properly endorsed stock certificate is unconditionally delivered to the donee[22]; a contribution of real estate is complete on the date that the donor delivers to the donee an executed deed that operates to transfer the real property[23]; and a gift of tangible personal

[15]Treas. Reg. § 1.170A-1(b). The IRS has issued a ruling describing those situations in which the delivery of a check to a noncharitable donee will be deemed to be complete for estate and gift tax purposes. Rev. Rul. 96-56, 1996 I.R.B. 7, modifying Rev. Rul. 67-396, 1967-2 C.B. 351.
[16]*Guren v. Commissioner*, 66 T.C. 118 (1976).
[17]Priv. Ltr. Rul. 8420002 (Feb. 16, 1984).
[18]Rev. Rul. 78-38, 1978-1 C.B. 67.
[19]Treas. Reg. § 1.170A-1(g).
[20]IRC § 170(j).
[21]*Pauley v. United States*, 459 F.2d 624, 626 (9th Cir. 1972).
[22]Treas. Reg. § 1.170A-1(b).
[23]*Johnson v. United States*, 280 F. Supp. 412, 414 (N.D. N.Y. 1967).

property (e.g., works of art, books, cars, boats) is complete on the date that the donor parts with dominion and control over the property.

Finally, the law is explicitly clear that no deduction is allowed for the value of services performed by the taxpayer for a charitable or educational organization, although, as noted above, any unreimbursed expenses incurred in connection with performing the services are deductible.[24] In some cases, however, there is a question as to whether the contribution constitutes services or property. For example, in one case an independent filmmaker donated to a charity certain films that the taxpayer had made. The IRS argued that the contribution represented services performed by the taxpayer and denied the claimed charitable contribution, but the court allowed the deduction, holding that the contribution should be treated as one of property.[25]

§ 6.3 PERMISSIBLE DONEES

In order for a payment to be deductible, the contribution or gift must be made to (1) a state or the United States, but only if made exclusively for a public purpose, or (2) a charitable, educational, or similar type of organization organized or created in the United States and that has been recognized by the IRS as exempt from income tax under section 501(c)(3) of the Code.[26] The requirement that the payment be made to a certain type of organization does not normally cause a problem when the college or university is the donee because virtually all educational institutions qualify, assuming they are organized on a nonprofit basis.

(a) Designated Contributions—Fraternities and Sororities

Even though a college or university will almost always meet these requirements, an issue can arise if the contributor designates that the contribution be used by the school for a particular purpose that is not charitable or educational in nature. For example, a deduction was denied in the case of a contribution made to a college to pay tuition for the donor's grandson.[27] Nevertheless, a donor can request—but not demand or require—that the recipient organization use the funds in a specified manner. Thus, a deduction was allowed where the donor gave funds to an organization with the request that it grant

[24]Treas. Reg. § 1.170A-1(g).

[25]*Holmes v. Commissioner*, 57 T.C. 430, 436 (1971).

[26]IRC § 170(c).

[27]*Cooper v. Commissioner*, 264 F.2d 889, 890 (4th Cir. 1959). *See also* Priv. Ltr. Rul. 9829053 (Apr. 22, 1998), in which the IRS ruled that contributions to a university for the construction of a new building on campus to provide additional meeting space for students are deductible as charitable contributions under IRC § 170. The university planned to lease part of the building to a nonprofit corporation that was made up of sororities on campus, and the nonprofit corporation, in turn, would lease space in the building to its member sororities. While the corporation would conduct the fund-raising campaign, all funds would be paid directly to the university.

scholarships with a preference for the donor's relatives.[28] And, the IRS held that a couple could deduct their gift to a section 501(c)(3) organization when they requested but did not require, that their gift be used to support the work of a particular music composer. Even though the contributed funds were used by the organization to support the composer, that the organization had unrestricted discretion and control over the funds was sufficient to avoid treating the organization as a conduit of funds to the composer.[29]

These designated contribution rules come into play when a donor makes a contribution to a college or university for use by a specific campus fraternity or sorority. A number of years ago, the IRS ruled that contributions made to a college for the purpose of acquiring or constructing a housing facility for use by a designated fraternity are deductible by the donors.[30] Under the facts of this ruling, the college owned the fraternity houses and rented them to the fraternities under short-term leases. Even though a non-section 501(c)(3) organization (the fraternity) obviously derived some benefit from the contributions, the IRS ruled that the contributions were deductible because it found that the gift was, in reality, made to the college and not the fraternity. Of key importance was the fact that the college, and not the fraternity, owned the housing facilities and rented them to the fraternity under short-term leases that the college could decide whether or not to renew. Therefore, the IRS found that the college would be the primary beneficiary of the gift. Also, the facts indicated that the college had the right of ownership in the donated funds and was free to use the funds for other purposes if it chose to do so. The IRS cautioned that it would have found the college to be a conduit of funds to the fraternity (and therefore would have disallowed the claimed deduction) if the gift was limited by conditions or restrictions that, in effect, made the fraternity the beneficiary of the donated funds.

Relying on this earlier ruling, the IRS reached the same conclusion in a 1997 private letter ruling.[31] This ruling involved a university that engaged in fundraising solicitations for the purpose of renovating a particular fraternity house. Like the college in the earlier ruling, the university owned the house and rented it to the fraternity under a short-term lease. As part of its fund-raising solicitations, the university advised prospective donors that, although it planned to use the funds to renovate the fraternity house, it nevertheless retained the right to use the donated funds as it wished.[32]

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[28]*Canal Nat'l Bank v. United States*, 258 F. Supp. 626, 630 (S.D. Me. 1966). *See also* Priv. Ltr. Rul. 9829053 (Apr. 22, 1998), discussed in footnote 27 above.

[29]Priv. Ltr. Rul. 200250029 (Mar. 20, 2002).

[30]Rev. Rul. 60-367, 1960-2 C.B. 73.

[31]Priv. Ltr. Rul. 9733015 (May 19, 1997). See also Priv. Ltr. Rul. 199929050 (Apr. 30, 1999), and Priv. Ltr. Rul. 200003013 (Oct. 20, 1999), both of which reached essentially the same conclusion on similar facts.

[32]See also Priv. Ltr. Rul. 200538026 (June 28, 2005) in which the IRS addressed a university that proposed to solicit gifts from alumni to renovate a fraternity house owned by the fraternity

In addition, the IRS has ruled that contributions made by fraternity alumni and others to a foundation that was organized and operated for the purpose of maintaining and preserving the facade and interior portions of a designated fraternity house qualified as charitable contribution deductions.[33] The fraternity house in question was listed on the National Register of Historic Places and was owned by a nonexempt housing corporation. The IRS ruling, however, was conditioned on this housing corporation's granting a preservation and conservation easement that qualified as a ''qualified conservation contribution'' under section 170(h)(1). The IRS rationale was that the proposed donations were, in substance, donations to both the charitable foundation and the recipient of the conservation easement in furtherance of their respective exempt purposes.

But in an earlier ruling, the IRS disallowed deductions relating to the restoration of a fraternity house.[34] This ruling involved a section 501(c)(3) historical preservation society that proposed to make a grant to a corporation that owned a fraternity chapter house that was located within the boundaries of an area that met the standards of the National Register of Historic Places. The grant would cover the portion of the renovation costs that the society considered attributable to historic preservation. The society did not plan to use any of its own funds to make the grant; rather, it proposed to solicit contributions from individuals who had an interest in the fraternity house, primarily fraternity alumni. The IRS held that contributions to the society by the fraternity alumni members would not be deductible, even though the society retained the right to use the contributed funds as it saw fit and refused to accept funds earmarked to renovate the house. The IRS said that ''the charitable donee's discretion and control are merely the threshold test,'' and that a second test—whether the donor expected a benefit in return for the gift—must also be met. Here, the IRS said that the alumni contributors expected benefits to flow to a third party (the fraternity) in which the alumni had a significant personal interest. Therefore, their contributions to the historical society were not deductible.

(b) Contributions to Foreign Charitable and Educational Organizations

Another issue that arises within the ''permissible donee'' context involves foreign charitable and educational organizations. In order to qualify as a

but located on the university's campus. The university entered into a ground lease with the fraternity under which it leased to the fraternity the land on which the house was located. The university represented to the IRS that all funds donated to the university would be earmarked by donors for the renovation of the house. The IRS ruled the university's section IRC § 501(c)(3) status would not be adversely affected by the renovation activities, and though the IRS did not specifically rule on whether the contributions to the university would be deductible under IRC § 170, the implication from the ruling is that they would be.

[33]Priv. Ltr. Rul. 199933029 (May 24, 1999).

[34]Priv. Ltr. Rul. 9118012 (Jan. 31, 1991). *See also* Priv. Ltr. Rul. 9119001 (Jan. 31, 1991), which is virtually identical.

permissible donee eligible to receive tax deductible contributions, the organization must be one that is organized or created in the United States.[35] Therefore, no matter how charitable or educational a foreign organization may be (e.g., Oxford University), a contribution made directly to it is not deductible for U.S. tax purposes. Thus, if a U.S. college or university establishes a school in a foreign country, contributions made directly to the school are not deductible for U.S. tax purposes. This is the case even if the foreign school has received its own section 501(c)(3) tax-exempt status from the IRS, which foreign charitable and educational organizations can do. Of course, if the school in the foreign country is not separately incorporated or organized, but is simply an extension and part of the U.S. school, the contribution will be treated as made to the U.S. school and therefore be deductible.

A corollary of this rule is that a charitable contribution deduction will be disallowed if the contribution is made to a U.S. organization, but with the requirement that the U.S. organization distribute the amount to a specific foreign charity.[36] In these cases, the U.S. organization is acting as a mere conduit for the distribution of funds to the foreign charity, and the contribution is treated, in substance, as if it were made to the foreign charity. The IRS has issued guidelines, however, that, if followed to the letter, permit a donor to claim a deduction if the contribution is made to a U.S. charitable or educational organization with the request that the funds be distributed to a foreign organization. Essentially, these guidelines require that the U.S. organization maintain legal ownership over the donated funds and make the contribution to the foreign organization as a result of its own decision, not that of the donor.[37]

Another foreign-related restriction in the charitable contribution deduction area often causes confusion. The Code provides that a ''contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible. . .only if it is used within the United States or any of its possessions. . . .''[38] This provision is often interpreted to mean that contributions received from a corporation must be used by the donee organization for U.S. activities and cannot be used overseas. In a 1969 ruling, however, the IRS carved the heart out of this provision by ruling that it does not apply to contributions made to charitable or educational ''corporations'' because the statute does not include such entities in the list of recipients.[39] Because most section 501(c)(3) organizations are organized as nonprofit corporations under state law, this restriction hardly ever comes into play, and virtually all corporate contributions are deductible, even if used by the donee organization overseas.

[35]IRC § 170(c).
[36]Rev. Rul. 63-252, 1963-2 C.B. 101.
[37]*Id.;* Rev. Rul. 66-79, 1966-1 C.B. 48.
[38]IRC § 170(c) (flush language).
[39]Rev. Rul. 69-80, 1969-1 C.B. 65.

(c) List of Permissible Donees

The IRS publishes a list of permissible donees in Publication 78, entitled *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*. The IRS also includes the Publication 78 list on its web site, which can be found at *www.irs.gov*. The purpose of the list is to advise taxpayers regarding which organizations qualify for tax deductible contributions without requiring the organizations to submit a copy of their exemption letters to prospective donors and constantly having to ask the IRS to confirm their status as a qualified organization. The list is updated periodically, but the IRS warns that the list is ''not all-inclusive'' and that a copy of an exemption letter will generally serve as sufficient evidence of the organization's right to receive tax-deductible contributions.

§ 6.4 NO CONSIDERATION RECEIVED IN RETURN

Section 170 requires that, in order to be deductible, the transfer of the money or property to the charitable or educational organization must be a ''contribution or gift.''[40] This term has been defined by the Supreme Court as a ''transfer of money or property without adequate consideration.''[41] A corollary principle is that the gift or contribution must be made with donative intent. The classic definition of this concept was set forth by the Supreme Court, which held that in order to be excludable from the recipient's gross income as a ''gift,'' the transfer must be made with ''detached or disinterested generosity'' and without any expectation of receiving an economic benefit in return.[42] Some courts have used the ''detached-and-disinterested-generosity'' test in the charitable deduction area, but other courts have refused to do so.[43] Another test that has been used is whether the donor expected to receive (or actually did receive) a quid pro quo benefit in return.[44] This is an easier test to apply because various objective factors are examined to see if a quid pro quo return was part of the transfer. By contrast, the detached-and-disinterested-generosity test requires a subjective examination of the taxpayer's motivation in making the transfer, and is usually a much harder determination to make.

If the taxpayer transfers money or property to a charitable organization and receives in return something that is valued in an amount equal to or greater than the value of the transferred item, no deduction is allowed because

[40] IRC § 170(c).
[41] *United States v. American Bar Endowment*, 477 U.S. 105, 118 (1986).
[42] *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960); gifts are excludable from gross income under IRC § 102.
[43] *Compare Howard v. Commissioner*, 39 T.C. 833 (1963), with *United States v. Transamerica Corp.*, 392 F.2d 522 (9th Cir. 1968).
[44] *Singer Co. v. United States*, 449 F.2d 413, 414 (Ct. Cl. 1971);*Arceneaux v. Commissioner*, 36 T.C.M. (CCH) 1461, 1464 (1977).

all the taxpayer has done is purchase property or services. For example, if the taxpayer transfers $500 to a university and receives in return season football tickets valued at $500, no deduction is allowed. If, however, the taxpayer pays the university $2,000 for the same tickets, with the intent that the extra $1,500 be used to support the school's athletic department, the excess $1,500 is deductible. In one case, a court denied a deduction to a company where the company paid money to a university to permit the school to purchase a calculator, but the company retained the right to use the calculator for three months during each year over a 20-year period.[45] The rationale was that the company had simply purchased the use of the calculator and had not ''given'' the school anything more than what it received.

(a) Tuition Payments

This ''consideration-received-in-return'' issue often arises in connection with tuition payments made to a school and whether the payor has the requisite donative intent. Courts have held that payments made to a school to permit a particular person to attend the school are not deductible as charitable contributions because the donor received something of equal value in return—the education of the individual attending the school.[46] Nevertheless, some situations are not so clear, and the IRS has issued guidance to help distinguish tuition payments from charitable contributions.[47] According to those guidelines, a transfer by a parent of money or property to a school is treated as a charitable contribution if all of the facts and circumstances clearly demonstrate that (1) the child's enrollment was not contingent on the payment, (2) the payment was not made under an agreement to convert the amount of the payment to a tuition payment, and (3) the ability to attend the school was not otherwise dependent on the payment. The guidelines state that certain factors create a presumption that the payment is not deductible: A contract under which the parent agrees to make a contribution and the child is permitted to attend the school; a plan under which the parent either pays tuition or makes a ''contribution''; situations in which the contribution is earmarked for a particular individual; and an unexplained denial of

[45] *Allis-Chalmers Mfg. Co. v. United States*, 200 F. Supp. 91, 94 (E.D. Wis. 1961).

[46] *Ryan v. Commissioner*, 28 T.C.M. (CCH) 1120, 1122 (1969);*Sklar v. Commissioner*, T.C. Memo 2000-18 (2000), *aff'd* 282 F.3d 610 (9th Cir. 2002); *Sklar v. Commissioner*, 125 T.C. 281(2005), which contains a good discussion of the law in this area. *See also* Rev. Rul. 79-99, 1979-1 C.B. 108, which concerned a fixed ''donation'' that was required to be paid with the tuition was held nondeductible. This ruling was subsequently superseded by Rev. Rul. 83-104, 1983-2 C.B. 46, which sets forth different factual situations illustrating the distinction between charitable contributions and tuition payments. *See also* ILM 200623063 (AQpr. 20, 2006) in which the IRS said that a penalty under IRC § 6714 should be imposed against a church that received ''contributions'' that allowed the donors to send their children to a school operated by the church.

[47] Rev. Rul. 83-104, 1983-2 C.B. 46.

admission to children whose parents choose not to make contributions. These guidelines contain the following examples to illustrate the application of these principles:

> **Example 1:** S, a private school, requests parents to make a $1,000 contribution for each child enrolled at S. Parents who do not contribute are obligated to pay tuition of $1,000 for each child enrolled at S. Children of parents who neither contribute nor pay tuition cannot attend S. In response to S's solicitation of contributions, P pays $2,000 to S. Two of P's children are enrolled at S. P's payment to S represents tuition and cannot be deducted as a charitable contribution.[48]
>
> **Example 2:** R operates a private school for the secular and religious education of its members' children. R does not charge tuition. R solicits contributions from members, nonmembers, and area churches; however, contributions from nonmembers and churches represent an insignificant amount of R's total support. Parents with children attending R typically contribute to R on a regular, established schedule. R's treasurer periodically makes personal appeals to parents to contribute in accordance with their financial abilities. P, a member of R with a child enrolled in the school, made a contribution to R. P's contribution is not deductible.[49]
>
> **Example 3:** Q operates a private school. Q's tuition charge is $3,000 per student. Q solicits contributions from parents of children attending its school. The solicitation materials indicate that the parents have been singled out as a class for solicitation and suggest contribution levels based on financial ability to pay. The solicitations are not timed to coincide with application or enrollment procedures. No unusual pressure is placed on parents to contribute; some parents contribute, and some parents do not respond. Q also receives contributions from alumni and other individuals. P, a parent of a child enrolled in the school, contributed $1,000 to Q. P's contribution is deductible.[50]

The IRS was called on to apply these principles in the case of parents who made tuition payments to a Jewish religious school and claimed a charitable contribution for the payments on the ground that they and their children received only incidental benefits from these payments and that the primary beneficiaries were the members of the Jewish faith.[51] The IRS refused to analyze the issue by weighing the religious versus the secular nature of the payments; rather, the IRS relied on a 1989 Supreme Court decision holding that payments made by members of the Church of Scientology for auditing and training were not deductible because the contributor expected to receive a quid pro quo from the contribution.[52] In the same manner, the IRS said that the tuition payments

[48] *Id*. at 46, 48.
[49] *Id*. at 46–47, 48. The negative factors are (1) R's economic dependence on the parents' contributions; (2) the regular schedule for making contributions; and (3) the personal solicitations by a school official, which suggest unusual pressure to contribute. *Id*. at 48.
[50] *Id*. at 48, 49.
[51] FSA 2000-1 (July 11, 1997).
[52] *Hernandez v. Commissioner*, 490 U.S. 680 (1989).

made by the parents ''entitled their children to attend a facility where, in the company of others and under the supervision of a trained rabbi or instructor they could engage in regular religious study and prayer.'' The IRS went on to say that the ''inquiry ends there; the doctrinal content and significance of the activity is [*sic*] not germane.''

(b) Fund-Raising Events

As noted earlier, there is a potential problem with claiming the charitable contribution tax deduction whenever the donor receives some benefit in return. On the one hand, if the donor receives a product, service, or other benefit that has a value that equals or exceeds the amount of the contribution, the deduction is disallowed in full. On the other hand, if the benefit received is de minimis or incidental, the full amount of the contribution is deductible. In those cases in which the value of the benefit received is more than incidental, but less than the amount of the contribution, the Supreme Court has held that the deduction is allowed but only to the extent of the excess of the contribution over the value received, and the excess amount must be made with the intention of making a gift.[53] As discussed later in section 6.6, Congress enacted substantiation rules with regard to these types of quid pro quo contributions.

This situation arises frequently in the case of fund-raising events, such as banquets, shows, and athletic events, in which the individual makes a payment to the charitable organization but receives a benefit in return—that is, the right to attend the event. The IRS has formulated a two-part test that has been cited with approval by the Supreme Court to determine whether such payments are deductible and, if so, to what extent.[54] Under this test, if the taxpayer receives a benefit in connection with a fund-raising event, there is a presumption that the payment is not a gift and that the deduction should be disallowed. The taxpayer can rebut this presumption, however, by showing, first, that the payment exceeded the value received and, second, that the payment of this excess amount was made with the intention of making a gift.

The IRS has issued rulings that illustrate this principle:

> A symphony association sponsors a gala symphony performance as part of a fund-raising effort to solicit contributions for a new symphony hall. Admission prices for the gala performance are $100 for orchestra tickets and $50 for balcony tickets. The established admission charges for comparable symphony performances are $40 for orchestra tickets and $25 for balcony tickets. This information is reflected in all promotional materials for the gala. D purchased two orchestra tickets for $200. The value of D's admission privilege is $80. Applying the two-part test, D's payment of $200 exceeds the $80 benefit that D received. Moreover, based on the association's publicity of its use of the gala as an occasion for soliciting contributions, it appears

[53] *American Bar Endowment*, 477 U.S. at 118.

[54] Rev. Rul. 67-246, 1967-2 C.B. 104, cited with approval in *American Bar Endowment*, 477 U.S. at 118.

> that D intended to make a gift of the excess. Thus, of D's total payment of $200, $120 ($200 payment less $80 benefit received) constitutes a charitable contribution.[55]
>
> A theater group sponsors a season series of six theatrical performances. The cost of a season ticket is $60, or $10 per performance. Tickets to individual performances are sold for $15. D and E each purchased a season ticket. Because she was unable to attend the first performance, D donated her ticket for that performance to the theater group for resale. D has made a charitable contribution and may deduct $10, her cost of the ticket.[56] E, who was also unable to attend the first performance, simply retained his unused ticket. E is not eligible to deduct any part of his payment to the theater group as a charitable contribution.[57]

The same issue arose in a case involving a university that conducted a sweepstakes program that was open to the general public.[58] Under this program, sweepstakes tickets were mailed to members of the general public for free, and the person was required to return an entry form in order to participate. As part of the mailing, the university solicited voluntary contributions but made it clear that a person's chances of winning the sweepstakes prizes were not conditioned on receipt of a contribution. The IRS said that the general rule that the value of the gift must be reduced by the value of what is received in return for the gift was not applicable here because the person's ability to win the sweepstakes prizes did not depend on whether the person made a contribution; therefore, the person received nothing in return for the contribution and was entitled to a full deduction for the amount of the contribution.

(c) Payments for Right to Purchase Athletic Event Tickets

This consideration-received-in-return issue has particular application in connection with fund-raising programs in which individuals make a payment to a college or university and receive in return the right to purchase seating at athletic events. The fact that the donor receives something of value in return for the contribution (the right to purchase the tickets) raised a substantial question as to the deductibility of the payment, and during the 1980s, the IRS issued rulings permitting the donor to claim a charitable contribution deduction, but only for the excess, if any, of the amount contributed over the value of the ticket purchase privilege. Because of the many difficulties associated with valuing this privilege, Congress in 1988 enacted a special provision that permits a donor to claim a deduction if (1) the contribution is made to an educational institution and (2) the donation would otherwise be deductible as a charitable

[55]Rev. Rul. 67-246, 1967-2 C.B. at 107–08.

[56]Rev. Rul. 74-348, 1974-2 C.B. 80 (distinguishing Rev. Rul. 67-246, 1967-2 C.B. 104).

[57]Rev. Rul. 67-246, 1967-2 C.B. 104, 108. The same result would occur if E had given his ticket to another individual. *Id*. at 108. ''The test of deductibility is not whether the right to admission or privileges is exercised but whether the right was accepted or rejected by the taxpayer.'' *Id*. at 106.

[58]Priv. Ltr. Rul. 200012061 (Dec. 21, 1999).

contribution but for the fact that the donor received the right to purchase tickets for seating at an athletic event in the stadium of the institution.[59] If these two tests are met, the donor is allowed a deduction in an amount equal to 80 percent of the amount contributed.

The statute makes it clear that it does not apply to the actual purchase of tickets, which is subject to the normal rule that no deduction is allowed if the benefit received is equal to the amount paid.[60] If a donor makes a payment to a college or university that consists of both the right to purchase tickets and the purchase of the tickets themselves, the payment must be bifurcated, with the portion allocable to the right to purchase subject to the 80 percent rule. To illustrate:

> University X announces that a contribution of $1,500 or more to its athletic scholarship program entitles a contributor to purchase season tickets for home football games. Because University X has a successful football program, season tickets are in great demand and are usually unavailable to those not making contributions. D sends State University a check for $1,800, consisting of a $1,500 contribution to the scholarship program and $300 for two season tickets. D's $1,500 contribution to the scholarship program is subject to this special rule, and D may treat $1,200 ($1,500 × 80 percent) as a charitable contribution. D may not deduct either the remaining $300 of the $1,000 contribution or the $300 paid to purchase the tickets.[61]

Some schools and donors have taken the position that payments allocable to the right to purchase tickets in skybox suites in athletic facilities qualify for a deduction under section 170(*l*) and are not disallowed under the rules of section 274. In one specific case, a company claimed such a charitable contribution deduction and was audited by the IRS. The IRS agent asked the national office for assistance under the technical advice procedures, and the national office allowed the deduction.[62]

The case involved a company that made a $200,000 payment to a foundation affiliated with Iowa State University. In consideration for this payment, the company received (1) a lease for a specific skybox for university home football games for 10 years; (2) parking for four cars for each game; and (3) passes for six guests to visit persons sitting in the skybox before the game and during half-time. The company initially computed its charitable contribution

[59]IRC § 170(*l*). Note that this provision does not apply if the event is not held in the school's own stadium, for example, bowl games or NCAA tournament basketball games. For the rules that existed prior to the enactment of this provision, see Rev. Rul. 86-63, 1986-1 C.B. 88.

[60]IRC§170(*l*)(2)(flush language).

[61]IRC § 170(*l*)(2) states that if a donor makes a payment to an educational institution both for the right to purchase tickets and for the purchase of the tickets themselves, the portion of the payment subject to the 80 percent rule and the portion representing the ticket purchase are treated as separate amounts for purposes of IRC § 170(*l*).

[62]Tech. Adv. Mem. 200004001 (July 7, 1999). Although this technical advice memorandum was released by the IRS in redacted form, the original copy of the memorandum, which included the names of the parties involved, was widely circulated within the college and university community shortly after the letter was issued by the IRS National Office. For a discussion of the IRS technical advice procedures, *see* § 10.8.

deduction by valuing the skybox lease at $19,872, the pregame parking at $648, and the passes to visit the skybox at $0. It subtracted the total value of these benefits ($20,520) from the $200,000 contribution and applied the 80 percent amount permitted by section 170(*l*) to the difference, there by claiming a tax deduction of $143,584.

During consideration of the case at the national office, the company conceded that an additional $19,200 should have been subtracted from the $200,000 payment to reflect the value of 16 skybox tickets, thereby reducing its charitable contribution deduction by an additional $15,360 (i.e., 80 percent of $19,200). It is interesting to note that the IRS permitted the company to value the skybox tickets at the same price as the amount paid for nonluxury seat tickets in the university's stadium.

Although the IRS national office did not rule on the valuations of each of the items (saying that these are issues best left to the field agents), it did conclude that the company had made a payment that gave it the right to buy seating at athletic events at the university's stadium and that 80 percent of the portion of the payment allocable to such right was deductible under section 170(l), even though ''the seating is located in a special viewing area within the athletic stadium.'' Moreover, the national office ruled that the deduction was not disallowed by section 274, which generally disallows any deduction claimed with respect to an entertainment facility. The rationale for this conclusion was based on section 274(f), which generally provides that the disallowance rules of section 274 will not apply if the payment would be deductible under another Code section that applies to both business and nonbusiness taxpayers. Because the deduction under section 170(l) is allowed without regard to the business or nonbusiness nature of the taxpayer, the national office ruled that the section 274 disallowance rules were not applicable.

What if a school added $20 to the ticket price of one home game, with the additional amount earmarked for a charitable purpose? Would the fact that the additional $20 was paid for the ticket itself cause the deduction to be disallowed? Probably not, because the purchaser should be able to show that the value received (the right to attend the game) was represented by the normal ticket price, with the extra $20 being over and above that amount, and that the $20 was paid with the intent that it be distributed for charitable purposes.

(d) Receipt of Low-Cost Items

The no-consideration-in-return rule that applies in the case of charitable contribution deductions would, if taken literally, prohibit a full deduction any time the donor received some type of token benefit (e.g., coffee mug, calendar) in return for making the contribution. But the IRS has issued guidelines relating to such contributions that provide safe harbor rules under which the value of the benefit is treated as insubstantial in amount, so that the donor can disregard the benefit in determining the amount of his or her charitable contribution.

Under the first safe harbor rule, a benefit is deemed to have an insubstantial fair market value if (1) the contribution occurs in the context of a fund-raising campaign in which the charitable recipient advises donors how much of their payment is a deductible contribution and (2) the transaction meets one of the two following alternative tests:

1. The fair market value of all benefits received in connection with the contribution does not exceed the lesser of 2 percent of the contribution or $50

   OR

2. The contribution is $25 or more and the only benefits received in connection with the contribution are token items such as mugs, posters and tee shirts, bearing the charitable recipient's name or logo.[63]

These guidelines also contain a safe harbor rule pertaining to newsletters or program guides distributed by the organization to its members or patrons. Under these guidelines, a newsletter or program guide is deemed not to have a measurable fair market value if (1) the primary purpose of the newsletter or program guide is to inform members about the organization's activities, and (2) the newsletter or program guide is not available to nonmembers by paid subscription or through newsstand sales. The guidelines specifically state, however, that this safe harbor rule does not apply in the case of commercial-quality publications, which are generally professional journals and publications that compensate authors and accept advertising. To illustrate the application of these rules, assume that a contributor to a college is entitled to receive a monthly newsletter, the primary purpose of which is to inform donors about upcoming college events. The newsletter is not available to nonmembers, is prepared by a salaried employee of the college, and does not accept advertising. Because the newsletter is not a commercial-quality publication, and the other guideline tests are met, the college may inform donors that the full amount of their payments qualifies as deductible contributions.

In a subsequent set of guidelines, the IRS addressed charitable or educational organizations that mail or distribute unordered items to prospective donors for free. Under these guidelines, the item is deemed to have an insubstantial fair market value if (1) the item is not distributed at the patron's request, (2) the item is accompanied by a request for a charitable contribution and a statement that the donor may retain the item regardless of whether the contribution is made, and (3) the cost of all items distributed to donors in a calendar year is within the limitations for ''low-cost articles.''[64]

[63]Rev. Proc. 90-12, 1990-1 C.B. 471, amplified by Rev. Proc. 92-49, 1992-1 C.B. 987. These amounts are adjusted for inflation annually, and for 2007, the inflation-adjustment amount is $44.50 in lieu of $25 and $89 in lieu of $50. Rev. Proc. 2006-53, 2006-48 I.R.B. 996.

[64]Rev. Proc. 92-49, 1992-1 C.B. 987.

§ 6.5 GIFTS OF PATENTS AND RELATED RIGHTS

In a ruling issued in 2003, the IRS described three different conditions imposed on gifts of patents and analyzed their effect on the grantor's ability to claim a charitable contribution deduction.[65]

Situation 1. The taxpayer contributed to a university a license to use a patent but retained the right to license the patent to others. The IRS said that this constituted a ''partial interest'' in the patent and was, therefore, nondeductible under section 170(f)(3), which disallows deductions for gifts of partial interests. The IRS said that the same conclusion would pertain if the taxpayer had retained other substantial rights in the transferred patent, such as the right to use the patent in other geographical areas.

Situation 2. The taxpayer contributed a patent to a university subject to a condition that a particular faculty member, who was an expert in the technology covered by the patent, remained employed by the university for the remaining life of the patent, which was 15 years. The IRS said that this situation falls within the scope of the rule that says no deduction for a transfer of property that may be defeated by the happening of an event shall be allowed unless the possibility that the event will occur is so remote as to be negligible.[66] The IRS concluded that the possibility that the faculty member would leave the university's employ within the next 15 years was not so remote as to be negligible.

Situation 3. The taxpayer contributed all of his interest in a patent to a university, but the transfer agreement provided that the university could not sell or license the patent for a period of three years. Because the three-year restriction did not benefit the taxpayer and there were no circumstances under which the patent could revert to the taxpayer, the IRS concluded that the charitable contribution deduction would be allowed. The IRS did note, however, that the fact that the university could not sell or license the patent for three years would likely affect the fair market value of the patent.

Individuals and corporations routinely contribute patents and other items of intellectual property to colleges, universities, and scientific research institutions and claim a charitable contribution deduction under section 170 for the claimed value of the gift. Over the past few years, several research universities have reported being contacted by IRS agents as part of an IRS audit of the individual or company that donated the patent or intellectual

[65]Rev. Rul. 2003-28, 2003-11 I.R.B. 594.

[66]Rev. Rul. 74-348, 1974-2 C.B. 80 (distinguishing Rev. Rul. 67-246, 1967-2 C.B. 104).

property to the university. In some cases, the IRS agents appeared to question the donor-determined value of the intellectual property, and in others, questions were raised as to whether donor employees continued to work on patent-related research projects after the transfer. Based on these reports, it was clear that the IRS viewed with suspicion many contributions of patents and other intellectual property to colleges, universities, and other section 501(c)(3) organizations.

The IRS has formally announced that it is going to review these intellectual property contributions and will disallow any claimed charitable contribution deductions if the circumstances warrant.[67] The IRS said it has encountered the following four issues in connection with patent and intellectual property contributions:

1. *Partial interest*. The transfer is of a nondeductible partial interest in the intellectual property. For example, the donor retains a right to manufacture or use products covered by the contributed patent.
2. *Quid pro quo*. The donor expects to receive something of value in return for the contribution. For example, the donation agreement states that the college or university donee assumes the donor's liability for a lease of a research facility in which work on the patent will be done, or the university donee agrees to hold the patent for a specific period of time.
3. *Substantiation*. There is inadequate substantiation of the contribution; that is, substantiation that does not meet the rules of section 170(f)(8).
4. *Inflated value*. The value of the contributed intellectual property has been overstated. For example, a patent's value may be substantially diminished if: (a) the patented technology has been made obsolete by other technology, (b) there are restrictions on the donee's right and ability to use the patent, or (c) there is little remaining time on the life of the patent.

In addition, a provision added by the American Jobs Creation Act of 2004[68] significantly changed the charitable contribution deduction rules with respect to gifts of patents and intellectual property.

By way of background, charitable contributions of capital gain property are generally deductible at fair market value. Under this provision added by the 2004 tax act, however, if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a college, university, or other section 501(c)(3) organization, the taxpayer's initial charitable deduction will be limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[69] In addition, the taxpayer is permitted

[67]Notice 2004-7, 2004-3 I.R.B. 310.
[68]Pub. L. 108-755.
[69]IRC § 170(m).

to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the ''qualified donee income'' received by the college or university with respect to the contributed property.[70] For this purpose, ''qualified donee income'' includes net income received or accrued by the school that is properly allocable to the intellectual property as opposed to the activity in which the intellectual property is used.[71]

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income determined as follows[72]:

TAXABLE YEAR OF DONOR	DEDUCTION PERMITTED FOR SUCH TAXABLE YEAR
1st year ending on or after contribution	100 percent of qualified donee income
2nd year ending on or after contribution	100 percent of qualified donee income
3rd year ending on or after contribution	90 percent of qualified donee income
4th year ending on or after contribution	80 percent of qualified donee income
5th year ending on or after contribution	70 percent of qualified donee income
6th year ending on or after contribution	60 percent of qualified donee income
7th year ending on or after contribution	50 percent of qualified donee income
8th year ending on or after contribution	40 percent of qualified donee income
9th year ending on or after contribution	30 percent of qualified donee income
10th year ending on or after contribution	20 percent of qualified donee income
11th year ending on or after contribution	10 percent of qualified donee income
12th year ending on or after contribution	10 percent of qualified donee income
Taxable years thereafter	No deduction permitted

Also, if a college or university receives a donation of a patent or intellectual property, it is required to inform the donee at the time of the contribution that the school intends to treat the contribution as a contribution subject to these special charitable deduction rules.[73] The IRS has issued additional guidance regarding these qualified intellectual property contribution notification rules, including Notice 2005-41[74] and temporary regulations under section 6050L.[75]

§ 6.6 THE SUBSTANTIATION AND DISCLOSURE REQUIREMENTS

In 1993, Congress imposed two new requirements concerning charitable deductions. These requirements are sometimes referred to as the ''substantiation'' and ''disclosure'' requirements.

[70]IRC § 170(m)(1).
[71]IRC § 170(m)(3).
[72]IRC § 170(m)(7).
[73]IRC § 170(m)(8)(B).
[74]2005-23 I.R.B. 1.
[75]Temp. Treas. Reg. § 1.6050L-2T.

Under the substantiation requirement, no deduction is allowed for any charitable contribution of $250 or more unless the donor has a ''contemporaneous written acknowledgment'' from the donee organization.[76] The acknowledgment must contain three items:

1. The amount of any cash contribution, or, in the case of noncash contributions, a description of the property
2. A statement of whether the donee organization provided any goods or services to the donor in consideration for the contribution
3. If any goods or services were so provided, a description and good-faith estimate of the fair market value of the goods or services[77]

The acknowledgment must be ''contemporaneous.'' This means the acknowledgment must be received by the earlier of (1) the date the donor actually files the donor's tax return for the year of the contribution, or (2) the due date (including extensions) of the return.[78] The acknowledgment need not be in any particular form. Letters, postcards, or computer-generated forms are acceptable, and the acknowledgment does not have to include the donor's Social Security number or tax identification number.[79] The acknowledgment may be provided for each contribution of $250 or more, or may be provided in a periodic statement, for example, an annual summary.[80] For purposes of the $250 threshold, separate contributions of less than $250 are not aggregated.[81] Although the IRS is authorized to prescribe antiabuse rules to prevent avoidance of the substantiation requirement by writing multiple checks on the same date, no such rules have as yet been prescribed.[82]

An issue of current concern in the substantiation area is whether and to what extent taxpayers can meet the substantiation requirements with a printed web confirmation page or a copy of an e-mail confirmation from the donee organization. The IRS has sought guidance from the general public on this and various other Internet-related questions[83] but in one case has said that the IRS would most likely accept a timely supplied electronic mail message that contains the necessary information.[84]

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[76]IRC § 170(f)(8)(A).

[77]IRC § 170(f)(8)(B)(i)–(iii). In 2006, Congress added IRC § 170(f)(17), which provides that no deduction shall be allowed for any cash or other monetary contribution ''unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.''

[78]IRC § 170(f)(8)(c)(i), (ii).

[79]H.R. Rep. No. 103-111, at 785 (1993).

[80]IRC § 170(f)(8)(D).

[81]Treas. Reg. § 1.170A-13(f)(11)(ii).

[82]The IRS has, however, issued a ruling in which it expressly approved an organization's acknowledgment procedures under IRC § 170(f)(8)(B). See Priv. Ltr. Rul. 9743054 (Aug. 1, 1997).

[83]I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385. *See* § 3.22.

[84]I.R.S. Information Letter 200000070 (May 17, 2000).

The disclosure requirement relates to so-called ''quid pro quo contributions'' of over $75, and requires donee organizations to provide certain written statements to donors in connection with the solicitation or receipt of the contributions.[85] A *quid pro quo contribution* is a payment made partly as a contribution and partly in consideration for goods or services provided to the donor by the donee organization.[86] The ''over $75'' threshold is determined based on the amount of the ''payment,'' not on the amount of the contribution element of the payment. Thus, for example, a payment of $100 in exchange for a dinner worth $40 is a quid pro quo contribution, even though the amount of the contribution ($60) is less than $75.[87] Separate payments are not aggregated for purposes of the ''over $75'' threshold.[88] As in the case of the substantiation requirement, the IRS is authorized to prescribe antiabuse rules to prevent the avoidance of the disclosure requirement by writing multiple checks for the same transaction, but no such rules have yet been prescribed.

The written statement must (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of the goods or services provided by the donee organization, and (2) contain a good-faith estimate of the fair market value of the goods and services.[89] The written statement must be made in a manner that is reasonably likely to come to the donor's attention. Thus, a disclosure of the required information in small print set forth within a larger document might not meet the requirement.[90]

A $10 penalty is imposed on the donee organization for each contribution that violates the disclosure requirement.[91] Violations include the failure to provide a statement and the provision of an incomplete or inaccurate statement. The total penalty for a particular fund-raising event may not exceed $5,000. If it is shown that the violation was due to reasonable cause, no penalty is imposed.[92] To date, however, no specific ''reasonable cause'' examples have been released by the IRS or litigated in the courts.

The IRS has issued a series of questions and answers that help illustrate these substantiation and disclosure rules: [93]

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[85]IRC § 6115.
[86]IRC § 6115(b).
[87]S. Rep. No. 103-36, at 223-24 (1993).
[88]*Id*.
[89]IRC § 6115(a)(1), (2).
[90]S. Rep. No. 103-36, at 223 n.12.
[91]IRC § 6714(a).
[92]IRC § 6714(b).
[93]*1996 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 67 (20th ed. 1996). See also Treas. Reg. § 1.170A-13; Treas. Reg. § 1.6115-1; I.R.S. Publication 1771 (Charitable Contributions—Substantiation and Disclosure Requirements).

1. *Late receipt of substantiation statement*. In 1995, taxpayer X presented Y charity with a contribution in the form of a check in the amount of $1,000, for which X neglected to claim a charitable deduction on his Form 1040 for 1995 (which he filed on April 15, 1996) because X did not get a receipt from the organization until July 15, 1996. In 1997, X filed an amended return for 1995. Will the 1996 receipt obtained by the taxpayer satisfy the substantiation requirement, since it was obtained before the date of filing the amended return?

Answer: No. The acknowledgment must be obtained by the due date (including extensions) of a return. Unlike the IRS's granting of an extension to file, the IRS's acceptance of amended returns for a tax year after the due date does not require the IRS to recognize the statement obtained after the due date as having been made in a timely fashion. In fact, such a recognition would be contrary to the statute.

2. *Raffles and lotteries*. The purchase price for a ticket is $85, including the cost of a dinner and entertainment. The dinner is valued at $25, and the entertainment is estimated at an additional $20. Additionally, the ticket entitles the bearer to a chance at a drawing for a car valued at $22,000. Does the quid pro quo disclosure by the charity have to include the value of the donor's chance at winning a $22,000 car? What amount should be disclosed by the charity as being deductible to the ticket purchaser?

Answer: The amount that may be deducted by the purchaser of such a ticket is zero because the purchaser acquires something of value as the result of his purchase—the opportunity to win a prize in addition to the value of the dinner and the entertainment provided by the organization. This quid pro quo embraces the entire purchase price of $85, notwithstanding that the meal and entertainment components total only $45. There is no authority to make an actuarial computation of win probabilities and prize cost to assign a value to the service or opportunity, and the entire price of the raffle ticket is construed as a payment for goods or services.[94] Thus, it is immaterial how much, if anything, in excess of the value of the meal and entertainment may have been paid. The purchaser may not deduct any of the purchase price.

3. *Who is responsible for furnishing the substantiation statement?* It is the donor's responsibility to secure the substantiation from the charity regarding any contributions of cash or property of $250 or more, and if goods or services are provided by the charity in consideration for the contribution, the substantiation document must include a good-faith estimate of the value of these goods or services. Presumably, as with

[94]Rev. Rul. 83-130, 1983-2 C.B. 148; *Goldman v. Commissioner*, 46 T.C. 136 (1966), *aff'd*, 388 F.2d 476 (6th Cir. 1967).

a $250 or more contribution, the responsibility for obtaining the documentation is on the donor. However, the law pertaining to disclosure of an ''over $75'' quid pro quo contribution stipulates that the charity receiving such contribution is obligated to furnish a statement. Does this mean that if the quid pro quo donation is $250 or more, the charity is no longer obliged to furnish a statement?

Answer: No. The $250 rule pertains only to the requirement of the donor to document his or her contribution by obtaining the stipulated information. The $75 rule relates only to the requirement of the charity to provide a breakdown of the value of the component parts of the quid pro quo contribution. The charity's disclosure for the quid pro quo contribution does not have to be individualized in the form of a ''receipt'' issued to each donor. It simply has to inform donor(s), whether in an individualized or a generic format, that the item (or service/event) made available to each donor/purchaser will carry a value of $x and a charitable donation component of $y. For example, a flyer advising purchasers of $75 tickets to a circus that the tickets have a value of $45 and that the remaining $30 cost of the ticket will thus be deductible to the donor as a charitable contribution will not suffice to substantiate a $300 deduction claimed by the purchaser of a block of 10 tickets. That person will have to secure an acknowledgment from the charity that the $750 check received made out to the charity represents payment for 10 tickets valued at $450, of which $300 represents a charitable contribution. The flyer sent to promote ticket sales will not suffice for purposes of substantiating that patron's claimed charitable deduction of $300.

4. *Purchase of a block of tickets: failure to attend*. What is the proper tax treatment of a donor who has purchased from a charity at a premium a subscription series ticket to an entire run of performances? If the donor does not attend, but gives no advance indication of this intention, is there a mechanism through which he or she can take the entire amount paid or value of the ticket as a charitable deduction?

Answer: The determining factor is not whether the donor has an intention of exercising the right to admission, but whether the tickets are accepted by the donor. If the ticket holder wants to support the charity and forgo the right of admission, he or she can simply pay the charity the face value of the ticket and refuse to accept it or the admission entitlement. The charity might consider advising any such persons in advance that it is their right to refuse the tickets and claim the entire amount of payment (or entitlement). The donor who earns the right of admission through giving a prescribed dollar amount, rather than by outright purchase of the ticket, is also entitled to deduct the full

amount of his or her payment if he or she relinquishes the prerogative of attending the events.

5. *Use of canceled check as substantiation*. X writes a check to Y Charity in the sum of $500. X notes on the check ''donation'' but does not receive a receipt from Y Charity. X takes a charitable deduction for the amount on his Form 1040. Is X entitled to the deduction claimed?

Answer: No. The check alone is not sufficient substantiation of the contribution.

6. *Timing of substantiation statement*. The IRS grants X, an individual whose tax year ends December 31, 1995, and who normally must file by April 15, 1996, a three-month extension to file a Form 1040. X's extended filing date is July 15, 1996. On November 15, 1995, X issued a check for $500 to the Y Medical Research Foundation as a charitable contribution. X filed a Form 1040 on June 15, 1996, and, on the same date, obtained a substantiation note from Y Foundation. (1) Is this a ''contemporaneous'' substantiation? (2) If the substantiation statement was obtained on June 16, 1996, would this meet the contemporaneous standard?

Answer: The answer to (1) is yes. The answer to (2) is no. The rule stipulates that the controlling date is the earlier of the date the return was filed or the due date (including extensions) of the return.

7. *Sufficient substantiation*. X donates 10 old suits and 10 of his used shirts to Y Charity, which resells them at its thrift store. X had left these items on his doorstep, whereupon Y Charity had picked them up and left a receipt stating the number and nature of the items collected and that nothing was provided to the taxpayer in return for the donated goods. Is the substantiation requirement met?

Answer: Yes. The receipt properly describes the property donated, and it states whether Y Charity provided any goods or services in consideration, in whole or in part, for the property donated. It is important to remember that the quid pro quo aspect has to be addressed in the substantiation document one way or the other; that is, if no goods or services were furnished to the donor, this fact must be noted. Also note that Y is not remiss in failing to include a dollar amount since the charity has no obligation to place a value on the donation.

8. *Sufficient substantiation*. The same charity that received the box of clothing leaves the donor a receipt that consists entirely of the following statement:

Thank you for your kind donation. We intend to use the proceeds of any sale of the property to provide disaster relief to the victims of the recent flood in Tasmania. Any unsold items will be furnished directly to these victims for their use. Your contribution will assist us in our mission

of demonstrating to the unfortunate victims of disasters throughout the world that Americans are a generous and caring people. You might note your estimated value of the contributed goods on the line at the bottom of this receipt.

Is the substantiation requirement met?

Answer: No. The notice fails to provide a description of the contributed property. It also neglects to mention whether any goods or services were furnished to the donor in return.

9. *Quid pro quo disclosure statement*. Z, a public TV station, provides contributors with an autographed baseball with a fair market value of $200, in return for a ''contribution'' of $250. Must Z provide a quid pro quo statement?

Answer: Yes; since each payment is over $75, the charity must inform its donors that only $50 is deductible for income tax purposes.

The IRS and the courts appear to have lost any patience they might have had with taxpayers who attempt to claim charitable contribution deductions without complying with the substantiation requirements. In a 2006 Tax Court case, the IRS asserted, and the Tax Court sustained, the disallowance of an unsubstantiated charitable contribution deduction and a negligence penalty imposed by the IRS on the taxpayer involved. That the individual was an IRS employee who presumably should have known about the substantiation requirements may have had something to do with both the IRS and the Tax Court's determinations.[95]

§ 6.7 BARGAIN SALES

A bargain sale occurs when a donor transfers property to a college or university for a sale price that is less than the fair market value of the property. A bargain sale is treated for tax purposes as, in part, a charitable contribution and, in part, a sale or exchange of the contributed property.[96] To illustrate, assume that a computer company sells a computer to a university for $50,000, but the fair market value of the computer is $75,000. Assume also that at the time of the sale, the computer had an adjusted basis to the company of $45,000. Because the university paid the company less than the fair market value of the computer, the bargain sale rules apply. The gift portion of the bargain sale (which is deductible) is $25,000 ($75,000 fair market value minus $50,000 cost), and the sale portion (which is taxed) is $5,000 ($50,000 sale price minus $45,000 adjusted basis).

[95] *Kendrix v. Commissioner*, T.C. Memo. 2006-04.
[96] *Connell v. Commissioner*, 51 T.C.M (CCH) 1657 (1986), *aff'd*, 842 F.2d 285 (11th Cir. 1988).

A similar rule applies when encumbered property is donated to a college or university. If a school receives property subject to indebtedness, it is treated as a sale or exchange of the property in which the donor receives consideration equal to the amount of the indebtedness assumed by the college or university. If the value of the property exceeds the amount of the indebtedness, the contribution is treated like a bargain sale of the property to the school. For example, assume that a donor purchased unimproved real property as an investment. This donor contributed the property to a university, and at the time of the contribution, the property had a fair market value of $50,000, an adjusted basis of $30,000, and was subject to a mortgage of $20,000. The donor's contribution is treated as a bargain sale of the property to the university for $20,000 ($50,000 fair market value less $30,000 adjusted basis). The gift portion of the bargain sale is $30,000 ($50,000 fair market value minus $20,000 indebtedness).

§ 6.8 GIFTS OF PARTIAL INTERESTS

A basic charitable contribution deduction principle is that, in order to qualify for deduction, the donor must part with his or her entire interest in the donated property; gifts of partial interests in property are generally not deductible. Examples of nondeductible gifts of partial interests include the donation to a college or university of the rent-free use of office space,[97] an interest-free loan,[98] and a contribution of voting common stock, where the donor retains voting rights.[99]

There are, however, a number of exceptions to this ''no-gifts-of-partial-interests'' rule. First, if the contribution of the partial interest in the property represents the donor's entire interest in the property, the deduction is allowed. For example, if an individual received under a will a life interest in a piece of real property, with another individual receiving the remainder interest, a contribution by the individual of his or her life interest to a college or university is deductible because the life interest (although a partial interest in the property) represents the individual's entire interest in the property. Another exception applies when the individual's interest in the property represents an undivided portion of the entire interest.[100] For example, if an individual contributes an undivided one-half interest in property to a university, the individual and the university would thereafter be tenants in common with respect to the property. Because the university has the right to possession, dominion, and control over the property appropriate to its

[97]Treas. Reg. § 1.170A-7(d), Example 1.
[98]*Id*., Example 3.
[99]Rev. Rul. 81-282, 1981-2 C.B. 78.
[100]IRC § 170(f)(3)(B)(ii).

ownership interest, the contribution of the undivided portion of the entire interest is deductible as a charitable contribution.[101]

In 2006, Congress added to the Code section 170(o), which imposes additional requirements for deducting a contribution of an undivided fractional interest in property. Under these new rules, (1) the donor's retained undivided fractional interest must be donated to the donee by the earlier of ten years after the initial donation or the donor's death, and (2) the donee organization must have had ''substantial physical possession'' of the property and actually used the property in a purpose or function related to its tax-exempt purposes during the period commencing with the initial contribution and concluding with the final contribution.

§ 6.9 CONTRIBUTIONS MADE IN TRUST

Many donors accomplish their charitable goals by creating what is known as a ''split interest trust,'' which has both charitable and noncharitable beneficiaries. In order to prevent abuse of the charitable contribution deduction rules, Congress in 1969 strictly limited the deductibility of gifts made in the form of split interest trusts.[102] The most popular of these types of gifts is a charitable remainder trust, in which noncharitable beneficiaries receive a life interest in the property with the remainder interest given to a charitable or educational organization. An income tax deduction is allowed for contributions of the remainder interest only if the trust qualifies as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. A discussion of these different types of charitable remainder trusts is beyond the scope of this book, but basically a charitable remainder annuity trust requires the payment of a stated dollar amount to the noncharitable beneficiary; a charitable remainder unitrust requires that the noncharitable beneficiary receive a fixed percentage of the net fair market value of the assets; and a pooled income fund is a trust operated by a charitable organization for the purpose of receiving gifts from donors who wish to retain life estates for themselves or for others and must meet a number of different characteristics.

In a series of revenue procedures, the IRS has set forth the following sample charitable remainder annuity documents:

- Testamentary CRUT Declaration for a Term of Years[103]
- Testamentary CRUT Declaration for One Measuring Life[104]
- Testamentary CRUT Declaration for Consecutive Measuring Lives[105]

[101]Treas. Reg. § 1.170A-7(b)(1).
[102]Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1), 83 Stat. 487, 549.
[103]Rev. Proc. 2005-52, 2005-34 I.R.B. 326.
[104]Rev. Proc. 2005-53, 2005-34 I.R.B. 329.
[105]Rev. Proc. 2005-54, 2005-34 I.R.B. 353.

- Testamentary CRUT Declaration for Concurrent and Consecutive Measuring Lives[106]
- Inter Vivos CRUT Declaration for a Term of Years[107]
- Inter Vivos CRUT Declaration for One Measuring Life[108]
- Inter Vivos CRUT Declaration for Consecutive Measuring Lives[109]
- Inter Vivos CRUT Declaration for Concurrent and Consecutive Measuring Lives[110]

§ 6.10 GIFT ANNUITIES

A charitable gift annuity is an arrangement under which a taxpayer transfers money or other property to a college or university in exchange for a promise by the school to pay an annuity to the taxpayer or to another person. These transactions are treated as, in part, the purchase of an annuity and, in part, as a charitable contribution. The gift element of the transaction relates to the annuity rate, which in a charitable gift annuity is lower than the rate paid on comparable commercial annuities. The money or other property that is transferred to the college or university is not held by the school in trust; rather, the annuity represents a general obligation of the college or university with its assets subject to the obligation. The charitable contribution component reflects the excess of the amount of money or value of the property transferred to the college or university over the fair market value of the annuity at the time of purchase. The present value of the annuity is determined pursuant to tables provided by the IRS.

The ''planned giving'' area is a difficult and complex area and one that has received excellent treatment in other publications to which readers should refer for more detailed information.

§ 6.11 CHARITABLE SPLIT-DOLLAR LIFE INSURANCE

Under a typical charitable split-dollar life insurance arrangement, an individual makes a cash contribution to a college or university, for which the individual takes a full charitable contribution deduction. At the same time, the donor establishes an irrevocable life insurance trust for his or her family members. The school then purchases a whole life insurance policy on the donor's life, and both the school and the trust pay the premiums on the policy. Upon the death of the donor, the college or university is entitled to a return

[106]Rev. Proc. 2005-55, 2005-34 I.R.B. 367.
[107]Rev. Proc. 2005-56, 2005-34 I.R.B. 383.
[108]Rev. Proc. 2005-57, 2005-34 I.R.B. 392.
[109]Rev. Proc. 2005-58, 2005-34 I.R.B. 402.
[110]Rev. Proc. 2005-59, 2005-34 I.R.B. 412.

of its premiums, plus interest, while the trust for the family members receives the remaining insurance proceeds.

In 1999, the IRS challenged these arrangements by denying the charitable contribution deduction for the initial gift to the charitable or educational organization on the ground that it was a gift of a partial interest and therefore nondeductible.[111] The IRS also warned that participation in this type of activity could jeopardize the organization's tax-exempt status or result in the imposition of the intermediate sanctions excise taxes under section 4958.[112] Shortly after the publication of this notice, however, Congress enacted a new statutory provision that denies a deduction for any transfer to an organization if the organization uses the funds to pay any premium on a life insurance policy or other ''personal benefit contract'' with respect to the transferor.[113] A ''personal benefit contract'' is defined as a life insurance, annuity, or endowment contract of which the direct or indirect beneficiary is the donor, a member of the donor's family, or any person designated by the donor.[114]

This IRS notice coupled with the enactment of this new statutory provision, which was effective for transfers occurring after February 8, 1999, effectively ended the marketing and use of charitable split-dollar life insurance transactions. But other types of potentially abusive transactions are always being created. One of these is a so-called ''char-flip,'' which involves an individual's donating most (but not all) of the stock in a closely held company to a college or university, but staying on in a control position and directing a portion of the sales proceeds to a spouse or other family members. This program received some rather unfavorable publicity in a front-page story in the *Wall Street Journal* and can be expected to draw IRS scrutiny.[115]

[111] I.R.S. Notice 99-36, 1999-26 I.R.B. 3.

[112] *See* § 9.1(d).

[113] IRC § 170(f)(10), which was added by the Work Incentives Improvement Act of 1999, Pub. L. No. 106 170, § 53, 113 Stat. 1860.

[114] IRC § 170(f)(10)(B). For guidance on the reporting requirements imposed by violations of these rules, see I.R.S. Notice 2000-24, 2000-1 C.B. 952.

[115] Langley, ''Hot New Tax Strategy Yields Fast Deductions and Long-Term Gains,'' *Wall Street Journal*, July 13, 1999, at 1; Duronio, ''Let the Donor Be Aware of the Family Limited Partnership,'' *Journal of Taxation of Exempt Organizations*, May/June 2001.

CHAPTER SEVEN

Scholarships and Fellowships

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§ 7.1 INTRODUCTION

The taxation of scholarships and fellowships is important to colleges and universities because, in most instances, the school is the one making the scholarship/fellowship payment to the student. It needs to know whether the award is taxable and, if so, whether it has to withhold income tax on the payment and file any reports with the IRS. There is also the tax impact on the student who receives the scholarship or fellowship grant. Most schools have a strong interest in seeing that their students are aware of and are in compliance with the applicable tax laws.

For the most part, the rules relating to the taxation of scholarships and fellowships are found in section 117 of the Code. This chapter discusses those rules in detail. If the scholarship or fellowship payment is made to a non–U.S. citizen, however, a totally different tax scheme comes into play. Those provisions are discussed in this chapter as well.

(a) Background to Section 117

Prior to 1954, no specific income exclusion existed for scholarships and fellowships, and a payment of an individual's educational expenses was treated as taxable, unless it could be excluded from the recipient's gross income as a gift.[1] Because of the many problems that arose in making gift determinations, in 1954 Congress enacted section 117, which set forth a specific income exclusion for scholarships and fellowships. Section 117, as originally enacted in 1954, generally excluded from the recipient's gross income all elements of the scholarship or fellowship award, including tuition, fees, books, room, board, living expenses, and travel.[2]

(b) Changes Made by Tax Reform Act of 1986

Section 117 remained relatively unchanged for the next 30 years, but as part of the Tax Reform Act of 1986,[3] Congress significantly limited the section 117 exclusion. The fundamental philosophy underlying the restrictive changes made in 1986 was Congress's belief that the exclusion should apply only to those components of a scholarship/fellowship award that are directly related to education (e.g., tuition, fees, and books). Those elements of the award that do not have a direct relationship to education (e.g., room, board, living expenses, and travel) should not qualify for the exclusion.[4]

In addition to drastically changing the basic tests for exclusion, the 1986 Congress made other significant modifications to section 117. Specifically, prior to 1986, degree candidates could exclude under section 117 tuition and other amounts received in return for services rendered, provided that all candidates for the degree were required to perform such services.[5] Thus, if a graduate program required all candidates to teach a certain number of undergraduate courses or work a specified number of hours in the research laboratory, the amounts paid by the institution to the candidate in return for the services were excludable under section 117, even though the payments were clearly compensatory in nature. In 1986, however, Congress repealed this provision, and made clear that an exclusion is no longer allowed for any portion of an award ''which represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or fellowship award.''[6] The 1986 Congress also repealed the prior

[1]Under IRC § 102, the value of any property received by gift, bequest, device, or inheritance is excluded from the recipient's gross income.

[2]For nondegree candidates, the exclusion was limited to grants from educational and other IRC § 501(c)(3) organizations, and could not exceed $300 per month for a maximum of 36 months. See Treas. Reg. § 1.117-2, now obsolete.

[3]Tax Reform Act of 1986, Pub. L. No. 99-514, § 123, 100 Stat. 2085, 2109.

[4]Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 40 (1987).

[5]Treas. Reg. § 1.117-2(a)(2), now obsolete.

[6]Staff of Joint Comm. on Taxation, at 43.

law rule permitting the exclusion of certain federal grants under section 117 even though the recipient was required to perform future services as a federal employee.[7]

If there were any question about whether the new statutory scheme enacted by Congress in 1986 replaced the law in place up to that time, it was dispelled by the Tax Court in a case involving a National Institutes of Health (NIH) fellowship grant made to a physician participating in a postdoctoral fellowship program at Johns Hopkins University.[8] The person argued that he should be entitled to exclude the value of a cash stipend that he received under the program, arguing that under cases decided in 1973 the amount qualified for an exclusion under section 117 because any services he provided were *de minimis* and most of his time was spent on training and other educational activities.[9] The Court agreed that he might qualify for the exclusion under these earlier cases but said that the changes made by Congress in 1986 rendered these earlier cases moot.

As a result of these changes, in its current form section 117 is divided into four subsections, each of which contains important rules regarding the taxation of scholarships and fellowships.

1. Section 117(a) sets forth the general rule that any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational institution is excludable from the recipient's gross income.
2. Section 117(b) defines the term *qualified scholarships* and explains what type of payments qualify for the exclusion.
3. Section 117(c) is a short but extremely important provision that states that the exclusion does not apply to any portion of the scholarship or fellowship award (including tuition reductions) that represents payment for services rendered, such as teaching or conducting research.
4. Section 117(d) sets forth the tests that must be met in order for a reduction in tuition provided by a college or university to one of its employees (or the employee's spouse or dependents) to be excludable from the employee's gross income.

§ 7.2 THE SECTION 117 RULES

In order to qualify for the post-1986 section 117 exclusion, the following three tests must be met: (1) the award must be a ''qualified scholarship''; (2) the recipient must be a ''candidate for a degree''; and (3) the award must

[7] *Id*. at 43–44.
[8] *Streiff v. Commissioner*, T.C. Memo 1999-84, 77 T.C.M. (CCH) 1565 (1999).
[9] *Bieberdorf v. Commissioner*, 60 T.C. 114 (1973); *Bailey v. Commissioner*, 60 T.C. 447 (1973).

be for the purpose of studying or conducting research at an ''educational organization.''[10]

(a) The ''Qualified Scholarship'' Requirements

In order to be a qualified scholarship, the grant, in the first instance, must be either a scholarship or a fellowship, as opposed to some other type of payment. Although the statute does not define either term, the regulations define a *scholarship* as ''an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies,'' and a *fellowship* as ''an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research.''[11]

If the payment made to the individual is not a scholarship or a fellowship, then section 117 is inapplicable, and the tax consequences of the payment must be determined by looking at the rules applicable to the particular type of payment involved. For example, if a cash payment is made to an individual to assist in the pursuit of his or her studies, but the individual is required to repay the amount to the grantee, the payment is a nontaxable loan and not a scholarship or fellowship.[12] Also, because most scholarship/fellowship awards could also be classified as gifts, it might be tempting to try to avoid the restrictive rules of section 117 by classifying the payment as a gift, which is excludable under section 102. The regulations under sections 102 and 117, however, anticipate such an attempted end run around section 117. They specifically provide that if a payment qualifies as both a scholarship/fellowship and a gift, section 117 overrides section 102, and the payment is subject to the more restrictive section 117 rules.[13] As discussed in greater detail later in section 7.5, the most difficult classification issue involves distinguishing a purported scholarship/fellowship from compensation for services rendered.

Assuming that the award is, in fact, a scholarship or fellowship, the next step is to determine if it is a ''qualified scholarship.'' A payment is a qualified scholarship if it is for either (1) tuition and fees required for enrollment or attendance at the educational institution; or (2) fees, books, supplies, or equipment required for courses of instruction at the institution.[14] Thus, amounts paid to an individual for expenses such as room, board, living

[10]IRC § 117(a); Prop. Treas. Reg. § 1.117-6(b).

[11]Treas. Reg. § 1.117-3(a), (c). Although these regulations were drafted long before the 1986 changes to IRC § 117, they seem to still represent the IRS's definitions of the two terms.

[12]*See* Priv. Ltr. Rul. 9021027 (Feb. 22, 1990), holding that funds advanced to students who have a bona fide obligation to repay such amounts are loans and do not constitute a scholarship or fellowship grant under IRC § 117.

[13]Treas. Reg. § 1.102-1(a); Treas. Reg. § 1.117-1(a).

[14]Prop. Treas. Reg. § 1.117-6(c)(2).

allowances, travel, research, and clerical help (as well as equipment and other expenses *not required* for enrollment or attendance) do not fall within the ''qualified scholarship'' definition and are taxable to the recipient.

The regulations impose a substantiation requirement on qualified scholarships and require that the recipient be able to establish that the grant payments were, in fact, used for tuition and related expenses.''[15] Therefore, the recipient must maintain adequate records (e.g., bills, receipts, canceled checks) to be able to demonstrate that the payments received were actually expended for qualified scholarship amounts.[16]

An issue that sometimes arises in the qualified scholarship area is whether a particular expense is actually required for either enrollment or attendance at the educational institution. The IRS position is clear—the expense must be for an item that is actually required; it is not sufficient that the expense be helpful or suggested.[17] For example, if a computer is listed as one of the ''suggested supplies'' for a course, but is not required, the cost of the computer processor does not qualify as an excludable tuition-related expense under section 117.[18] Other expenses that raise this issue are health service fees, student activity fees, and graduation fees. Although there is no IRS guidance with respect to these types of fees, they should qualify for the section 117 exclusion if they are required of all students and relate to either enrollment in the institution or a particular course of instruction.

(b) The ''Candidate for a Degree'' Requirement

This definitional term is somewhat misleading. While it covers those individuals normally thought of as degree candidates—undergraduate and graduate students who are enrolled in a degree program—it also encompasses full- and part-time students who are not actually seeking a degree. The regulations provide that an individual attending an educational institution is treated as a candidate for a degree for section 117 purposes even if not enrolled in a degree program, provided that the educational institution (1) offers an educational program that is acceptable for full credit toward a bachelor's or higher degree, (2) is authorized under federal or state law to provide such a program, and (3) is accredited by a nationally recognized accreditation agency.[19] To illustrate, assume that an individual attends a university under a one-year fellowship program that does not involve the granting of a degree. Even though the student will not receive a degree from the institution as a result of participating in and completing the program, the individual will

[15]Prop. Treas. Reg. § 1.117-6(c).
[16]Prop. Treas. Reg. § 1.117-6(e).
[17]Prop. Treas. Reg. § 1.117-6(d)(2).
[18]Prop. Treas. Reg. § 1.117-6(c)(6), Example 1.
[19]Prop. Treas. Reg. § 1.117-6(c)(4)(iii).

be treated as a candidate for a degree for purposes of section 117, if the university meets the foregoing three requirements, which virtually all colleges and universities do.

The regulations also provide that an individual may pursue studies or conduct research at an educational organization other than the one actually conferring the degree and still qualify as a candidate for a degree, provided that the study or research meets the requirements of the educational organization granting the degree.[20]

(c) The ''Educational Organization'' Requirement

The final test for exclusion under section 117 is relatively straightforward and usually raises few issues. The recipient of the scholarship or fellowship must be attending an ''educational organization,'' a term that is defined in section 170(b)(1)(A)(ii) as an organization that ''normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on.'' For students attending most colleges and universities, this element of the section 117 test is not generally a problem. Where a problem sometimes arises is with respect to scientific research institutions, which generally do not meet the section 170(b)(1)(A)(ii) definition due to a lack of a regular faculty, a curriculum, and a body of pupils.[21]

(d) Interaction with Education Tax Credits

A legal memorandum prepared by the IRS Chief Counsel's office addressed issues involving the interaction of the section 117 scholarship/fellowship exclusion and the section 25A education tax credits.[22] The issue involved a scholarship program offered by the State of Louisiana called the Louisiana Tuition Opportunity Program for Students.

In this memorandum, the IRS said that if the scholarship is excluded from gross income, the amount of the award must be subtracted before calculating the education credits; however, if the award is includable in income and the student paid the tuition and related expenses with his or her own funds, no reduction will be required. Also, if (1) a student asks that a nontaxable award be delayed after it is granted, (2) the tuition is paid, and (3) an education tax credit is claimed, the subsequent payment of the award will be treated as a refund of the qualified tuition and will cause a recapture of the claimed tax credit.

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[20] *Id*.

[21] Rev. Rul. 75-10, 1975-1 C.B. 389 (scientists granted fellowships at the National Institutes of Health are not attending an ''educational organization'').

[22] ILM 200137006 (June 1, 2001).

§ 7.3 WITHHOLDING AND REPORTING ON SCHOLARSHIP/FELLOWSHIP PAYMENTS

(a) Rules Applicable to Students Who Are U.S. Citizens and Residents

Because of the changes made to section 117 in 1986, a substantial number of previously excluded scholarship and fellowship awards became taxable to the recipients. This led to a logical question raised by colleges and universities as to whether they, as the grantors and payors of the scholarship/fellowship awards, are required to withhold any income tax or file any reports with the IRS with respect to the taxable portions of scholarship and fellowship grants.

With respect to payments made to students who are U.S. citizens and residents, the IRS answered these questions in 1987. In Notice 87-31,[23] the IRS said that, unless the scholarship or fellowship grant is treated under section 117(c) as paid in return for services rendered, the amount of the grant is not subject to income tax, Social Security, or federal unemployment tax withholding because it is not a payment of ''wages.'' The IRS went on to say in Notice 87-31 that, unless the payment is treated as compensatory under section 117(c), neither the grantor of the award nor the educational institution attended by the recipient (in those cases where the educational institution is not the grantor) is required to file any information or other returns with respect to the grant.

With respect to those scholarship/fellowship awards that are treated under section 117(c) as paid in return for services rendered, Notice 87-31 provides that such amounts are ''wages'' and therefore subject to normal income tax withholding requirements. Whether the payor must withhold Social Security or federal unemployment tax depends on the nature of the employment and the status of the organization, but as a general rule, these taxes must also be withheld.[24] Also, Notice 87-31 states that the grantor of a compensatory scholarship/fellowship grant to which section 117(c) applies must file a Form W-2 with respect to such amounts.

Notice 87-31 imposes the sole responsibility for determining taxability of the scholarship/fellowship award on the recipient. It is not the college or university's obligation to make this determination on behalf of the student; however, Notice 87-31 recommends that if the school is aware that some or all of the award is taxable, it so advise the recipient in writing. This is, however, simply a recommendation; there is no requirement to do so.

As a result of news accounts of IRS subpoenas issued to colleges and universities to determine the names of their students who received scholarship/

[23]I.R.S. Notice 87-31, 1987-1 C.B. 475.

[24]It is possible (albeit unlikely) that no Social Security or federal unemployment tax must be withheld because the student could be an independent contractor, not an employee. In this case, no ''wage'' income tax withholding would be required as well. *See* § 4.2. Also, the student might qualify for the ''student FICA'' exception set forth in IRC § 3121(b)(10). *See* § 4.3.

fellowship payments,[25] coupled with the widespread belief that many taxable scholarships and fellowships go unreported by the recipients, there has been speculation that the IRS may one day modify the ''no withholding/no reporting'' rule of Notice 87-31, and require either some type of tax withholding or, at a minimum, that the taxable portion of the scholarship/fellowship payment be reported to the IRS. To date, however, this has not occurred.

(b) Rules Applicable to Nonresident Alien Students

Although Notice 87-31 does not explicitly state that its ''no withholding/no reporting'' rule is applicable only to those students who are U.S. citizens and residents, that is clearly the case because the separate statutory scheme dealing with withholding and reporting on scholarship/fellowship payments made to nonresidential aliens overrides Notice 87-31.[26]

Section 1441(a) sets forth the general rule that the payor of taxable income to a nonresident alien is required to withhold tax in an amount equal to 30 percent of the payment. There are, however, several exceptions to this 30 percent withholding rule. First, the amount of the withholding tax may be reduced or eliminated under a tax treaty between the United States and the payee's home country.[27] Second, tax is not required to be withheld if the payor of a scholarship or fellowship grant reasonably believes that the grant payment qualifies for exclusion under section 117.[28] Third, the section 1441(a) withholding requirement applies only to ''U.S. source'' income; therefore, if the scholarship/fellowship grant is classified as a ''foreign source,'' no withholding is required.[29] On this point, scholarship and fellowship payments are treated as either ''U.S. source'' or ''foreign source'' based on the location of the grantor of the scholarship or fellowship grant.''[30] For most colleges and universities, a foreign source scholarship or fellowship payment occurs only when they are serving as the paying agent for a grantor that is either an international organization (e.g., the United Nations, the World Bank)[31] or located outside the United States (e.g., a foreign government, a foreign foundation).

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[25]Chris Black, ''IRS Seeks MIT Records,'' *Boston Globe*, Mar. 17, 1993, at 25; Scott Jaschik, ''IRS Expands Inquiry on Scholarships That Pay for Expenses Beyond Tuition,'' *Chronicle of Higher Education*, Mar. 24, 1993, at A23.

[26]IRC § 1441. Classification of a non–U.S. citizen as either a ''U.S. resident alien'' (who is taxed as a U.S. citizen) or as a ''nonresident alien'' (who is subject to an entirely different set of tax rules) is made by applying the green-card and substantial presence tests set forth in IRC § 7701(b) and Treas. Reg. § 301.7701(b)-1 through (b)(9). *See* § 8.2.

[27]This follows from the requirement under IRC § 1441(a) that withholding is only required with respect to items of ''gross income.'' Income exempted under a tax treaty is not gross income.

[28]Same rationale as for exempt tax treaty income, except that the gross income exclusion is found in IRC § 117.

[29]*See* § 8.3.

[30]Treas. Reg. § 1.863-1; Rev. Rul. 89-67, 1989-1 C.B. 233.

[31]An ''international organization'' is defined in IRC § 7701(a)(18).

Section 1441(b) sets forth the final exception to the 30 percent withholding rule and provides that payments made to nonresident alien scholarship/fellowship recipients who are temporarily present in the United States under an F, J, M, or Q visa may be eligible for a reduced 14 percent withholding rate. This 14 percent withholding rate applies in the following two situations:

1. For an individual who is a candidate for a degree,[32] the payment must be a scholarship or fellowship that does not qualify for the section 117 exclusion (generally, room, board, living allowances, and travel). (Note that no withholding at all is required for those scholarship/fellowship payments that qualify for exclusion under section 117.)
2. For an individual who is not a candidate for a degree, the grant must be for study, training, or research at an educational organization located in the United States, and the grantor of the scholarship/fellowship (the true grantor, not the paying agent) must be (a) a tax-exempt charitable or educational organization; (b) a foreign government; (c) an international organization or a binational/multinational educational and cultural foundation or commission under the Mutual Educational and Cultural Exchange Act of 1961; or (d) the U.S. government, a state, a possession of the United States, a political subdivision, or the District of Columbia.

Turning to the reporting requirements imposed on scholarship/fellowship payments made to nonresident aliens, while Notice 87-31 provides that no information or other returns must be filed with respect to scholarship/fellowship payments made to United States citizen or resident alien students, the taxable portions of payments (e.g., room, board, travel) made to nonresident alien students must be reported on Form 1042 and 1042-S.[33] Prior to 2001, schools were also required to report the nontaxable scholarship/fellowship payments (e.g., tuition and fees), but beginning with payments made in 2001, reporting of these payments is no longer required.[34]

§ 7.4 QUALIFIED TUITION REDUCTIONS

(a) General Rule

Under section 117(d), if a college or university employee (or the employee's spouse or dependents) receives a tuition waiver, which constitutes a ''qualified tuition reduction,'' the amount of the tuition waiver is excludable from the employee's gross income. The section 117(d) ''qualified tuition reduction'' provision is an exception to the general rule that free or reduced tuition

[32] *See* Prop. Treas. Reg. § 1.117-6(c)(4).
[33] Treas. Reg. § 1.1461-1(c)(2)(i)(K).
[34] This is implicit from a reading of this regulation, which only requires reporting on the nontaxable portion of the scholarship/fellowship grant.

provided by a college or university to its employees is treated as compensatory and not eligible for exclusion under section 117.[35]

Section 117(d)(2) defines the term *qualified tuition reduction* as the amount of any reduction in tuition provided to an employee of a school to attend either the school at which the employee works or another school. It is important to note that the exclusion can be claimed not only by the employee but also by any individual who is ''treated as an employee'' under the rules of section 132(h), which include spouses and dependent children. In this regard, the IRS has ruled that tuition reduction benefits provided by a university to its employees' domestic partners may not be excluded from the employees' gross income unless the state of the employee's residence recognizes the relationship as a valid marriage.[36]

Section 117(d)(2) also provides that the education for which the qualified tuition reduction is granted must be ''below the graduate level.'' An issue that arises with respect to this requirement is whether this restriction relates to the status of the student or the status of the courses that are taken. For example, if a college or university employee is enrolled in the school as an undergraduate student, but is taking certain graduate level courses as part of the undergraduate degree program, will the value of the tuition reduction allocable to the graduate courses be excluded under section 117(d)? The position of the IRS appears to be to look to the status of the student, not the status of the course. In one ruling, the IRS made the fairly obvious observation that a graduate-level course is generally not considered to be ''below the graduate level,'' but carved out an exception where the graduate level course ''is taken toward a degree below the graduate level.''[37] This suggests that where an undergraduate student takes a graduate-level course that is credited toward her undergraduate degree, the course would be treated as ''below the graduate level.''[38] Under this same rationale, if a graduate-level student takes an undergraduate course that is credited toward her graduate degree, the course would be treated as a graduate-level course.

There is, however, an important exception to the ''below-the-graduate-level'' restriction. The exclusion can be claimed by graduate students who

[35]In Priv. Ltr. Rul. 200149030 (Sept. 10, 2001), the IRS ruled that a tuition reduction and reimbursement plan established by a church school system for its full and part-time employees met the requirements of the IRC section 117(d) qualified tuition reduction rules. *See also* Priv. Ltr. Rul. 200442001 (June 3, 2004), in which the IRS ruled that a tuition reduction program conducted by a university for its faculty and staff and their families met the requirements of IRC § 117(d) and that the benefits were, therefore, excludable from the employees' gross income.

[36]Priv. Ltr. Rul. 9431017 (May 4, 1994). *See also* Priv. Ltr. 200137041 (June 20, 2001).

[37]Priv. Ltr. Rul. 200029051 (Apr. 26, 2000).

[38]*See* I.R.S. Notice 96-68, 1996-52 I.R.B. 30, which defines a ''graduate level course'' for purposes of the section 127 educational assistance plan rules. In this ruling, the IRS limits ''graduate level courses'' to those taken by an employee who ''has a bachelor's degree or is receiving credit toward a more advanced degree.'' This suggests that a graduate level course taken by an undergraduate student would not be treated as a graduate level course. For a discussion of the rules relating to section 127 educational assistance plans, *see* § 5.3(p).

are engaged in teaching or research activities at the school, provided that the other tests of section 117(d) are met.[39] In 1990, the IRS issued an interesting ruling addressing the issue whether the section 117(d) tuition reduction exclusion is available to graduate-level tuition reductions provided to faculty and staff members of a university who are engaged in teaching and research activities but who are not graduate teaching or research assistants.[40] The university involved in that ruling had two tuition reduction plans—one plan for regular and part-time faculty and staff, and a second plan for graduate teaching and research assistants. The university contended that the exception for graduate-level tuition reduction applies to those faculty and staff members who are engaged in teaching and research activities because these individuals qualify under the literal language of the statute—that is, they are ''graduate students at an educational organization'' and ''engaged in teaching and research activities for such organization.'' The IRS disagreed with such a literal reading of the statute, ruling that Congress intended that the exception apply only to ''graduate teaching and research assistants,'' not to full-time or part-time faculty and staff members who may be engaged in teaching or research activities as part of their employment.[41]

Even if the plan provides for ineligible graduation tuition benefit (or extends benefits to ineligible persons, such as domestic partners), the plan was still able to provide tax-free benefits to those eligible persons receiving allowable benefits.[42]

(b) Nondiscrimination Rules

Even if the tuition reduction otherwise qualifies under section 117(d), it does not operate to exclude tuition reductions provided to ''highly compensated employees'' unless the tuition reduction is available on ''substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer, which does not discriminate in favor of highly compensated employees (within the meaning of section 414(q)).''[43] This nondiscrimination provision operates only to deny the

[39]IRC § 117(d)(5). There is a typographical error in this section of the Code. This section should be IRC § 117(d)(4), since it falls immediately after IRC § 117(d)(3), but it is generally cited as IRC § 117(d)(5).

[40]Priv. Ltr. Rul. 9040045 (July 10, 1990).

[41]*See also* Priv. Ltr. Rul. 200137041 (June 20, 2001), in which the IRS ruled that graduate education benefits provided to non-teaching/research assistants did not qualify under IRC section 117(d)(5).

[42]Priv. Ltr. Rul. 200137041 (June 20, 2001).

[43]IRC § 117(d)(3). See also Priv. Ltr. Rul. 9728017 (Apr. 10, 1997) and Priv. Ltr. Rul. 9710022 (Dec. 6, 1996), in which the IRS ruled that a school's tuition waiver program met the nondiscrimination rules. The IRS reached a similar conclusion in Priv. Ltr. Rul. 199940025 (July 12, 1999). One issue that arises in the nondiscrimination area is whether these rules will be violated if the college or university routinely permits otherwise ineligible persons to receive tuition benefits or permits eligible employees to receive more than the maximum allowed benefit. The problem

section 117(d) exclusion to ''highly compensated employees''; even if the tuition reduction plan is found to be discriminatory in favor of highly compensated employees, it will not adversely affect the benefits provided to non–highly compensated employees.[44] For example, assume that a tuition reduction plan covers 500 employees, 50 of whom are highly compensated. If the plan is found to be discriminatory, the tuition reductions provided to the 50 highly compensated employees are taxable, but the 450 non–highly compensated employees can continue to exclude the value of the tuition reduction.

While the statute requires that the group of highly compensated employees be determined by reference to section 414(q), there is nothing in the statute to indicate how the nondiscrimination test itself should be applied. In a 1994 private letter ruling, the IRS provided some guidance as to how section 117(d)(3) nondiscrimination determinations should be made.[45] In this ruling, a university asked the IRS to determine whether four separate tuition reduction plans were discriminatory under section 117(d)(3). The IRS made a determination with respect to each plan by applying the nondiscrimination rules applicable to retirement plans.[46] These rules generally require that in order to be nondiscriminatory, a retirement plan must meet two tests—that is, it must be ''reasonable'' by reflecting a bona fide grouping based on job categories, and it must satisfy a complex, mathematical test.

The ruling is instructive because it presents a useful illustration of how the mathematical nondiscrimination test is applied in the tuition reduction plan context. It is also interesting to note that one of the four plans involved in the ruling actually failed the mathematical test, but the IRS nevertheless held the plan to be nondiscriminatory for purposes of section 117(d)(3). The IRS's rationale for this seemingly contradictory conclusion was the lack of any specific language in section 117(d)(3) mandating that the qualified plan nondiscrimination tests be used in making nondiscrimination determinations under section 117(d)(3). Therefore, even though the plan failed the mathematical nondiscrimination test, the IRS ruled it to be nondiscriminatory for purposes of section 117(d)(3), primarily because the number of the university's non–highly compensated employees eligible for the plan in question (891) was ''substantial'' as compared to the 2,007 total number of university employees.

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arises from the fact that the statute requires that the tuition reduction benefits be ''defined under a reasonable classification set up by the employer.'' This statutory language could be read as setting forth two requirements—(1) a requirement that the employer have a ''classification'' of eligible employees, and (2) a requirement that such classification be ''reasonable.'' The IRS could argue that when an employer has a policy of permitting on an ad hoc or random basis certain selected, but otherwise ineligible, employees to receive tuition reduction benefits, the employer does not have a ''classification'' of eligible employees as contemplated by the statute.

[44]While there is no specific authority for this conclusion in the IRC § 117(d)(3) area, this is the IRS general position with respect to highly compensation discrimination rules so as to not unfairly penalize the non–highly compensated employees.

[45]Priv. Ltr. Rul. 9436050 (June 14, 1994). *See also* Priv. Ltr. Rul. 9621033 (Feb. 26, 1996).

[46]These rules are set forth in Treas. Reg. § 1.410(b)-4.

It is difficult to determine what this ruling stands for. On the one hand, it seems to be authority for applying the qualified plan nondiscrimination tests in making section 117(d)(3) nondiscrimination determinations; on the other hand, the ruling clearly indicates that other factors may override these tests in certain situations.[47]

§ 7.5 SECTION 117(C)—DISTINGUISHING BETWEEN SCHOLARSHIP/FELLOWSHIP GRANTS AND COMPENSATION

Whether a payment made to an individual is for the primary purpose of assisting in the pursuit of the individual's educational studies (and therefore properly treated as a ''scholarship/fellowship grant''), or instead represents a payment for past, present, or future services rendered is an issue that has confounded the IRS, taxpayers, and the courts since the enactment of section 117 in 1954.

The issue usually arises in one of two ways—the recipient either performs services for the educational institution as a condition for receiving the scholarship or fellowship grant or is required to perform future services for the grantor in return for the educational assistance provided. The leading case in this area is *Bingler v. Johnson*,[48] decided by the Supreme Court in 1969. This case involved a grant made by a company to an individual to permit him to work on his doctoral dissertation, but on the condition that he return to the company's employ after his studies were completed. The Supreme Court held that grants such as these should be treated as taxable compensation that do not qualify for the section 117 exclusion, stating:

> The thrust of the provision dealing with compensation is that bargained-for payments, given only as a ''quo'' in return for the quid of services rendered—whether past, present, or future—should not be excluded as ''scholarship'' funds. That provision clearly covers this case.[49]

Section 117(c), enacted as part of the 1986 changes to section 117, removes whatever ambiguity that may have existed after *Bingler* by clearly providing

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[47] *See also* Priv. Ltr. Rul. 200442001 (June 3, 2004) in which the IRS approved a college's qualified tuition reduction plan and concluded that it met the IRC §117(d)(3) nondiscrimination rules; Priv. Ltr. Rul. 200403050 (Sept. 30, 2003) where the IRS applied the general principles, but not the precise rules, of the employee benefit plan nondiscrimination rules to a qualified tuition reduction plan; and Priv. Ltr. Rul. 200137041 (June 20, 2001), in which the IRS ruled that a plan met the nondiscrimination rules and used the regulations under IRC § 410 (Treas. Reg. § 1.410-4(b)) as guidance.

[48] 394 U.S. 741 (1969). See also *Hembree v. United States*, 464 F.2d 1262, 1264 (4th Cir. 1972); *Brubakker v. Commissioner*, 67 T.C. 249, 255 (1976); *Reese v. Commissioner*, 45 T.C. 407, 413 (1966), *aff'd*, 373 F.2 d 742 (4th Cir. 1967). STET

[49] *Id*. at 757-58.

that, even though a payment may meet the ''qualified scholarship'' requirements of section 117(b) or the ''qualified tuition reduction'' rules of section 117(d), neither such section operates to exclude the payment if it ''represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or the qualified tuition reduction.''[50] As one leading commentator has noted:

> For years after 1986, the *Bingler v. Johnson* test should be reformulated as three questions: (1) Did the student render services? (2) If so, were the services a condition for receiving the award? (3) If so, was the award payment for the services? If all three questions are answered affirmatively, the award is taxable compensation. The compensation stigma is avoided, in contrast, if any of the three is answered no.[51]

(a) Grants for Independent Study

One of the remaining difficult issues in this area relates to graduate students who conduct teaching or research activities as an integral part of their graduate program. The IRS generally views teaching activities as provided primarily for the benefit of the institution and therefore treats the payment to the individual as compensation for services rendered under section 117(c). This same result may be less likely, however, in the case of graduate research activities, as in many of these situations, the individual can make a strong case that the research is ''independent'' and primarily furthers the student's own educational pursuits, as opposed to benefiting the institution at which the research is conducted. Factors that should be taken into account in making this determination are the extent of faculty supervision of the individual's work schedule, the individual's ability to direct the course of the research work, and the right of the individual to retain any patents or copyrights resulting from the research. The mere fact, however, that the individual is required to furnish periodic reports to the grantor for the purpose of keeping the grantor apprised of the progress of the research is not sufficient, in and of itself, to convert a fellowship grant into compensation.[52]

Whether a research assistant is receiving compensation income or a true independent research fellowship depends on the primary purpose for the payment. The Tax Court has described this primary-purpose test as requiring ''a determination of the raison d'etre of the payment in question, that is,

[50] In 2001, Congress added an exception to this general rule for scholarships received under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professionals Scholarship and Financial Assistance Program. IRC § 117(c)(2).

[51] Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 11.2.2, at 11-14 to -15, 2nd ed. (1989).

[52] Prop. Treas. Reg. § 1.117-6(d)(2). *See also* Priv. Ltr. Rul. 200113020 (Dec. 27, 2000), in which the IRS held that fellowship and training programs conducted by a nonprofit education organization were true fellowship programs and did not represent compensation for services rendered. The grants were determined to be ''relatively disinterested'' and designed to allow participants to pursue ''programs of independent development, training and independent study.''

was it to further the education and training of the recipient or was it in reality payment for services which directly benefited the payor.''[53] This is a question of fact that varies from case to case, or as the Tax Court said in another case, ''the decided cases run the gamut of the full spectrum with all its shadings, making precisional line-drawing impossible. As a result, each case must turn on its own particular facts and circumstances.''[54] This ''primary-purpose'' test even applies if the payor is a nonprofit organization or a governmental agency. In one case, the IRS ruled that grants made by a private foundation to college students on the condition that the students teach in a particular state after graduation were not scholarships because the students were required to render ''substantial services'' in return for the grants and the grants furthered the objectives of the foundation.[55] Similarly, the Tax Court held that governmental grants designed to induce recipients to engage in educational activities beneficial to those agencies were not scholarships because they were primarily intended to further the objectives of the grantor agencies.[56] But the IRS also has ruled that a scholarship provided by a university to permit students to attend law school was not compensatory when it was conditioned on the student's agreeing to practice law on a full-time basis in public, nonprofit, or other low-paying sectors of the legal profession following graduation.[57] The IRS reached this conclusion after finding that the scholarships were ''disinterested grants . . . designed to accomplish public rather than private or proprietary purposes.'' Presumably, unlike the situations involving the private foundation and government grants, there was not a sufficient nexus between the postgraduate work requirement and the mission and objectives of the grantor university.

Factors that the courts have used in determining whether or not services performed by a research assistant are compensatory include:

- Whether the individual's services were directly related to the fulfillment of a contractual commitment to a specifically sponsored project.[58]
- Whether the individual's services were subject to supervision, were geared to planned time schedules, required specific progress reports, and were valuable in enabling the college or university to fulfill its commitments.[59]
- Whether the individual was required to devote full-time to the project or work a certain number of hours a week.[60]

[53] *Willie v. Commissioner*, 57 T.C. 383, 388 (1971).
[54] *Gibb v. Commissioner*, 32 T.C.M. (CCH) 784, 787 (1973), *aff'd*, 501 F.2d 1086 (6th Cir. 1974).
[55] Rev. Rul. 77-44, 1977-1 C.B. 355. See also Rev. Rul. 73-256, 1973-2 C.B. 56.
[56] *Turem v. Commissioner*, 54 T.C. 1494 (1970).
[57] Priv. Ltr. Rul. 9526020 (Apr. 3, 1995).
[58] *Littman v. Commissioner*, 42 T.C. 503 (1964).
[59] *Wrobleski v. Bingler*, 161 F. Supp. 901 (W.D. Pa.*1958); Bonn v. Commissioner*, 34 T.C. 64 (1960).
[60] *Zolany v. Commissioner*, 49 T.C. 389 (1968).

- Because fellowship grants tend to be less generous than salary payments, whether the amount received by the individual was unusually large compared with the amount normally awarded for fellowships.[61]
- The manner in which the college or university treated the individual—that is, whether the payments were reported as wages, whether the individual was accorded faculty privileges, and whether the person received health and other employee benefits.[62]

In a case illustrating this issue,[63] a postdoctoral fellow received a fellowship to attend Columbia University to conduct independent scientific research, and under the terms and conditions of this fellowship award, he could choose his own subject and determine how best to conduct his own research. He had no teaching or other responsibilities at Columbia, and the university had no legal right to, or interest in, the results of his research. He was not required to observe office hours or report to a supervisor. The specific issue in this case was whether the payments made by Columbia constituted a ''fellowship'' under section 117 or instead represented self-employment income to the fellow from his conduct of a trade or business. The Tax Court held that the fellowship in question was a true ''fellowship,'' and not income from a trade or business, stating:

> The facts indicate that the grant at issue, although not excludable from gross income as a ''qualified scholarship,'' is a scholarship or fellowship grant as defined by the case law and regulations interpreting section 117. The funds . . . were not provided to [the fellow] as compensation for research services, and [the fellow's] efforts did not economically benefit Columbia University. [The fellow] performed his research and studies primarily to further his own education and training, and the fellowship grant was bestowed upon him in recognition of and in furtherance of his pursuit of academic excellence.[64]

This case should be helpful in those situations in which the graduate research student has a significant amount of control over the content and conduct of the research activities, and where the institution does not have right to the results of the research. Where these factors are not present, however, the issue gets murkier, and a court may not reach the same conclusion.

This same issue as to whether a grant should be treated as a bona fide fellowship or as self-employment income arose in a Tax Court case that had an interesting fact pattern.[65] This case involved a professor at the University of Connecticut who received a fellowship to conduct independent research

[61] *Id*.
[62] *Id.; Proskey v. Commissioner*, 51 T.C. 918 (1969); but *see Vaccaro v. Commissioner*, 58 T.C. 721 (1972) (facts clearly indicated taxpayer not required to perform services even though treated as employee by institution).
[63] *Spiegelman v. Commissioner*, 102 T.C. 394 (1994).
[64] *Id*. at 405-06.
[65] *Ruggiero v. Commissioner*, T.C. Memo 1997-423 (Sept. 22, 1997).

while still employed at the university. The university granted him a leave of absence to conduct his research and gave him the option to either (1) continue to receive his full salary ($53,000) and remit the amount of the fellowship grant ($33,500) to the university, or (2) keep the full amount of the fellowship grant and have his salary reduced by 50 percent. The professor chose to maintain his full salary and pay the fellowship grant to the university. Under these facts, the court held that:

- The professor could not (as he claimed on his return) reduce the amount of his wages for the year by the amount of the fellowship remitted to the university. He was required to report the full $53,000 as taxable wage income.
- The full amount of the fellowship proceeds was includable in the professor's income, but the fellowship income should be treated as noncompensatory and not subject to the self-employment tax.
- The professor was entitled to an employee business expense deduction under section 162 for the amount of the fellowship payment remitted to the University.
- The other expenses that the professor incurred while conducting his research were not incurred as part of an independent profit-making venture or as part of his University employment but rather were related to his fellowship income. These expenses were deductible under section 212 as expenses incurred in connection with the production of income.

(b) National Research Services Act Awards

This fellowship versus compensation issue has arisen in the case of stipends paid under the National Research Services Act (NRSA),[66] which is a program sponsored by the NIH. In at least one audit of a university, IRS agents questioned whether these stipends should be treated as fellowship payments, notwithstanding the existence of a 1989 private letter ruling clearly holding these stipends to be part of a noncompensatory training grant.[67]

The fact that NRSA training grants have been determined by the IRS to be noncompensatory is significant because fellowship programs that are organized in a similar manner might also qualify for noncompensatory treatment.[68] However, a review of the background and history of the IRS position with respect to NRSA grants indicates that the IRS position may be unique to NRSA

[66] 42 U.S.C. § 288. See also Priv. Ltr. Rul. 199933021 (May 20, 1999).

[67] Priv. Ltr. Rul. 8940066 (July 12, 1989).

[68] In fact, the IRS has so ruled in Priv. Ltr. Rul. 199933021 (May 20, 1999); Priv. Ltr. Rul. 199910047 (Sept. 3, 1998); Priv. Ltr. Rul. 199910048 (Sept. 3, 1998); Priv. Ltr. Rul. 199910049 (Sept. 3, 1998); Priv. Ltr. Rul. 199910050 (Sept. 3, 1998); Priv. Ltr. Rul. 199908041 (Nov. 23, 1998); Priv. Ltr. Rul. 9851002 (Sept. 3, 1998); and Priv. Ltr. Rul. 200042027 (July 25, 2000).

grants (or grant programs that are precisely modeled after the NRSA program) and may not have any broader impact on other fellowship grant programs.

At one time, the IRS took the position that NRSA grants constituted compensation for services rendered and were not true fellowships. In 1977, the IRS issued a ruling that reached this conclusion based on the following rationale:

> In the instant case, a substantial quid pro quo from the recipients is required because, in return for receiving the awards, (1) the recipients must, within two years after completion of the award period, engage in health research or teaching or some equivalent service for a period equal to the award period, and (2) the Government reserves the right to make royalty-free use of any copyrighted materials produced as a result of the research performed during the award period [citations omitted]. Therefore, the awards are made primarily for the benefit of the grantor.[69]

In response to this ruling, Congress included in the Revenue Act of 1978 a provision that, in effect, suspended this ruling until 1983.[70] When that suspension expired in 1983, the IRS issued a ruling that said, because of changes made by Congress to the NRSA grant program in 1981, the 1977 ruling is ''obsolete.''[71] Although this 1983 IRS ruling did not expressly say that NRSA grants would thereafter be treated as noncompensatory fellowships, in several private letter rulings issued since that time, the IRS has said that this is how these grants are treated.[72]

The IRS did not say, however, what changes made by Congress in 1981 to the NRSA grant program caused the IRS to change its position on the treatment of these grants. Prior to 1981, NRSA grant recipients were subject to a requirement that they must engage in health research or teaching for a period equal to the full amount of the award period. This appears to have been the most important reason that the IRS in 1977 held the grants to be compensatory.[73] The primary change made by Congress in 1981 to the NRSA grant program was that one year of the post-grant service requirement was eliminated. For example, if a person received a three-year NRSA grant, he or she was required to work in the research or teaching area for only two years, whereas prior to 1981, that person was required to conduct post-grant services for the entire three-year period of the grant.[74] In addition, one of the reasons stated by the IRS in 1977 for treating the NRSA grants as compensatory was the fact that the government was able to make royalty-free use of any copyrights

[69]Rev. Rul. 77-319, 1977-2 C.B. 48.
[70]Revenue Act of 1978, Pub. L. No. 95-600, § 161(b), 92 Stat. 2763.
[71]Rev. Rul. 83-97, 1983-1 C.B. 364.
[72]*See* footnotes 67 and 68. *See also* Priv. Ltr. Rul. 8633011 (May 14, 1986).
[73]The pre-1981 NRSA grant provisions are set forth in 42 U.S.C. § 2891-1.
[74]This 1981 change in the post-grant service requirement was subsequently amended in 1993 so that only the first year of the award was subject to a payback provision, and subsequent participation in the program itself for an additional year would satisfy the payback requirement. See 42 U.S.C. § 288(c).

created by the grantees. The copyright ownership rules were not changed by the 1981 legislation, and after 1981 the government was still able to make royalty-free use of any such copyrights created by the grant recipients.[75]

Thus, it is not clear why the IRS changed its position with respect to the NRSA grants. Both before and after the 1981 changes to the NRSA program, grantees were required to perform services in a health-related field, with the only difference being that the post-grant service requirement was reduced by one year. This relatively minor change would not seem to be sufficient to convert the grants from compensation to true fellowships, because the requirement to perform post-grant services that benefit the grantor remained in place, albeit slightly reduced. We cannot ignore the possibility, however, that the change in the IRS position was caused more by political considerations than by any fundamental change in the program itself. This may be the reason why the IRS never set forth any rationale for its new position with respect to NRSA grants. The 1983 IRS ruling does not say that the NRSA grants will be treated as fellowships, but only that its earlier 1977 ruling is ''obsolete''; the subsequent IRS private letter rulings only make the conclusory statement, with no supporting rationale, that NRSA grants are treated as fellowships and not as compensation.

It is somewhat unusual for the IRS to make such a dramatic change in its treatment of a tax issue without setting forth some rationale and basis for the change. The fact that it did not do so here suggests that perhaps the change was dictated more by the lobbying efforts directed at the IRS by NIH or Congress than by any objective application of the tax law. Such a conclusion is strengthened by the following statement in legislative history in connection with the 1981 change in the NRSA grant program:

> Finally, the conferees are concerned about the federal income tax status of the National Research Service Awards. In 1977, the Internal Revenue Service ruled that NRSA stipends must be included in gross taxable income (Revenue Ruling 77-319). In 1978, the Committee on Interstate and Foreign Commerce expressed its views in the report on ''The Biomedical Research and Research Training Amendments of 1978'' that the Internal Revenue Service's ruling on NRSAs represented a misreading of the purpose of these awards. The Committee stated that in its opinion the primary purpose of such awards is payment, not for service, but rather for the training of individuals in order that they might be better equipped to pursue research careers. The Committee then expressed the hope that the IRS would reverse its ruling in light of the statement of the Committee's intent. Further expression of Congressional purpose is contained in Section 161 of the Revenue Act of 1978, which in order to rectify the situation, included a provision that expires on December 31, 1983, requiring that awards be treated as a scholarship or fellowship grant under the Internal Revenue Code.

[75]Ruth L. Kirschstein National Research Service Awards for Individual Postdoctoral Fellows (F32), PA-03-067 (Feb. 6, 2003).

> The Conferees recognized that the jurisdiction of a permanent tax exemption for NRSAs remains with the House Ways and Means and the Senate Finance Committees. However, as the purpose of the awards—a matter directly in the purview of the Conferees—is at the heart of the dispute, the conferees feel obligated to clarify their intent regarding the primary purpose of the NRSA program. National Research Service Awards are not made for the purpose of receiving services designed by the grantor. Rather the payback requirement offers benefits to the Nation from the participation of NRSA recipients in the research enterprise. As the Committee does not believe that the payback requirement is a *quid pro quo*, the tax exemption should be applicable.[76]

Thus, it may be that the IRS position with respect to NRSA grants (and grant programs identical to the NRSA model) is unique to these grant programs and that the IRS rationale cannot be expanded to other types of grant programs.[77]

As noted above, the IRS position is that NRSA grants are treated as bona fide fellowships, and grant programs that are modeled on the NRSA program likewise qualify for fellowship treatment. In a private letter ruling, the IRS described the factors that it relied on to determine that a non-NRSA grant program conducted by a research hospital was sufficiently similar to the NRSA program to be treated as a bona fide fellowship program. The IRS found 10 important factors in this regard:

1. The research fellows engaged in extensive research, training, and education designed to foster and develop their research skills and abilities.
2. The research training programs varied in length, depending on the specialty, from three to five years.
3. The stipends were paid to help defray the research fellows' living expenses during their periods of training.
4. The research fellows did not serve as medical residents or as laboratory technicians as part of the research training programs and were not replacements or substitutes for either.
5. The activities of the research fellows during their research training programs did not materially benefit the hospital.
6. The research issues were not determined by the hospital but by the research fellows themselves in conjunction with their faculty mentors after selection into the programs.
7. The research training and mentoring that the research fellows received under these programs were almost identical to the training and mentoring under the NRSA training program.

[76] U.S. Code Cong. & Admin. News, 97th Cong., 1st Sess., Vol. 2, at 1166.

[77] *See also* ILM 200441029 (Apr. 7, 2004), in which the IRS Chief Counsel's office discusses the history of the IRS treatment of the NRSA program and confirms that its current position remains that awards made under this program are not treated as taxable wages.

8. The research fellows were not required to have performed past services or to agree to perform future services for the hospital as a condition to receiving a research training stipend.
9. The fellows were not required to enter into any agreements regarding the future patenting or use of any research findings or inventions attributable to their research activities.
10. The research fellows were encouraged to publish and copyright their research findings to the same extent and subject to the same conditions and practices imposed by the NIH upon NRSA grant recipients.[78]

(c) Amount of Grant Treated as Compensation

Simply because a scholarship/fellowship grant is treated as compensatory under section 117(c) does not mean that the entire amount of the grant will be so treated. The regulations state that if only a portion of the grant represents payment for services, ''the grantor must determine the amount of the scholarship or fellowship grant (including any reduction in tuition or related expenses) to be allocated to payment for services.''[79] The regulations state that the following factors should be taken into account in making this allocation:

- Amount of compensation paid by the grantor for similar services performed by nonscholarship students with qualifications similar to those of the scholarship recipient
- Amount of compensation paid by the grantor for similar services performed by part-time or full-time employees of the grantor who are not students
- Amount of compensation paid by other educational organizations for similar services performed by either students or nonstudent employees[80]

If, after making a determination of the fair market value of the services provided under these rules, there remain additional amounts paid to the individual under the scholarship or fellowship grant, then these additional amounts can qualify for the exclusion under section 117, assuming they meet either the ''qualified tuition'' rules of section 117(b) or the ''qualified tuition reduction'' requirements of section 117(d). Even if the excess amounts do not qualify for exclusion under section 117(b) or 117(d), they still represent ''scholarship/fellowship grants,'' which are subject to the ''no withholding/no reporting'' rule of Notice 87-31.

[78]Priv. Ltr. Rul. 20060717 (Mar. 7, 2005).
[79]Prop. Treas. Reg. § 1.117-6(d)(3). *See* Priv. Ltr. Rul. 200226005 (Mar. 3, 2002), holding that stipends paid by a scientific research organization to training participants were bona fide fellowship payments and not compensation for services rendered.
[80]*Id*.

The regulations illustrate these allocation rules with two helpful examples:

> **Example 1:** On June 11, 1987, E receives a $6,000 scholarship for academic year 1987–1988 from University Y. As a condition to receiving the scholarship, E performs services as a researcher for Y. Other researchers who are not scholarship recipients receive $2,000 for similar services for the year. Therefore, Y allocates $2,000 of the scholarship amount to compensation for services performed by E. Thus, the portion of the scholarship that represents payment for services, $2,000, must be included in E's gross income as wages. However, if E establishes expenditures of $4,000 for qualified tuition and related expenses. . . then $4,000 of E's scholarship is excludable from E's gross income as a qualified scholarship.
>
> **Example 2:** During 1987, F is employed as a research assistant to a faculty member at University Z. F receives a salary from Z that represents reasonable compensation for the position of research assistant. In addition to salary, F receives from Z a qualified tuition reduction (as defined in section 117(d)) to be used to enroll in an undergraduate course at Z. F includes the salary in gross income. Thus, the qualified tuition reduction does not represent payment for services and, therefore, is not includable in F's gross income.[81]

If under the rules of section 117(c) some or all of a qualified scholarship or qualified tuition reduction should be treated as compensation for services rendered, an issue sometimes arises as to the timing of the income inclusion. The regulations say that if a grant represents payment for services, the recipient recognizes the income ''when the grantor requires the recipient to perform services in return for the granting of the scholarship or fellowship.''[82] In most cases, the timing of the income will be clear, but suppose that on September 1, 2007, a university and the grantee enter into an agreement whereby the university provides the grantee with free tuition for the September 1, 2007–May 31, 2008, academic year, on the condition that the grantee agrees to work for the university for at least one year beginning on July 1, 2008. Clearly, the university has provided the grantee with the tuition benefit in consideration for the performance by the grantee of future services; therefore, the value of the tuition must be treated as compensation for services rendered. But should the grantee be treated as recognizing the income on September 1, 2007, the date that he enters into the agreement with the university, or on July 1, 2008, when he actually begins to work for the university? The answer is not entirely clear, but if the agreement provided that the grantee had the option not to work for the university and to repay the amount of the tuition benefit, it would be possible to characterize the transaction as a nontaxable loan from September 1, 2007, until such time as the grantee either begins to work or repays the university. If he repays the university, the entire transaction is a nontaxable loan; however, if he chooses to perform the bargained-for services, he has income recognition on the date that he begins to work. If the agreement

[81]Prop. Treas. Reg. § 1.117-6(d)(5), Examples 5 and 6.
[82]Prop. Treas. Reg. § 1.117-6(d)(2).

provides that the grantee has no option to repay the loan, an argument could be made that the income is recognized in 2007, which is the date that, under the regulations, he is ''required'' to perform the services.

In connection with the ''services'' rule of section 117(c), the IRS has never addressed the question of whether there might be a de minimis exception where the services, though required as a condition of the grant, are relatively minor in the context of the overall grant. But, in a 2003 ruling, the IRS suggests that it may recognize a de minimis exception to section 117(c).[83] The ruling involved a theological seminary that conducts training programs to develop the skills that ministers will need to pursue their pastoral activities, one of which is an understanding and familiarity with fund raising and the solicitation of charitable contributions. The school planned to offer scholarships to students to participate in this training program but, as part of the program, the students would be required to identify and contact individuals who might be willing to provide financial support to the seminary's ministry training program. Thus, the scholarship students will, as part of their training, assist the grantor of the scholarship (the seminary) in raising funds from third parties, thereby putting before the IRS the question of whether some or all of the scholarship grant should be recharacterized as compensation for services rendered to reflect the value received by the seminary from these fund-raising services.

The IRS ruled that no part of the scholarship program should be treated as compensation for services rendered because the fundraising commitments imposed on the scholarship recipients ''do not constitute the requirement of a substantial quid pro quo from the recipients'' and represent only a ''de minimis limitation designed to ensure that [the seminary's] graduates are competent in the field of church financial and economic stewardship.'' Thus, the IRS appears to allow scholarship recipients to perform a certain small amount of services as part of the scholarship grant without causing a portion of the grant to be recharacterized as compensation income. Whether other services conducted as part of a scholarship grant will be accorded similar de minimis treatment will depend on the nature and scope of those services as compared to the overall educational nature of the grant program.

(d) Tuition Remission Reimbursements under Federal Grants

One of the factors used by the IRS to distinguish a scholarship/fellowship grant from compensation is how the institution treated the payment in other contexts. This factor was of significant importance in a long-standing conflict that existed between the tax treatment of tuition remission benefits provided to graduate students and the rules regarding costs that can be reimbursed to a college or university under federal grant contracts.

[83]Priv. Ltr. Rul. 200414039 (Dec. 23, 2003).

By way of background, colleges and universities provide many graduate students with two basic benefits—full or partial tuition remission and a cash stipend. Schools generally treat the cash stipend as taxable wages and withhold normal income tax on the stipend amount, but they treat the tuition remission as a scholarship/fellowship and do not withhold income tax on this benefit under the above-described provisions of Notice 87-31. Many of these same schools, however, routinely charge the value of the tuition remission as a cost in performing under government contracts and seek reimbursement of the tuition remission amount from the government agency. OMB Circular A-21, ''Cost Principles for Educational Institutions,'' which sets forth the rules regarding those federal contract costs that are eligible for reimbursement, provides that tuition remission costs for students are allowable for reimbursement if ''there is a bona fide employer-employee relationship between the student and the institution.''[84]

This ''employer-employee'' rule led to the common perception that, if a college or university attempted to obtain reimbursement for tuition remission costs under a federal grant, the school was also taking the position that the tuition remission was provided as part of the employer-employee relationship between the school and the student. Such a position, of course, implies that the tuition remission represented a wage payment and therefore would be in direct conflict with the school's tax position that the tuition remission is a true scholarship/fellowship, not compensation for employment services rendered.

This conflict seems to have been resolved, however, in a memorandum issued early in 2001 by the Office of Management and Budget to the heads of federal government agencies.[85] This memorandum ''clarifies'' this aspect of Circular A-21 and says that ''the Circular did not intend to tie the allowability of tuition remission costs to how they are treated for tax purposes.'' The memorandum goes on to set forth certain tests that must be met in order for a school to be reimbursed for tuition remission costs and says that any tuition remission that satisfies these criteria is allowable for cost reimbursement ''regardless of whether the tuition remission or other form of support qualifies as wages for tax purposes.''[86]

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[84]OMB Circular A-21, § J.41. Circular A-21 also requires that (1) the tuition costs be reasonable compensation for the work performed and are conditioned explicitly upon the performance of necessary work, and (2) it is the institution's practice to similarly compensate students in nonsponsored as well as sponsored activities.

[85]This memorandum is dated January 5, 2001, and can be found at *www.ostp.gov/html/OM-BA21—01.pdf*.

[86]The cost reimbursement criteria that must be met are (1) the individual is conducting activities necessary to the sponsored agreement; (2) the tuition remission is provided in accordance with well-established educational institution policy and consistently provided in a like manner to students for similar activities conducted as part of nonsponsored activities; and (3) the student is enrolled in an advanced degree program and the activities of the student in relation to the federal project are related to the degree program.

Thus, while schools will still have to be able to demonstrate that the cash stipend portion of the grant represents a fair market value for the services rendered or risk having some or all of the tuition remission treated as compensation income, it now appears that the IRS can no longer assert as one of its arguments that the tuition remission should be treated as wages on the ground that the school took a ''wage'' position in connection with a federal grant.

(e) Forgiveness of Penalties

In some cases, a penalty is imposed if the student refuses to perform certain agreed-upon services for the grantor after graduation. What is the penalty is forgiven—does the student have to recognize income equal to the amount of the forgiven penalty? This situation arose in a case involving a scholarship provided by the Department of Health and Human Services (HHS) to a medical school student. The student signed an agreement and agreed to work in a hardship area after graduation. He did not do so, however, and the penalty for this contractual breach was three times the amount of the scholarship. HHS decided not to pursue the collection of the penalty, and the issue was whether this represented cancellation of indebtedness income to the student. The IRS concluded that the cancellation of the penalty by HHS did give rise to cancellation of indebtedness income under section 108 and, further, that the student loan provisions of section 108(f) did not apply because penalties do not qualify as student loans.[87]

§ 7.6 ATHLETIC SCHOLARSHIPS

The compensation versus scholarship issue also arises within the context of athletic scholarships. As a general rule, individuals receiving athletic scholarships are treated no differently from a tax standpoint than those receiving a scholarship award because of financial need or academic achievement—that is, the same ''qualified scholarship'' rules apply, resulting in the tuition, fees, and books excludable from income, but subjecting room, board, travel, and any living allowances to taxation.

Because of the popular view that some athletes attending colleges and universities on athletic scholarships are instrumental in bringing significant amounts of revenue to the school, an issue sometimes arises as to whether an athletic scholarship is more compensatory than academic. The IRS addressed this issue in a ruling, which involved athletic scholarships awarded by a university to individuals to participate in intercollegiate athletic programs.[88] Eligibility for the scholarship and the terms of the award were governed by rules established by a collegiate athletic association, which required that the

[87]CCA 200038044 (Aug. 14, 2000). For a discussion of IRC § 108(f), see § 7.7.
[88]Rev. Rul. 77-263, 1977-2 C.B. 47.

individual be a full-time student and be accepted by the university under the standards applied to all students. In addition, once the scholarship was awarded, it could not be terminated if the individual was injured or unilaterally decided not to participate in the sport. The IRS reviewed the Supreme Court's quid pro quo rule set forth in the *Bingler* case, as well as a 1971 Tax Court case involving the issue of whether the value of an athletic scholarship should be considered ''support'' for purposes of the income-averaging provisions,[89] and concluded that there was no quid pro quo arrangement in the situation presented. Although the students who received the scholarships were expected to participate in their particular sport, the ruling stated that ''the scholarship is not canceled in the event the student cannot participate and the student is not required to engage in any other activities in lieu of participating in the sport.''[90]

An interesting issue arises in the case of athletic scholarships awarded to nonresident alien athletes. As noted in section 7.3(b), unlike scholarship grants made to U.S. citizens and residents where the school is not required to withhold tax on the taxable portion of the award, a college or university is required to withhold income tax on the value of any room, board, travel, and living allowances provided to nonresident alien athletes. Some schools, rather than deducting this tax from payments made to these students or requiring them to pay the amount of the tax to the school, simply pay the applicable withholding tax on the student's behalf. Because this tax payment represents a payment by the school of the nonresident alien student's tax liability, it represents additional income to the student.[91] The National Collegiate Athletic Association (NCAA) rules prohibit a school from making payments to an athletic scholarship recipient in an amount in excess of the scholarship award,[92] and additional tax that is paid by the school on the athlete's behalf

[89] *Heidel v. Commissioner*, 56 T.C. 95 (1971).

[90] Rev. Rul. 77-263, 1977-2 C.B. at 48.

[91] This situation also results in a ''tax pyramiding'' problem, assuming that the school agrees to make the tax payment as part of the grant. *See* Treas. Reg. § 1.1441-2(d)(3). If so, income tax withholding is required on this additional income, which in turn creates additional income on which tax must be withheld and paid, which creates additional income, and so on. The tax pyramiding problem can be solved by applying the following ''gross-up'' formula:

$$\text{Net amount of award}/1 - \text{tax rate of } 14\% = \text{gross amount to be paid}$$

For example: Assume that an institution makes a $20,000 grant to a nonresident alien in a calendar year, all of which is taxable to the individual. During that year, the institution withholds and pays over to the IRS $2,800 (i.e., 14% × $20,000). This $2,800 constitutes additional income to the nonresident alien and is therefore subject to withholding. The institution must withhold an additional $392 (i.e., 14% × $2,800) and pay that amount over to the IRS. The $392 is additional income subject to withholding, etc. Applying the ''gross-up'' formula, the institution would have to make a total grant of $23,256 to the nonresident alien in order to properly account for the withholding tax that is paid on the nonresident alien's behalf. This ''grossed-up'' amount is calculated as follows: $20,000/[1 − 0.14] = $23,256.

[92] The 2004-2005 NCAA Division I Manual reprints the NCAA Operating Bylaws, and art. 16.01.1 of such Bylaws states as follows:

is potentially in violation of this rule. As of this writing, the NCAA has not issued any formal guidelines as to how to treat the problem, but in a letter dated February 11, 1997, from Stephen A. Mallonee, the NCAA's director of legal affairs, addressed to the author, Mr. Mallonee stated:

> Under current financial aid legislation, a student-athlete is not eligible to participate in intercollegiate athletics if he or she receives financial aid that exceeds the value of a full grant. In Divisions I and II, the two divisions that permit institutions to provide athletic scholarships to student-athletes, a full grant consists of tuition and fees, room and board, and required course related books.
>
> During its June 15, 1996, meeting, the legislative services staff reviewed this issue and confirmed that under current financial aid legislation, it would not be permissible for a Division I or II institution to provide a foreign student-athlete with a full grant-in-aid and, in addition, pay the nonresident alien withholding tax. Such activity would result in the student-athlete receiving financial aid from his or her institution that exceeds the value of a full grant and, thus, would jeopardize the student-athlete's remaining eligibility. Under the current regulations, a nonresident alien (foreign) student-athlete would be required to reimburse the institution the value of the nonresident alien withholding tax. Although the staff was sensitive to the situation that has arisen, it did not believe it had the authority to set aside the application of the legislation.

In response to a request for an update on this 1997 position, Mr. Mallonee noted that in 1999 the NCAA's Division I Management Council considered an amendment to the NCAA rules that, if adopted, would have permitted Division I institutions to pay the withholding tax on the student-athlete's behalf without being in violation of the NCAA rules. This proposal, however, was defeated at the Council's April 1999 meeting. Thus, at least as of 2007, the rules governing NCAA financial aid as it relates to paying a nonresident alien student-athlete the value of the withholding tax still require that such amount be included in the student-athlete's individual limit.

Mr. Mallonee notes, however, that since 1997 there have been significant changes in the NCAA financial aid limits themselves and what sources of aid are included or not included in that limit. For example, student-athletes no longer have to include compensation from term-time employment in the individual limit. Therefore, many nonresident alien student-athletes whose families may not have the financial resources to cover the value of the withholding tax now obtain part-time employment during the year to cover the charges assessed by the institution for the taxable portion of the scholarship. In addition, NCAA rules now permit student-athletes to receive aid up to the cost of attendance, an amount far greater that the previous value of a full grant,

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Eligibility Effect of Violation. A student-athlete shall not receive any extra benefit. Receipt by a student-athlete of an award, benefit or expense allowance not authorized by NCAA legislation renders the student-athlete ineligible for athletics competition in the sport for which the improper award, benefit or expense was received. If the student-athlete receives an extra benefit not authorized by NCAA legislation, the individual is ineligible in all sports.

provided that any aid in excess of a full grant may not be athletically related. The result of this change is that, again, there are avenues for nonresident alien student-athletes to qualify for sources of nonathletic aid that may be used to cover the charges assessed by the institution for room, board, and other taxable items. Mr. Mallonee believes that these changes in the NCAA financial aid limitations have greatly lessened any adverse impact that the NCAA rules may have on the ability of the student-athlete and the institution to comply with both the NCAA and the IRS rules.

§ 7.7 TAX-FREE DISCHARGES OF STUDENT LOANS

As a general rule, if a lender forgives a loan made to an individual, the person realizes gross income in the amount of the debt discharge.[93] There are a number of exceptions to this general rule, for example, where the person can show that the forgiven loan meets all the requirements of a tax-free gift in section 102. Other exceptions are set forth in section 108, one of which relates to the discharge of certain student loans.[94]

The student loan exception relates to the rule that if a loan is discharged on the condition that the person performs future services, the discharge cannot be treated as a tax-free gift and will likely be included in the person's income. This rule had a negative impact on those educational organizations that provided loans to students but agreed to forgive the loan if the person performed future charitable or educational services (e.g., works as a physician in a poor or distressed area). For example, prior to the enactment of section 108(f), the IRS had ruled that the cancellation of a student loan for attending medical school, where the recipient was required to practice medicine in a rural area for a specified period after the completion of his or her education, was taxable income from the discharge of indebtedness.[95]

To avoid this result, section 108(f) provides that the discharge of a student loan will not be treated as gross income where the loan is made by certain types of organizations and the individual is required to work ''for a certain period of time in certain professions for a broad class of employers.'' Looking at the first requirement, the loan must be made by the United States, a state, a tax-exempt public benefit corporation that operates a state hospital, or an educational institution.[96] If the discharged loan is made by an educational institution, the discharge must be made pursuant to a program designed to fulfill unmet social needs with the services of the students being provided under the direction of a governmental unit or a charitable organization.[97]

[93]Treas. Reg. 1.61-12(a).
[94]IRC § 108(f).
[95]Rev. Rul. 73-256, 1973-1 C.B. 56, as modified by Rev. Rul. 74-540, 1974-2 C.B. 38.
[96]IRC § 108(f)(2).
[97]IRC § 108(f)(2)(D).

With respect to the second requirement in the statute, the term *certain professions* is defined in the legislative history to section 108(f) as medicine, nursing, and teaching,[98] and the reference to a broad class of employers means that the work requirement must relate to a general class of employers, not specific organizations or entities. The Tax Court addressed this requirement in a case involving loans made to students by the state of Alaska that were discharged if the student worked in Alaska for a certain period of time following graduation.[99] The court held that the student loan provisions of section 108(f) were inapplicable because the future employment was not limited to medicine, nursing, or teaching and because the work requirement permitted the student to work for any employer within the state.

As part of the American Jobs Creation Act of 2004, Congress amended section 108(f) to exclude from gross income and employment taxes education loan repayments provided under the National Health Service Corps Loan Repayment Program and similar state programs under the Public Health Service Act. This new provision is effective for taxable years beginning after December 31, 2003.[100]

The statute contains a special provision that is applicable only to loans discharged by educational institutions. The provision says that the tax-free loan discharge rules will not apply if the discharge is conditioned on the performance of services for the lending institution.[101] The IRS relied on this provision in a ruling to hold that tuition loans made by a college to its faculty and staff were taxable to the individuals where one third of the amount of the loan was forgiven for each year that the person worked for the college after graduation.[102]

In order for section 108(f) to apply, however, there must be a loan that is discharged. The Tax Court refused to apply the section 108(f) gross income exception where the student received a cash award that was intended and was used to pay off a portion of a student's law school loan.[103] The court said that for section 108(f) to apply, there must be an actual discharge of a debt obligation. The cash award did not discharge the debt obligation but provided the student with funds that he or she could use to pay off the loan. In addition, the IRS chief counsel's office has held that penalties imposed for not performing the required services under a loan program are not ''loans,'' so that any discharge of the penalties would not qualify under section 108(f).[104]

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[98]Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 119.
[99]*Porten v. Commissioner*, T.C. Memo 1993-73, 65 T.C.M. 1994 (1973).
[100]IRC § 108(f)(4).
[101]IRC § 108(f)(3).
[102]Priv. Ltr. Rul. 8714035 (Jan. 2, 1987).
[103]*Moloney v. Commissioner*, T.C. Summ. Op. 2006-53.
[104]CCA 200038044 (Aug. 14, 2000).

In addition, some schools have questioned whether the loan could be discharged under the terms of a section 127 educational assistance plan, with the amount of the discharge qualifying as a tax-free fringe benefit under those rules.[105] Though it would seem possible to structure a section 127 plan that would provide tax-free loan discharge benefits, the IRS has issued a ruling that casts some doubt on such a conclusion.[106]

[105]For a discussion of section 127 educational assistance plans, see § 5.3(p).
[106]Priv. Ltr. Rul. 8714035 (Jan. 2, 1987).

CHAPTER EIGHT

Income Tax Withholding and Reporting on Payments to Nonresident Aliens

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§ 8.1 INTRODUCTION

At any given point in time, most colleges and universities have on campus a variety of non–U.S. citizens to whom they make different types of payments, including scholarship or fellowship grants to students, wages paid to employees, compensation payments to independent contractors, and honoraria awards to guest speakers. If the foreign national to whom the payment is made is classified as a ''resident alien'' for tax purposes, the institution's

withholding and reporting responsibilities will generally be the same as those required for payments made to U.S. citizens. But if the person is treated as a ''nonresident alien,'' the institution is subject both to a special set of income and Federal Insurance Contributions Act (FICA) tax withholding rules and to a totally different reporting scheme.

Up until the early 1990s, many colleges and universities were either unaware of the special rules that pertain to nonresident aliens or were simply unable to institute the necessary administrative procedures to identify the foreign nationals, classify them as either resident aliens or nonresident aliens, and apply the applicable withholding and reporting rules. Once the IRS became aware that many schools were not in compliance, it added this area of the law to the areas typically examined as part of the Coordinated Audit Program directed at colleges and universities[1] or, in some cases, instituted audits focused solely on the nonresident alien tax area. Some of the tax assessments proposed by the IRS during these audit examinations have been substantial, and schools are therefore well advised to ensure that their nonresident alien withholding and reporting procedures are in full compliance with the laws.

§ 8.2 DETERMINING U.S. TAX RESIDENCY

In determining whether and to what extent payments made to nonresident alien employees, scholarships/fellowship recipients, and independent contractors are subject to U.S. tax income withholding and reporting, the most basic test is whether the individual is treated as a ''resident alien'' or a ''nonresident alien'' for U.S. tax purposes. In virtually all situations where the individual is classified as a resident alien, the individual is taxed in the same manner as a U.S. citizen, and the withholding and reporting rules are the same as those applicable to U.S. citizens. If, however, the individual is classified as a ''nonresident alien,'' the individual is subject to an entirely different tax structure, and the college and university that makes payments to the individual is likewise subject to a different tax withholding and reporting scheme.

There are two tests that are used to determine how to classify non–U.S. citizens as either resident aliens or nonresident aliens—the ''green card'' test and the ''substantial presence'' test. If the non–U.S. citizen satisfies either of these two tests, the individual is a U.S. resident for tax purposes. But if the individual satisfies neither test, he or she is taxed as a nonresident alien.

(a) Green Card Test

Under this test, an individual is treated as a U.S. resident for tax purposes if the person has been issued an alien registration card (also known as

[1] *See* Chap. 10.

a ''green card'') by the United States immigration authorities.[2] This status continues until it is either rescinded or judicially determined to have been abandoned.[3] The date on which resident alien status is deemed to begin (called the ''residency starting date'' in the regulations) is the first day of the calendar year in which the individual was physically present in the United States as a lawful permanent resident.[4] And the date on which this status ends (called the ''residency termination date'' in the regulations) is the last day of the calendar year in which the green card is rescinded or abandoned. For example, if the green card is rescinded on August 15, the person's resident alien status continues to December 31 of that year but then terminates. There is, however, an exception to this residency termination date rule where, for the remainder of the year, the person is able to establish a ''closer connection'' with his or her foreign country than with the United States. The ''closer connection'' factors are set forth in the regulations,[5] and if this exception is met, the person's resident alien status terminates on the first day during the calendar year in which the person is no longer a permanent resident.

(b) Substantial Presence Test

This test is much more complicated than the green card test and consists of two subtests—a 31-day test and a 183-day test.[6] The first subtest is met if the individual is physically present in the United States for at least 31 days during the calendar year being tested. The 183-day test, however, requires an examination of three different calendar years—the current year being tested and the two immediately preceding years. In applying the 183-day test, the individual must count (1) all of the days the person was present in the United States in the current year (the year being tested), (2) one-third of the days present in the United States during the preceding year, and (3) one-sixth of the days present in the United States in the second preceding year.

For example, assume that a foreign national was physically present in the United States for 138 days in 2005, 129 days in 2006, and 120 days in 2007. To determine if the individual meets the substantial presence test for 2007, the individual should count the full 120 days of presence in 2007, 43 days in 2006 (one-third of 129 days), and 23 days in 2005 (one-sixth of 138 days). Because the individual is in the United States for at least 31 days in 2007, he passes the 31-day subtest; because his total number of days in the United States for the

[2]IRC § 7701(b)(6)(A).
[3]Treas. Reg. § 301.7701(b)-1(b)(1).
[4]Treas. Reg. § 301.7701(b)-4(a). This is generally considered to be the earlier of the ''Notice Date'' set forth on the Form I-797 notice received from the INS approving the application for permanent resident status or the date that the person initially enters the United States on an immigrant visa issued by a U.S. consulate.
[5]Treas. Reg. § 301.7701(b)-2(d).
[6]IRC § 7701(b)(6)(A).

three-year period is 186 days, he also passes the 183-day subtest. Therefore, the individual is considered a U.S. resident alien for tax purposes under the substantial presence test for 2007. Note that a new test must be applied again in 2008 and in each subsequent year. Also, although the year being tested is usually the current year, this is not always the case. For example, if the IRS is conducting an audit in 2007 of a school's 2004 tax year and trying to determine whether certain foreign nationals were resident aliens or nonresident aliens during that year, the ''test year'' is 2004, and the two preceding years that must be taken into account in making the 183-day determination are 2003 and 2002.

The manner in which days of physical presence in the United States are computed can be complicated. The complicating factor arises from the fact that certain individuals who may be physically present in the United States are ''exempt'' from having to count those days of physical presence for purposes of the substantial presence test. Although there are a number of different ''exempt individual'' categories (e.g., individuals who are unable to leave the United States because of a medical condition), the exempt-individual categories that are of particular interest to colleges and universities involve teachers/trainees and students. If the individual is a teacher or trainee who is in the United States under a J or Q visa, the individual is treated as an exempt individual for two calendar years.[7] If the individual is a student who is in the United States under an F, J, M, or Q visa, the individual is exempt from having to count days of presence in the United States for five calendar years.[8]

This rule is further complicated by the fact that presence in the United States for only part of a year counts as a full calendar year. For example, assume that a teacher enters the United States on a J visa on December 15, 2007. The individual is an exempt individual (and not required to count days of presence in the United States) for 2007 and 2008, but must start counting days of presence on January 1, 2009. (Note that the first calendar year is 2007, even though the individual was in the United States for only 17 days of the year.) If the individual leaves the United States in 2009 before spending 183 days in the United States, the 183-day test is not met, and the individual is not considered a U.S. resident for 2009 either. If, however, the individual stays in the United States for at least 183 days in 2009, the individual will meet the substantial presence test and be considered a resident alien for that year. Because of the manner in which these rules operate, the individual's treatment as a U.S. resident is retroactive to January 1, 2009.[9]

Like the green card test, the substantial presence test also has residency starting and ending date rules. The residency starting date is the first day

[7]IRC § 7701(b)(5)(E)(i); Treas. Reg. § 301.7701(b)-3(b)(7).
[8]IRC § 7701(b)(5)(E)(ii).
[9]Treas. Reg. § 301.7701(b)-4.

during the calendar year that the person is physically present in the United States.[10] For example, if a person arrives in the United States on April 1 under an H visa, she must immediately begin counting days toward the substantial presence test. When she hits the 183-day mark, she will be treated as a resident alien effective on April 1, the first day she was physically present in the United States. In a more typical situation, assume that an F or J visa holder's period of exemption from counting days expired on December 31 of the year. She must begin counting days on January 1 of the following year. Once she is in the United States for 183 days during that year, she will be a resident alien effective retroactively to January 1. The residency termination date under the substantial presence test is the same as under the green card test—the last day of the calendar year in which the person ceases to be a resident alien.[11] Furthermore, the same ''closer connection'' exception rule applies, and if this test is met, the residency termination date is the last day during the calendar year that the person was physically present in the United States.[12]

§ 8.3 DETERMINING U.S. TAXABLE INCOME

One of the primary differences between the manner in which resident aliens and nonresident aliens are taxed by the United States relates to the fact that resident aliens, like U.S. citizens, are taxed on their worldwide income, while nonresident aliens are taxed only on their ''U.S. source'' income.[13] Similarly, a college or university making a payment to a foreign national is only required to withhold tax and report to the IRS if the payment is U.S. source income.[14] If the payment is treated as ''foreign source'' income, the individual is not subject to tax and the college and university is not required to withhold tax or file any returns with the IRS. Therefore, it is important to determine whether payments made to a foreign national are treated as U.S. source or as foreign source income.

U.S. tax law classifies all types of income (interest, dividends, rent, etc.) as either ''U.S. source'' or ''foreign source.''[15] Different sourcing rules apply to each income category. For example, the source of dividend income is based on the nationality of the payor corporation, and rental income is sourced in the country in which the rental property is located.[16]

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[10]Treas. Reg. § 301.7701(b)-4(a).
[11]Treas. Reg. § 301.7701(b)-4(b)(1).
[12]Treas. Reg. § 301.7701(b)-4(b)(2).
[13]IRC § 871.
[14]IRC § 1441.
[15]IRC §§ 861–863.
[16]Treas. Reg. § 1.861-3 (dividends); Treas. Reg. § 1.861-5 (rental income). *See also* Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, which sets forth a method of determining the source of pension payments made to nonresident alien individuals from a U.S. pension plan.

The sourcing rule with respect to compensation payments is based on the location where the services were rendered.[17] Therefore, if a foreign national earns compensation income (either as an employee or as an independent contractor) with respect to services that the individual performs within the United States, the income is U.S. source income. If, however, those services are performed outside the United States, the income is foreign source income and not subject to U.S. tax withholding or reporting. For example, if a foreign national comes to the United States to teach at a U.S. university, the compensation income earned is U.S. source income because the activity for which the income was earned (teaching) was conducted in the United States. By contrast, if a U.S. university has a foreign campus and hires foreign nationals to teach at that campus, the income paid by the university to the foreign nationals is foreign source income because the services are rendered outside the United States. It is possible for a foreign national to receive both U.S. source and foreign source income, if the services provided are divided between the United States and a foreign country. An example would be when a U.S. university hires a foreign national to teach for several months in the United States and for several months at the school's foreign campus.[18]

The income sourcing rule with respect to scholarship/fellowship grants is quite different. This rule is based on the ''residence of the payor,'' not the location of the educational activities for which the scholarship or fellowship was granted.[19] These rules require a determination as to the ''true grantor'' of the scholarship/fellowship. For example, if the French government chooses 25 French students to come to the United States to study at a U.S. university and pays the funds necessary to pay for the scholarships to the U.S. university for eventual payment to the individuals, the ''true grantor'' of the scholarships is the French government, not the U.S. university, and therefore the payments are foreign source income. There is one aspect to the sourcing rule with respect to scholarship/fellowship grants that deserves special mention. If the grantor of the scholarship/fellowship is a U.S. entity, but the foreign national recipient is studying overseas, the payment is treated as foreign source, even though a technical application of the ''residence of the payor'' rule would lead to a U.S. source determination.[20] Given the different sourcing rules that apply to payments of compensation and scholarship/fellowship grants, it is important to be able to determine whether a particular payment should be treated as a wage payment or a scholarship/fellowship award. This is particularly true with respect to nonresident alien graduate students who

[17]IRC § 861(a)(3).
[18]Treas. Reg. § 1.861-4(b), which sets forth the rules when the personal services income is earned partly within and partly without the United States.
[19]Treas. Reg. § 1.863-1; Rev. Rul. 89-67, 1989-1 C.B. 233.
[20]Treas. Reg. § 1.863-1(d)(2)(iii).

may receive both a stipend that is treated as wages for tax purposes as well as a tuition remission benefit. The same rules described in section 7.5 dealing with distinguishing between compensation scholarship/fellowship grants in connection with U.S. student employees apply equally to nonresident aliens.

If a payment is treated as U.S. source income, it is potentially subject to tax in the hands of the nonresident alien. It is only ''potentially'' subject to tax because it may still be excluded from the nonresident alien's income under either a provision of the Internal Revenue Code or a tax treaty.

§ 8.4 WITHHOLDING AGENT

If withholding and reporting is required on a payment made to a nonresident alien, it is the ''withholding agent'' that is required to perform the withholding and reporting.[21] As a general rule, the withholding agent is defined as the entity that actually makes the payment, whether directly to the individual or to a third party on the individual's behalf. In compensation situations, the withholding agent is normally the same entity for whom the services are rendered. For example, if a nonresident alien performs research in a university laboratory, the university makes the payments to the researcher and the university is the withholding agent. In scholarship/fellowship situations, this is not necessarily the case. It is not unusual for a scholarship/fellowship grant to be funded by another entity that pays the funds to the university for distribution to the scholarship/fellowship recipient. In these cases, because the university actually distributes the funds, the university is the withholding agent with respect to the grant and is the entity that is required to withhold tax and file reports with the IRS.

The Code makes it clear that a withholding agent is liable for the income tax that must be withheld from payments made to or on behalf of a nonresident alien, even though the ultimate tax is imposed on the foreign national, not the withholding agent.[22] It is also important to note that the withholding tax has to be paid, even though it may not be possible to actually withhold the tax from the payment. For example, if a university pays a travel agency $3,000 for airline tickets, the university obviously cannot reduce the amount of those payments by the withholding tax. In these situations, the withholding agent (the university) has three options—take the tax out of other grant payments made to the individual, request payment of the tax from the individual, or pay the tax itself out of its own funds. This last option may raise the ''tax pyramiding'' problem discussed in section 7.6.

[21]IRC § 1441
[22]IRC § 1461.

§ 8.5 U.S. TAX WITHHOLDING OBLIGATIONS

Once a college or university has determined that (1) it is the withholding agent and therefore has the obligation to withhold any applicable tax, (2) the foreign national in question is a nonresident alien, and (3) the payment has been properly classified as wages, scholarship/fellowship, and so on, the next question is whether and to what extent withholding is actually required.

The best way to approach this question is to begin with the assumption that the payment is taxable to the recipient and that withholding is required but then determine whether any withholding exclusions may be applicable. There are generally three exclusions that may come into play. First, if the payment is determined to be foreign source income under the principles described above, the institution is not required to withhold income tax from the payment that is made.[23]Second, if the payment qualifies under one of the gross income exclusions set forth in the Code, no withholding is required.[24]For colleges and universities, this rule most typically comes into play in connection with qualified scholarship payments that are excluded under the rules of section 117.[25]Finally, if the payment is wholly or partially excludable from the person's gross income by reason of a tax treaty between the United States and the person's country of residence, no withholding is required.[26]

If the payment to the nonresident alien is subject to withholding, the general rule is that withholding is required at a rate of 30 percent of the amount of the payment.[27]There are so many exceptions to this general rule, however, that colleges and universities will normally have to withhold tax at the 30 percent rate only on payments made to nonresident alien independent contractors (e.g., attorneys, accountants, consultants, etc.).

The first exception relates to wage or salary payments made to nonresident alien employees. These payments are subject to the normal graduated-rate withholding rules that are applicable to U.S. citizens, with some modifications.[28] It is important to note that the graduated-rate withholding applies only if the person is a bona fide employee; if the person is an independent contractor, the 30 percent rate will likely apply.[29] Like a U.S. citizen employee,

[23]IRC § 1441(a); Treas. Reg. § 1.1441-2(a).

[24]Treas. Reg. § 1.1441-2(b)(1).

[25]IRC § 117. *See* § 7.2. Other possible exclusions are those for gifts under IRC § 102; payments made by a foreign employer to an employee in a U.S. exchange or training program under IRC § 872(b)(3); and payments made to employees of foreign governments or international organizations under IRC § 893.

[26]Treas. Reg. § 1.1441-6(a). *See* § 8.8.

[27]IRC § 1441(a).

[28]IRC § 1441(c)(4); Treas. Reg. § 1.1441-4(b)(1)(i).

[29]For a discussion of the distinction between an employee and an independent contractor, *see* § 4.2.Notice 2005-76, 2005-46 I.R.B 947. The IRS instituted these new rules to correct an overwithholding problem that arises when a nonresident alien employee earns wages less than the personal exemption amount because the previously required ''additional amount'' that had

a nonresident employee must provide the college or university employer with a Form W-4, but beginning in 2006, the IRS issued revised rules as to how the tax on wages paid to nonresident aliens is to be withheld.[30] Under these revised Form W-4 rules, nonresident alien employees are required to do the following:

- Not claim exemption from withholding
- Request withholding as if they are single, regardless of their actual marital status
- Claim only one allowance (although more allowances may be claimed if the person is from Canada, Mexico, or South Korea)
- Write ''Nonresident Alien'' or ''NRA'' above the dotted line on line 6 of Form W-4

Employers are required to add an ''additional amount'' to the wages of the nonresident alien employee solely for purposes of calculating the income tax withholding for each payroll period. This additional amount, which varies depending on the payroll period, will offset the assumed standard deduction that is incorporated into the withholding tables.[31] The employer determines the income tax to be withheld by applying the normal withholding tables to the sum of the wages paid for the payroll period plus the additional amount. The IRS says that the additional amount (1) is not income or wages to the employee, (2) does not affect income, FICA, or federal unemployment tax (FUTA) liability for the employer or the employee; and (3) is not to be reported as income or wages.

Because of a provision in the U.S.-India tax treaty, these new rules do not apply to a nonresident alien employee who is from India and is present in the United States for the principal purpose of education or training. This exception only applies for such period of time as may be reasonable or customarily required to complete the education or training undertaken.

The second exemption relates to scholarship or fellowship payments made to the nonresident alien. These payments are subject to withholding but at a reduced rate of 14 percent.[32] To qualify for the 14 percent withholding rate,

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to be withheld applied to the first dollar of wages with no de minimis exception. Thus, when the amount of the nonresident alien employee's total annual wages was less than the personal exemption amount, income tax was withheld and the nonresident alien was required to file a return and request a refund to get back the amount withheld. The wage withholding rules that went into effect on January 1, 2006, are designed to provide for nonresident alien wage withholding that more closely approximates the individual's true income tax liability.

[30]Publication 15 (Circular E, Employer's Tax Guide). Note that this amount changes depending on the pay period schedule; for example, if wages are paid on a biweekly basis, $15.30 must be withheld.

[31]The additional amount is set forth in Notice 2005-76, 2005-46 I.R.B 947, and is updated periodically.

[32]IRC § 1441(b).

the nonresident alien must be temporarily present in the United States under an F, J, M, or Q visa. If the person is a ''candidate for a degree'' under the principles of section 117,[33] the 14 percent rate applies to the taxable portion of the scholarship/fellowship grant; however, if the person is not a candidate for a degree, in order for the 14 percent rate to be applicable, the grantor of the scholarship/fellowship must be a section 501(c)(3) organization, a foreign government, an international organization, or the United States or a state government. Beginning in 2001, withholding agents can elect to withhold on taxable scholarship/fellowship payments at either the 30 or 14 percent rates (whichever is applicable) or at the normal graduated rates applicable to wages.[34]

Another exception to the general 30 percent withholding rate rule applies to those payments made to scholarship/fellowship recipients that constitute a ''per diem for subsistence'' under a U.S. Agency for International Development training program grant. Under this exception, no withholding is required.[35] There are two aspects to this exception that are important to note—(1) the exception applies only to U.S. Agency for International Development grants, not to grants by any other government agencies, and (2) it has no bearing on whether the subsistence payment may be taxable to the recipient (it most likely is), but rather only on whether withholding on the payment is required.

§ 8.6 TRAVEL AND LIVING EXPENSE REIMBURSEMENTS

There is an additional issue that arises with respect to reimbursement of travel and living expenses made to nonresident alien employees and contractors. In the case of nonresident alien employees, the IRS permits withholding agents to apply the same ''accountable plan'' rules applicable to reimbursements made to U.S. employees. Under these rules, if the employee is able to substantiate the travel or living expense payments, the withholding agent is not required to withhold tax on the reimbursement and the individual is not required to include the payment in income or claim it as a business expense deduction.[36]

At one time, the IRS informally took the position that the section 274 accountable plan rules could not be used in connection with payments made to nonresident alien independent contractors, although the IRS's legal basis for disallowing the use of these rules with respect to nonresident alien independent contractors, but allowing them to be used for nonresident alien employees, was never clear. This issue most typically arose in cases where a foreign scholar came to the United States to make a speech or present a paper, and

[33] *See* § 7.2(b).
[34] Treas. Reg. § 1.1441-4(c).
[35] IRC § 1441(c)(6).
[36] *See generally* Temp. Treas. Reg. § 1.274-5 T.

the sponsoring institution reimbursed the individual for an airline ticket, hotel charges, and other living expenses while in the United States.

For example, assume that a nonresident alien professor came to the United States to present a paper at a university conference, and the university agreed to reimburse his travel and living expenses in the amount of $2,000. If the individual were a U.S. citizen or resident, the university could avoid withholding any tax on the reimbursement if the professor were able to produce substantiating receipts; however, because the professor was a nonresident alien, the $2,000 payment was treated as taxable income from which a 30 percent tax had to be withheld, even if the professor produced the receipts. (Note that if the professor was from a country that had a tax treaty with the United States, the IRS did allow the school to exempt the reimbursement under the tax treaty article that exempts income paid to ''teachers.'')

In 1998, the National Association of College and University Business Officers (NACUBO) sponsored the filing of an IRS ruling request designed to persuade the IRS to change its position that the section 274 ''accountable plan'' rules did not apply when making expense reimbursement payments to nonresident alien independent contractors. This NACUBO effort appears to have been largely successful. The ruling request (filed on behalf of the University of Vermont) was withdrawn, with the IRS instead issuing an ''information letter'' which stated that where the nonresident alien guest lecturer (or other independent contractor) properly substantiates his or her expenses in the manner required by the section 274 accountable plan rules, the expense reimbursement payment made to such person is excluded from gross income, and no withholding is required.[37]

The letter, however, also contains some guidance that may prove to be a problem in certain circumstances. Specifically, the IRS says that if the guest lecturers are employed by foreign institutions or other employers and ''if the nonresident aliens served as guest lecturers in their capacities as employees of another entity (e.g., employees of foreign universities),'' then in order for the U.S. institution to be able to apply the section 274 accountable plan rules, the person's foreign employer must maintain a reimbursement plan that meets the section 274 requirements. Thus, in these cases, the fact that the U.S. institution has an accountable plan is irrelevant; rather, the U.S. institution must inquire of the guest lecturer's foreign employer to see whether that entity has a plan that qualifies under section 274. If so, the expense payment can be excluded from gross income; if not, the 30 percent withholding rule will apply. In these situations, it may be administratively difficult or impossible for a school to determine whether the guest lecturer's foreign employer has an accountable plan and, if so, whether the plan complies with the requirements of section 274.[38]

[37]Letter dated Dec. 16, 1998, to Edwin C. Shoenfeld, PricewaterhouseCoopers, from Mary E. Oppenheimer, assistant chief counsel (Employee Benefits and Exempt Organizations Division).
[38]Treas. Reg. § 1.1441-4.

§ 8.7 U.S. TAX REPORTING OBLIGATIONS

If the payment to the nonresident alien consists of taxable employee wage payments, the same rules that apply to payments made to U.S. citizen employees also apply to the payment made to the nonresident alien—that is, the wages are subject to graduated withholding, and the withholding agent reports the payment made and the tax withheld on Form W-2.[39] For virtually all other documents made to nonresident aliens, however, the basic reporting documents are Forms 1042 and 1042-S.[40]

Form 1042 is an income tax return that is filed with the IRS by the withholding agent to summarize both the amount of the payments that it made and the tax that it withheld from these payments.[41] Form 1042-S is an information return that is used to report the income paid and tax withheld to the individual payee.[42] All payments made to a nonresident alien, other than employee wage compensation as noted above that are reported on Form W-2, are reported on Form 1042-S. These include independent contractor payments, scholarship/fellowship grants, royalties, dividends, and many others. Form 1042-S must not only be sent to the nonresident alien but must also be included with the Form 1042 that is filed with the IRS.

Form 1042, together with the attached Form 1042-S, must be filed with the IRS on or before March 15 of the year following the year in which the payments were made. The withholding agent is also required to provide the nonresident alien with Form 1042-S by the same date. It should be noted, however, that withholding agents that are required to file 250 or more Forms 1042-S are required to file the forms with the IRS electronically or on magnetic media, although a paper Form 1042-S still must be furnished to the nonresident alien. The IRS sets forth the procedures and rules regarding the electronic or magnetic media filing in annually published guidance.[43]

As a general rule, a payment made to a nonresident alien must be reported on Form 1042-S even if the payment is nontaxable to the recipient because of an exemption under the Internal Revenue Code or a tax treaty.[44] There is, however, an exception to this general rule with respect to the portion of scholarship/fellowships that is exempt under section 117—generally, tuition, books, and fees. Beginning with Forms 1042-S that are filed in 2002 for payments made in 2001, these nontaxable scholarship/fellowship payments made to nonresident aliens no longer need to be reported.[45]

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[39]Treas. Reg. § 1.1461-1(c)(2)(ii)(D).
[40]Treas. Reg. § 1.1461-1(c).
[41]Treas. Reg. § 1.1461-1(b).
[42]Treas. Reg. § 1.1461-1(c).
[43]The most current rules as of this writing can be found in Rev. Proc. 2006-34, 2006-38 I.R.B 460.
[44]Treas. Reg. § 1.1461-1(c)(2).
[45]Treas. Reg. § 1.1461-1(c)(2)(i)(K).

One cardinal reporting rule in the nonresident alien area is that payments made to a nonresident alien are never reported on a Form 1099.[46] All nonresident alien payments are reported on either Form W-2 (if the nonresident alien is an employee whose income is not exempt from tax) or on a Form 1042-S (all other types of payments made to nonresident aliens). It is possible in some circumstances for the nonresident alien to receive both a Form W-2 and a Form 1042-S. For example, assume that a nonresident alien is claiming an income tax treaty exemption for $15,000 compensation where the treaty has a maximum exemption amount of $5,000. In this case, $5,000 of the compensation is reported on a Form 1042-S because it represents the amount that is excludable from the nonresident alien's gross income under the tax treaty, while the remaining $10,000 is reported on a Form W-2.

Finally, one of the required items of information that must be indicated on Form 1042-S is the person's Social Security number or individual taxpayer identification number (ITIN).[47] If the withholding agent fails to include this number on the Form 1042-S, it is potentially liable for a penalty,[48] but the withholding agent can avoid this penalty by preparing and signing an affidavit that states that the withholding agent requested the payee's taxpayer identification number but the payee refused to provide it and that sets forth the payee's name.[49]

§ 8.8 INCOME TAX TREATIES

An income tax treaty is an agreement entered into between two governments under which each country agrees to limit or modify the application of its domestic tax laws in an attempt to avoid double taxation of income—that is, having the same income item taxed by both countries. Tax treaties contain various provisions (referred to as ''articles''), most of which relate to commercial trade and business and are designed to facilitate the flow of capital and technology between the two tax treaty countries. All tax treaties include articles that deal with individuals from one country working in the other, both as employees and as independent contractors. The tax treaties refer to service as an employee as ''dependent personal services'' and service as an independent contractor as ''independent personal services.'' All tax treaties also include specific articles designed to foster educational and cross-cultural exchanges between the two tax treaty countries. These articles are directed at the taxation of students, trainees, teachers, and researchers and, depending on the particular tax treaty provision, may totally exempt or restrict U.S. taxation

[46]Treas. Reg. § 1.1461-1(c)(2)(ii)(E).
[47]Treas. Reg. § 1.1461-1(d). The ITIN is a number assigned to those foreign nationals who are unable to qualify for a Social Security number because they are not employed.
[48]IRC § 6721.
[49]Treas. Reg. § 301.6109-1(c).

of scholarship/fellowship grants and compensation payments made to these individuals.[50]

The United States has more than 50 income tax treaties currently in force, and is constantly negotiating new treaties and amendments (known as ''protocols'') to existing treaties. The tax treaty negotiation process is a dynamic one, with some negotiations being terminated and others begun on a fairly routine basis. Therefore, if a college or university is trying to determine the list of countries with which the United States has an income tax treaty in force, it must make sure that it reviews the most recent list of tax treaty countries.

(a) Residency Requirement

In order for a nonresident alien to be eligible for a tax treaty benefit from his or her home country, the individual must first be a resident of that country. Most of the tax treaties define the term *resident* for purposes of the tax treaty by reference to whether the individual is subject to tax in his or her home country. Making this determination requires a determination of foreign law and, specifically, whether the individual is (or whether immediately prior to coming to the United States was) subject to income tax in his or her home country. Although this is not generally a difficult problem, in some cases it can be. For example, assume that a U.K. citizen left the United Kingdom five years ago, during which period she lived in Canada. Six months before coming to the United States, she moved to Switzerland. She leaves Switzerland to come to the United States to teach at a U.S. university. The United States has tax treaties with all three countries. In order to determine which one would control, each ''residency'' article in each treaty must be examined to determine her country of residency.

One aspect of tax treaties that is of particular interest to students, trainees, teachers, and researchers is the fact that these individuals can continue to qualify for tax treaty benefits, even though they may be deemed to be a U.S. resident alien under the residency rules described above. With a very few exceptions, however, this applies only if the individual is a U.S. resident alien by virtue of the substantial presence test. If the individual is treated as a U.S. resident alien under the green card test, the individual is not eligible for tax treaty benefits under most tax treaties.[51]

(b) Students and Trainees

With respect to the tax treaty benefits allowed to students and trainees, there are two different types of tax treaty articles. The first, which is generally

[50]The current list of tax treaties can be found on the IRS web site at *www.irs.gov*. Key in ''income tax treaties'' in the Search box and then click on ''Income Tax Treaties.''

[51]Under the U.S.-China tax treaty, green card holders can qualify for tax treaty benefits.

found in the older tax treaties, limits the exemption to payments received from the individual's home country. This benefit is really no benefit at all because under the U.S. income sourcing rules, these payments are treated as foreign source income and, as such, are exempt from U.S. tax anyway. Newer tax treaties provide a much broader exemption for scholarship/fellowship recipients and generally provide an exemption if the individual is in the United States (1) studying at a U.S. educational institution, (2) training to pursue a practice or preferred specialty, or (3) studying or doing research under a grant from a government, charitable, or educational organization. If the individual falls into any one of these categories, he or she is generally not subject to U.S. tax on the full amount of the grant or award, regardless of whether the grant comes from U.S. or foreign sources. Therefore, unlike the older tax treaties that only exempt payments received from outside the United States, these provisions also exempt grants made by U.S. organizations. In most cases, however, the exemption is available only for a limited period of time.

A number of tax treaties provide a limited exemption for compensation income earned by students and trainees. In order to qualify for the student/trainee compensation income exemption, the individual generally must have been a resident of the tax treaty country immediately before coming to the United States. Also, the tax treaties require that the individual must be in the United States for the ''primary purpose'' of one of the following: (1) studying at a university or other recognized educational institution; (2) securing training required to qualify the individual to practice a profession or professional specialty; or (3) studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization. Most tax treaties set an annual maximum dollar amount for which the exemption for personal services can be claimed, and tax treaties typically contain a time limit as to the availability of the personal services income exemption.

(c) Teachers and Researchers

Teachers and researchers also generally receive benefits under income tax treaties. Most tax treaties contain a specific but limited exemption for remuneration received by visiting teachers for their teaching activities while in the United States. Many tax treaties do not explicitly cover remuneration for research carried on by the visiting teacher, and the position of the IRS is that the ''teacher'' exemption applies to all of the teacher's remuneration, including remuneration for research, if the primary purpose of the individual's visit to the United States is to teach, and the individual devotes a substantial portion of his or her time to teaching duties. The IRS has even gone so far as to quantify what constitutes ''substantial'' teaching activities, holding that if at least 60 percent of the individual's time is spent teaching, this will be treated

as ''substantial.''[52] Some of the more modern teacher articles specifically cover remuneration for research activities.

The teacher/researcher articles apply only for a specific length of time, generally two years. Most of these time limits begin to run on the day that the individual first enters the United States before beginning the teacher/research services, and brief absences from the United States are not generally counted against the exemption period.[53]

Another issue involves an individual's repeated use of a ''teacher'' exemption provision. In one case, the IRS held that a Dutch teacher who had claimed the exemption during a two-year period was entitled to claim the exemption again for a subsequent two-year period, provided that he had been absent from the United States for a full calendar year between the two visits.[54] Some tax treaties, however, provide that the teacher exemption may be used only once, and other treaties prevent an individual from claiming the exemption during the period that immediately follows one in which the individual has claimed a student/trainee exemption.

(d) Forms Required for Claiming Income Tax Treaty Withholding Exemptions

If the payment that a college or university makes to a nonresident alien payee is exempt from U.S. income tax under the provisions of a tax treaty, the school is entitled not to withhold income tax from the payment. But this exemption from withholding applies only if the school receives from the individual the proper form that the IRS says must be provided by the person to the withholding agent.[55]

(i) Form 8233. Form 8233 is used by nonresident alien employees, independent contractors, teachers, and researchers who receive compensation that is exempt under a tax treaty between the United States and the person's home country. As a general rule, Form 8233 is used only to report exempt compensation income; however, if a student receives both compensation that is exempt under a tax treaty and also scholarship/fellowship benefits that are exempt under the treaty, Form 8233 is used to report both amounts.[56] The person is required to fill out Form 8233, prepare an accompanying statement that varies depending on the treaty involved, sign Form 8233, and deliver it, together

[52]Rev. Rul. 74-174, 1974-1 C.B. 371. *See also* Priv. Ltr. Rul. 8512020 (Dec. 12, 1984), holding that an amount paid to an Italian resident for teaching and performing research in the United States is exempt under the ''teaching'' exception in the U.S-Italy tax treaty.
[53]Rev. Rul. 89-5, 1989-1 C.B. 753.
[54]Rev. Rul. 56-164, 1956-1 C.B. 848. *See also* Rev. Rul. 77-242, 1977-2 C.B. 489.
[55]Treas. Reg. § 1.1441-4(b)(2)(ii).
[56]Treas. Reg. § 1.1441-4(c)(1).

with the statement, to the college or university. The school must then review the form to see if it is accurate and complete, and then send in the form and statement to the IRS. The school can stop withholding tax on the compensation payments upon sending in the form to the IRS; however, if the IRS contacts the school because of a defect in the form or the statement, the school must begin withholding at that time and will be liable for taxes that should have been withheld in the interim.[57]

The statements that must be provided with the Form 8233 vary depending on whether the individual is a nonresident alien student, teacher, or researcher and the particular treaty country involved. For many years, the different representations for the different tax treaty countries could be found in Rev. Proc. 87-8 (for students),[58] Rev. Proc. 87-9 (for teachers and researchers),[59] and Rev. Proc. 93-22 (which modified certain of the representations required for students and teachers/researchers).[60] But, because many of the U.S. tax treaties have been updated or replaced since the publication of these three revenue procedures, in 2005 the IRS issued a new revenue procedure that renders the earlier revenue procedures obsolete.[61] In this revenue procedure, the IRS says that the appropriate student, teacher, and researcher representations that are required to be attached to the Form 8233 are set forth in IRS Publication 519 (U.S. Tax Guide for Aliens).

(ii) Form W-8BEN. This form is used by nonresident aliens to report non-compensatory payments that are exempt from U.S. income tax under a tax treaty. In the college and university context, FormW-8BEN is typically used by students to report the room, board, travel, and other portions of scholarship/fellowship grants that are not exempt under U.S. tax but are exempt under a tax treaty. The college or university receiving the form is required to review it to ensure that it is accurate and complete, but unlike Form 8233, Form W-8BEN need not be filed with the IRS. Schools are, however, required to keep these completed forms in their files. Also, while Form 8233 is valid for so long as the person's status remains unchanged, FormW-8BEN is valid for only three calendar years.[62]

(iii) Form W-9. Resident aliens are also normally able to claim tax treaty benefits, and the IRS has said that the proper form for a resident alien to use

[57]The Form 8233 review and approval requirements are set forth in Treas. Reg. § 1.1441-4(b)(iii) and (iv).
[58]1987-1 C.B. 366.
[59]1987-1 C.B. 368.
[60]1993-1 C.B. 535.
[61]Rev. Proc. 2005-44, 2005-29 I.R.B. 110.
[62]For a description of the W-8BEN filing rules, see Instructions, Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding).

to claim a tax treaty benefit (for compensation or any other type of income) is Form W-9.[63] Form W-9 need not be filed with the IRS but instead need only be retained in the withholding agents' files.

(e) Taxpayer Identification Numbers

There are two different types of taxpayer identification numbers for individuals—Social Security numbers (SSNs) and individual taxpayer identification numbers (ITINs).[64] A foreign national can obtain a Social Security number if he or she is authorized to work in the United States, but this is frequently not the case, and sometimes the Social Security Administration office will refuse to issue an SSN to a foreign national who may be authorized to work but is not currently employed. The ITIN, on the other hand, is designed to serve as a taxpayer identification number for those foreign nationals who are not eligible to receive an SSN. The IRS takes the position that a Form 8233 or W-8BEN is not valid if the person's SSN or ITIN is not set forth on the form.[65] If the application for the number is in process and the person is submitting a Form 8233, he or she can attach a copy of the completed application to the form and it will be accepted.[66] However, this procedure does not work for Form W-8BEN, and these forms are invalid unless the number itself is on the form.[67]

(f) Special Rules under Tax Treaty with Japan

The United States and Japan entered into a new tax treaty effective January 1, 2005.[68] However, the provisions relating to withholding at source are effective for amounts paid or credited after July 1, 2004, and the IRS says that individuals claiming an exemption as a teacher/researcher or student under Articles 19 and 20, respectively, of the former treaty can continue to use those provisions during the 2005 calendar year.

The new U.S.-Japan income tax treaty makes a significant change to the exemption grants to students. Under the old tax treaty, Japanese students were exempt on all components of their scholarship grants (tuition, fees, room, board, lodging, etc.), whether from U.S. or foreign sources, for a period of up

[63]Treas. Reg. § 1.1441-6(b)(4).
[64]To obtain a Social Security number, the individual must file Form SS-5. An ITIN is obtained by filing Form W-7. In 2004, the IRS issued a new Form W-7 as well as a revised set of instructions for completing the form. In addition, the IRS issued Notice 2004-1, 2004-2 I.R.B. 268, which explains the updated Form W-7 procedures.
[65]Treas. Reg. § 1.1441-4(b)(2)(ii)(A).
[66]*Id.*
[67]The ability to attach the application is set forth only in the regulations applicable to Form 8233. There is no similar authority in the regulations with respect to Form W-8BEN.
[68]*See* Announcement 2004-54, 2004-24 I.R.B. 1061.

to five years and could exclude up to $2,000 a year in personal services income. But the new treaty limits the scholarship/fellowship exclusion to grants that are paid from outside the United States and eliminates the $2,000 personal services income exemption.[69]

§ 8.9 FOREIGN ATHLETES: THE NCAA VERSUS THE IRS

Many institutions that provide athletic scholarships to foreign students have been faced with a potential situation where complying with the tax laws results in an NCAA violation, while complying with the NCAA rules requires the school to violate the tax laws.

This situation arises from the fact that under the tax laws, institutions that make nontuition scholarship payments (typically, room, board, and travel) to nonresident alien students are required to withhold and pay over to the IRS a tax equal to 14 percent of the taxable portion of the scholarship grant, unless a tax treaty operates to exclude the amount from the individual's income.[70] In some instances, it is not possible for the school to (or the school does not want to) actually withhold any tax from the room, board, and travel amounts. But this does not eliminate the school's obligation to make the requisite tax payment to the IRS, and a school in this situation has one of two choices—it can either require the foreign student to pay the 14 percent tax out of his or her own funds, or it can pay the tax to the IRS out of its own funds. Most schools would prefer to follow the latter option, and many do.

If a school pays the withholding tax out of its own funds, it is providing the foreign student with a monetary benefit because the withholding tax payment will be credited by the IRS against the student's individual U.S. tax liability. This is where the conflict with the NCAA arises because under its rules, a school cannot pay a student-athlete more than the value of the scholarship grant, and by paying the student-athlete's U.S. tax liability, it is clearly doing so. For a detailed discussion of the current status of this issue, see section 7.6.

§ 8.10 HONORARIUM PAYMENT ISSUES

Colleges and universities have for years routinely invited foreign scholars to visit school campuses to give speeches or lectures, present papers, participate in panel discussions, or conduct some similar educational activity. In most cases, the school promises to pay the foreign scholar an honorarium of

[69]U.S.-Japan Treaty, Article 19.
[70]IRC § 1441(b).

some amount and/or reimburse the scholar for any travel expenses. Prior to 1998, though, the United States immigration authority rules provided that no honorarium payment could be made if the foreign scholar was in the United States on a B-1 or B-2 visa.[71] Moreover, if the scholar was on a B-2 visa, it was improper even to reimburse the person for travel expenses.[72] Under these circumstances, it was not unusual for a school to agree to make the honorarium/expense reimbursement payments before finding out that the scholar was in the United States on a B visa, thereby putting the school in the position of having to either renege on its agreement with the scholar or violate the immigration laws.

Because of this problem, higher education lobbyists convinced Congress to pass a statute in 1998 that essentially permits a college or university to make honoraria and expense reimbursement payments to B visa–holder scholars if certain conditions are met.[73] Specifically, the activity in which the scholar engages must be a ''usual academic activity''; the activity cannot last longer than nine days; and the scholar must not have accepted similar honoraria and expense reimbursement payments from more than five other institutions within the past six months.

§ 8.11 VOLUNTARY COMPLIANCE PROGRAM FOR NONRESIDENT ALIEN TAX ISSUES

In early 2001, the IRS released a voluntary compliance program (which they call a VCAP), which is specifically directed at colleges and universities and their charitable affiliated organizations.[74] Under this program, colleges and universities and affiliated organizations were provided substantial tax benefits in return for voluntarily disclosing their noncompliance to the IRS. The VCAP, however, was only ''temporary and experimental,'' and the IRS refused to accepted submissions filed after March 1, 2002.[75]

The IRS issued another voluntary compliance program in 2004 for withholding agents making payments to foreign persons.[76] This new voluntary compliance program, however, does not apply to (1) colleges and universities (whether public or private), or (2) section 501(c)(3) organizations that are affiliated with colleges and universities. In other words, those college/university organizations that were eligible for the 2001 voluntary compliance program are ineligible for the subsequent voluntary compliance program.

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[71] USCIS Prop. Reg. § 2.14.2(b)(2)(i), (3)(i)(c).
[72] *Id.*
[73] 8 U.S.C. § 1182(q).
[74] Rev. Proc. 2001-20, 2001-9 I.R.B. 1.
[75] *Id.* §§ 1.01, 6.
[76] Rev. Proc. 2004-59, 2004-42 I.R.B. 678.

§ 8.12 TAX TREATMENT OF IMMIGRATION-RELATED EXPENSES PAID BY COLLEGES AND UNIVERSITIES

Some colleges and universities pay immigration-related expenses on behalf of their employees, prospective employees, independent contractors, and fellowship recipients. Typical expenses include:

- Fees incurred in connection with visa applications and visa renewals
- Travel and related expenses incurred by the individual in connection with obtaining the visa to enter the United States (e.g., train fare to the U.S. consulate office in the foreign country for an immigration interview and expenses for photographs)
- Legal expenses incurred by the person in connection with obtaining status as a lawful permanent resident of the United States (i.e., obtaining a green card)
- Fees incurred in connection with petitions for permanent resident status

In some cases, the payment is made by the college or university directly to the foreign individual as a reimbursement for the expense that the person incurred and paid; in other cases, the payment is made by the school directly to the third party, for example, to the U.S. immigration authorities in the case of visa renewal fees or to the law firm that performed the green card–related legal work for the individual. The issue that these immigration-related payments raises is whether they are includable in the gross income of the person on whose behalf they are made. If so, the college or university may have a tax withholding and reporting obligation.

The tax treatment of the different types of immigration-related expenses depends in large part on whether the particular expense is ''business related,'' that is, whether there is a direct connection between the expense and the business purposes of the college or university or whether the expense is a ''personal'' expense (i.e., one that primarily represents a personal, living, or family expense that benefits the individual).

Looking first at the fees incurred in connection with visa applications and renewals, as well as all travel and other expenses related to obtaining those visas (categories 1 and 2 above), it seems clear that these expenses are primarily related to the business of the college or university and provide the individual with minimal personal benefit. These visas (primarily J, H, O, and TN visas in the case of educational institutions) are obtained by the school on behalf of the foreign individual for the express purpose of permitting that individual to enter the United States to work at the institution. The individual receives no personal benefit from the visa aside from the ability to enter the United States and work legally. Once the visa expires or is otherwise terminated, the person must return to his or her home country.

Matters with respect to the green card–related expenses (categories 3 and 4), however, are not so clear-cut. Whether such expenses paid by a college or university on behalf of an employee are includable in the employee's income depends on whether the school has a bona fide business-related reason for the payment. In this connection, there may be situations in which the school determines that it must obtain a green card for a particular employee in order to further certain specific business interests of the institution. Such a situation could arise in one of the following examples:

- An employee's work visa is going to expire, the visa cannot be renewed, and the only alternative to keeping the employee in the United States and working for the school is to obtain a green card for the individual.
- A particular government contract in which the school is involved requires that foreign nationals working on the contract have a green card.
- The foreign national is working on a project involving technology to which U.S. export control laws require that only green card holders can have access.
- The position involves extensive travel to other countries, and the foreign national's home country makes it difficult for the person to enter other countries; therefore, the foreign national needs a green card to obtain U.S. travel documents.

In these and other similar business-related situations, payment by the college or university pays the legal fees and other expenses to obtain a green card for the person should not result in income to the individual because the expense is primarily an institution-related expense, with the individual receiving only incidental benefits.

However, there may be situations in which a valued employee asks the college or university to obtain a green card because the person wants to have a green card, with no direct nexus between the green card and the person's employment functions. Or a foreign national may not agree to come to work for the school unless the school agrees to obtain a green card for him or her while he or she is in the United States, again, with no connection between the green card and the person's functions as a school employee. In these and other similar situations, obtaining the green card by the institution is primarily for the benefit of the individual, not the school, and is more in the nature of a bonus or a fringe benefit; therefore, the legal and other expenses paid by the school would likely constitute taxable income to the individual.

A more detailed analysis of how the payment by the college or university of each of these different types of expenses will be taxed to the different types of foreign individuals involved follows.

(a) Existing College or University Employees

As a general rule, any payment made by a college or university directly to an employee to reimburse the employee for an expense he or she incurred is included in the employee's gross income, unless the payment is made under the ''accountable plan'' rules of section 62.[77] If, however, the reimbursement is made under a plan that does not meet the accountable plan rules, the payment is included in the employee's gross income.[78] In those cases where the payment is not made by the school to the employee as a reimbursed expense but is instead made to a third party on the employee's behalf, the payment will generally be included in the employee's gross income unless it can be excluded as a ''working condition benefit'' under sections 132(a)(3) and (d).[79]

The accountable plan rules and the working condition fringe benefit rules require a substantial business relationship exists between the payment and the employer's business and any personal benefit flowing to the individual as a result of the payment be nonexistent or de minimis.[80] Thus, whether the legal expenses and related immigration authority fees incurred in connection with obtaining permanent/temporary U.S. resident status are includable in the employee's gross income depends on the facts and circumstances of each case. More specifically, if such payments are made for university business-related reasons and are properly substantiated, they should be excludable from employee's gross income as a working condition fringe benefit if paid to a third party or excludable under the accountable plan rules if reimbursed to the employee directly. If, however, they are made primarily to benefit the employee, they are includable in his or her gross income, whether made to a third party or as a reimbursement to the employee.

As discussed above, however, the visa application and renewal fees, as well as the travel and other expenses related to obtaining the visas, are primarily business-related expenses that result in little or no personal benefit to the individual; therefore, if these expenses are paid by the university as reimbursements to the employee under a qualified accountable plan, they should be excluded from the employee's gross income.[81] Alternatively, if the visa-related expenses are paid directly to third parties on the employee's behalf,

[77]Treas. Reg. § 1.62-2(b).
[78]Treas. Reg. § 1.62-2(c)(5).
[79]See § 5.2(c).
[80]Treas. Reg. § 1.62-2(d) (payment under an accountable plan must meet a ''business connection test'') Treas. Reg. § 1.132-5 (payment to a third party must be deductible as an employee business expense). Under IRC § 262, no deduction is allowed for ''personal, living, or family expenses.''
[81]Note, however, that if the reimbursement is made under a plan that does not meet the accountable plan rules, for example, because the plan fails the ''substantiation test'' or the ''returning amounts in excess of expense test'' as set forth in Treas. Reg. § 1.62-2(e) and (f), the payment will be taxable to the employee, regardless of the business nature of the expense. Treas. Reg. § 1.62-2(c)(5).

they should be excluded as a ''working condition fringe benefit,'' because the employee, had he or she paid the expenses, could have deducted them.

(b) Prospective College-University Employees

In some cases, the college and university may have entered into an agreement with the person that he or she will come to work for the school. In these cases, the IRS has held that payments made to such prospective employees are ''wages''[82]; therefore, the same conclusions set forth above with respect to existing university employees apply equally to these ''prospective employees.'' If, however, the person is merely a candidate for a job, the IRS has said that travel expenses reimbursed by a prospective employer to a person interviewing for a job are not includable in the gross income of the job candidate, assuming that the reimbursements do not exceed the expenses actually incurred.[83] Although there appears to be no authority directly on point, because obtaining a visa is a necessary prerequisite to being able to travel to the United States, it seems reasonable to include visa-related expenses within the scope of the travel expenses that are excluded from gross income under this rationale.

(c) Independent Contractors

The rules for expense payments made to independent contractors are substantially similar to those for employees. Under these rules, if a payment is made to the independent contractors to reimburse them for an expense they incurred, for purposes of computing their adjusted gross income, the contractors are able to exclude the value of the expense if it is directly related to the conduct of their trade or business.[84] Along the same lines, if the payment is made to a third party on the independent contractors' behalf, the contractors can exclude the value of the payment under the working condition fringe benefit rules if the contractor can show that, had they made the payment, they could have deducted it as a business expense.[85] For these reasons, the same conclusions set forth above with respect to existing employees should apply equally to the immigration-related expenses made by the school to or on behalf of independent contractors. In other words, whether the legal expenses and fees associated with obtaining permanent/temporary resident status will be includable in the contractor's gross income will depend on whether there are university business-related reasons for the payment even though the visa application/renewals fees and the travel and other visa-related expenses will

[82]Rev. Rul. 58-145, 1958-1 C.B. 310.
[83]Rev. Rul. 63-77, 1963-1 C.B. 177.
[84]Section 62(1). Note that the expense must be substantiated in accordance with Treas. Reg. § 1.274-5 T(h).
[85]Treas. Reg. § 1.132-1(b)(2)(iv), which extends the working condition fringe benefit rules to independent contractors.

be excluded. Both of these conclusions should pertain regardless of whether the payments are made directly to the contractor as reimbursements or to a third party on the contractor's behalf; however, if the payment is paid to the independent contract as a reimbursement, it must be adequately substantiated.

(d) Fellowship Recipients

Unlike the situation with employees and independent contractors, payments that are made to or on behalf of fellowship recipients are not treated as compensation for services rendered because the person, by definition, is not providing any services. Rather, the person is receiving a fellowship, and the immigration-related payment, regardless of its ''business or personal'' character, is another component of the fellowship grant. Under section 117, which defines the types of scholarship/fellowship grants that are excludable from the recipient's gross income, only tuition, books, and related fees can be from gross income. All other aspects of the scholarship/fellowship grant are included in the person's gross income, such as items as stipends, and room and board. Clearly, none of the typically paid immigration-related expenses falls into the tuition, books, or fee categories and, therefore, should be included in the recipient's gross income as taxable fellowship income. However, unless the person is a nonresident alien, the institution is not required to withhold any tax with respect to any of the ''immigration-related'' fellowship grant, nor is the college or university required to report this part of the grant to the IRS or the individual.[86]

[86]Notice 87-34, 1987-10 C.B. 475; *see* § 7.2.

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§ 9.1 EXEMPTION ISSUES

(a) Obtaining and Maintaining Tax-Exempt Status

One of the most fundamental issues in the tax-exempt organization area is whether the organization qualifies for tax-exempt status under section 501(c)(3) as a charitable, educational, religious, or scientific organization.[1] This is virtually never an issue in the college and university area, however, because higher education institutions are almost always organized on a nonprofit basis and operated primarily for one of the most basic and fundamental of all section 501(c)(3) purposes—providing educational instruction to enrolled

[1]As a technical matter, an organization is not exempt under IRC § 501(c)(3); rather, tax-exempt status is conferred by IRC § 501(a) to organizations ''described'' in IRC § 501(c)(3).

students.[2] In addition, many schools also conduct significant research activities and thereby have a dual section 501(c)(3) status—educational and scientific. Certainly, colleges and universities conduct other activities in addition to pure educational instruction and scientific research, such as athletic events, school newspapers, theater events, health clubs, and television and radio stations, to name just a few. But these activities, to the extent they raise any tax-related issues at all, only raise the question whether the particular activity is ''substantially related'' to the school's primary purpose of providing educational instruction or conducting scientific research so as to bring the unrelated business income rules into play.[3] These noneducational/scientific activities, either individually or collectively, never become a substantial part of the institution's overall activities and therefore do not threaten its qualification under section 501(c)(3). But a college or university may encounter tax exemption issues with respect to related foundations or other nonprofit entities that it establishes. In this connection, the IRS ruled that a limited liability company (LLC) that was wholly owned by a state university was not required to file its own application for tax-exempt status, presumably because it was deemed to be exempt from tax under the umbrella of its state university parent.[4]

That is not to say, however, that a school that has obtained section 501(c)(3) status cannot have that status revoked for violations of the private inurement rules or engaging in political activities, both of which are discussed below. Still, 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. For a discussion of how these section 501(c)(3) rules impact state colleges and universities that are exempt under section 115, see section 9.7.

(b) Private Inurement

One exemption issue that is of occasional concern to colleges and universities relates to two similar but technically different concepts—private benefit and private inurement. Although the two terms are often used synonymously, they are substantially different. Both relate to the conduct of an activity that benefits one or more private individuals, as opposed to furthering the institution's educational or scientific goals. If the individual is not an ''insider,''

[2]But see the petition filed with the Board of Regents of the University of the State of New York against the president of Adelphi University and the University's Board of Trustees setting forth the reasons why the petitioners believed these individuals should be removed from their respective positions. Allegations of this nature, if substantiated by the IRS, could lead to revocation of exempt status.

[3]*See* § 2.1(c). Of course, colleges and universities do face issues as to whether affiliated and separately incorporated institutions qualify for IRC § 501(c)(3) status, such as alumni associations, booster clubs, athletic foundations, and university presses.

[4]Priv. Ltr. Rul. 200134025 (May 22, 2001).

the activity is private benefit; if the person being benefited is an insider, the activity is private inurement. The distinction is vital because private benefit transactions cause a problem with the institution's tax-exempt status only if they become substantial, while a single private inurement transaction, no matter how small, can theoretically result in revocation of tax-exempt status.

Looking first at private inurement, this doctrine stems from the statutory language of 501(c)(3), which in addition to requiring that the organization be organized and operated exclusively for charitable, educational, or scientific purposes, also mandates that ''no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual.'' The purpose of the private inurement doctrine is to prevent the income or assets of a tax-exempt organization from being distributed to one or more persons related to that organization for purposes not in furtherance of the organization's exempt purposes. The IRS has described the doctrine as one that is likely to arise ''where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes.''[5] Another IRS description of the private inurement doctrine is a bit more graphic and to the point: ''The inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use.''[6]

(i) Determining Whether an Individual Is an Insider. An important aspect of the private inurement doctrine is that it applies only to a transaction entered into between a tax-exempt organization and an individual who is an ''insider'' with respect to that organization. This requirement stems from the statutory language that inurement only applies when there is benefit flowing to a ''private shareholder or individual.'' In order for private inurement to occur, (1) the individual who receives the benefit must be an insider—that is, have the ability to control or otherwise influence the actions of the tax-exempt organization, and (2) the benefit itself must be conferred intentionally by the tax-exempt organization.[7] For example, if a university were to provide below-market mortgage loans to a junior faculty member, the IRS might conclude that the private benefit received by the individual outweighs the public benefit of easing the faculty member's housing concerns and making it more likely that he or she can be retained to teach at the institution. If the IRS were to so conclude, the loan would constitute a ''private benefit'' activity because the junior faculty member is not an insider. But if the below-market mortgage loan is made to the president of the school or a member of the Board of Trustees, it could be viewed as private inurement because that person would

[5]Gen. Couns. Mem. 38,459 (July 31, 1980).
[6]Gen. Couns. Mem. 39,862 (Dec. 2, 1991).
[7]*See* Priv. Ltr. Rul. 200233024 (May 21, 2002), in which the IRS ruled that certain for-profit hospitals were not ''insiders'' with respect to a IRC § 501 (c)(3) organization.

presumably be an insider as one who is in a position to influence or control the school's actions.[8]

Most of the cases in which a tax-exempt organization's exempt status has been revoked because of violations of the private inurement doctrine have involved fairly egregious situations in which the founders of the organization were in total control of the organization and used its income and assets for their own private benefit. For example, in one case involving the revocation of a business college's tax-exempt status, the founder of the college and his relatives served as the college's trustees, and the court found a ''constant co-mingling of the funds'' between these individuals and the college.[9] In another case involving a trade school, the court found that the school had engaged in private inurement by making excessive rent payments to the founders of the school.[10]

In some cases, whether the individual receiving the benefit is an ''insider'' is not totally clear. For example, in one case, a tax-exempt hospital's exempt status was revoked because the physicians who organized the hospital, even though they were not technically in control of it, were so vital to the hospital's financial well-being that they were deemed to be ''insiders'' for purposes of the private inurement doctrine.[11] The IRS at one time took the position that all physicians practicing at the hospital are ''insiders'' in relation to the hospital,[12] but Congress reversed this position in enacting the intermediate sanctions legislation discussed in section 9.1(d).

There is also an issue as to whether a person can become an insider with respect to a section 501(c)(3) organization by reason of the person's initial contract with the organization. For example, if a college or university entered into an employment contract with a new president or athletic director, could this transaction be treated as private inurement even if there had been no contract between the school and the person in the past? The IRS has taken the position that there is no ''initial contract'' exception for private inurement purposes, but its position was rejected by the Seventh Circuit, which said: ''If a charity's contract with the [individual] makes the latter an insider, triggering the inurement clause of section 501(c)(3) and destroying the charity's tax exemption, the charity sector of the economy is in real trouble.''[13] It appears

[8]*See also Anclote Psychiatric Ctr., Inc. v. Commissioner*, T.C. Memo 1998-273, 76 T.C.M. 175 (1998), in which the Tax Court sustained the IRS's revocation of an organization's IRC § 501(c)(3) status because the sale of the organization's hospital was for less than fair market value, thereby resulting in inurement to private shareholders. The sale was made to a for-profit corporation whose stock was held by directors of the IRC § 501(c)(3) organization. The sale price was $6.6 million, but the court found that the fair market value of the assets that were transferred was approximately $7.8 million. The court found that the $1.2 million difference was substantial enough to constitute grounds for revocation of the organization's IRC § 501(c)(3) status.

[9]*Birmingham Bus. College, Inc. v. Commissioner*, 276 F.2 d 476, 479 (5th Cir. 1960).

[10]*Texas Trade Sch. v. Commissioner*, 30 T.C. 642, 647 (1958), aff'd, 272 F.2 d 168 (5th Cir. 1959).

[11]*Harding Hosp., Inc. v. United States*, 505 F.2 d 1068, 1078 (6th Cir. 1974).

[12]Gen. Couns. Mem. 39,862 (Dec. 2, 1991).

[13]*United Cancer Council, Inc. v. Commissioner*, 165 F.3 d 1173, 1176 (7th Cir. 1999), *rev'g* 109 T.C. 326 (1997).

that the IRS now agrees with the court's rationale in the private inurement context because in the closely related intermediate sanctions area it has carved out a ''first contract'' exception, which essentially says that there will be no intermediate sanctions violation if the transaction represented the initial contract between the organization and the individual.[14] Presumably, the IRS will apply this same rationale to private inurement situations.

(ii) Evaluating Reasonableness of Compensation. An activity or transaction conducted by a college or university is unlikely to violate the private inurement doctrine, primarily because these institutions usually have comprehensive and strict controls in place governing how the officers, directors, and trustees are to operate. To 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.[15]

In determining whether private inurement might exist in connection with compensation for services, the determination must first be made as to whether the compensation is ''unreasonable.'' If it is unreasonable and if paid to an ''insider,'' the IRS could conceivably try to revoke a college or university's tax-exempt status. Although it is a well-established legal principle that a tax-exempt organization is entitled to pay reasonable compensation to the organization's trustees, officers, or founders for services rendered,[16] excessive compensation can constitute private inurement of the organization's net earnings to that individual, thereby resulting in revocation of the organization's tax-exempt status.[17]

In determining whether an organization's net earnings have inured to the benefit of an individual through the payment of unreasonable or excessive compensation, the proper analysis is to look to the ''reasonable compensation'' guidelines used to determine whether compensation paid by a for-profit company is deductible by that company as an ordinary and necessary business expense.[18] One of the most often quoted descriptions of the various factors that are taken into account when making reasonable compensation determinations

[14]Treas. Reg. § 53.4958-4(a)(3). *See* § 9.1(d).

[15]*See* Gen. Couns. Mem. 39,670 (June 17, 1987), in which the IRS Chief Counsel's office held that the following payments made to or on behalf of a university's athletic coach did not constitute private inurement: deferred compensation payments, purchase of the coach's contract from another school, life insurance premiums, bonuses when the team competed in post-season games, and moving expenses.

[16]*World Family Corp. v. Commissioner*, 81 T.C. 958, 968 (1983); *Founding Church of Scientology v. United States*, 412 F.2 d 1197, 1202 (Ct. Cl. 1969); *Mabee Petroleum Corp. v. United States*, 203 F.2 d 872, 875 (5th Cir. 1953).

[17]*Bubbling Well Church of Universal Love, Inc. v. Commissioner*, 74 T.C. 531, 537 (1980), *aff'd*, 670 F.2 d 104 (9th Cir. 1981).

[18]*B.H.W. Anesthesia Found. v. Commissioner*, 72 T.C. 681, 686 (1979).

in a for-profit context is set forth in a 1949 case in which the court stated as follows:

> Although every case of this kind must stand up on its own facts and circumstances, it is well settled that several basic factors should be considered by the Court in reaching its decision in any particular case. Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees. . . . The situation must be considered as a whole with no single factor decisive.[19]

The reasonable compensation issue also arises in connection with salary bonuses paid by a college or university to senior employees. The IRS addressed a section 501(c)(3) organization's bonus program in a private letter ruling in which a tax-exempt scientific research organization proposed to implement a long-term incentive bonus program.[20] The organization represented to the IRS that under this program:

- All bonus determinations will be made based on objective performance evaluations of each individual.
- Bonuses will be based on a percentage of the individual's base salary.
- No bonus will be awarded if the amount of the bonus, when added to the individual's regular salary and other benefits, would result in the total compensation paid to the individual to be unreasonable.
- The organization will enter into a written agreement with a compensation consultant, who will assist in the organizational and operational structure of the incentive bonus program.

The IRS, in ruling that the proposed bonus program will not jeopardize the organization's tax-exempt status, seemed to base its determination primarily on the fact that the bonuses were intended to motivate the senior-level employees to ''achieve specific measurable goals that will continue to advance [the organization's] tax-exempt purposes by maintaining the level of human and capital assets necessary to achieve its strategic agenda.'' In addition, the IRS found important the fact that the organization represented it would take the necessary steps to ensure the amount of the bonus, when added to the individual's other compensation, would not exceed what would otherwise be deemed to be reasonable compensation for the particular services rendered. It

[19] *Mayson Mfg. Co. v. Commissioner*, 178 F.2 d 115, 119 (6th Cir. 1949). The IRS has elaborated on the reasonable compensation area in *1992 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 191–215, 16th ed. (1992).

[20] Priv. Ltr. Rul. 200601030 (Oct. 12, 2005).

also found the facts in the requested ruling similar to several of the situations presented in Rev. Rul. 97-21, which held that various physician financial recruitment incentives provided by section 501(c)(3) hospitals were consistent with the principles of section 501(c)(3).[21]

With respect to potential ''sweetheart arrangements'' between the college 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 the 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.[22] 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 purpose.[23]

Another area of potential private inurement concern to colleges and universities involves partnerships or joint ventures entered into with officers, directors, trustees, or other insiders. Although a school can enter into a partnership or joint venture with such a person either to pursue educational goals or simply for investment purposes, the school must ensure that its activities in connection with the venture do not confer unwarranted benefit on the individual. For example, if a college enters into partnership with one of its directors to undertake an experimental program in education, the school must ensure that all compensation received by the director is no more than what it would pay to an unrelated person.

Another development in the area of physician compensation may be of interest to colleges and universities, even if they do not have an affiliated hospital. In connection with a reorganization of the Duke University Health System, the System filed an application for tax-exempt status under section 501(c)(3), which was eventually approved by the IRS. The administrative file underlying this application was released, and one of the items in this administrative file is a detailed incentive compensation plan for the new entity's physicians. Because this incentive compensation plan was approved by the IRS, it may serve as a guide to other hospitals, as well as other section 501(c)(3) organizations, in helping them structure incentive compensation arrangements.

In addition, the IRS ruled that a hospital's physician recruitment plan will not jeopardize the hospital's section 501(c)(3) status. The plan included income guarantees, relocation assistance, and signing bonuses, with the payments being made by way of loans that would be forgiven if the physician practiced

[21] 1997-1 C.B. 121.

[22] *Best Lock Corp. v. Commissioner*, 31 T.C. 1217 (1959); Rev. Rul. 67-5, 1967-1 C.B. 123.

[23] *John Marshall Law Sch. v. United States*, Nos. 27-78, 28-78, 1981 WL 11168, at *3 (Ct. Cl. June 24, 1981).

in the community for a specified period of time. This ruling is interesting in that some of the physicians being recruited lived and worked in the community where the hospital is located, as opposed to being recruited from other geographic areas. Again, the principles set forth in this ruling may be applicable to recruitment plans implemented by colleges and universities for both health care and non–health care workers.

The IRS also issued favorable rulings to two health care organizations regarding so-called ''gainsharing arrangements.''[24] These are arrangements in which a hospital provides its physicians with a portion of the cost savings that have been generated by the physicians' activities. Under the programs reportedly approved by the IRS, the physicians agreed to assist the hospitals in the development of certain cost-effective initiatives; in return, the physicians received a percentage of the cost savings. After the gainsharing payment is determined, it is analyzed by an independent third-party appraiser to confirm that the total amount paid to the physician represents fair market value for the services rendered. If not, the amount of the payment is adjusted accordingly.

In reaching a favorable result in these two cases, the IRS relied on earlier revenue rulings. One of these outlined the factors to be used to determine if a compensation plan results in private inurement,[25] and the other related to the scope and amount of benefits that could be paid by a hospital to a physician on its medical staff.[26] In reaching its favorable determination, the IRS seemed to place significant emphasis on the fact that the physicians would be providing valuable services for the hospital and that the physicians' salaries, even after taking the gainsharing payment into account, would not exceed fair market compensation for the services rendered.

Whether and to what extent gainsharing arrangements may raise a problem under nontax statutes and regulations are beyond the scope of this discussion,[27] although the IRS noted in 2001 that it is unlikely that it would issue any rulings on gainsharing arrangements that would pass muster with the Department of Health and Human Services until such time as final revenue-sharing regulations under section 4958 are published.[28]

The IRS amplified how it views incentive compensation payments to physicians in a 1999 training manual issued by the national office.[29] The

[24]This letter has not been released, but can be found in *Exempt Organization Tax Review*, Aug. 1999, at 252.

[25]Rev. Rul. 69–383, 1969-2 C.B. 113.

[26]Rev. Rul. 97–21, 1997-1 C.B. 121.

[27]See, for example, Special Advisory Bulletin, HHS Office of Inspector General, July 8, 1999, issued the Office of the Inspector General of Health and Human Services a few months after the favorable IRS determination. This ruling stated that gainsharing arrangements between hospitals and physicians are prohibited by federal law and are subject to civil monetary penalties.

[28]*2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002*, 24th ed., at 171 (2001).

[29]*2000 Continuing Professional Education Technical Instruction Program for FY 2000*, 22nd ed., at 25–34 (1999).

IRS began this discussion with a review of earlier revenue rulings and court cases addressing this issue.[30] It focused particularly on a 1969 revenue ruling that had held that compensation paid under a plan whereby physicians received a fixed percentage of their own gross billings did not result in private inurement, when (1) the plan was not merely a device to distribute profits or create a substantive joint venture, (2) the compensation was the result of arm's-length bargaining, and (3) the compensation resulted in payments that bore a relationship to payments made by other hospitals to physicians having comparable responsibilities and patient volume.[31]

The IRS also discussed a memorandum prepared by the IRS chief counsel's office holding that a health care organization that compensated physicians by paying them, in part, 50 percent of net revenues was acceptable, based on the presence of the following five factors:

1. There was a completely arm's-length relationship between the parties.
2. The contingent payments served a bona fide business need of the health care organization.
3. The compensation was based more on the increase of net revenue flowing from reduced expenses than from increased revenue.
4. The compensation arrangement did not cause the organization's prices and operating costs to be different from those of other health care organizations in the community.
5. The organization had a compensation ceiling to prevent the possibility of a windfall to the physician based on factors that had no bearing on the level of service provided.[32]

The IRS also listed and discussed several other decisions by its chief counsel's office relating to the reasonable compensation issue,[33] and then listed the following factors that it takes into account in determining whether a physician incentive compensation arrangement results in private inurement or private benefit:

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[30]*Lorain Ave. Clinic v. Commissioner*, 31 T.C. 141 (1958); *Birmingham Bus. College v. Commissioner*, 276 F.2 d 476 (5th Cir. 1960); *Sonora Community Hosp. v. Commissioner*, 46 T.C. 519 (1966), *aff'd*, 397 F.2 d 814 (9th Cir. 1968).

[31]Rev. Rul. 69–383, 1969-2 C.B. 113.

[32]Gen. Couns. Mem. 32,453 (Nov. 30, 1962).

[33]Gen. Couns. Mem. 35,638 (Jan. 21, 1974) (plan involving shared savings generated by productivity increases approved); Gen. Couns. Mem. 38,283 (Feb. 15, 1980) (plan where profits are a factor approved); Gen. Couns. Mem. 38,394 (June 2, 1980) (plans with independent board of directors or independent compensation committee approved); Gen. Couns. Mem. 39,498 (Apr. 24, 1986) (plan where salaries are subsidized as employment inducement approved); Gen. Couns. Mem. 39,670 (Oct. 14, 1987) (deferred compensation plans approved); Gen. Couns. Mem. 39,674 (Oct. 23, 1987) (profit sharing plans based on economic performance of hospital approved).

- Whether the compensation arrangement was established by an independent board of directors or independent compensation committee
- Whether the compensation arrangement results in total compensation that is reasonable under the standard for determining reasonableness of compensation
- Whether there is an arm's-length relationship between the physician and the health care organization or whether physicians control the organization
- Whether the arrangement includes a ceiling on the amount of incentive compensation, to protect against substantial windfall benefits
- Whether a result of the incentive arrangement is to reduce the charitable services or benefits that the organization provides
- Whether the incentive arrangement takes into account data that measure quality of care and patient satisfaction
- If the incentive compensation arrangement is based on net revenue, whether the arrangement helps accomplish the organization's purpose of keeping expenses within budget
- Whether the effect of the arrangement is to convert the relationship into a joint venture
- Whether the arrangement is simply a device for the distribution of profits to the physician
- Whether the arrangement has a real and bona fide business purpose, such as achieving maximum efficiency and economy
- Whether the organization's prices and costs are comparable to those of organizations that do not offer incentive compensation arrangements
- Whether the incentive compensation arrangement rewards the physician for services that he or she actually performs

In another training manual issued a year earlier, the IRS provided some insight as to how it might view ''reasonable compensation'' issues in those situations in which a college or university makes incentive payments to research scientist employees.[34] The training manual sets forth a case study that involves a state university that has an affiliated tax-exempt research institute. A particular scientist has assisted the research institute in the development of a patent, and he is jointly employed by both the university and the research institute. The research institute proposes to enter into a license agreement with a for-profit company to commercially exploit the patent, and also proposes to pay the scientist an annual salary of $20,000 plus a 5 percent interest in

[34] *1999 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook*, 21st ed., at 21–54 (1998).

any royalties received by the institute. The IRS says that the issue in this case ''boils down to one of reasonableness of compensation'' and that, in order to decide this issue, ''it is important to determine if similar institutes engage in comparable arrangements with their employees.'' In looking at these other institutes, the IRS concludes that it was reasonable to provide key employees with a equity interest in the royalties to ensure that the persons will not ''bolt'' to set up their own company to conduct the research necessary to bring the product to market. The IRS goes on to say that a tax-exempt organization can offer its employees a share in royalties or profits from the exploitation of intellectual property, provided that the compensation is reasonable taking into account the norms of the industry. Any such arrangements should be decided in advance, contain arm's-length terms and conditions, and be reflected in a written agreement.

(iii) Sales Transactions with Insiders. If the college or university sells any assets to insiders, there is potential for private inurement. A 1982 ruling illustrates one method in which such sales can be undertaken without raising private inurement concerns. In that situation, a tax-exempt organization that operated a hospital was required to sell the hospital to pursue other activities, but there was a limited market of purchasers for the hospital. Accordingly, it sold the hospital to a for-profit entity controlled by the organization's board of directors. The IRS approved the transaction because the organization secured a valuation from a qualified independent appraiser; the property was sold at the appraised value; the directors received no loan abatements or other special concessions; and the organization took steps to ensure that it would continue to deal with the hospital on an arm's-length basis.[35] The ruling also illustrates the inherent danger in these types of transactions. Approximately two years after the sale, the facility was resold for almost four times its original valuation, and the IRS ended up revoking the organization's tax-exempt status because the initial valuation was faulty.[36]

(c) Private Benefit

The private benefit doctrine is an outgrowth of the requirement of section 501(c)(3) that an organization must be operated exclusively for charitable or educational purposes, and not for the benefit of any private persons. From a practical standpoint, the types of activities that violate the private benefit doctrine are the same as those that violate the private inurement doctrine, with the only difference being that the benefited individual is not an ''insider.'' As long as the organization is not operated substantially to benefit

[35]Priv. Ltr. Rul. 8234084 (May 27, 1982).

[36]Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 7th ed., § 13.4 (New York: John Wiley & Sons, 1998). *But see* Priv. Ltr. Rul. 9726021 (Mar. 31, 1997), wherein a sales transaction was found not to be private inurement on the strength of a third-party appraisal.

private individuals, the private benefit doctrine will not result in revocation of exemption.[37]

(d) Intermediate Sanctions

After years of lobbying by Treasury and IRS officials, the ''intermediate sanctions'' legislation was finally enacted into law in 1996.[38] The reason for the government's strong interest in this legislation arose from the fact that under prior law the only penalty that the IRS was able to impose against tax-exempt organizations for private inurement and private benefit transactions was revocation of the offending organization's tax-exempt status. This so-called ''death penalty'' sanction was rarely used by the IRS, a fact well known to tax-exempt organizations and their counsel. The IRS believed that many organizations felt relatively safe in entering into potential private benefit/private inurement transactions because of the wide latitude that existed as to what constituted private benefit or private inurement and because organizations rightly had little realistic expectation that they would ever be sanctioned, even if the transaction were ultimately found to be private benefit or inurement.

In addition, the IRS itself often felt uncomfortable in considering the revocation of the tax-exempt status of a large major university or other nonprofit institution for private inurement violations, as evidenced by the following example given by the IRS Commissioner during congressional hearings on the intermediate sanctions legislation:

> An examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to salaries paid to presidents of comparable universities. Also, the university may have provided the president with a substantial interest-free loan, or it may have paid for costly and luxurious amenities in the president's official residence. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community—employees, students, and area residents. For instance, an employee of a section 501(c)(3) organization is eligible for a section 403(b) retirement benefit. However, if the section 501(c)(3) organization loses its exempt status, its employees could find themselves also losing their section 403(b) retirement plan without having committed any wrong. Similarly, investors who hold tax-exempt bonds issued with respect to a section 501(c)(3) hospital or university that loses its tax-exempt status could find themselves with significant tax problems because the interest on the bonds would no longer be excludable from their income.

[37] In Priv. Ltr. Rul. 200233024 (May 21, 2003), the IRS said that a private benefit provided by a IRC § 501 (c)(3) organization to for-profit entities would be ''both quantitatively and qualitatively incidental,'' because the total expenses related to the benefit only represented 12 percent to 15 percent of the organization's total expenses.

[38] Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).

The intermediate sanctions rules give the IRS a substantial weapon to combat alleged private inurement and private benefit transactions. The basic structure of the statutory scheme imposes a ''penalty excise tax'' when the tax-exempt organization engages in an ''excess benefit transaction.''[39] An *excess benefit transaction* is defined as a transaction in which an economic benefit is provided, directly or indirectly, by the organization to a ''disqualified person'' where the value of the economic benefit provided to the individual exceeds the value (if any) of the consideration received by the organization.[40] This includes both excessive compensation payments and direct and indirect transactions (e.g., sales, leases, loans) between the organization and a disqualified person. The term also includes any transaction (to be determined by IRS regulations) in which the amount of economic benefit provided by a tax-exempt organization to a disqualified person is determined, in whole or in part, by the revenue of the organization, provided that the transaction would be classified as private inurement or private benefit under the existing section 501(c)(3) law.[41] This is intended to include revenue-sharing transactions in which the individual receives compensation tied to the organization's income. Congress instructed the Treasury Department to issue guidance setting forth which types of revenue-sharing proposals are permissible and which are not.[42]

In 1998, the IRS issued proposed regulations under section 4958 and in 2002 issued final regulations. The key aspects of these final regulations are described below.

(i) Exemption for State Colleges and Universities. State colleges and universities are not subject to federal income tax by reason of the exemption granted by section 115 to states and their political subdivisions,[43] but many state schools have also applied for and received tax-exempt status under section 501(c)(3). Because the intermediate sanctions rules apply to section 501(c)(3) organizations, an issue arose as to whether section 501(c)(3) state institutions would be subject to the intermediate sanctions provisions while the state institutions without section 501(c)(3) status would not. Although the IRS proposed regulations indicated that this would be the case, the final regulations say that a state governmental entity that is exempt under section 501(c)(3), but is also exempt from tax without regard to section 501(c)(3), is not subject to the intermediate sanctions provisions.[44] Therefore, those state colleges, universities, and other state institutions (e.g., hospitals) that qualify

[39]IRC § 4958(a). These rules apply to IRC § 501(c)(3) organizations as well as IRC § 501(c)(4) social welfare organizations.
[40]IRC § 4958(c)(1)(A).
[41]IRC § 4958(c)(2).
[42]H. Rep. No. 506, 104th Cong., 2 d Sess. 56 (1996).
[43]*See* § 9.7.
[44]Treas. Reg. § 53.4958-2(a)(2)(ii).

for the section 115 exemption are not subject to the intermediate sanctions provisions, even if they have their own section 501(c)(3) status.

(ii) Taxes Imposed. The basic structure of the section 4958 intermediate sanctions provisions is the imposition of an excise tax on each ''excess benefit transaction'' between an ''applicable tax-exempt organization'' and a ''disqualified person.'' This tax is imposed not on the organization, but on the disqualified person, and the amount of the tax is equal to 25 percent of the amount of the excess benefit.[45] In addition, the transaction must be ''corrected'' within a certain designated period of time, and if it is not, the disqualified person is liable for an additional tax equal to 200 percent of the excess benefit.[46]

The statutory scheme also provides for an excise tax on an ''organization manager'' who knowingly participates in an excess benefit transaction. This tax is equal to 10 percent of the amount of the excess benefit, and if the organization manager is also a disqualified person, he or she can be subject to both taxes.[47] An ''organization manager'' is (1) an officer, director, or trustee of the organization, or any person having powers or responsibilities similar to such persons regardless of title, or (2) a person who serves on a committee that is attempting to invoke the rebuttable presumption of reasonableness (described below).[48] The organization manager ''knowingly'' participates in the excess benefit transaction if the person (1) has actual knowledge of sufficient facts to show that the transaction would be an excess benefit transaction, (2) is aware that the transaction may violate the excess benefit provisions, or (3) negligently fails to make a reasonable attempt to determine whether the transaction is an excess benefit transaction or is aware that it is such.[49] The organization manager can escape liability, however, if he or she relied on a ''reasoned legal opinion'' that the transaction was not an excess benefit transaction, and this opinion can be written by legal counsel (including in-house counsel), certified public accountants, or independent valuation experts.[50] In addition, the regulations state that an organization manager will not be liable for the 10 percent tax if the person can show that his or her participation was due to reasonable cause.[51]

(iii) Date of Occurrence. With respect to any alleged excess benefit transaction, it is important to be able to fix the date on which the transaction occurred because the valuation of the transaction must take place on that date. The general rule is that the date that the excess benefit transaction will be deemed

[45]IRC § 4958(a)(1).
[46]IRC § 4958(b); Treas. Reg. § 53.4958-1(a).
[47]IRC § 4958(a)(2). The maximum amount of such tax with respect to any single excess benefit transaction is capped at $20,000. IRC § 4958(d)(2).
[48]Treas. Reg. § 53.4958-1(d)(2).
[49]Treas. Reg. § 53.4958-1(d)(4).
[50]Treas. Reg. § 53.4958-1(d)(4)(iii).
[51]Treas. Reg. § 53.4958-1(d)(6).

to occur is the date on which the disqualified person receives the economic benefit for federal income tax purposes.[52] There are, however, certain exceptions to this general rule, for example, (1) if the benefit is provided as part of a qualified pension plan, the transaction occurs on the date that the benefit is vested, and (2) where the excess benefit transaction relates to property that is received under a substantial risk of forfeiture, the transaction occurs when the property vests in the disqualified person.[53]

(iv) Written Contract Exception. The regulations provide that the intermediate sanctions provisions will not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs. If, however, the organization is able to cancel the contract without the disqualified person's consent and without substantial penalty, the contract does not qualify for this exception. In addition, the exception does not apply if the contract is materially changed after the September 13, 1995, date.[54]

(v) Organizations Subject to the Rules. The intermediate sanctions provisions apply to all ''applicable tax-exempt organizations,'' and all organizations that are exempt from tax under either section 501(c)(3) or section 501(c)(4) are so classified, except for private foundations, and as previously noted, governmental entities, which include state colleges and universities.[55] Even those organizations that have had their section 501(c)(3) or (4) exemption revoked are subject to the rules if the excess benefit transaction occurred within five years after the revocation.[56]

(vi) Disqualified Persons. The general definition of a *disqualified person* is a person who was in a position to exercise substantial influence over the affairs of the organization at any time within a five-year period ending on the date of the transaction.[57] In addition, family members of disqualified persons, and entities that are at least 35 percent controlled by a disqualified person, are also treated as disqualified persons in their own right.[58]

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[52]Treas. Reg. § 53.4958-1(e)(1).

[53]Treas. Reg. § 53.4958-1(e)(2).

[54]Treas. Reg. § 53.4958-1(f)(2). When a consulting agreement did not go into effect until the person's employment agreement terminated, and that date was beyond September 13, 1995, the IRS ruled that the written contract exception did not apply. Tech Adv. Mem. 200244028 (June 21, 2002).

[55]Treas. Reg. § 53.4958-2(a).

[56]Treas. Reg. § 53.4958-2(a)(5).

[57]IRC § 4958(f)(1)(A). In one ruling, the IRS held that scholarship awards would not be treated as made to disqualified persons, and therefore would not attract an intermediate sanctions excise tax. But this ruling is not terribly helpful because the definition of the persons who were ineligible for the awards was the same definition used for ''disqualified persons'' in the Code. Priv. Ltr. Rul. 9802045 (Oct. 16, 1997).

[58]Treas. Reg. § 53.4958-3(b)(1), (2).

The regulations provide a significant amount of guidance as to which persons will and which persons will not be treated as disqualified persons. For example, persons who are deemed in the regulations to be disqualified persons are (1) voting members of the organization's board of directors or similar governing body; (2) presidents, chief executive officers, chief operating officers, or persons who, regardless of title, have ultimate responsibility for implementing the decisions of the governing body or supervising the operation of the organization; and (3) treasurers and chief financial officers, or persons who, regardless of title, have the ultimate responsibility for managing the organization's finances.[59] In addition, the spouse of a disqualified person is treated as a disqualified person.[60] On the other hand, the regulations specifically except from disqualified person classification (1) section 501(c)(3) organizations (and section 501(c)(4) organizations with respect to other section 501(c)(4) organizations), and (2) those employees who receive, directly or indirectly, compensation that is less than the amount that is used to define a highly compensated employee under section 414(q)(1)(B)(i).[61]

All other determinations are made based on an examination of all the facts and circumstances. Those facts and circumstances that the IRS says tend to show the existence of substantial influence are:

- The person founded the organization.
- The person is a substantial contributor (within the meaning of section 507(d)(2)(A)) to the organization.
- The person's compensation is primarily based on revenues derived from the activities of the organization.
- The person has (or shares) authority to control or determine a substantial part of the organization's capital expenditures, operating budget, or employee compensation.
- The person manages a discrete segment or activity of the organization, which segment or activity represents a substantial part of the organization's total activities, assets, income, or expenses.
- The person owns a controlling interest in a corporation, partnership, or trust that is a disqualified person.
- The entity is a nonstock organization that is controlled by one or more disqualified persons[62]

[59]Treas. Reg. § 53.4958-3(c).
[60]Treas. Reg. § 53. 4958-3(b)(1); Tech. Adv. Mem. 200244028 (June 2, 2002), which held that the spouse of a ection 501(c)(3) organization's founder and former officer was a disqualified person, received excess benefits subject to the intermediate sanctions excise tax, and was also subject to additional penalties.
[61]Treas. Reg. § 53.4958-3(d).
[62]Treas. Reg. § 53.4958-3(e)(2).

Those facts and circumstances that tend to show that the person does not have the necessary substantial influence over the affairs of the organization to be treated as a disqualified person are:

- The person has taken a vow of poverty as an employee, agent, or on behalf of a religious organization.
- The person is an independent contractor (such as an attorney, accountant, or investment adviser) whose sole relationship to the organization is providing professional advice with respect to transactions from which the person will not economically benefit, aside from earning fees.
- The person's direct supervisor is not a disqualified person.
- The person does not participate in any management decisions affecting either the organization as a whole or a discrete segment of the organization that represents a substantial portion of the organization's activities, assets, income, or expenses.
- Any preferential treatment accorded the person based on the size of the person's donation to the organization is also offered to other donors making comparable contributions.[63]

The rules governing those employees who will and will not be treated as disqualified persons are obviously quite important in determining whether a transaction is subject to the intermediate sanctions rules. In its temporary regulations, the IRS set forth several examples that help illustrate how these disqualified person rules will be applied[64]:

> **Example 1:** N, an artist by profession, works part-time at R, a local museum. In the first taxable year in which R employs N, R pays N a salary and provides no additional benefits to N except for free admission to the museum, a benefit R provides to all of its employees and volunteers. The total economic benefits N receives from R during the taxable year are less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i). The part-time job constitutes N's only relationship with R. N is not related to any other disqualified person with respect to R. N is deemed not to be in a position to exercise substantial influence over the affairs of R. Therefore, N is not a disqualified person with respect to R in that year.
>
> **Example 2**: The facts are the same as in Example 1, except that in addition to the salary that R pays N for N's services during the taxable year, R also purchases one of N's paintings for $x. The total of N's salary plus $x exceeds the amount referenced for highly compensated employees in section 414(q)(1)(B)(i). Consequently, whether N is in a position to exercise substantial influence over the affairs of R for that taxable year depends upon all of the relevant facts and circumstances.

[63]Treas. Reg. § 53.4958-3(e)(3).
[64]Treas. Reg. § 53.4958-3(g).

Example 3: Q is a member of K, a section 501(c)(3) organization with a broad-based public membership. Members of K are entitled to vote only with respect to the annual election of directors and the approval of major organizational transactions such as a merger or dissolution. Q is not related to any other disqualified person of K.Q has no other relationship to K besides being a member of K and occasionally making modest donations to K. Whether Q is a disqualified person is determined by all relevant facts and circumstances. Q's voting rights, which are the same as granted to all members of K, do not place Q in a position to exercise substantial influence over K. Under these facts and circumstances, Q is not a disqualified person with respect to K.

Example 4: E is the headmaster of Z, a school that is an applicable tax-exempt organization for purposes of section 4958. E reports to Z's board of trustees and has ultimate responsibility for supervising Z's day-to-day operations. For example, E can hire faculty members and staff, make changes to the school's curriculum, and discipline students without specific board approval. Because E has ultimate responsibility for supervising the operation of Z, E is in a position to exercise substantial influence over the affairs of Z. Therefore, E is a disqualified person with respect to Z.

Example 5: Y is an applicable tax-exempt organization for purposes of section 4958 that decides to use bingo games as a method of generating revenue. Y enters into a contract with B, a company that operates bingo games. Under the contract, B manages the promotion and operation of the bingo activity, provides all necessary staff, equipment, and services, and pays Y q percent of the revenue from this activity. B retains the balance of the proceeds. Y provides no goods or services in connection with the bingo operation other than the use of its hall for the bingo games. The annual gross revenue earned from the bingo games represents more than half of Y's total annual revenue. B's compensation is primarily based on revenues from an activity B controls. B also manages a discrete activity of Y that represents a substantial portion of Y's income compared to the organization as a whole. Under these facts and circumstances, B is in a position to exercise substantial influence over the affairs of Y. Therefore, B is a disqualified person with respect to Y.

Example 6: The facts are the same as in Example 5, with the additional fact that P owns a majority of the stock of B and is actively involved in managing B. Because P owns a controlling interest (measured by either vote or value) in and actively manages B, P is also in a position to exercise substantial influence over the affairs of Y. Therefore, under these facts and circumstances, P is a disqualified person with respect to Y.

Example 7: A, an applicable tax-exempt organization for purposes of section 4958, owns and operates one acute care hospital. B, a for-profit corporation, owns and operates a number of hospitals. A and B form C, a limited liability company. In exchange for proportional ownership interests, A contributes its hospital, and B contributes other assets, to C. All of A's assets then consist of its membership interest in C. A continues to be operated for exempt purposes based almost exclusively on the activities it conducts through C. C enters into a management agreement with a management company, M, to provide day to day management services to C. M is generally subject to supervision by C's board, but M is given broad discretion

to manage C's day to day operation. Under these facts and circumstances, M is in a position to exercise substantial influence over the affairs of A because it has day to day control over the hospital operated by C, A's ownership interest in C is its primary asset, and C's activities form the basis for A's continued exemption as an organization described in section 501(c)(3). Therefore, M is a disqualified person with respect to A.

Example 8: T is a large university and an applicable tax-exempt organization for purposes of section 4958. L is the dean of the College of Law of T, a substantial source of revenue for T, including contributions from alumni and foundations. L is not related to any other disqualified person of T. L does not serve on T's governing body or have ultimate responsibility for managing the university as whole. However, as dean of the College of Law, L plays a key role in faculty hiring and determines a substantial portion of the capital expenditures and operating budget of the College of Law. L's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. L's management of a discrete segment of T that represents a substantial portion of the income of T (as compared to T as a whole) places L in a position to exercise substantial influence over the affairs of T. Under these facts and circumstances, L is a disqualified person with respect to T.

Example 9: S chairs a small academic department in the College of Arts and Sciences of the same university T described in Example 8. S is not related to any other disqualified person of T. S does not serve on T's governing body or as an officer of T. As department chair, S supervises faculty in the department, approves the course curriculum, and oversees the operating budget for the department. S's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. Even though S manages the department, that department does not represent a substantial portion of T's activities, assets, income, expenses, or operating budget. Therefore, S does not participate in any management decisions affecting either T as a whole, or a discrete segment or activity of T that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, S does not have substantial influence over the affairs of T, and therefore S is not a disqualified person with respect to T.

Example 10: U is a large acute-care hospital that is an applicable tax-exempt organization for purposes of section 4958. U employs X as a radiologist. X gives instructions to staff with respect to the radiology work X conducts, but X does not supervise other U employees or manage any substantial part of U's operations. X's compensation is primarily in the form of a fixed salary. In addition, X is eligible to receive an incentive award based on revenues of the radiology department. X's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. X is not related to any other disqualified person of U. X does not serve on U's governing body or as an officer of U. Although U participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act), X does not have a material financial interest in that organization. X does not receive compensation primarily based on revenues derived from activities of U that X controls. X does not participate

in any management decisions affecting either U as a whole or a discrete segment of U that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, X does not have substantial influence over the affairs of U, and therefore X is not a disqualified person with respect to U.

Example 11: W is a cardiologist and head of the cardiology department of the same hospital U described in Example 10. The cardiology department is a major source of patients admitted to U and consequently represents a substantial portion of U's income, as compared to U as a whole. W does not serve on U's governing board or as an officer of U. W does not have a material financial interest in the provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) in which U participates. W receives a salary and retirement and welfare benefits fixed by a three-year renewable employment contract with U. W's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. As department head, W manages the cardiology department and has authority to allocate the budget for that department, which includes authority to distribute incentive bonuses among cardiologists according to criteria that W has authority to set. W's management of a discrete segment of U that represents a substantial portion of its income and activities (as compared to U as a whole) places W in a position to exercise substantial influence over the affairs of U. Under these facts and circumstances, W is a disqualified person with respect to U.

Example 12: M is a museum that is an applicable tax-exempt organization for purposes of section 4958. D provides accounting services and tax advice to M as an independent contractor in return for a fee. D has no other relationship with M and is not related to any disqualified person of M. D does not provide professional advice with respect to any transaction from which D might economically benefit either directly or indirectly (aside from fees received for the professional advice rendered). Because D's sole relationship to M is providing professional advice (without having decision-making authority) with respect to transactions from which D will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered), under these facts and circumstances, D is not a disqualified person with respect to M.

Example 13: F is a repertory theater company that is an applicable tax-exempt organization for purposes of section 4958. F holds a fund-raising campaign to pay for the construction of a new theater. J is a regular subscriber to F's productions who has made modest gifts to F in the past. J has no relationship to F other than as a subscriber and contributor. F solicits contributions as part of a broad public campaign intended to attract a large number of donors, including a substantial number of donors making large gifts. In its solicitations for contributions, F promises to invite all contributors giving $z or more to a special opening production and party held at the new theater. These contributors are also given a special number to call in F's office to reserve tickets for performances, make ticket exchanges, and make other special arrangements for their convenience. J makes a contribution of $z to F, which makes J a substantial contributor within the meaning of section 507(d)(2)(A), taking into account only contributions received by F during its current and the four preceding taxable years. J receives the benefits described in F's solicitation. Because

F offers the same benefit to all donors of $z or more, the preferential treatment that J receives does not indicate that J is in a position to exercise substantial influence over the affairs of the organization. Therefore, under these facts and circumstances, J is not a disqualified person with respect to F.

Of particular interest to colleges and universities is Example 8, in which the dean of a university's law school is held to be a disqualified person, and Example 9, in which a chair of a ''small academic department'' in the same university's College of Arts and Sciences is held not to be a disqualified person. The primary difference between the two situations appears to be that the law school was responsible for a substantial portion of the university's revenue, while the small academic department was not. Also, it is interesting to note that the radiologist described in Example 10 was held not to be a disqualified person even though his salary was in excess of the highly compensated employee threshold and he received an incentive award based on the revenues of the radiology department. At the same time, a cardiologist who was also head of the same hospital's cardiology department was determined to be a disqualified person because that department represented a substantial portion of the income and activities of the hospital as a whole.

Although the final regulations contain quite a bit of detail with respect to the definition of a disqualified person, the inherently subjective nature of the ''substantial influence over the affairs'' test will cause most colleges and universities to continue to struggle to make disqualified person determinations with respect to senior officials.

(vii) Excess Benefit Transactions. The intermediate sanctions excise tax is only imposed where there is an ''excess benefit transaction'' between a section 501(c)(3) or (4) organization and a disqualified person. The statute provides for two quite different types of transactions that are treated as excess benefit transactions, both of which are described below.

Value of Benefit Provided Exceeds Value of Consideration Received

The first type of excess benefit transaction is one where an economic benefit is provided by the organization, directly or indirectly, to a disqualified person, and the value of the economic benefit that is provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit.[65] The two common types of transactions that fall within the scope of this provision are non-fair-market-value sales transactions between the organization and the disqualified person and the payment of excessive compensation to the disqualified person.[66] The excess

[65]IRC § 4958(c)(1)(A).

[66]For a discussion of how excessive or unreasonable compensation determinations are made, *see* § 9.1(b)(ii). In 2005 the IRS announced a new enforcement effort to identify and halt perceived abuses by tax-exempt organizations that pay excessive compensation and benefits to officers

benefit, whether it be through a sale of property or the payment of excessive compensation, can be provided both directly and indirectly, and the regulations say that indirect excess benefit transactions can occur either through an entity that is controlled by the organization or through an intermediary.[67]

At one time, the IRS took the position in the closely related private inurement area that an initial contract between a previously unrelated person and a section 501(c)(3) organization could result in private inurement. A logical extension of this position is that such an initial contract could also result in an intermediate sanctions violation. The IRS litigated and won the private inurement issue in the Tax Court, but the Seventh Circuit Court of Appeals reversed, saying: ''If the charity's contract with the [individual] makes the latter an insider, triggering the inurement clause of section 501(c)(3) and destroying the charity's tax exemption, the charity sector of the economy is in real trouble.''[68] The same issue arises in the intermediate sanctions area—that is, can there be an excess benefit transaction between an organization and a person who becomes a disqualified person solely by reason of entering into the transaction? The IRS has apparently decided that the logic of the Seventh Circuit was correct and provides in the regulations that section 4958 will not apply to any fixed payment made to a person pursuant to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit transaction.[69] This rule is of significant importance to a college or university that enters into an initial employment contract with such senior officials and the president, athletic director, and so on. The rule applies, however, only to fixed payments, as illustrated by two examples in the regulations[70]:

> **Example 1:** T is an applicable tax-exempt organization for purposes of section 4958. On January 1, 2000, T hires S as its chief financial officer by entering into a five-year written employment contract with S. S was not a disqualified person within the meaning of sections 4958(f)(1) and 53.4958-3 T immediately prior to entering into the January 1, 2000, contract (initial contract). S's duties and responsibilities under the contract make S a disqualified person with respect to T (see section 53.4958-3 T(a)). Under the initial contract, T agrees to pay S an annual salary of $200,000, payable in monthly installments. The contract provides that, beginning in 2001, S's annual salary will be adjusted by the increase in the Consumer Price Index (CPI) for the prior year. Section 4958 does not apply because S's compensation under the contract is a fixed payment pursuant to an initial contract within the meaning of

and other insiders. Under this program, the IRS contacted approximately 2,000 tax-exempt organizations to obtain information about their compensation payment levels and practices. *See* IRS Information Release 2004-106 (Aug. 10, 2004).

[67]Treas. Reg. § 53.4958-4(a)(2)(ii), (iii). The regulations also contain several examples of indirectly provided economic benefits at Treas. Reg. § 53.4958-4(a)(2)(iv).

[68]*United Cancer Council, Inc. v. Commissioner*, 165 F.3 d 1173, 1176 (7th Cir. 1999), *rev'g* 109 T.C. 326 (1997).

[69]Treas. Reg. § 53.4958-4(a)(3).

[70]Treas. Reg. § 53.4958-4(a)(3)(vii).

paragraph (a)(3) of this section. Thus, for section 4958 purposes, it is unnecessary to evaluate whether any portion of the compensation paid to S pursuant to the initial contract is an excess benefit transaction.

Example 2: The facts are the same as in Example 1, except that the initial contract provides that, in addition to a base salary of $200,000, T may pay S an annual performance-based bonus. The contract provides that T's governing body will determine the amount of the annual bonus as of the end of each year during the term of the contract, based on the board's evaluation of S's performance, but the bonus cannot exceed $100,000 per year. Unlike the base salary portion of S's compensation, the bonus portion of S's compensation is not a fixed payment pursuant to an initial contract, because the governing body has discretion over the amount, if any, of the bonus payment. Section 4958 does not apply to payment of the $200,000 base salary (as adjusted for inflation), because it is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. By contrast, the annual bonuses that may be paid to S under the initial contract are not protected by the initial contract exception. Therefore, each bonus payment will be evaluated under section 4958, taking into account all payments and consideration exchanged between the parties.

The regulations also provide that, with certain minor exceptions, all fringe benefits that are excluded from an employee's income under the section 132 fringe benefit exceptions are disregarded for section 4958 purposes.[71] This means, however, that if luxury or spousal travel would not be excludable under section 132, it remains potentially subject to the intermediate sanctions rules.

As noted above, the most typical types of excess benefit transactions are those in which there is a non-fair-market-value sale of property between the organization and the disqualified person and in which the organization pays excessive (or ''unreasonable'') compensation to the disqualified person in return for services rendered. In connection with making these determinations, the regulations set forth rules to follow in determining the fair market value of property and the reasonableness of compensation.[72] As to the latter determination, the regulations bring into play the well-known standards for determining reasonable compensation for purposes of claiming section 162 business expense deductions.

There is an aspect of this first type of excess benefit transaction that is a significant trap for the unwary. Specifically, the statute says that an economic benefit will not be treated as consideration for the performance of services unless the organization indicates its intent at the time of the transaction to treat the benefit as compensation.[73] In other words, if a university does not indicate an intent to treat a payment as compensation at the time that it is made, the payment will not be regarded as provided in return for the performance of

[71]Treas. Reg. § 53.4958-4(a)(4)(i). See Chapter 5 for a discussion of the IRC § 132 fringe benefit rules.
[72]Treas. Reg. § 53.4958-4(b)(1)(i), (ii).
[73]IRC § 4958(c)(1)(A).

services. If the payment is not in return for the performance of services, then it is a per se excess benefit transaction because the university is deemed to have received nothing in return for the payment provided. The regulations make it clear that an organization can avoid this aspect of the statute if it reports the payment on a Form W-2 or Form 1099, or if the disqualified person reports the income on his or her Form 1040 in the year in which the payment was received.[74] The requisite intent will be found to exist even if the report is made on an amended return that is filed by the organization or the individual before the commencement of an IRS examination for the year in which the transaction occurred.[75] In addition, intent can be demonstrated by ''written substantiation that is contemporaneous with the transfer of benefits at issue,'' and the regulations say that this written substantiation can include a written employment contract or minutes of a board meeting indicating the intent to treat the payment as compensation.[76]

The IRS has held in a series of recent technical advice memorandums that the reimbursement of unsubstantiated expenses can result in an intermediate sanctions violation.[77] The cases involved a section 501(c)(3) public charity founded by an individual who served as a director of the organization together with his wife and several family members. Several of the alleged private inurement transactions in question involved the payment by the organization of certain credit card, cell phone, and other similar expenses on behalf of the individual and his family members. The organization was unable to provide substantiation to show that these expenses were related to the ongoing activities of the organization, and the IRS held that the unsubstantiated expense payments represented excess benefit transactions.

Benefit Determined by Revenues of Organization's Activities

The second type of transaction that is treated as an excess benefit transaction is ''any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization,'' provided that the transaction would also constitute private inurement.[78] But the statute goes on to say that a revenue-sharing transaction of this type will be treated as an excess benefit transaction only to ''the extent provided in regulations.''[79]

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[74]Treas. Reg. § 53.4958-4(c)(3)(i)(A), (B).
[75]*Id*.
[76]Treas. Reg. § 53.4958-4(c)(1), (3)(ii).
[77]Tech. Adv. Mems. 200435018; 200435019; 200435020; 200435021; 200435022 (May 5, 2004).
[78]IRC § 4958(c)(2). *See also* a chapter in the IRS Exempt Organization's Division FY 2004 Continuing Professional Education Text dealing with whether economic benefits received by a disqualified person from a ection 501(c)(3) or (4) organization should be treated as an ''automatic'' excess benefit transaction under section 4958. This CPE Text chapter can be found on the IRS web site at *www.irs.gov/pub/irs-tege/eotopice04.pdf*.
[79]*Id*.

The preamble to the 1998 proposed regulations said that whether a revenue-sharing transaction would be treated as an excess benefit transaction would be determined based on all the facts and circumstances, but in no event would such a transaction be treated as such until final regulations are issued. The final regulations issued in 2002 refused to provide additional guidance on these types of transactions, other than to say that, for the present, revenue-sharing transactions will be governed under the general rules relating to excess benefit transactions and may attract an excise tax for that reason.[80] In other words, if the revenue-sharing transaction would constitute an excess benefit transaction under the first definition (e.g., unreasonable compensation), it will be treated as such. In the preamble to the final regulations, the IRS says that it plans to issue further guidance on revenue-sharing transactions by way of proposed regulations, which will allow the general public to file additional comments. Therefore, it will be some time before the revenue-sharing regulations are finalized and this aspect of the intermediate sanctions rules goes into effect.

(viii) Rebuttable Presumption. Following language contained in the legislative history to section 4958, the IRS sets forth in the regulations a rebuttable presumption that a transaction with a disqualified person is reasonable and not an excess benefit transaction if the transaction was approved by the board of directors or trustees (or a committee thereof), and this body:

- Is composed entirely of persons unrelated to and not subject to the control of the disqualified person involved in the transaction
- Obtained and relied upon appropriate data as to comparability
- Adequately documented the basis for its determination[81]

If these three conditions are met, a presumption of reasonableness arises, and the IRS can rebut this presumption only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the governing body.[82] It is important to note that with respect to fixed payments the rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date that the parties entered into the contract under which the payment was made.[83] Therefore, for example, the fact that circumstances may later arise to show that a compensation payment was excessive or a sales

[80]Treas. Reg. § 53.4958-5.
[81]Treas. Reg. § 53.4958-6(a). IRS officials have indicated in public presentations that, following recent conflict of interest standards imposed on for-profit companies by the Sarbanes-Oxley legislation, the IRS will review all compensation comparability reports that are prepared by the organization's accounting firm.
[82]Treas. Reg. § 53.4958-6(b).
[83]*Id*.

transaction was not at fair market value cannot be taken into account to rebut the presumption.

The regulations set forth various rules regarding the types of governing bodies that can make this decision, the applicable conflict of interest rules, and how the decision must be documented,[84] but the most important aspect of this rebuttable presumption is whether the body relied on adequate ''comparability data.'' The type of data that meets this test for the purpose of determining the reasonableness of compensation includes (1) compensation levels paid by similarly situated organizations, both nonprofit and for-profit, for functionally comparable positions; (2) the availability of similar services in the organization's geographic area; (3) current compensation surveys compiled by independent firms; and (4) actual written offers from similar organizations competing for the services of the disqualified person. In the case of property sale transactions, the type of data that qualifies includes current independent appraisals of the value of the property and offers received as part of an open and competitive bidding process. The regulations include several examples that are helpful in understanding how the comparability data rules operate:[85]

> **Example 1:** Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q's compensation for its president at $600x per annum, the executive committee of the board of trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of $100x to $700x; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee's decision with respect to Q's compensation was not based upon appropriate data as to comparability.
>
> **Example 2:** The facts are the same as Example 1, except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of $200x to $300x. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q's many years of service as a tenured professor and high-ranking university official at Z in setting Q's compensation at $275x annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

[84]Treas. Reg. § 53.4958-6(c)(1), (3).
[85]Treas. Reg. 53.4958-6(c)(2)(iv).

Example 3: X is a tax-exempt hospital that is an applicable tax-exempt organization for purposes of section 4958. Before renewing the contracts of X's chief executive officer and chief financial officer, X's governing board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. The survey, as prepared and presented to X's board, constitutes appropriate data as to comparability.

Example 4: The facts are the same as Example 3, except that one year later, X is negotiating a new contract with its chief executive officer. The governing board of X has no information indicating that the relevant market conditions have changed or that the results of the prior year's survey are no longer valid. Therefore, X may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.

Example 5: W is a local repertory theater and an applicable tax-exempt organization for purposes of section 4958. W has had annual gross receipts ranging from $400,000 to $800,000 over its past three taxable years. In determining the next year's compensation for W's artistic director, the board of directors of W relies on data compiled from a telephone survey of three other unrelated repertory theaters of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability.

These examples illustrate some important concepts—first, that general salary comparability data may not be sufficient to ensure that the rebuttable presumption will apply. In the first example, in determining the salary for the university president, the board of trustees looked at a national survey of annual salaries paid to university presidents but did not further break down these salary comparability figures into criteria such as the number of students, annual revenues, academic ranking, or geographical location. For this reason, the university was not able to rely on the rebuttable presumption, but in the second example, where these types of ''university-specific'' factors were taken into account, the IRS determined that the rebuttable presumption would apply. It is also important to note that, although the regulations mention reports prepared by independent compensation consulting firms as an approved type of comparability data, it is not necessary to retain an independent firm. In the last example, the board relied on a telephone survey presumably conducted by members of the organization's staff. Finally, the examples illustrate that an organization can satisfy the rebuttable presumption test even if it does

not collect third-party information. In the fourth example, the organization was permitted to rely on previously collected information because it had no information that the relevant market conditions had changed. The preamble to the temporary regulations issued by the IRS in 2001 also made it clear that, under certain circumstances, failure to collect third-party data ''in no way implies that a transaction is unreasonable.''[86]

(ix) Correction of the Excess Benefit Transaction. As noted earlier, the intermediate sanctions statutory scheme provides for an excise tax that is imposed on the disqualified person who participates in the transaction, and in addition, requires that the transaction be corrected. In most cases, correction is accomplished by undoing the transaction to the extent possible and taking any additional measures necessary to place the organization in the situation that is not worse than if it had entered into the transaction on an arm's-length basis. The regulations set forth a fairly detailed set of instructions as to how this correction is to be accomplished.[87]

(x) Effect on Tax-Exempt Status. The intermediate sanctions rules are based on the theories of private inurement, and it is fair to say that, as a general rule, an activity that results in an intermediate sanctions violation could also be treated by the IRS as private inurement.[88] The legislative history to section 4958 contains some seemingly contradictory statements as to whether the IRS should both impose the intermediate sanctions provisions as well as seek revocation of the offending organization's tax-exempt status. On the one hand, the committee reports say that, as a general rule, the intermediate sanctions should be the sole sanction except where the excess benefit at issue rises to a level where it calls into question whether the organization, as a whole, functions as a charitable or other tax-exempt organization, and ''[i]n practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.''[89] But the same report also says that ''[t]he intermediate sanctions for excess benefit transactions may be imposed by the IRS in lieu of (or in addition to) revocation of the organization's tax-exempt status.''[90]

In the preamble to the 1998 proposed regulations, the IRS said that it would, as a general rule, look only to the intermediate sanctions provisions and would not pursue revocation of an organization's tax-exempt status. In deciding whether to also pursue revocation, the IRS said it would look to (1) whether

[86]Preamble to T.D. 8920, Jan. 9, 2001. For a situation in which the IRS found inadequate comparability data, *see* Tech. Adv. Mem. 200244028 (June 21, 2002).
[87]Treas. Reg. § 53.4958-7.
[88]For a discussion of the private inurement rules, *see* § 9.1(b).
[89]H. Rep. No. 506, 104th Cong., 2 d Sess. 53, 59 n. 15 (1996).
[90]*Id*.

the organization had been involved in repeated excess benefit transactions, (2) the size and scope of the excess benefit transactions, (3) whether, after concluding that it has been a party to an excess benefit transaction, the organization has implemented safeguards to prevent future reoccurrence, and (4) whether there was compliance with other applicable laws. The preamble to the temporary regulations takes the same general approach and says that the IRS will continue to apply its ''administrative discretion'' in determining whether to pursue both the intermediate sanctions taxes and revocation. But the preamble to the 2001 temporary regulations did not repeat the same factors as were in the preamble to the proposed regulations, but instead said that the IRS will publish the factors that will be taken into account ''as it gains more experience administering the section 4958 regime.''[91]

Thus, it seems that the IRS will, only in rare circumstances, impose the intermediate sanctions provisions and also seek revocation of the organization's exempt status. This is the approach that the Tax Court took in the first case that it decided under the intermediate sanctions provisions, which involved alleged excess benefit transactions entered into by three organizations with disqualified persons.[92] The court, while finding that the IRS properly imposed the intermediate sanctions excise taxes, refused to revoke the organizations' tax-exempt status, saying that revocation was appropriate only in ''unusual'' cases.

(xi) IRS Audits of Intermediate Sanctions Issues. In early 2000, the IRS released a new section of the Internal Revenue Manual that provides guidance to examining agents on how to audit and impose the intermediate sanctions provisions.[93] These internal guidelines contain a comprehensive overview of the entire intermediate sanctions statutory scheme. In addition, the guidelines provide that agents cannot impose any intermediate sanctions excise taxes without first seeking technical advice from the national office.[94] The apparent reason for this rule is to allow the national office to ensure that these taxes are being imposed in a correct and consistent manner throughout the country. Some additional guidance was also set forth in a training manual prepared by the national office for its field agents with respect to how agents are to apply these provisions.[95]

(xii) IRS Informal Explanation of Regulations. Because of their length and complexity, Steven T. Miller, director of exempt organizations, prepared an

[91] Preamble to T.D. 8920, Jan. 9, 2001.

[92] *Caracci v. Commissioner*, 118 T.C. No. 379 (2002), *rev'd*, 98 AFTR 2d 5264 (5th Cir. 2006) on the ground that the valuation methods that the IRS and the Tax Court used to value certain transferred assets were flawed.

[93] *Internal Revenue Manual* ''Taxes on Excess Benefits Transactions,'' § 7.27.30 (May 1, 2006).

[94] For a description of the technical advice procedures, *see* § 10.8.

[95] *2000 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook for FY 2000*, 22nd ed., at 21–24 (1999).

analysis of the section 4958 temporary regulations that were issued in 2001. Because the final regulations issued a year later are almost identical to the temporary regulations, this analysis applies equally to the final regulations. Mr. Miller provided a helpful ''Rebuttable Presumption Checklist'' that schools can use to ensure they comply with all aspects of the reasonable presumption safe harbor. Given the significance of the intermediate sanctions provisions and the importance of the reasonable presumption safe harbor, this analysis and checklist are worth reproducing in their entirety[96]:

> On January 10, 2001, the Treasury Department issued Temporary Regulations interpreting the benefit limitation provisions of Section 4958 of the Internal Revenue Code. These provisions are important to the exempt organization community as a whole and to those of us with responsibility for ensuring compliance in this area.
>
> Proposed intermediate sanction regulations were issued in 1998. Since that time, staff from my office, the Office of Chief Counsel, and the Office of Tax Policy received and analyzed comments from the public. We incorporated many suggestions into the new regulations. I believe the regulations remain true to the language and legislative history of the statute.
>
> Because of the number of changes incorporated, the new regulations were issued in temporary form. As such, they have the same force and effect as final regulations for up to three years. However, I have no doubt that during this three-year period, you will continue to share your thoughts on the new regulations. This is a healthy process, and I am confident that this process will ensure that the final regulations will incorporate interpretations that are easy for taxpayers to follow and efficient for the Service to administer.
>
> The new regulations are lengthy—they cover all provisions of section 4958 applicable to the various benefits exempt organization officials receive. I am providing this brief analysis hoping to make the regulations easier to understand and follow. In my view, the primary purpose of the statute and the regulations is not solely to give the Service another tool in its enforcement arsenal, but to provide a road map by which an organization may steer clear of situations that may give rise to inurement. Needless to say, my analysis reflects my own views and does not necessarily represent the official views of the Treasury Department or the Internal Revenue Service.
>
> ***1.*** *The Regulations Apply Only to 501(c)(3) and 501(c)(4) Organizations*
>
> It is important to emphasize that the regulations apply only to certain ''applicable'' section 501(c)(3) and 501(c)(4) organizations. An applicable tax-exempt organization

[96]The IRS training manual issued in 2002 contains another description and analysis of the temporary regulations, and this discussion includes a copy of the rebuttable presumption checklist with respect to compensation as well as a similar checklist with respect to property sales or transfers to disqualified persons. It also contains a step-by-step method to analyze intermediate sanctions issues. *2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002*, 24th ed., at 259 (2001).

is a section 501(c)(3) or a section 501(c)(4) organization that is tax-exempt under section 501(a), or was such an organization at any time during a five-year period ending on the day of the excess benefit transaction. An applicable tax-exempt organization does not include:

- A private foundation as defined in section 509(a)
- A governmental entity that is exempt from (or not subject to) taxation without regard to section 501(a)
- Certain foreign organizations

An organization is not treated as a section 501(c)(3) or 501(c)(4) organization for any period covered by a final determination that the organization was not tax-exempt under section 501(a), but only if the determination was not based on private inurement or one or more excess benefit transactions.

2. *Section 4958 Applies Only to Certain Influential or ''Disqualified'' Persons*

The vast majority of section 501(c)(3) or 501(c)(4) organization employees and contractors will not be affected by the section 4958 regulations. Only the few influential persons within these organizations are covered by the regulations when they receive benefits, such as compensation, fringe benefits, or contract payments. The IRS calls this class of covered individuals ''disqualified persons.'' A disqualified person, regarding any transaction, is any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction. Persons who hold certain powers, responsibilities, or interests are among those who are in a position to exercise substantial influence over the affairs of the organization. This would include, for example, voting members of the governing body and persons holding the power of:

- Presidents, chief executive officers, or chief operating officers
- Treasurers and chief financial officers

A disqualified person also includes certain family members of a disqualified person and 35 percent controlled entities of a disqualified person.

3. *Persons Who Are Not Disqualified*

The regulations also clarify which persons are not considered to be in a position to exercise substantial influence over the affairs of an organization. They include:

- An employee who receives benefits that total less than the ''highly compensated'' amount in section 414(q)(1)(B)(i) ($85,000 in 2001) and who does not hold the executive or voting powers just mentioned; is not a family member of a disqualified person; and is not a substantial contributor
- Tax-exempt organizations described in section 501(c)(3)
- Section 501(c)(4) organizations with respect to transactions engaged in with other section 501(c)(4) organizations

4. Other Persons Are Subject to a Facts and Circumstances Test

Other persons not described in sections 2 or 3 above can also be considered disqualified persons, depending on all the relevant facts and circumstances.

Facts and circumstances tending to show substantial influence:

- The person founded the organization
- The person is a substantial contributor to the organization under the section 507(d)(2)(A) definition, only taking into account contributions to the organization for the past five years
- The person's compensation is primarily based on revenues derived from activities of the organization that the person controls
- The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole
- The person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person
- The person is a nonstock organization controlled directly or indirectly by one or more disqualified persons

Facts and circumstances tending to show no substantial influence:

- The person is an independent contractor whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the independent contractor will not economically benefit
- The person has taken a vow of poverty
- Any preferential treatment the person receives based on the size of the person's donation is also offered to others making comparable widely solicited donations
- The direct supervisor of the person is not a disqualified person
- The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole

Persons Staffing Affiliated Organizations
In the case of multiple affiliated organizations, the determination of whether a person has substantial influence is made separately for each applicable tax-exempt organization. A person may be a disqualified person with respect to transactions with more than one organization.

5. Section 4958 Applies Only to ''Excess Benefit'' Transactions of Disqualified Persons

Fair market value determines whether the tax-exempt organization provides an excess benefit to a disqualified person. An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing such benefit.

To determine whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization, and all entities it controls, are taken into account. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is the fair market value. Fair market value is the price at which property, or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of relevant facts.

An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a disqualified person or in an exchange of property between a disqualified person and the exempt organization.

6. Compensation Provided by Tax Exempts Is Not Excessive if ''Reasonable''

Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances. This is the section 162 standard that will apply in determining the reasonableness of compensation. The fact that a bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation.

For determining the reasonableness of compensation, all items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation (except for certain economic benefits that are disregarded, as discussed at paragraph 8 below). Items of compensation include:

- All forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation.
- The payment of liability insurance premiums for or the payment or reimbursement by the organization of taxes or certain expenses under section 4958, unless excludable from income as a *de minimis* fringe benefit under section 132(a)(4). (A similar rule applies in the private foundation area.) Inclusion in compensation for purposes of determining reasonableness under section 4958 does not control inclusion in income for income tax purposes.
- All other compensatory benefits, whether or not included in gross income for income tax purposes.

- Taxable and nontaxable fringe benefits, except fringe benefits described in section 132.
- Forgone interest on loans.

7. Written Intent Required to Treat Benefits as Compensation

An economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid.

An applicable tax-exempt organization (or entity that it controls) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is contemporaneous with the transfer of the economic benefits under consideration. Ways to provide contemporaneous written substantiation of its intent to provide an economic benefit as compensation include:

- The organization produces a signed written employment contract
- The organization reports the benefit as compensation on an original Form W-2, Form 1099, or Form 990, or on an amended form filed prior to the start of an IRS examination
- The disqualified person reports the benefit as income on the person's original Form 1040 or on an amended form filed prior to the start of an IRS examination
- *Exception*. To the extent the economic benefit is excluded from the disqualified person's gross income for income tax purposes, the applicable tax-exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services (e.g., employer-provided health benefits, contributions to qualified plans under section 401(a)).

8. Disregarded Benefits

The following economic benefits are disregarded for purposes of section 4958:

- Nontaxable fringe benefits: an economic benefit that is excluded from income under section 132
- Benefits to volunteer: an economic benefit provided to a volunteer for the organization if the benefit is provided to the general public in exchange for a membership fee or contribution of $75.00 or less per year
- Benefits to members or donors: an economic benefit provided to a member of an organization due to the payment of a membership fee, or to a donor as a result of a deductible contribution, if a significant number of nondisqualified persons make similar payments or contributions and are offered a similar economic benefit
- Benefits to a charitable beneficiary: an economic benefit provided to a person solely as a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of its exempt purpose

- Benefits to a governmental unit: a transfer of an economic benefit to or for the use of a governmental unit, as defined in section 170(c)(1), if exclusively for public purposes

9. *Special Exception for Initial Contracts*

Section 4958 does not apply to any ''fixed payment'' made to a person pursuant to an initial contract. This is a very important exception, since it would potentially apply, for example, to all initial contracts with new, previously unrelated officers and contractors.

An ''initial contract'' is a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately prior to entering into the contract.

A ''fixed payment'' is an amount of cash or other property specified in the contract, or determined by a fixed formula that is specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property.

A ''fixed formula'' may, in general, incorporate an amount that depends on future specified events or contingencies, as long as no one has discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus).

Treatment as New Contract: A binding written contract, providing that it may be terminated or canceled by the applicable tax-exempt organization without the other party's consent (except as a result of substantial nonperformance) and without substantial penalty, is treated as a new contract as of the earliest date that any termination or cancellation would be effective. Also, a contract in which there is a ''material change,'' which includes an extension or renewal of the contract (except for an extension or renewal resulting from the exercise of an option by the disqualified person), or a more than incidental change to the amount payable under the contract, is treated as a new contract as of the effective date of the material change. Treatment as a new contract may cause the contract to fall outside the initial contract exception, and it thus would be tested under the fair market value standards of section 4958.

10. *Tax Exempts Can Create a Rebuttable Presumption of Reasonableness*

We understand how concerned many tax-exempt officials may be that they could be forced to reach into their pockets and come up with substantial taxes and interest because a mistake was made in determining or recording their compensation and other benefits. Congress was aware of these concerns and, thus proposed a type of safe harbor—a ''rebuttable presumption''—in the legislative history. We have incorporated this presumption in the new regulations in the form of a step-by-step, ''cookbook'' procedure. Following this ''recipe'' will require some time and effort, but it should be relatively easy in most cases and will give the organization's disqualified persons substantial comfort and confidence.

Payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the following three conditions are met:

1. The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction.
2. Prior to making its determination, the authorized body obtained and relied on appropriate data as to comparability. There is a special safe harbor for small organizations—if the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services.
3. The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:
   i. The terms of the approved transaction and the date approved;
   ii. The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;
   iii. The comparability data obtained and relied upon by the authorized body and how the data was obtained;
   iv. Any actions by a member of the authorized body having a conflict of interest; and
   v. Documentation of the basis for the determination before the later of the next meeting of the authorized body or 60 days after the final actions of the authorized body are taken, and approval of records as reasonable, accurate, and complete within a reasonable time thereafter.

11. *Special Rebuttable Presumption Rule for Nonfixed Payments*

As a general rule, in the case of a nonfixed payment, no rebuttable presumption arises until the exact amount of the payment is determined or a fixed formula for calculating the payment is specified, and the three requirements creating the presumption have been satisfied. However, if the authorized body approves an employment contract with a disqualified person that includes a nonfixed payment (for example, discretionary bonus) with a specified cap on the amount, the authorized body may establish a rebuttable presumption as to the nonfixed payment when the employment contract is entered into by, in effect, assuming that the maximum amount payable under the contract will be paid, and satisfying the requirements giving rise to the rebuttable presumption for that maximum amount.

12. *The IRS Has the Burden of Overcoming the Presumption*

The Internal Revenue Service may refute the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the authorized body. This provision gives taxpayers added protection if they faithfully find and use contemporaneous persuasive comparability data when they provide the benefits.

13. *Organizations Not Establishing Presumption Can Still Comply with Section 4958*

In some cases, an organization may find it impossible or impracticable to fully implement each step of the rebuttable presumption process described above. In such cases, the organization should try to implement as many steps as possible, in whole or in part, in order to substantiate the reasonableness of benefits as timely and as well as possible. If an organization does not satisfy the requirements of the rebuttable presumption of reasonableness, a facts and circumstances approach will be followed, using established rules for determining reasonableness of compensation and benefit deductions in a manner similar to the established procedures for section 162 business expenses.

14. *The Excess Benefit Usually Occurs on the Date the Disqualified Person Receives the Benefit*

An excess benefit transaction occurs on the date the disqualified person receives the economic benefit from the organization for federal income tax purposes. However, when a single contractual arrangement provides for a series of compensation payments or other payments to a disqualified person during the disqualified person's taxable year, any excess benefit transaction with respect to these payments occurs on the last day of the taxpayer's taxable year.

In the case of the transfer of property subject to a substantial risk of forfeiture, or in the case of rights to future compensation or property the transaction occurs on the date the property, or the rights to future compensation or property is not subject to a substantial risk of forfeiture. Where the disqualified person elects to include an amount in gross income in the taxable year of transfer under section 83(b), the excess benefit transaction occurs on the date the disqualified person receives the economic benefit for federal income tax purposes.

15. *Excise Taxes under Section 4958*

Tax on Disqualified Persons
An excise tax equal to 25 percent of the excess benefit is imposed on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. The disqualified person who benefited from the transaction is liable for the tax. If the 25 percent tax is imposed and the excess benefit transaction is not corrected within the taxable period, an additional excise tax equal to 200 percent of the excess benefit is imposed.

If a disqualified person makes a payment of less than the full correction amount, the 200 percent tax is imposed only on the unpaid portion of the correction amount. If more than one disqualified person received an excess benefit from an excess benefit transaction, all such disqualified persons are jointly and severally liable for the taxes.

To avoid the imposition of the 200 percent tax, a disqualified person must correct the excess benefit transaction during the taxable period. The taxable period begins on the date the transaction occurs and ends on the earlier of the date the statutory notice of deficiency is issued or the section 4958 taxes are assessed. This 200 percent tax may be abated if the excess benefit transaction subsequently is corrected during a 90-day correction period.

Tax on Organization Managers

An excise tax equal to 10 percent of the excess benefit may be imposed on the participation of an organization manager in an excess benefit transaction between an applicable tax-exempt organization and a disqualified person. This tax, which may not exceed $10,000 with respect to any single transaction, is imposed only if the 25 percent tax is imposed on the disqualified person, the organization manager knowingly participated in the transaction, and the manager's participation was willful and not due to reasonable cause. There is also joint and several liability for this tax. A person may be liable for both the tax paid by the disqualified person and this organization manager tax in appropriate circumstances.

An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the organization, regardless of title. An organization manager is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the organization. For example, a director who votes against giving an excess benefit would ordinarily not be subject to this tax.

A person participates in a transaction knowingly if the person has actual knowledge of sufficient facts so that, based solely on such facts, the transaction would be an excess benefit transaction. Knowing does not mean having reason to know. The organization manager ordinarily will not be considered knowing if, after full disclosure of the factual situation to an appropriate professional, the organization manager relied on the professional's reasoned written opinion on matters within the professional's expertise or if the manager relied on the fact that the requirements for the rebuttable presumption of reasonableness have been satisfied. Participation by an organization manager is willful if it is voluntary, conscious, and intentional. An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

16. *Correcting the Excess Benefit*

A disqualified person corrects an excess benefit transaction by undoing the excess benefit to the extent possible and by taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. The organization is not required to rescind the underlying agreement; however, the parties may need to modify an ongoing contract with respect to future payments.

A disqualified person corrects an excess benefit by making a payment in cash or cash equivalents equal to the correction amount to the applicable tax-exempt organization. The correction amount equals the excess benefit plus the interest on the excess benefit; the interest rate may be no lower than the applicable federal rate. There is an anti-abuse rule to prevent the disqualified person from effectively transferring property other than cash or cash equivalents.

Property. With the agreement of the applicable tax-exempt organization, a disqualified person may make a payment by returning the specific property previously

transferred in the excess benefit transaction. The return of the property is considered a payment of cash (or cash equivalent) equal to the lesser of:

- The fair market value of the property on the date the property is returned to the organization, or
- The fair market value of the property on the date the excess benefit transaction occurred.

Insufficient Payment. If the payment resulting from the return of the property is less than the correction amount, the disqualified person must make an additional cash payment to the organization equal to the difference.

Excess Payment. If the payment resulting from the return of the property exceeds the correction amount described above, the organization may make a cash payment to the disqualified person equal to the difference.

17. *Application of Section 4958 to Churches*

The regulations make it clear that the IRS will apply the procedures of section 7611 when initiating and conducting any inquiry or examination into whether an excess benefit transaction has occurred between a church and a disqualified person.

18. *Section 4958 Applies Only to Post–September 1995 Transactions*

Section 4958 applies to excess benefit transactions occurring on or after September 14, 1995. Section 4958 does not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs.

19. *Revenue Sharing Transactions Are Subject to the Same Rules as Other Compensatory Arrangements*

The proposed regulations had special provisions covering ''any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization . . . ''—so-called ''revenue-sharing transactions.'' Numerous comments were received on this section of the proposed regulations. Rather than setting forth additional rules on revenue-sharing transactions, the temporary regulations reserve this section. Consequently, unless the Service issues new proposed regulations providing additional rules for revenue-sharing transactions, these transactions will be evaluated under the general rules of the temporary regulations (i.e., the fair market value standards) that apply to all contractual arrangements between applicable tax-exempt organizations and their disqualified persons.

20. *Section 4958 Does Not Replace Revocation of Exemption*

Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or section 501(c)(4), including the requirements that the organization be organized and operated exclusively for exempt purposes and that no part of its net earnings inure to the benefit of any private shareholder or individual. The legislative history indicates that, in most instances, the imposition of this intermediate sanction will be in lieu of revocation. The IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable

tax-exempt organization's exemption status where an excess benefit transaction has occurred:

1. Whether the organization has been involved in repeated excess benefit transactions
2. The size and scope of the excess benefit transaction
3. Whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences
4. Whether there was compliance with other applicable laws

21. Conclusion

While summary in nature, I hope this explanation will help you understand and comply with the new regulations. For further explanation, you should refer to the thorough ''Explanation of Provisions'' that precedes the text of the regulations in the official published version.

During the coming months, Service officials will be speaking on the regulations. I hope you will avail yourself of the opportunity to pose questions and comments in these forums. Again, I welcome your comments and suggestions; your feedback will enable us to craft the most effective final regulations.

Rebuttable Presumption Checklist

1. Name of disqualified person:
2. Position under consideration:
3. Duration of contract (1 yr., 3 yr., etc.): **4.** Proposed Compensation:
Salary:
Bonus:
Deferred compensation:
Fringe benefits (list, excluding Sec. 132 fringes):
Liability insurance premiums:
Forgone interest on loans:
Other:
5. Description of types of comparability data relied upon (e.g., association survey, phone inquiries):
a.
b.
c.
d.

6. Sources and amounts of comparability data:
Salaries:
Bonuses:
Deferred compensation:
Fringe benefits (list, excluding Sec. 132 fringes):
Liability insurance premiums:
Forgone interest on loans:
Other:
7. Office or file where comparability data kept:
8. Total proposed compensation:
9. Maximum total compensation per comparability data:
10. Compensation package approved by authorized body:
Salary:
Bonus:
Fringe benefits (list, excluding Sec. 132 fringes):
Deferred compensation:
Liability insurance premiums:
Forgone interest on loans:
Other:
11. Date compensation approved by authorized body:
12. Members of the authorized body present (indicate with X if voted in favor):
13. Comparability data relied on by approving body and how data was obtained:
14. Names of and actions (if any) by members of authorized body having conflict of interest:
15. Date of preparation of this documentation (must be prepared by the later of next meeting of authorized body, or 60 days after authorized body approved compensation):
16. Date of approval of this documentation by board (must be within reasonable time after preparation of documentation above):

—Steven T. Miller

(e) Legislative Activities

One of the requirements of obtaining and retaining tax-exempt status under section 501(c)(3) is that the organization cannot, as a ''substantial part'' of its activities, engage in activities that may constitute ''carrying on propaganda

or otherwise attempting to influence legislation.'' *Legislation* has a special meaning for these purposes. It includes actions by Congress, state legislative bodies, local counsels or similar bodies, and the general public in a referendum, initiative, constitutional amendment, or similar procedure. The IRS also takes the position that it includes attempts to influence or make laws in foreign countries,[97] as well as attempts to influence the confirmation of a federal judicial nominee.[98] It does not encompass actions by the executive branch (such as the promulgation of rules and regulations) and also does not include actions by independent regulatory agencies.

Activities that constitute attempts to influence legislation can take a number of different forms. They can include direct lobbying activities, presentation of testimony at public hearings, correspondence and conferences with legislatures and their staffs, and publishing documents or papers advocating specific legislative action. The attempt to influence legislation also includes so-called grassroots lobbying, which consists of appeals to the general public to contact their legislators or take other specific action with respect to legislative proposals. Under the IRS regulations, an organization is treated as attempting to influence legislation if it (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (2) advocates the adoption or rejection of legislation.[99] If, however, legislative activities, such as testifying at public hearings, are undertaken at the written invitation of a legislative body or committee, they are not regarded as lobbying.[100] In addition, to the extent that the organization disseminates information that constitutes nonpartisan analysis, study, or research, such activities are likewise not regarded as attempting to influence legislation, even though they may indirectly have that effect.[101]

The prohibition against lobbying activities arises only if the organization is found to have engaged in ''substantial'' lobbying activities. This is a subjective test that has been criticized as being ''so vague as to encourage subjective application of the sanction.''[102] Although some approaches have attempted to measure ''substantiality'' by determining the percentage of the organization's spending that is devoted on an annual basis on efforts to influence legislation, the test is more complex than that. Although it was once suggested that 5 percent of an organization's time and effort devoted to legislative activities is

[97]Rev. Rul. 73-440, 1973-2 C.B. 177.

[98]IRS Notice 88-76, 1988-2 C.B. 392. The IRS has set forth an expanded discussion of how attempts to influence judicial appointments can constitute lobbying. This discussion can be found on the IRS web site at *www.irs.gov/charities/article/0*,,id = 141372.00.html.

[99]Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii)(a), (b).

[100]Rev. Rul. 70-449, 1970-2 C.B. 111.

[101]Treas. Reg. § 1.501(c)(3)-1(c)(3)(iv); Rev. Rul. 70-79, 1970-1 C.B. 127. See also *Fund for Study of Economic Growth & Tax Reform v. United States*, No. 98-5105 (D.C. Cir. Dec. 8, 1998), *aff'g* 997 F. Supp. 15 (D.D.C. 1998), which contains a discussion and analysis of the extent to which IRC § 501(c)(3) organizations can engage in activities designed to support or oppose legislation.

[102]S. Rep. No. 92-552, 91st Cong., 1st Sess. 47 (1969).

not ''substantial,''[103] one court has explicitly rejected any type of a percentage test and has instead looked at the total picture of the organization's legislative activities as compared to its charitable/educational activities to make the determination.[104]

Although the basic rule of section 501(c)(3) is that an organization cannot engage in ''substantial'' lobbying activities, there is another way in which educational institutions can deal with this lobbying restriction. In 1976, Congress enacted a provision that permits tax-exempt organizations to elect to spend a certain amount of funds each year for legislative activities; if the expenditures do not exceed a set amount, the legislative activities will be deemed not to be substantial.[105] The permitted annual level of expenditures is determined by using a sliding-scale percentage of the expenditures that the organization spends each year for exempt purposes. Allowable legislative expenditures can be as much as 20 percent of the first $500,000 of an organization's exempt purposes expenditures, plus 15 percent of the next $500,000, 10 percent of the next $500,000, and 5 percent of any remaining expenditures. The total amount spent for legislative activities in any one year, however, may not exceed $1 million. There is a separate limitation equal to 25 percent of the above amounts imposed on attempts to influence legislation through grassroots lobbying. If a college or university makes the election, but exceeds the limitations, there is an excise tax imposed equal to 25 percent of the amount of the so-called ''excess lobbying expenditure.''[106]

(f) Political Activities

Another requirement imposed on section 501(c)(3) organizations is that they are not permitted to ''participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.''[107] The stated position of the IRS is that this is an absolute prohibition and, unlike the legislative activities restriction, is not subject to a ''substantial'' test.[108] From a practical standpoint, however, the IRS does not threaten an organization's tax-exempt status unless there is some measurable quantum of political activity. Certainly, the amount of political activity that can lead to a proposed revocation of tax-exempt status is less than the amount of legislative activity, but from a practical standpoint there must be some measurable amount of political activity in order for the

[103] *Seasongood v. Commissioner*, 227 F.2 d 907, 912 (6th Cir. 1955).
[104] *Christian Echoes Nat'l Ministry, Inc. v. United States*, 470 F.2 d 84 (10th Cir. 1972), *cert. denied*, 414 U.S. 864 (1973).
[105] IRC § 501(h).
[106] IRC § 4911(a)(1).
[107] IRC § 501(c)(3).
[108] See, for example, Gen. Couns. Mem. 39694, which states that an IRC § 501(c)(3) organization ''is precluded from engaging in *any* political activities'' (emphasis added).

IRS to propose revocation. In addition, a tax-exempt organization that makes a political expenditure is subject to an excise tax equal to 10 percent of the amount of the expenditure under section 4955. If the political expenditure is not corrected within the specified period, an additional excise tax equal to 100 percent of the expenditure is imposed on the organization.[109]

The prohibition against political campaign activities requires that the organization not participate or intervene in a political campaign with respect to an individual who is a candidate for public office. Whether there is ''participation'' or ''intervention'' in a political campaign is usually relatively clear, and as a consequence, there are limited rulings in cases on the subject. Of particular interest to colleges and universities, the IRS has ruled that a university does not intervene in a political campaign when it conducts a political science course that required the students to participate in political campaigns of their choice.[110] In addition, the IRS has ruled that the provision of faculty advisers and facilities for a campus newspaper that publishes students' opinions on political matters does not constitute the participation or intervention by the university in a political campaign.[111] As a general rule, colleges and universities have fairly wide latitude as to the types of political activities in which they can engage as long as they are able to show a reasonable nexus between those activities and pursuit of educational goals.

Also, the IRS national office held that a section 501(c)(3) organization's payroll deduction program under which employees were able to contribute to a political action committee constituted prohibited political activity by the organization, thereby triggering the excise tax under section 4955.[112] And, in a private letter ruling, the IRS said that fund-raising letters sent by two members of Congress on behalf of a section 501(c)(3) organization did not constitute impermissible political activity on the part of the organization.[113] In making this determination, the IRS said that it looks to the ''communication as a whole'' to determine whether it contains any support for, or opposition to, any candidate for public office, whether express or implied. Here, it felt that the fund-raising letters did not do so.

(g) Partnership Activities

(i) Impact on Tax-Exempt Status. One activity that can cause a section 501(c)(3) organization's tax exemption to be called into question is serving as a general partner in a partnership with one or more for-profit entities. The reason for the IRS concern in this area is that a partnership, by definition, is engaged in an activity for the purpose of earning a profit, and the section 501(c)(3)

[109]IRC § 4955(b).
[110]Rev. Rul. 72-512, 1972-2 C.B. 246.
[111]Rev. Rul. 72-513, 1972-2 C.B. 246.
[112]Tech. Adv. Mem. 200437040 (June 7, 2004).
[113]Priv. Ltr. Rul. 200602042 (Oct. 19, 2005).

organization can be viewed as using its income and assets to benefit the for-profit partner in violation of the rules against benefiting private interests. Nevertheless, the IRS has on a number of occasions ruled that a section 501(c)(3) organization may participate as a partner in a general partnership,[114] and one commentator has suggested that the partnership agreement should contain most or all of the following provisions in order to ensure that the exempt partner's income and assets will not be used for the private interests of its for-profit partner:

- A requirement of income distributions to the organization at least in proportion to its capital contribution
- A ceiling on losses allocable to the organization equal to its share of total capital
- A requirement that all transactions between the partnership and other parties be at fair market value
- A limit on the exposure of the organization to liabilities of the joint venture and corresponding indemnification
- Exoneration of the organization from repayments of amounts invested by the other partner
- A prohibition against loans by the organization to the partnership to finance operations (at least not without full security) or to the nonexempt partner to finance contributions
- Options (puts, calls, or rights of first refusal) granted to the organization upon disposition of the partnership property or interests
- No such options in the nonexempt partner unless the exempt organization is to receive at least fair market value
- Powers in the organization to appoint a majority of the governing body of the partnership[115]

In a 1997 letter to a health care organization, the IRS proposed to deny the organization's application for tax-exempt status under section 501(c)(3) on the ground that its proposed activity of entering into a partnership with a for-profit entity primarily served the private interests of the for-profit partner. In this letter, the IRS based its denial primarily on the fact that the exempt entity would not be in control of the partnership, saying:

> A charitable organization may enter into business relationships with for-profit entities without violating the private benefit test so long as the charity retains

[114]*See, e.g.*, Priv. Ltr. Rul. 9736039 (June 9, 1997), which involved participation in a low-income housing partnership, and Priv. Ltr. Rul. 9739036 (June 30, 1997), which involved participation in a limited liability company, which is treated as a partnership for tax purposes.
[115]Sanders, *Partnerships & Joint Ventures Involving Tax-Exempt Organizations*, 2nd ed. (New York: John Wiley & Sons, Inc., 1999).

> control over the income and assets necessary to carry out its charitable functions; however, if the arrangement is structured so that the charity is not in control, such arrangement will generate impermissible private benefit.[116]

In addition, it is interesting to note that the IRS objected to a provision in the partnership agreement under which the parties agreed to submit all disputes under the agreement to mandatory arbitration, finding it likely that the arbitrators ''would rule in favor of a decision likely to yield larger profits to the general partnership.''[117]

In 1998, the IRS issued a ruling that had a significant impact on the manner in which section 501(c)(3) organizations can participate in a partnership or joint venture with a for-profit entity.[118] The ruling involved a joint venture between a tax-exempt hospital and a for-profit health care company, but the principles set forth in the ruling have ramifications outside the health care arena. The ruling involved two situations, and in both an exempt hospital formed a limited liability company (LLC) with a for-profit corporation. (An LLC is organized as a corporation under state law but is taxed as a partnership.) Each exempt hospital contributed all of its operating assets to the LLC in return for a profits interest in the LLC, with the LLC's profits returned to the partners in proportion to their respective investments. Each exempt hospital used its profits from the joint venture to fund activities furthering the promotion of health, and in both situations the LLC was operated by a for-profit management company.

In the first situation, the IRS ruled that the hospital's participation in the joint venture would not jeopardize its section 501(c)(3) status or change its classification as a hospital. The significant elements that led the IRS to this conclusion were:

- The exempt hospital controlled the joint venture through its power to appoint a majority of the LLC's governing board and by the right to veto critical operational decisions.
- The LLC's governing documents required it to operate for charitable purposes.
- The management company that operated the hospital was independent of the for-profit partner.
- No officers, directors, or key employees of the hospital received any financial inducements that were contingent upon approval of the transfer of the hospital to the LLC.

In the second situation, however, the IRS ruled that the hospital's participation in the joint venture will result in the loss of the hospital's tax-exempt

[116]''IRS Denial Letter Issued to Redlands Surgical Services,'' Apr. 1, 1996, as reproduced in Paul Streckfus, 2 *EO Tax Journal*, No. 15, at 38–48 (Nov. 10, 1997).
[117]*Id*.
[118]Rev. Rul. 98-15, 1998-12 I.R.B. 6.

status. The factual aspects in this second situation that led to a different result were:

- The hospital and the for-profit entity had equal control over the LLC.
- The LLC's governing documents did not state that it will be operated for charitable purposes.
- The management company that operated the hospital was not an independent entity but rather was a wholly owned subsidiary of the for-profit entity.
- The management agreement was renewable at the discretion of the management company and could be terminated by the LLC only for cause.
- Two of the LLC's top officers were previously employees of the for-profit partner.

These two examples describe situations on either end of the spectrum, and the difficult task is trying to analyze those joint venture agreements that fall somewhere in between. But, based on this ruling, the IRS's position with respect to joint venture arrangements between a tax-exempt organization and a for-profit company appears to be that (1) joint ventures must be structured to carry on activities in a charitable manner, and (2) the exempt organization partner must have sufficient control to ensure that the venture is always conducted in a charitable manner.

Some additional guidance was issued by the Tax Court in a decision involving a nonprofit health care organization that entered into a partnership with a for-profit surgical center.[119] The nonprofit organization filed an application for tax-exempt status under section 501(c)(3), but the IRS refused to grant the requested exemption on the ground that the partnership agreement and a related management contract with the for-profit entity were structured to give the for-profit entity control over the operation of the surgical center. The health care organization filed a petition in the Tax Court contesting the IRS determination, arguing that the surgical center was open to all members of the community regardless of their ability to pay and that all dealings with the for-profit partner had been on arm's-length terms.

The Tax Court, however, agreed with the IRS, saying that the health care organization had ''ceded effective control'' over the activities of the surgical center and had thereby conferred a ''significant private benefit'' on the for-profit partner. The court found that significant profit-making objectives

[119] *Redlands Surgical Servs. v. Commissioner*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3 d 904 (9th Cir. 2001). Interestingly, the Ninth Circuit affirmed the Tax Court's decision just 10 days after oral argument, suggesting that the appellate court wanted to send a message as to how strongly it perceived the strength of the IRS position on the ''control'' issue.

existed in the operation of the surgical center and said that its decision was influenced by the following factors:

- A lack of any express or implied obligation of the for-profit parties involved in operation of the surgical center to put charitable objectives ahead of noncharitable objectives
- The fact that the health care organization did not have voting control over the partnership and, in addition, did not have any other form of formal or informal control over the partnership
- The long-term contract with an affiliate of the for-profit partner gave the affiliate and the for-profit parties effective control over the day-to-day activities of the surgical center and contained profit-maximizing incentives
- The market advantages and competitive benefits that were obtained by the affiliate of the for-profit partner as a result of this arrangement

The court seemed to accept the ''control'' position set forth in the 1998 IRS ruling, as well as the apparent IRS view that a long-term management contract is inappropriate no matter what its terms and conditions.

In 2002, however, a district court said that a nonprofit organization can demonstrate the requisite control without necessarily being able to appoint a majority of the partnership's governing body.[120] The case involved a nonprofit, tax-exempt hospital that entered into a limited partnership with a for-profit health care company. The hospital did not have control over the partnership, as evidenced by the fact that only half of the partnership's board was appointed by the hospital. The hospital was only one of two general partners and owned only a 45.9 percent interest in the venture. The court held that the hospital's exempt status should not be revoked, because (1) the partnership was dedicated to conducting exclusively exempt activities, (2) the hospital had the right to prevent the partnership from conducting any nonexempt activities, and the hospital had the effective right to appoint the manager and chief executive officer of the new venture.

Thus, the court said that, although the hospital did not have legal control over the venture, these other protections gave the hospital ''substantially more control than the for-profit partner, despite the facial 50-50 split in voting on the Board of Governors.'' The government appealed this case to the Fifth Circuit Court of Appeals, which vacated the district court's decision on the ground that the ''other factors'' relied on by the district court were insufficient to show the requisite control by the hospital of the partnership.[121] The Fifth Circuit remanded the case to the district court for further proceedings to determine

[120] *St. David's Health Care System v. United States*, 89 A.F.T.R. 2 d 2002-2998, 2003-3005 (W.D. Tex. 2002).

[121] *St. David's Health Care System v. U.S.*, 92 AFTR 2 d 2003-6865 (5th Cir. 2003).

whether genuine control by the hospital existed. In the retrial of the case at the district court, a jury determined that the facts demonstrated sufficient control by the hospital; therefore, the IRS position revoking the hospital's exempt status was rejected.[122]

In late 1999, the IRS published a training manual for its agents that updated its position on these joint venture arrangements.[123] It began by listing the similarities and dissimilarities between Situation 1 and Situation 2 from Rev. Rul. 98-15, discussed above. The similarities included the fact that in each situation:

- The nonprofit formed a limited liability company (LLC) with a for-profit company out of a need to generate additional funds.
- The nonprofit contributed its hospital and other operating assets to the LLC, which then operated the hospital.
- The LLC was structured as a partnership for tax purposes.
- Both the nonprofit and the for-profit received ownership interests in the LLC proportionate and equal in value to their respective contributions.
- All returns of capital and distributions of earnings made to the members of the LLC were proportionate to their ownership interests.
- The nonprofit intended to use the distributions from the LLC to support activities that promote the health of the community.

The IRS, however, also noted several important dissimilarities between the two situations. First, in Situation 1 a majority of the board was chosen by the nonprofit and had the power to approve major operational decisions, whereas in Situation 2 the governing board was equally represented by the nonprofit and the for-profit, thereby giving the nonprofit at best a veto power over major decisions. In addition, the types of ''major decisions'' reserved to the governing board were much more limited in Situation 2 than in Situation 1, which resulted in the governing board in Situation 2 having less power and authority over operations. In Situation 1, the governing documents of the LLC required that the hospital be operated in a manner that furthered charitable purposes and promoted health in the community; no such reference to charitable/community health activities existed in the governing documents in Situation 2. The LLC in Situation 1 entered into a contract with a management company that was unrelated to either member of the LLC, while in Situation 2 the management company was related to the for-profit member. Finally, it was clear in Situation 1, but not in Situation 2, that there was no possibility

[122]The decision of the district court was reported in press accounts. The case is currently unreported.

[123]*2000Continuing Professional Education Technical Instruction Program for FY 2000*, 22nd ed., at 33–43 (1999).

of conflicts of interest or ''sweetheart'' deals, because in Situation 1 none of the officers, directors, or key employees of the nonprofit were involved in the decision making or the negotiations involving the formation of the LLC or were promised employment or any other inducements.[124]

Against this factual background, the IRS said that whether an LLC arrangement between a nonprofit and a for-profit is in furtherance of the nonprofit's charitable purposes ''requires a factual determination.'' It said that in making this factual determination particular emphasis should be placed on (1) board composition and operation, including areas such as structural and financial arrangements; (2) who actually makes the recommendations on decisions that come before the board; (3) the nature of the contractual arrangements; and (4) how the governing board of the joint venture is selected. The IRS went on to say that it would be ''difficult, if not impossible,'' to reform Situation 2 to convert it into a charitable arrangement, because the determination is based on all the facts and circumstances and simply changing one or two facts would not necessarily change the conclusion. In addition, the IRS noted that the result set forth in the two situations would be the same whether the joint venture was structured as an LLC (as in the ruling) or as a limited or general partnership. The only reason that the IRS chose an LLC as the vehicle in the ruling was to ''bring into focus a relatively unknown kind of arrangement that in and of itself does not cause problems, so long as it is deemed as a partnership for tax purposes.''

Finally, in this training manual the IRS also addressed joint ventures between two tax-exempt organizations. It cited and discussed a private letter ruling involving the formation of a health care joint venture by several different tax-exempt organizations, and distinguished that situation from the case in which one of the partners is a for-profit entity.[125] This distinction was based primarily on the fact that, both before and after the formation of the joint venture, the exempt organizations continued to pursue their exempt purposes, and the joint venture itself was operated exclusively for exempt purposes.

In a subsequent training manual published in 2002, the IRS provided further clarification of its position with respect to the 1998 ruling and the *Redlands* case.[126] In this manual, the IRS retreated a bit from its previous absolute control position, saying that an organization can participate in a partnership with a for-profit entity without controlling it if there is ''another mechanism to ensure the joint venture will operate to further the exempt organization's purposes.'' The manual does not explain, however, what ''another mechanism'' might be.

[124] *See*, in this regard, Priv. Ltr. Rul. 200206058 (Nov. 16, 2001), in which the IRS approved a proposed LLC venture between an IRC § 501(c)(3) organization and various physicians. The IRS determined that the LLC was structured in such a fashion as to meet the control and other requirements of Rev. Rul. 98-15.

[125] Priv. Ltr. Rul. 199913035 (Dec. 22, 1998).

[126] *2002 Exempt Organizations Continuing Professional Technical Instruction Program for FY 2002*, 24th ed., at 155 (2001).

This manual contains a ''joint venture checklist'' that, the IRS says, while not being exhaustive or conclusive, can assist an organization in determining whether the transaction qualifies under the 1998 ruling. The checklist covers the following items:

- Did the exempt organization receive an ownership interest in the joint venture proportionate to the value of the assets contributed?
- Does the exempt organization have voting control over the joint venture board with respect to policies and actions that affect the exempt organization's tax-exempt purposes?
- Are the representatives of the exempt organization on the joint venture board representative of the community?
- Does the exempt organization have voting control on joint venture policies and actions that affect the exempt organization's tax-exempt purposes?
- Does the joint venture agreement require the joint venture to operate its hospitals or other healthcare operations for charitable purposes, by the community benefit standards?
- Does the joint venture agreement explicitly state that the joint venture's duty to further charitable purposes overrides its duty to operate for the financial benefit of its partners or members?
- Does the joint venture agreement have a dispute resolution provision that would cause the joint venture to satisfy charitable purposes without regard to profitability when a disagreement arises between the board and the members over the joint venture's policies or actions?
- Are the provisions in the joint venture agreement with respect to charitable activities legal, binding, and enforceable under the laws of the state where the joint venture was formed?
- Does the joint venture agreement contain a noncompete provision that causes the exempt organization to yield significant market advantages and competitive benefits to the for-profit partner or member?
- Does a company related to the for-profit partner or member manage the day-to-day operations of the joint venture?
- Are the terms and conditions of the management agreement reasonable and comparable to similar arrangements in the marketplace?
- Does the management company have binding and enforceable obligation to further the charitable purposes of the exempt organization?
- Does the exempt organization have the unilateral right to terminate the management agreement if the management company is not acting to

further (or is acting contrary to) the exempt organization's charitable purposes?

- If a CEO manages the day-to-day affairs of the joint venture, does the exempt organization have the unilateral right to remove the CEO if he or she is not acting to further (or is acting contrary to) the exempt organization's charitable purposes?

But what if the LLC is owned solely by tax-exempt entities, and the LLC is pursuing charitable or educational purposes? Can the LLC itself be entitled to tax-exempt status? At present, the answer appears to be no because a LLC, by definition, is organized primarily to earn a profit; however, a private letter ruling suggests that the IRS might be moving toward a different conclusion.[127] The ruling involved an LLC owned by a number of different health care providers and engaged in charitable activities. The IRS ruled that the income derived by the tax-exempt members of the LLC was not subject to unrelated business income tax, and at least one commentator has suggested that the IRS came very close in this ruling to holding that the LLC itself could qualify for exemption.[128]

There is also the problem of the single-member LLC. This is an LLC formed by a nonprofit organization, where the nonprofit is the sole member. Unless the nonprofit elects that the LLC be treated as a corporation, the LLC will be disregarded for tax purposes and treated as an integral part of the nonprofit. The IRS has issued rulings that explain the tax consequences when additional persons acquire the membership interests in a single-member LLC,[129] and in the reverse situation when a single person acquires all of the membership interests in a multimember LLC.[130]

Thus, the LLC landscape seems to be changing, and schools should make sure that they are aware of the latest developments before forming a single-member LLC or entering into an LLC arrangement with other entities.

Another question that has arisen is whether these partnership rules apply where the organization acquires a limited partnership interest. With an unrelated business income tax consequence, both the IRS and the courts have treated a section 501(c)(3) organization's interest in a limited partnership in the

[127]Priv. Ltr. Rul. 9839039 (July 1, 1998).

[128]Hopkins, 15 *Nonprofit Tax Counsel*, No. 12, Dec. 1998, at 5. The IRS expanded on the question whether an LLC might be able to qualify for exemption under IRC § 501(c)(3) in a training manual prepared for its field agents. See *Continuing Professional Education Technical Instruction Program for FY 2000*, 22nd ed., at 111–118 (1999). The IRS concluded, however, that at present ''there are more questions than answers regarding LLCs as 501(c)(3) organizations.'' It said that it is currently examining various policy considerations relating to this issue and that for now it will not issue letter rulings involving a disregarded LLC whose sole member is a tax-exempt organization.

[129]Rev. Rul. 99-5, 1999-6 I.R.B. 8.

[130]Rev. Rul. 99-6, 1999-6 I.R.B. 6.

same manner as an interest in a general partnership.[131] Although there seems to be no reason to apply the ''control'' principles of the 1998 ruling to what are almost always clearly passive investment activities, at the present, the IRS has not issued any guidance that would suggest that an organization that has, say, a 5 percent limited partnership interest in a real estate partnership would not be subject to the control rules.

(ii) Ancillary Joint Ventures. The guidance set forth in Rev. Rul. 98-15 pertains to those transactions where a tax-exempt organization and a for-profit company each transfer all of their assets to a partnership or LLC. This guidance, however, is not particularly helpful to educational institutions because they more typically enter into what are known in IRS parlance as ''ancillary joint ventures,'' where they transfer only a portion (not all) of their assets to the partnership/LLC. Until 2004, it was unclear the same Rev. Rul. 98-15 guidelines would apply to ancillary joint ventures.[132]

The IRS answered this question in Rev. Rul. 2004-51.[133] This ruling involves a university that is exempt under section 501(c)(3), and as part of its educational activities, it conducts summer seminars to enhance the skill level of elementary and secondary schoolteachers. To expand the reach of these seminars, the university formed an LLC with a for-profit company that specializes in conducting interactive video training programs. The university does not control the LLC because it and the for-profit company each hold a 50 percent ownership interest. The LLC is managed by a governing board comprised of three directors chosen by the university and three directors chosen by the company. The LLC's purpose is to arrange and conduct all aspects of the video teacher-training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials, and broadcasting the seminars to various locations.

The LLC's governing instruments give control over the ''educational'' aspects of the seminars to the university, which has the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars. The for-profit company is given control over certain ''business'' aspects of the LLC's operations, such as the right to select the locations where participants can receive a video

[131] *See* § 3.8.

[132] Although it seemed clear from IRS private letter rulings that the same test would apply. For example, in PLR 200436022 (June 9, 2004), an IRC § 501(c)(3) hospital, through its wholly-owned and disregarded limited liability company (LLC), served as the general partner of a limited partnership. The purpose of the partnership was to conduct diagnostic imaging services through a free-standing imaging center. The limited partners consisted of physicians and physician groups. The IRS said that because the hospital satisfied the control and other requirements of Rev. Rul. 98-15, its participation in the partnership with nonexempt partners will not jeopardize its IRC § 501(c)(3) status.

[133] 2004-22 I.R.B. 974.

link to the seminars and to approve nonteaching personnel (such as camera operators) necessary to conduct the video teacher-training seminars. All other actions require the mutual consent of the university and the company.

Importantly, the IRS says that the university's participation in the LLC will be an ''insubstantial'' part of its overall educational activities. In its analysis, the IRS concludes that, regardless of whether the university controls the partnership/LLC or whether the activities conducted by the LLC and attributed to the university are ''educational'' in nature, the university's involvement in the LLC will not adversely affect its section 501(c)(3) status because the activities that it is treated as conducting through the LLC are an insubstantial part of its overall activities.

Turning next to the issue of whether the teacher-training seminar activity should be treated as an unrelated business income activity, the IRS concludes that the seminars are a related activity because the university alone approves the curriculum, training materials, and instructors, and determines the standards for successfully completing the seminars. The fact that the for-profit company selects the locations and approves the nonteaching personnel necessary to conduct the seminars does not affect whether the seminars are substantially related to the university's educational purposes.

A reading of Rev. Rul. 2004-51 leads to the following two conclusions:

1. As long as the activities that the college or university conducts through the partnership/LLC are an ''insubstantial'' part of the school's overall activities, there will be no adverse effect on the college or university's exempt status even if the IRS may ultimately conclude that such activities are not in furtherance of the school's exempt purposes or if the school does not control the partnership/LLC.
2. Even if the ancillary joint venture represents an insubstantial part of the college or university's overall activities, the unrelated business income tax rules are potentially applicable. In these situations, whether the school's distributive share of the partnership/LLC's income will be subject to the unrelated business income tax depends on whether the partnership/LLC's activities constitute bona fide educational or scientific activities and, if they do, whether the school has sufficient control over the conduct of those activities. Thus, it appears that, if the exempt organization does not control the partnership/LLC's activities, any income distributions to the school would be taxable even if the activity would otherwise be treated as a ''related'' one.

(iii) Recharacterization of Legal Relationships as Partnerships. As can be seen from the foregoing discussion, a college or university must be careful in structuring its partnership arrangements to ensure that they do not jeopardize the school's tax-exempt status. However, a relationship that is not denominated

as a ''partnership'' (e.g., license, lease, etc.) may be recharacterized by the IRS as a partnership, thereby resulting in possible adverse tax consequences.[134]

In determining whether a legal relationship such as a license or lease will be recharacterized as a partnership, the first step is to define a partnership. A *partnership* is defined as an association of two or more persons or entities formed for the purpose of carrying on, as co-owners, a business for profit.[135] A *joint venture* is a one-time grouping of two or more persons or entities in a business undertaking and differs from a partnership in that a joint venture involves a one-time business activity as opposed to a continuing relationship among the parties; however, a joint venture is treated as a partnership for tax purposes.[136]

Whether a partnership exists in any particular situation depends on whether the parties intended to form a partnership. The existence of the requisite subjective intent is determined by examining certain objective factors. Factors found by courts to indicate the existence of a partnership relationship include:

- The intention stated by the parties in the agreement
- A mutual interest in both the profits and losses
- Maintenance of separate financial books
- Joint participation in management
- Joint contribution of capital or services
- Joint ownership of the contributed capital
- Representation to others of a partnership relationship
- Conducting business, holding property, and filing tax returns in the partnership name[137]

In a private ruling, the IRS recharacterized a business transaction between a section 501(c)(3) organization and a commercial entity as a partnership and then applied the Rev. Rul. 98-15 tests to the deemed partnership arrangement.[138] The case involved a section 501(c)(3) educational and literary organization that proposed to sell a 50 percent interest in a literary journal to a for-profit publishing company. Under the proposed agreement, the company and the organization would have equal interests in the copyright and revenues; the company would publish and distribute the journal to all subscribers; and the

[134]For a detailed and comprehensive discussion of the factors taken into account in determining whether an agreement that is not styled as a partnership agreement should be recharacterized as a partnership agreement for tax purposes, see *Comtek Expositions, Inc. v. Commissioner*, T.C. Memo. 2003-135.

[135]Uniform Partnership Act § 6(1); IRC § 7701(a)(2).

[136]*Harlan E. Moore Charitable Trust v. United States*, 812 F. Supp. 130 (C.D. Ill. 1993).

[137]*Long v. Commissioner*, 77 T.C. 1045 (1981); *Podell v. Commissioner*, 55 T.C. 429 (1970); *Kahn Estate v. Commissioner*, 499 F.2 d 1186 (2 d Cir. 1974); *Luna v. Commissioner*, 42 T.C. 1067 (1964).

[138]Priv. Ltr. Rul. 200610022 (Dec. 12, 2005).

organization would provide all journal content, make all editorial decisions, and provide the company with its list of subscribers. Also, the company would pay the organization a royalty on revenues from certain subscriptions, revenues from advertising, and nonsubscription/advertising revenue earned.

The IRS disregarded the sale and concluded instead that ''the sale and joint publication agreement is similar to a joint venture'' between the organization and the company. It went on to analyze the tax consequences of the transaction under the rules of Rev. Rul. 98-15 and compared the situation to that presented in Rev. Rul. 2004-51,[139] where a university provided educational material to a for-profit partner that disseminated the material through interactive video technology. In that case, the IRS said the partnership activity constituted only an insubstantial part of the exempt activities of the university. ''Here, by contrast, the publishing of the literary journal and the other activities under the agreement constitute a substantial apart of the activities of [the organization].''

Therefore, the IRS said that it ''must then determine whether the agreement satisfies the two-part test of Rev. Rul. 98-15.'' The IRS went on to say that both tests were met because the agreement with the company will further the charitable educational purpose of the organization, and the organization will retain full control over the editorial content of the publication, thus assuring that it will be operated for educational purposes.

Licensor-Licensee Relationships

The key factors that the courts have used to distinguish a license agreement from a partnership are (1) whether there was a provision for the sharing of both profits and losses from the business enterprise, and (2) joint participation in the enterprise. The fact that the licensee retains the right to purchase the intangible property rights and the fact that the licensor has the right to supervise the licensee's activities are not sufficient, in and of themselves, to create a partnership.[140]

Also, in the *Sierra Club* case,[141] the Sierra Club and a bank entered into an affinity credit card agreement under which the Sierra Club licensed its name, logo, and mailing lists to the bank in return for a royalty. The IRS, however, ignored the ''licensor-licensee'' relationship and contended that the Sierra Club and the bank had, in fact, entered into a partnership. The Tax Court rejected the IRS argument because the following indicia of a partnership were *not* present in the relationship:

- The existence in the agreement of an intent to create a partnership
- A mutual coproprietorship interest in the profits and losses of the venture

[139] 2004-22 I.R.B. 974.
[140] *Lemp Brewing Co. v. Commissioner*, 18 T.C. 586 (1952).
[141] *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307 (1994). *See* § 2.2(d).

- Separate books of account for the venture
- Joint participation by the parties in the management of the enterprise

Employer-Employee Relationships

Because profit sharing is common to both partnerships and employment relationships, the fact that the two parties agree to share profits from the business is given little weight in determining whether a purported employer-employee relationship should be recharacterized as a partnership. The primary factors used to distinguish an employer-employee relationship from a partnership arrangement are:

- The stated intent of the parties
- Whether both parties make capital contributions to the enterprise
- Whether losses from the enterprise are shared
- Whether there is mutual control by both parties over the operation of the enterprise. [142]

There are cases in which the parties attempted to create a partnership but the courts held that the relationship was that of employer-employee,[143] as well as cases in which the courts found the existence of a partnership despite the parties' attempt to create an employment arrangement.[144]

Debtor-Creditor Relationships

Under certain circumstances, a purported debtor-creditor relationship can be recharacterized as a partnership, thereby converting interest payments into partnership distributions. The factors existing in cases in which a partnership has been found include:

- Whether there was an unconditional promise to repay the loan at a time certain or on demand
- Whether there was adequate security for the loan
- Whether the loan was made pursuant to normal commercial terms
- Whether the loan was subordinate to other debt
- Whether the lender had the right to participate in the management or control of the venture[145]

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[142] BNA Portfolio 710, ''Partnerships; Overview, Conceptual Aspects and Foundation,'' at A-5.
[143] *Dorman v. United States*, 296 F.2 d 27 (9th Cir. 1961); *Smith Estate v. Commissioner*, 313 F.2 d 724 (8th Cir. 1963).
[144] *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840 (1957); *Bartholomew v. Commissioner*, 10 T.C.M. 957 (1951).
[145] *Hartman v. Commissioner*, 17 T.C.M. 1020 (1958); *S.&M. Plumbing Corp. v. Commissioner*, 55 T.C. 702 (1971); Rev. Rul. 72-350, 1972-2 C.B. 394.

This issue has also arisen in cases involving purported loans to inventors, where the IRS has attempted to create a partnership relationship between the lender and the inventor.[146]

Seller-Purchaser Relationships

A sale can be recharacterized as a partnership when the sales agreement calls for a deferral of some or all of the purchase price, with the deferred amount to be paid out of the profits earned by the purchaser. The factors that are used to distinguish bona fide sales agreements from disguised partnership agreements are the same as in debtor-creditor situations, including, primarily, whether the seller has control over the activity and also shares in the losses.[147]

Lessor-Lessee Relationships

Simply because the lease agreement provides the lessor with a share of the income or profits from the lessee's use of the leased property does not, in and of itself, mean that the arrangement will be recharacterized as a partnership. But if the lessor is (1) actively engaged in the conduct of the lessee's business, (2) provides services or capital to the lessee's venture, and/or (3) shares in the expenses and losses, a partnership may be created.[148]

§ 9.2 RELATED ENTITIES

Most colleges and universities have some type of relationship with other affiliated organizations, such as nonprofit or for-profit subsidiaries, foundations, research institutions, research foundations, medical practice plans, and alumni associations. In some cases, these affiliated organizations are controlled by the school; in other cases, while there may be a close historical or working relationship between the school and the organization, the entity operates independently of the school. This section focuses primarily on control situations because that is where the potential problems lie. Although a school needs to be careful in how it deals with related but independent organizations, these relationships, for the most part, do not cause problems for the school; rather, problems arise when the entity is under the school's control to the extent that the IRS might allege that the entity's activities should be regarded as conducted by the school itself.[149]

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[146] *Koen Estate v. Commissioner*, 14 T.C. 1406 (1950); *Newby v. Commissioner*, 309 F.2 d 48 (7th Cir. 1968); *Cleveland v. Commissioner*, 34 T.C. 517 (1960).

[147] *Rupe v. United States*, 68-1 U.S.T.C. ¶ 9179 (D. Neb. 1968); *Kelly v. Commissioner*, 27 T.C.M. 1090 (1970); *Gant v. Commissioner*, 16 T.C.M. 990 (1957), *aff'd*, 263 F.2 d 558 (6th Cir. 1959); *Erikson v. Commissioner*, 56 T.C. 1112 (1971); *Abrams v. Commissioner*, 10 T.C.M. 1501 (1961).

[148] *Haley v. Commissioner*, 203 F.2 d 815 (5th Cir. 1953), *rev'g* 16 T.C. 1509 (1951); *Bauschard v. Commissioner*, 31 T.C. 910 (1959); *Bussing v. Commissioner*, 88 T.C. 449 (1987).

[149] For an example of a situation where the IRS ruled that the formation of a for-profit subsidiary will not jeopardize the tax-exempt status of an IRC § 501(c)(3) organization, *see* Priv. Ltr. Rul. 200425050 (May 24, 2004).

(a) Why Establish a Subsidiary Organization?

There are a number of reasons why tax-exempt organizations generally, and colleges and universities in particular, decide to set up separate controlled organizations:

- The organization may be planning to undertake an activity that is unrelated to its exempt purpose and wants to avoid the risk of having that activity deemed to be a ''substantial'' part of its overall activities, thereby jeopardizing its tax-exempt status. This is generally not a concern to a college or university because in almost all cases its educational instructional activity is its primary activity, and the fact that it may conduct one or more unrelated activities rarely places its tax-exempt status in jeopardy.
- Some tax-exempt organizations, including colleges and universities, attach a stigma to unrelated business income activities and simply do not want to be seen as conducting such activities themselves. By creating a separate organization to conduct these activities, the school is able to avoid direct involvement in the activity.
- A new venture may have potential legal liability associated with it, for example, breach of contract, copyright or trademark infringement, or tort claims. By conducting the activity in a separate organization, only the assets of that organization are subject to exposure.
- Although a school is able to conduct insubstantial lobbying activities itself without jeopardizing its tax-exempt status, there is sometimes a temptation for those individuals who are engaged in lobbying activities to cross the line and become involved in political activities. While a school itself can engage in an insubstantial amount of lobbying activities without jeopardizing its tax-exempt status, political activities are strictly prohibited and can lead to revocation of the school's tax-exempt status.[150] By isolating the lobbying activities in a separate organization, a school can protect itself should those activities evolve over time into the political arena.

(b) What Is a Related or Affiliated Entity?

One of the first requests for information that a college or university under audit receives is a request for a list of all its related or affiliated organizations. The term *related entity* or *affiliated entity* is confusing because it is often not clear whether the IRS is looking only for those entities over which the college and university has control. For example, many alumni associations are organized

[150] *See* § 9.1(f).

and operated separately from the college or university. Although there is obviously a close relationship between the two organizations, there may be no legal control by the institution over the association. Is the alumni association a ''related entity'' for purposes of responding to the IRS? In most cases, it is prudent to include such organizations in the list of related entities, if for no other reason than the IRS agents will most likely find them anyway during the course of the audit.

In analyzing any related-entity situations, the key question is whether there is control by the college or university over the related organization. If so, a question can arise as to whether the related organization's activities should be treated as if conducted by the college and university itself, but the existence of control, in and of itself, does not result in such an interpretation. If the affiliated organization is structured as a for-profit business corporation, control is determined by the percentage of stock held by the institution. Obviously, if the institution holds 51 percent or more of the stock, it is in legal control of the corporation. Control can also be obtained by holding less than a 50 percent stock ownership interest if the institution's percentage of ownership is great enough, as compared to other minority shareholders, as to be able to exercise effective control over the corporation.

Control is determined differently with respect to nonprofit corporate subsidiaries. In these situations, control is normally manifested either by having a majority of interlocking directors (i.e., a majority of the board members of the organization are also members of the school's board) or by the school's ability to appoint a majority of the members of the organization's board of directors. In either case, if the college or university is able to control at least a majority of the directors, it is deemed to be in control of the nonprofit subsidiary.

In both the for-profit and nonprofit subsidiary context, there can also be de facto control, even if strict legal control does not exist. This would arise, for example, if the organization were so financially dependent on the college or university that it acceded to its wishes and demands, even if the institution did not own a majority of the stock or was not able to appoint a majority of the members of the board. De facto control determinations are based on all the facts and circumstances of the case, and the mere existence of financial dependence is normally not sufficient; in most cases, it would have to be supplemented by numerous examples of situations where the school actually exercised control over the organization's day-to-day activities, for example, controlling the organization's bank account, hiring its employees, and having the same individual as president of both organizations. Although unusual, it is not unheard of for the IRS to contend that a tax-exempt organization ''controls'' an affiliated entity, even though it is not able to exercise actual control.

(c) Treated as Separate Entity

Even if actual control exists, the subsidiary is treated as a separate legal entity as long as it is separately created, was organized for bona fide business reasons, has real and substantial business functions, and manifests an independent existence through meetings of the board of directors, separate bank accounts, separate employees, and so forth. By contrast, if the institution controls the affiliated entity to such an extent that it is merely an extension of the school, the IRS may take a position that the subsidiary is not a separate entity but is part of the school itself.[151] The IRS position as to whether to attribute the activities of the affiliated entity to the parent has been set forth in a number of different pronouncements. In one General Counsel Memorandum, the IRS said that attribution ''should be made only where the evidence clearly shows that the subsidiary is merely a guise enabling the parent to carry out its . . . [disqualifying] activity or where it can be proven that the subsidiary is an arm, agent, or integral part of the parent.''[152] In another General Counsel Memorandum, the IRS stated that to ''disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or the finding of a true agency or trust relationship between the parties.''[153] In yet another General Counsel Memorandum, however, the IRS held that where a subsidiary is organized for a bona fide business purpose and the parent is not involved in the day-to-day management of the subsidiary, the activities of the subsidiary should not be attributed to the parent.[154] This is true even though the parent may own all the stock of the subsidiary or be able to appoint all of the board members. In one ruling, however, the IRS reached a contrary conclusion where the directors and officers of the subsidiary were identical to those of the parent.[155] In that case, the IRS concluded that the activities of the subsidiary should be attributed to the parent because the parent is ''necessarily'' involved in the day-to-day

[151] *Krivo Indus. Supply Co. v. National Distillers & Chem. Corp.*, 483 F.2 d 1098 (5th Cir. 1973); *Orange County Agric. Soc'y Inc. v. Commissioner*, 55 T.C.M. (CCH) 1602 (1988).

[152] Gen. Couns. Mem. 33,912 (Aug. 15, 1968).

[153] Gen. Couns. Mem. 35,719 (Mar. 11, 1974).

[154] Gen. Couns. Mem. 39,326 (Aug. 31, 1984). See also Priv. Ltr. Rul. 199938041 (June 28, 1999), in which the IRS ruled that activities conducted by a taxable subsidiary of an IRC § 501(c)(4) organization, including marketing and licensing activities conducted for its exempt parent, would not be attributed to the parent for purposes of making exempt or unrelated business income tax determinations. The IRS found that the subsidiary was organized for bona fide business purposes and had sufficient independence so as not to be an instrumentality or integral part of the parent. It has been reported that this ruling was issued to the American Association of Retired Persons (AARP). In another ruling, the IRS concluded that the activities of a university's for-profit real estate management subsidiary would not be attributed to its university parent, because the subsidiary was formed for a ''real and substantial business function.'' Priv. Ltr. Rul. 199941048 (July 20, 1999). *See also* Tech. Adv. Mem. 200208027 (Oct. 4, 2001), in which the IRS refused to attribute the activities of an organization's taxable subsidiary to the parent organization but treated each as separate legal entities.

[155] Priv. Ltr. Rul. 8606056 (Nov. 14, 1985).

management of the subsidiary because of the complete overlap of officers and directors.

(d) Operational Considerations

One of the first issues that arises in setting up a related entity is how to fund it. The college or university parent is permitted to capitalize a for-profit subsidiary by transferring cash and assets to it in exchange for stock. In most cases, the school will own most or all of the stock issued by the subsidiary, and will receive tax-free dividends on this stock.[156] In the nonprofit subsidiary context, the school can still transfer cash and assets to the organization—the only difference is that it receives no stock or anything else in return. This illustrates nicely the fundamental difference between for-profit and nonprofit corporations—in the former, the transferor receives tangible evidence of its ownership interest in the company (shares of stock), but in the latter, the transferred cash and assets are forever dedicated to charitable or educational purposed.[157]

In order to ensure that the subsidiary is treated as a bona fide, separate entity, it should establish a separate bank account, separate financial books and records, and separate business stationery. It is vital that strict financial and operational separation be maintained (e.g., no commingling of assets, no correspondence written on school letterhead, all contracts signed by the organization and not by the school).

The initial board of directors of the subsidiary can be appointed by the school. The subsidiary's officers are then appointed by the subsidiary's board. Although, as a technical legal matter, the subsidiary's board could be entirely composed of members of the school's board, this is not generally a prudent thing to do because it invites a possible IRS attack on the independence of the subsidiary. Effective control can be obtained by appointing a majority of the board.

The subsidiary can either hire its own employees or arrange to have certain employees of the college or university work on subsidiary matters. In the latter scenario, the subsidiary should reimburse the school, at the school's cost, for all staff time provided. Likewise, there is no problem with the school's providing the subsidiary with office space on campus, provided that the subsidiary reimburses the school—at its cost—for its allocable share of rent, office equipment and supplies, utilities, and so forth. Moreover, the school and the subsidiary should enter into an arm's-length written agreement covering all aspects of the shared facilities, equipment, supplies, and employees.[158]

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[156] *See* § 2.2(b).

[157] *See* Gen. Couns. Mem. 37,605 (July 14, 1978), in which the IRS Chief Counsel's office held that a separately incorporated nonprofit organization that provided food, beverages, and entertainment for students, faculty, and staff qualified for tax-exempt status under IRC § 501(c)(3).

[158] *See also* Priv. Ltr. Rul. 9705028 (Nov. 5, 1996), in which the IRS ruled that an IRC § 501(c)(3) organization's creation of a for-profit subsidiary would not jeopardize its tax-exempt status.

Another issue to watch out for when a school owns stock in a for-profit subsidiary corporation involves situations in which substantially all of the subsidiary's assets are transferred to the school in liquidation or otherwise. When a tax-exempt organization owns 80 percent or more of the stock of the subsidiary and the asset transfer is in complete liquidation of the subsidiary, the law is clear that gain or loss will be recognized on the transfer, unless the transferred assets are used by the tax-exempt entity in an unrelated trade or business.[159] If, however, the assets are used by the tax-exempt entity in an activity related to its exempt purposes, gain or loss on the transfer is recognized. In regulations, the IRS has expanded this concept to provide that a taxable corporation (like a for-profit subsidiary) that transfers all or substantially all of its assets to a tax-exempt entity (such as a college or university, including state universities not exempt under section 501(c)(3)) is required to recognize gain or loss on the transaction as if the assets were sold at their fair market values.[160] Like the rule applicable to transfers in complete liquidation, taxation is avoided if the tax-exempt entity uses the assets in an unrelated trade or business.

(e) Fraternity Foundations

It is well established that a college fraternity or sorority cannot qualify for tax-exempt status under section 501(c)(3) because the organization primarily serves social and not charitable or educational purposes.[161] Instead, these organizations qualify for tax-exempt status as social clubs under section 501(c)(7). While they are exempt from federal income tax, they cannot receive tax-deductible contributions as can organizations exempt under section 501(c)(3).[162]

Over the years, there have developed many ''fraternity foundations,'' which are organized and operated to benefit a national fraternity or sorority, but still qualify for tax-exempt status under section 501(c)(3). Unlike contributions to a fraternity or sorority, contributions to a fraternity foundation are tax deductible. The IRS has explained how these organizations can qualify under section 501(c)(3) and discussed certain issues and problems that have arisen in this area of the tax law.[163]

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[159]IRC § 337(b)(2).

[160]Treas. Reg. § 1.337(d)-4.

[161]*Davison v. Commissioner*, 60 F.2 d 50 (2 d Cir. 1932); Rev. Rul. 69-573, 1969-2 C.B. 125.

[162]*See also* Priv. Ltr. Rul. 200427031 (Apr. 8, 2004), which involved an IRC § 501(c)(7) social club organized and operated to own and acquire a fraternity house on the campus of a university. The university demanded that the fraternity cease its operations on campus, and as a result, the organization sold the fraternity house to the university at a gain. The IRS ruled that the organization would recognize capital gain on the sale only to the extent that the net sales proceeds exceed the cost of purchasing the securities under the special rule of IRC § 512(a)(3)(D) and that income from the sale of the house is not unrelated business income under the special rule of IRC § 512(a)(3)(A).

[163]*1999 Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook*, 21st ed., at 341–345 (1998).

While fraternities and sororities pursue primarily social goals, they also conduct certain charitable and educational activities, and the fraternity foundations qualify under section 501(c)(3) so long as they restrict their benefits to those fraternity or sorority activities that are charitable or educational in nature. These foundations are able to provide financial and other assistance to non–ection 501(c)(3) fraternities and sororities if they follow the guidelines set forth in a 1969 IRS ruling,[164] which holds that a section 501(c)(3) organization can make distributions to a non–ection 501(c)(3) organization (such as a fraternity or sorority) so long as (1) the grant is made for exclusively charitable/educational purposes, and (2) the grantor retains discretion and control as to the use of the funds and maintains records showing that the funds were used for section 501(c)(3) purposes. Under this rationale, for example, the IRS has approved scholarship grants made by a fraternity foundation to members of a designated fraternity,[165] as well as a grant to a college for the purpose of acquiring and constructing a housing facility for use by a designated fraternity.[166] In the latter instance, however, the grant was not made to the fraternity but instead was made to the college that owned the facility that was constructed.

On the other hand, the IRS has held that a fraternity foundation that proposed to make loans to a fraternity chapter so the chapter could acquire a fraternity house would not be acting in furtherance of section 501(c)(3) purposes because the house primarily served the social interests of the fraternity members.[167] But what if the foundation makes a grant to a fraternity that is earmarked for an educational purpose, such as for the construction of a library and study rooms in the fraternity house? In 1984, the IRS considered and rejected a request for approval of such a grant, holding that the private benefit received by the fraternity members outweighed the educational benefits they received. The issue was reconsidered in 1987, however, and the IRS reversed its earlier position, saying that these grants could be considered charitable and educational in nature, provided that (1) the library and study rooms are separate facilities that are segregated from the fraternity's social facilities, and (2) the grants are monitored to ensure that the funds are, in fact, used exclusively to construct these facilities.

The IRS has noted that the fraternity foundations have attempted to broaden the scope of the 1987 ruling by trying to use the same rationale to cover the construction of such areas as exercise facilities, common study areas, and computer use rooms, and says that ''where there is a commingling of social and educational use, it is difficult, if not impossible, to determine the portion that could be considered educational.''

[164]Rev. Rul. 69-489, 1962-2 C.B. 210.
[165]Rev. Rul. 56-403, 1956-2 C.B. 307.
[166]Rev. Rul. 60-367, 1960-2 C.B. 73.
[167]Priv. Ltr. Rul. 7913122 (n.d.).

In 2003, the IRS summarized its various rulings in this area of the law and described the types of grants that would be considered to be educational and those that would not.[168]

Allowable educational grants include those intended to:

- Build or improve dedicated library, study, computer, or instructional areas within a fraternity chapter house. These areas must be totally separate from social or recreational areas but they may be adjacent to such areas. As a general rule, the areas must be used solely for educational purposes, but the IRS says that ''minor'' social or recreational usage of these areas is permitted.
- Cover annual operating expenses (insurance, utilities, and similar items) allocated to the library, study, and other such areas. Such operating expenses could also include allocable expenses for fire alarms, smoke detectors, and internal sprinkler systems for these dedicated areas.
- Install Internet wiring in the house, provided that the university provides Internet wiring in its dormitories. The IRS included this proviso to prevent members of the fraternity from receiving, by virtue of their fraternity membership, a benefit that the general student body does not receive.
- Pay for computers, computer desks, and chairs in a chapter house that are similar to those that are provided by the university for the general student body.

Grants that the IRS said do *not* serve an educational purpose include those made to:

- Provide long-distance telephone services, laundry facilities dining areas, sleeping quarters, social or recreational areas, and physical fitness facilities or equipment, regardless of whether the university might provide such amenities to the general student body.
- Build or improve ''mixed'' social and educational areas, such as common hallways or rooms that are used interchangeably for social, recreational, and educational purposes.

Finally, the IRS has said that if a fraternity foundation makes grants to or for the benefit of a particular fraternity, the IRS requires that it maintain the following records of such distributions:

- If the grant is made to an individual fraternity member (scholarship, training grant, etc.), the foundation should maintain records showing (1) the recipient's name, address, and purpose of the grant; (2) the

[168] *2003 Exempt Organizations Continuing Professional Education Textbook*, Section N.

manner in which the individual was selected; and (3) the relationship (if any) of the individual to members, officers and directors of the fraternity.

- If the grants are made to a fraternity to build or renovate the chapter house, records to show that the funds were, in fact, used for the intended educational purposes.

To summarize, if the fraternity foundation follows these general guidelines, the foundation can make grants to or for the benefit of a particular fraternity chapter without jeopardizing its section 501(c)(3) tax-exempt status, and alumni can claim a charitable contribution deduction for a gift to the fraternity foundation.[169]

(f) Supporting Organizations

Many colleges and universities have related foundations that conduct fund-raising programs, provide assistance and support to the athletic department, or engage in other activities designed to benefit the institution. In many cases, these foundations are separate legal entities in their own right over which the college or university has no legal control. But in other cases the foundations are organized as ''supporting organizations'' under section 509(a)(3), which means that the institution has a very close relationship with the foundation, often in the form of legal control over it and its activities.

All section 501(c)(3) organizations are classified by the IRS as either public charities or private foundations. Public charity status is clearly the preferable of the two because private foundations are subject to an excise tax on their net investment income as well as certain operational restrictions that are enforced by a series of penalty excise taxes.[170] In addition, individuals are limited to giving a smaller percentage of their income to a private foundation than to a public charity.[171]

For the most part, the public charity/private foundation determination is made by looking at the sources and amounts of the organization's financial support. If the organization receives a large amount of relatively small contributions from a relatively large number of individuals or corporations, or if it receives gifts from other public charities or from the conduct of its exempt functions, it is classified as a public charity. But if it receives large contributions from a single person or a small number of individuals, or receives substantial financial support from investment income or the conduct of an unrelated trade or business, it is classified as a private foundation.[172]

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[169] For a discussion of the ability of donors to make tax deductible contributions to organizations that use the donated funds to provide assistance to fraternities and sororities, *see* § 6.3(a).
[170] IRC §§ 4940-4946.
[171] IRC § 170(b)(1).
[172] *See, generally*, IRC § 509(a)(1) and (s).

There is, however, another type of organization that can be classified as a public charity even if it is unable to meet these financial support tests. It is called a *supporting organization*, which is defined and described in section 509(a)(3). These are section 501(c)(3) organizations that are controlled by, or have a close relationship to, one or more public charities; therefore, Congress said that these supporting organizations can be classified as a public charities, even if they fail to meet the normal public support financial tests. Essentially, they derive their public charity status from the public charity status of the organization (or organizations) that they support.

The different organizational and operational tests that must be met in order to be classified as a supporting organization are extraordinarily complex and beyond the scope of this book.[173] Generally speaking, there are three types of supporting organizations: Type I organizations where the college or university is able to appoint the members of the foundation's board of directors (or a majority of the school's board sits on the foundation's board); Type II organizations where the same persons that control the college or university also control the foundation; and Type III organizations where the foundation's activities are such an important and integral part of the institution's activities that the institution will be presumed to exercise substantial oversight over the foundation and its activities.

Because of reported abuses in the supporting organization area, particularly with respect to the Type III organizations where the supported public charity does not actually control the foundation, Congress made sweeping changes to the supporting organization rules as part of the Pension Protection Act of 2006. Most, but not all, of these changes were directed at the Type III organizations. The major changes enacted by Congress were as follows:

- Type I and Type III organization may not accept gifts or contributions from any person who controls, directly or indirectly, the supported organization.[174]
- Private foundations may not make so-called ''qualifying distributions'' to Type III organizations, which means, from a practical standpoint, that most private foundations will cease making grants to Type III organizations.[175]
- Type II and III organizations are now subject to the excess business holding provisions that apply to private foundations.[176]
- Any grant, loan, compensation, or similar payment by a Type I, II, or III organization to a substantial contributor or related party is

[173] *See* Treas. Reg. § 1.509(a)-4.
[174] IRC § 509(f)(2).
[175] IRC § 4942(g). This restriction does not apply, however, if the Type III organizations classified under what is known as the ''but for'' test described in Treas. Reg. § 1.509(a)-4(i)(3)(ii).
[176] IRC § 4943(f).

automatically treated as an ''excess benefit transaction'' for purposes of the intermediate sanctions rules of section 4958.[177]

- Donor-advised funds are subject to a penalty excise tax if they make grants to Type III organizations.[178]

Because of the onerous nature of these new provisions, some supporting organizations may consider converting to section 509(a)(1) or (2) type public charities, and the IRS has issued procedures by which supporting organizations may do so.[179]

§ 9.3 SECTION 403(B) AND OTHER RETIREMENT PLANS

Although colleges and universities are able to offer to their employees most of the wide array of different available retirement plans, most schools choose to offer tax-deferred annuities (usually referred to as ''403(b) plans'' after the applicable section of the Code) because of the attractive salary reduction feature that permits employees, within certain limitations, to make pretax contributions to the plan.

This section provides a basic overview of the 403(b) plan rules and generally discusses other retirement plan options. For a detailed discussion and analysis of the retirement plan rules as they impact colleges and universities, the reader should refer to more in-depth source material.

(a) Section 403(b)—Legislative Background

Most people are surprised to learn that before Congress added section 403(b) to the Code in 1958, employees of tax-exempt organizations were able to defer income through the use of tax-sheltered annuity arrangements, and section 403(b) was enacted as a restriction on the amount of compensation that may be sheltered. Over the next few decades, Congress made several changes to section 403(b):

- In 1961, the provision was extended to employees of public education institutions, including colleges and universities.
- In 1974, custodial accounts in which contributions are invested in mutual funds were made available as funding vehicles.
- In 1982, section 403(b) was expanded to cover retirement income accounts for employees of church organizations.
- In 1986, Congress added rules similar to those applicable to qualified plans, including a new ceiling on elective deferrals, nondiscrimination

[177] IRC § 4958(c)(3). For a discussion of the intermediate sanctions rules, *see* § 9.1(d).
[178] IRC §§ 4966 and 4967. Again, this rule does not apply to ''but for'' Type III organizations.
[179] Announcement 2006-93, 2006-48 I.R.B. 1017.

and minimum distribution requirements, and restrictions on withdrawals of salary reduction contributions.

- In 1992, additional requirements regarding rollovers were added.
- In 1996, various modifications to the 403(b) rules were added, including elimination of the ''one salary reduction agreement per year'' rule.

The IRS has issued proposed regulations relating to tax-sheltered annuity contracts under section 403(b).[180] The IRS said that the purposes behind the issuance of these regulations was ''to update the current regulations under section 403(b) to delete provisions that no longer have legal effect due to changes in law, to include in the regulations a number of items of interpretive guidance that have been issued under section 403(b) since the 1964 regulations, and generally to reflect the numerous legal changes that have been made in section 403(b).''[181]

(b) Overview of Section 403(b)

A 403(b) plan is a retirement plan under which a public school or section 501(c)(3) organization purchases annuity contracts or contributes to custodial accounts for its employees (a ''custodial account'' is an account normally maintained by a bank that invests its funds solely in shares of mutual funds). Unlike qualified retirement plans maintained by for-profit employers, there may be no basic plan document[182]; instead, the 403(b) ''plan'' may consist simply of different salary reduction agreements and annuity contracts with the insurance company, or a custodial account agreement with a bank. A college or university's involvement in a 403(b) plan might be limited to merely providing a list of insurance carriers to the employees and executing the salary reduction agreements. By contrast, a 403(b) plan may have a basic plan document that is as comprehensive as any qualified plan maintained by a for-profit company, and there may be a high degree of involvement on the part of the school in the operation of the plan.

A 403(b) plan is normally funded through contributions made by both the institution and the employee, with the employee's contributions coming by way of salary reduction contributions. The contributed funds may be invested in annuity contracts or mutual funds. Contributions to a 403(b) plan that meet the other 403(b) requirements are not taxed to the employee until distributed. Earnings on the contributions are also tax deferred until distributed. Whether contributions satisfy the 403(b) requirements is important not only to the employees but also to the employer, which is responsible for any federal

[180]Prop. Treas. Reg. § 1.403(b).
[181]*Id.*, Preamble.
[182]But see Prop. Treas. Reg. § 1.403(b)-3(b)(3).

income and employment taxes that may be required to be withheld on contributions not entitled to tax-deferred treatment.

Most retirement plans are required to file an annual information return on Form 5500 with the IRS, and 403(b) plans are also generally required to file Form 5500. However, governmental 403(b) plans are not required to file Form 5500.[183]

(c) Eligibility

A 403(b) plan may be maintained only by ''eligible employers'' on behalf of ''eligible employees.'' If the employer is not eligible, the plan is not a 403(b) plan, with a resulting loss of the tax-deferred treatment for employees. Only two types of employers are eligible to maintain a 403(b) plan: (1) a state educational organization,[184] and (2) a section 501(c)(3) organization. Included in the former category are public schools as well as state colleges and universities.

An eligible employer can purchase a tax-sheltered annuity only for an employee. If an individual is subject to the direction and control of an employer regarding what work is to be done and how to perform the work, that person is generally considered an employee. If a person is subject to the direction and control of another as to the result only, and not how to do the work, that person will generally be considered an independent contractor. Employee status for purposes of 403(b) eligibility is determined by reference to whether the participant is an employee for federal employment tax purposes.[185] Both nonacademic staff and faculty qualify as ''eligible employees'' and may be covered, but elected or appointed officials (e.g., members of the board or trustees) are not eligible.[186] The IRS has held that employees of a single-member LLC that is owned by a section 501(c)(3) organization will be treated as employees of the exempt organization and are, therefore, eligible to participate in the organization's 403(b) plan.[187]

One issue that arises in this area is whether the individual should be treated as an employee or as a student for purposes of determining whether the person is eligible for a 403(b) plan. In connection with this issue, on February 6, 1997, Johns Hopkins University issued the following press release:

> The Johns Hopkins University announced today that it has reached a negotiated settlement with the Internal Revenue Service relative to an examination by the

[183] IRS Announcement 82-146, 1982-47 I.R.B. 53.

[184] An educational organization is defined as one that normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of students in attendance at the place where it regularly carries on educational activities. IRC § 170(b)(1)(A)(ii).

[185] *See* § 4.2.

[186] Treas. Reg. § 1.403(b)-1(b)(5); Rev. Rul. 73-607, 1973-2 C.B. 145.

[187] Priv. Ltr. Rul. 200334040 (May 30, 2003). The IRS reached the same conclusion in Priv. Ltr. Rul. 200341023 (July 18, 2003).

> Service of the University's tax sheltered annuity arrangements. The terms of the settlement include an agreement that medical residents and interns will be eligible to elect salary deferrals under the University's tax shelter annuity arrangements effective January 1, 1997. The Service had taken the position that residents and interns are employees within the meaning of section 3121(d) of the Internal Revenue Code, and must be included in the University's tax sheltered annuity arrangements under the universal availability requirements of section 403(b)(12) of the Internal Revenue Code. The University had maintained that residents and interns are students performing services described in section 3121(b)(10) of the Internal Revenue Code and, therefore, are not covered by those requirements.

The position of the IRS in this 1997 dispute is not surprising since the agency has always taken the position that medical residents are primarily employees, not students, and are therefore ineligible for the student Federal Insurance Contributions Act (FICA) exception.[188] Even if the IRS ends up losing this battle on the student FICA exception front and medical residents are held to be exempt from FICA tax, it may continue to asset that the residents are employees for section 403(b) purposes because medical residents will still be ''employees,'' albeit employees whose primary (but not sole) relationship with their educational institution is that of a student.

(d) Funding Arrangements

Funds contributed to a 403(b) plan may be invested either in annuity contracts or in custodial accounts for investment in mutual funds. An annuity contract is generally offered by an insurance company and may be owned by the individual or, in the case of a group annuity contract, by the employer. The annuity may be either variable or guaranteed.[189]

The annuity contract must provide that it is nontransferable[190]; however, loans may be made from an annuity contract, and amounts held under the contract may be transferred or rolled over to another 403(b) plan. Salary reduction contributions made to an annuity contract, and the earnings on the contract, are also subject to certain early distribution restrictions.[191] The annuity contract may also provide life insurance protection, as long as the death benefit is merely incidental to the primary purpose of providing retirement benefits.[192] In 1996, Congress added the additional requirement that the annuity contract itself (not just the 403(b) plan) must specifically provide that salary reduction

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[188] *See* § 4.3(a)(iv).

[189] Rev. Rul. 82-102, 1982-1 C.B. 62. The IRS has also set forth rules relating to IRC § 403(b) plans under which the contract premiums are invested at the direction of the contract holder in publicly traded securities. Rev. Proc. 99-44, 1999-48 I.R.B. 598. *See also* Priv. Ltr. Rul. 200537043 (June 23, 2005), in which the IRS sets forth a general overview of how annuity contracts are taxed.

[190] IRC § 401(g).

[191] IRC § 72(t).

[192] Treas. Reg. § 1.403(b)-1(c)(3).

contributions cannot exceed the maximum limit, currently $15,000, subject to annual cost-of-living increases.[193]

(e) Custodial Accounts

Contributions under a 403(b) plan can also be made to a custodial account, the assets of which must be used to purchase shares of regulated investment company stock (i.e., mutual funds). These plans are sometimes known as ''403(b)(7) plans'' after the section of the Code that sets forth the applicable rules. The assets of the custodial account must be held by a bank or other person who is approved by the IRS.[194] The assets must be invested exclusively in mutual fund shares. A custodial account may not provide life insurance, although it may permit loans to participants; both salary and nonsalary reduction contributions are subject to certain early distribution restrictions; and excess contributions are subject to a 6 percent cumulative excise tax.[195]

(f) Salary Reduction Contributions

403(b) plans are commonly funded, in whole or in part, by salary reduction contributions (sometimes referred to as ''elective contributions'' or ''elective deferrals''), which are contributions made by an employer as a result of an agreement with an employee to take a reduction in salary or forgo an increase in salary. While ordinarily thought of as ''employee contributions,'' these contributions are technically treated as employer contributions for most purposes, but as employee contributions for social security and federal unemployment tax purposes. The IRS has held that plan contributions qualify as salary reduction contributions even if they are not voluntary but are mandated by the employer.[196]

Salary reduction contributions are only effective with respect to amounts earned after the salary reduction agreement becomes effective.[197] Salary is ''earned'' when the services that give rise to the employee's entitlement to pay are performed. The salary reduction agreement must be legally binding on the parties and irrevocable with respect to amounts earned while the agreement is in effect; however, the employee may be permitted to terminate the agreement at any time with respect to amounts not yet earned.[198]

Up until 1997, an employee was not permitted to make more than one salary reduction agreement with the same employer during any taxable year of the

[193]Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1450(c), 110 Stat. 1755, 1815. See IRC § 402(g)(1)(B).
[194]*See* IRC § 401(f), which defines a ''non-bank trustee.''
[195]IRC § 4973.
[196]Tech. Adv. Mem. 200305006 (Aug. 30, 2002).
[197]Treas. Reg. § 1.403(b)-1(b)(3)(i).
[198]*Id*.

employee. Failure to satisfy this requirement caused the amounts contributed under any additional agreements in the same taxable year to be includable in the employee's gross income. In 1996, however, Congress eliminated this rule, beginning with plan years beginning on or after January 1, 1997[199]; therefore, there is no longer any limitation on the number of salary reduction agreements that can be entered into during the year.

(g) Contribution Limits

There are two separate but interrelated limitations on the amount that may be excluded from income as a contribution to a 403(b) plan: (1) the annual limitation on the amount of salary reduction contributions,[200] and (2) the limitation on employer contributions.[201]

(i) The Annual Limitation. With respect to the annual limit on salary reduction contributions, in the absence of a special catch-up election (discussed below), the maximum amount of annual salary reduction contributions that may be deferred under a 403(b) plan is $15,000 (subject to cost-of-living increases).[202] Salary reduction contributions under a 403(b) plan are technically employer contributions that are used to purchase an annuity contract (or made to a custodial account) under a salary reduction agreement. The limitation affects only salary reduction contributions; it does not apply to other kinds of contributions. Consequently, it is critical to determine which (if any) contributions are salary reduction contributions.

Notwithstanding this general annual $15,000 limitation, the 403(b) rules contain a special election for certain long-term employees, under which they may ''catch up'' on the funding of their retirement benefit by increasing their annual salary reduction contributions over the $15,000.[203] The election is available only to an employee who has completed at least 15 years of service as an employee with an educational organization, hospital, or certain other organizations. The annual limitation under the election is increased by the least of (1) $3,000, (2) $15,000 less salary reduction contributions previously excluded under the catch-up election, or (3) $5,000 multiplied by the employee's years of service less the salary reduction contributions made to plans of the employer in prior taxable years.

(ii) The Section 415 Limitation. The second contribution limitation—the limitation on employer contributions—is sometimes referred to as the ''section 415 limitation.'' Because a 403(b) plan is treated as a defined contribution plan

[199]Small Business Job Protection Act of 1996, § 1450.
[200]IRC § 402(g).
[201]IRC § 415.
[202]IRC § 402(g)(1)(B).
[203]IRC § 402(g)(8).

for purposes of the limitations on annual contributions, section 415 limitations on contributions that apply generally to qualified plans also apply to 403(b) plans.[204] Consequently, unless a special election is made, contributions to a 403(b) plan (including salary reduction contributions) may not exceed the lesser of $40,000 (as adjusted for cost-of-living increases) or 100 percent of the employee's compensation from the employer for the prior year.[205] Contributions to a 403(b) plan in excess of this limit (referred to as excess contributions) have two effects: (1) the excess is includable in the gross income of the employee, and (2) the excess reduces the available exclusion allowance in future years. Excess contributions, however, do not cause the plan to lose its 403(b) status.[206]

(h) Nondiscrimination

Prior to 1986, there were no nondiscrimination rules applicable to 403(b) plans. In 1986, Congress added separate nondiscrimination rules for non–salary reduction and salary reduction contributions.[207] In 1989, the IRS said that, pending the issuance of regulations or other guidance, a 403(b) plan is deemed to satisfy the nondiscrimination rules if either the employer operates the plan in accordance with a good-faith, reasonable interpretation of the nondiscrimination rules, or in accordance with certain safe harbors.[208] In late 1996, the IRS issued a set of extensive rules regarding the application of the nondiscrimination rules to 403(b) plans.[209]

Salary reduction contributions are tested separately for nondiscrimination. Nondiscrimination with respect to salary reduction contributions is generally satisfied if each employee may elect to defer more than $200 annually. The test requires universal eligibility to make salary reduction contributions. Once that opportunity is offered to any employee, it must be offered to all employees, with certain exceptions, including (1) nonresident aliens with no U.S. source income; (2) employees covered under a collectively bargained plan; (3) employees who normally work less than 20 hours per week; (4) students eligible for the student FICA exception;[210] (5) employees whose maximum salary reduction contributions under the plan would be no greater than $200; and (6) participants in a 457 plan or other salary reduction 403(b) plan. Unlike a qualified plan, there is no minimum age and service exclusion.

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[204] Treas. Reg. § 1.415-6(e)(1)(i). The IRS has set forth, in question-and-answer format, guidance on the increases in the section 415 Limitations. *See* Rev. Rul. 2001-51, 2001-45 I.R.B. 427.
[205] IRC § 415(c)(1).
[206] IRC § 415(a)(2).
[207] IRC § 403(b)(12)(A)(i), (ii).
[208] IRS Notice 89-23, 1989-1 C.B. 654, extended by I.R.S. Notice 92-36, 1992-2 C.B. 364.
[209] IRS Notice 96-64, 1996-51 I.R.B. 1.
[210] *See* § 4.3. Note that an erroneous classification of student employees as eligible for the student FICA exception can result in discrimination problems.

Non–salary reduction contributions are tested separately for nondiscrimination. This test requires compliance with rules generally applicable to qualified plans.[211] In addition, governmental plans are deemed to satisfy many of the nondiscrimination requirements that are applicable to nongovernmental plans.[212]

(i) Minimum Distribution Requirements

Section 403(b) annuity contracts must provide that amounts attributable to contributions under a salary reduction agreement may not be distributed before the employee reaches age 59-1/2, unless the employee is severed from employment, dies, becomes disabled (within the meaning of section 72(m)(7)), experiences a hardship, or receives a ''qualified reservist distribution'' as defined in section 72(t)(2)G)(iii)(I).[213] In addition, there are minimum distribution requirements that provide that the latest date at which predeath distributions must commence is April 1 of the calendar year immediately following the later of the calendar year in which the participant attains $70\frac{1}{2}$ years of age or retires.[214]

Sometimes a distribution from a 403(b) plan is not made in the traditional sense. In a Fifth Circuit decision, the court held that an individual's pledge of his or her section 403(b) retirement account as security for alimony payments constituted a deemed distribution of the account. Because the account was no longer part of the plan, it was subject to the claims of creditors.[215]

(j) Transfers and Rollovers

A *transfer* is a distribution of funds from one retirement plan directly to another, while a *rollover* is a transfer of funds from the retirement plan to the participants, who then contribute the funds to another plan. Funds may be moved by transfer or rollover from one 403(b) plan to another without being includable in gross income in the taxable year of the transfer or rollover.[216] The IRS has ruled that funds in a custodial account may be transferred tax-free to another custodial account, or to a 403(b) annuity contract, if the transferred funds continue to be subject to the same or more stringent distribution

[211]These rules are set forth in IRC § 401(a)(4) (nondiscrimination), IRC § 401(a)(5) (permitted disparity), IRC § 401(a)(17) (the $200,000 ceiling on compensation), IRC § 401(a)(26) (minimum participation), IRC § 401(m) (nondiscrimination in matching contributions), and IRC § 410(b) (minimum coverage).

[212]IRS Notice 2003-6, 2003-1 C.B. 298, which provides that governmental plans are exempt from the nondiscrimination requirements until such time as the IRS issues final regulations on the application of these rules to governmental plans.

[213]IRC § 403(b)(11).

[214]IRC § 401(a)(9)(C).

[215]*Coppola v. Beeson*, 96 AFTR 2005-5375 (5th Cir. 2005).

[216]IRC § 403(b)(8).

restrictions.[217] Under this ruling, the transfer is tax-free regardless of whether (1) a complete or partial interest is transferred, (2) the transfer is directed by the individual, or (3) the individual is a current employee, a former employee, or a beneficiary of a former employee.

In a rollover from a 403(b) plan, an employee's interest in the 403(b) plan is distributed to the employee and reinvested by the employee in another plan. Distributions from a 403(b) plan are not currently includable in the employee's gross income if they are properly rolled over.[218] The requirements for a proper rollover are:

- A portion of the balance to the credit of the distributee must be paid to the employee in an eligible rollover distribution.
- The employee must transfer the property received in the distribution to an individual retirement account (IRA) or another 403(b) investment.
- If property other than money is distributed, the property transferred must consist of the property distributed.

A proper rollover is required to be completed within 60 days of the employee's receipt of the distribution.[219] Distributions not properly rolled over are currently includable in the employee's gross income and may be subject to additional tax.[220]

Generally, a 403(b) plan must offer a direct rollover option.[221] Unless made in the form of a direct rollover, all eligible rollover distributions are subject to 20 percent mandatory income tax withholding, even if they subsequently are properly rolled over (and thus excludable from gross income).[222] A direct rollover is both exempt from withholding and excludable from gross income.

(k) Tax-Sheltered Annuity Voluntary Correction Program

In the mid-1990s, the IRS published a voluntary compliance program (known as the TVC Program) specifically tailored for section 403(b) plans.[223] Subsequently, however, the IRS consolidated all of its various voluntary compliance, or self-correction, programs for retirement plans into a single revenue procedure and merged the separate TVC Program into this new revenue procedure. The consolidated self-correction program is called the

[217]Rev. Rul. 90-24, 1990-1 C.B. 97.
[218]IRC § 403(b)(8).
[219]IRC §§ 403(b)(8)(B), 402(c)(3).
[220]IRC § 72(t).
[221]Treas. Reg. § 1.403(b)-2 T, Q&A-2.
[222]*Id*.
[223]Rev. Proc. 95-24, 1995-1 C.B. 694, as updated by Rev. Proc. 99-13, 1999-1 C.B. 409.

Employee Plans Compliance Resolution System, or EPCRS. Therefore, schools that are interested in correcting any known section 403(b) plan problems with the IRS should follow the guidelines set forth in the EPCRS revenue procedure.[224]

(l) Section 403(b) Proposed Regulations

In 2004, the IRS issued proposed regulations under section 403(b) that, if enacted, would provide comprehensive guidance on the many statutory and administrative changes that have occurred in the section 403(b) area over the past several decades and, in addition:

- Delete provisions that no longer have legal effect due to statutory changes.
- Include a number of items of interpretive guidance that have been issued since the issuance of the final regulations in 1964.
- Reflect the numerous statutory changes that have been made to section 403(b) over the years.

Some of the major changes contemplated by the proposed regulations are:

New plan document requirement. Prior to the issuance of the proposed regulations, there was no requirement that a section 403(b) plan be evidenced by a plan document, but such a document is required under the proposed regulations.[225] For this purpose, the IRS intends that the plan document would include all of the material provisions regarding eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made.

Comparison with section 401(k) elective deferrals. The proposed regulations clarify the extent to which section 403(b) elective deferrals are similar to elective deferrals under proposed and final section 401(k) rules. Specifically, the section 403(b) rules are fundamentally similar with respect to:

- The frequency with which a deferral election can be made, changed, or revoked, including automatic enrollment
- The ability for a deferral election that has been made in one year to be carried forward to later periods until modified
- The requirement that employees have an annual effective opportunity to make, revoke, or modify a deferral election

[224]Rev. Proc. 2002-47, 2002-2 C.B. 133.
[225]Prop. Treas. Reg. § 1.403(b)-3(b)(3).

- Allowing a deferral election to be made for compensation up to the day before the compensation is currently available[226]

The proposed regulations also would incorporate the major differences between 403(b) and 401(k) elective deferrals:

- Section 403(b) plans are limited to certain specific employers and employees (i.e., employees of a state public school, and employees of a section 501(c)(3) organization), while section 401(k) plans are available to all employers, except state or local governments.
- Section 403(b) plan contributions can be made only to certain funding arrangements, for example, an insurance annuity contract, custodial account that is limited to mutual fund shares, or church retirement income account.
- A universal availability rule applies to 403(b) elective deferrals, while different nondiscrimination rules apply to section 401(k) plans.[227]

Strengthened nondiscrimination requirements. The proposed regulations do not adopt the good faith reasonable standard for purposes of satisfying the section 403(b)(12)(A)(i) nondiscrimination requirements. Instead, a comprehensive set of new nondiscrimination rules are put into place.[228]

Distributions. The proposed regulations cover the many statutory changes that have been made over the years to distributions from section 403(b) annuities. Under the proposed regulations (1) loans to participants from a section 403(b) contract would be permitted[229]; (2) section 403(b) annuities generally would be treated as individual retirement accounts (IRAs) for purposes of the required minimum distribution rules;[230] and (3) any payment that is an eligible rollover distribution would not be taxed in the year distributed to the extent the payment is directly rolled over, or transferred, to an eligible retirement plan.[231]

Portability rules. The proposed regulations permit exchanges or transfers between section 403(b) plans and allow a section 403(b) plan to transfer assets to a qualified plan to purchase permissive service credit under a defined benefit governmental plan. Transfers from a qualified plan or a section 457 plan, however, may not be made to section 403(b) plans.[232]

Effective date. The IRS has said that the proposed regulations will not become effective earlier than January 1, 2008.[233]

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[226]Prop. Treas. Reg. § 1.403(b)-5.
[227]Prop. Treas. Reg. § 1.403(b)-5.
[228]Prop. Treas. Reg. §1.403-5.
[229]Prop. Treas. Reg. §1.403-6(f).
[230]Prop. Treas. Reg. §1.403-6(e).
[231]Prop. Treas. Reg. §1.403-7(b).
[232]Prop. Treas. Reg. §1.403-10(b).
[233]IR 2006-136 (Aug. 29, 2006).

(m) Section 457 Plans

In 1978, the IRS published a regulation in which it asserted that any payment of deferred compensation to an employee is includable in the employee's gross income in the taxable year in which the compensation is earned, if the employee has a right to elect to receive the compensation in that year. Congress responded to this proposed regulation by prohibiting the IRS from enforcing the rule with respect to all employers, except for state and local governments and tax-exempt organizations. With respect to those entities, Congress enacted section 457, which generally provides that any attempt by a state or local government or a tax-exempt organization to pay deferred compensation will be ineffective unless the arrangement meets the tests set forth in that section.

The reason that Congress suspended the IRS regulation with respect to for-profit employers but kept most of the substance of the regulation in existence for state and local governments and tax-exempt organizations, relates to the absence of ''the usual tension between employee's desire to defer tax on compensation and the employer's desire to obtain a current deduction.''[234] In other words, in the for-profit world, there will be a conflict between the employer (who wants to take the deduction currently) and the employee (who wants to defer the income). Congress felt that this natural tension would prevent abuse and obviated the need for any statutory change; however, this tension does not exist when the employer is a state or local government or a tax-exempt organization because these organizations do not generally claim tax deductions—hence the reason for the enactment of section 457.

Section 457 applies to deferred compensation arrangements for both individual employees and independent contractors who perform services for a state/local government or a tax-exempt organization.[235] In order to qualify as a 457 plan, a number of requirements must be met, including that all amounts of deferred compensation, all property purchased with such amounts, and all income attributable to such amounts must remain the property of the employer until paid to the participant, and the assets in the plan must be held subject to the claims of the employer's general creditors and may not be restricted to payment of benefits under the plan.[236]

Unlike qualified plans and 403(b) plans, 457 plans are not subject to any nondiscrimination requirements with respect to either coverage or benefits. The 457 plan must provide that a participant may not defer compensation for any calendar month unless a deferral agreement has been entered into prior to the first day of that month.[237] With respect to new employees, however, a plan

[234]Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 654 (1987).
[235]IRC § 457(e)(2); Treas. Reg. § 1.457-2(j).
[236]IRC § 457(b)(6)(B).
[237]IRC § 457(b)(4).

may provide that the employee can defer compensation in the first month of employment if the agreement providing for the deferral is entered into on or before the first day of work.[238]

The maximum amount of compensation that can be deferred for any year under a 457 plan is the lesser of $15,000 (adjusted for cost-of-living increases), or 100 percent of the employee's includable compensation.[239] The term ''includable compensation'' is similar, but not identical, to the same concept under section 403(b) and includes compensation attributable to services performed for the employer that is includable in the participant's gross income for the taxable year.[240] Accordingly, any compensation from other employers and amounts that are excludable from the worker's gross income are disregarded for purposes of making the includable compensation determination.

Section 457 also contains its own special rules with respect to the time and form of distributions that can be made from the plan. These rules are similar to the distribution rules under section 403(b). As a general rule, a 457 plan cannot distribute funds until the earliest of the calendar year in which the participant attains $70\frac{1}{2}$ years of age, separates from service with the employer, or is faced with an ''unforeseeable emergency.''[241] In order to constitute a separation from service, there must be a bona fide termination of employment as a result of the participant's death, retirement, or other cause, and the regulations refer to the qualified plan rules to determine the standard for a separation from service.[242] An ''unforeseeable emergency'' includes any severe financial hardship to the participant that may be caused by sudden and unexpected illness or accident of either the participant or a dependent of the participant, and the regulations set forth a detailed set of rules as to the types of situations that qualify.[243]

Certain types of plans are not treated as ''deferred compensation plans'' and are therefore exempt from the section 457 rules. These include vacation, sick leave, compensatory time, severance pay, disability pay, death benefits, and length of service plans.[244] But in order to qualify for the exception, the plan must be bona fide. In a 1999 technical advice memorandum, the IRS concluded that a denominated ''severance plan'' did not qualify as such because the payment called for under the plan would be paid at retirement regardless of the reason of the termination of employment. Accordingly, the IRS ruled that the ''severance plan'' exception was not applicable and that the employees must recognize income in the year that they first become entitled to the payment.[245] In addition, the IRS suggested in this ruling that other elements of

[238]Treas. Reg. § 1.457-2(g).
[239]IRC § 457(b)(2). This amount is adjusted annually.
[240]IRC § 457(e)(5).
[241]IRC § 457(d).
[242]IRC § 457(d).
[243]Treas. Reg. § 1.457-6(c).
[244]IRC § 457(e)(11).
[245]Tech. Adv. Mem. 199903032 (Oct. 2, 1999).

a bona fide severance plan as determined in Department of Labor regulations and under other sections of the Code may also be taken into account, for example, a requirement that (1) the payments are not contingent, directly or indirectly, on the employee's retirement; (2) the total payments do not exceed twice annual compensation; and (3) the payments are generally completed within two years of termination of employment.

Finally, there is an important exception to the rule that an agreement to defer compensation is not valid unless the agreement conforms with section 457. If compensation under a 457 plan is subject to a ''substantial risk of forfeiture'' when the compensation is earned, the compensation is treated as if it were compensation in the year in which the forfeiture restriction lapses.[246] Typical forfeiture restrictions include a requirement that the employee will not vest in the deferred compensation unless he or she works for the employer for a particular length of time.[247]

In 2004, the IRS issued a revenue procedure that contains amendments that may be used by state or local government employers to amend or draft eligible section 457 plans.[248] This new revenue procedure updates these provisions to comply with the final section 457 regulations and supersedes Rev. Proc. 98-41, which set forth model amendments under prior regulations.

In addition, the IRS has published additional section 457 guidance describing the section 457 withholding and reporting requirements.[249] More specifically, this guidance addresses income tax withholding and reporting with respect to annual deferrals made to a plan; income tax withholding and reporting with respect to distributions from a plan; FICA payment and reporting with respect to annual deferrals under a plan; employer identification number issues; and the annual reporting requirements imposed on plan administrators. And, in late 2005, the IRS issued two private letter rulings holding that a political subdivision's deferred compensation plan qualifies under section 457(b), provided that domestic partners under the plan are not treated as spouses for plan purposes and that the spousal provisions of the plan are interpreted in accordance with the Defense of Marriage Act.[250]

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[246]IRC § 457(f)(1). *See* Priv. Ltr. Rul. 200321002 (Feb. 11, 2003), which held that a plan met the IRC § 457(f)(1) requirements where the employees did not vest in the benefits until the earlier of the date that the employee dies, terminates service due to disability, or attains age 58. This ruling also permits the employer to operate the plan through a third-party trust arrangement, provided that the trust complies with Rev. Proc. 92-64, 1992-2 C.B. 422, which sets forth safe harbor rules against the constructive receipt of income and the realization of economic benefit.

[247]For a more detailed analysis of the substantial risk of forfeiture rules, see Treas. Reg. § 1.83-3(c). *See also* Priv. Ltr. Rul. 200229001 (Dec. 11, 2001), in which the IRS ruled that a deferred compensation arrangement included a substantial risk of forfeiture where the executive would lose the benefit at the earliest of the dates that he or she died, became disabled, or was no longer working for the company.

[248]Rev. Proc. 2004-56, 2004-35 I.R.B. 376.

[249]Notice 2003-20, 2003-19 I.R.B. 894.

[250]Priv. Ltr Rul. 200524016 (Mar. 17, 2005), and Priv. Ltr. Rul. 200524017 (Mar. 17, 2005).

(n) Other Retirement Plan Vehicles for Employees of Colleges and Universities

There are two basic types of qualified employer retirement plans—pension plans and profit sharing plans. Colleges and universities are authorized to maintain all types of pension plans, except for stock bonus plans that require distribution of benefits in the form of stock of the employer. At one time, the IRS took the position that a nonprofit employer could not maintain a profit sharing plan, but in 1980, it reversed its position and held that these entities can maintain profit sharing plans even though they lack a profit motive.[251] Pension plans include defined benefit plans (which provide participants with a fixed or determinable benefit at retirement), and defined contribution plans (under which the participant makes a fixed contribution each year, commonly expressed as a fixed percentage of annual compensation, and the employer makes a fixed annual contribution in accordance with a particular formula). In addition, retirement plans include profit sharing plans under which the employer makes a contribution equal to a certain percentage of the employer's current profits or a fixed percentage of the participants' compensation but is not required to do so.

§ 9.4 TAX-EXEMPT BONDS

Tax-exempt bond financing has been used for decades by private and state colleges and universities to finance building programs and other capital needs. This section briefly describes the basic requirements of using tax-exempt financing and describes some of the key issues of current IRS concern. Institutions contemplating entering into tax-exempt financing arrangements should be aware, however, that these rules are extremely complex, that mistakes in this area can be disastrous, and that the IRS is engaged in an aggressive program of reviewing tax-exempt bond issues. Therefore, schools contemplating entering into tax-exempt financing arrangements should consult with bond counsel who are specially trained in this highly complex area of the tax law.

(a) Overview

As the name suggests, a tax-exempt bond is one in which the interest paid on the bond is exempt from both federal income tax and income tax in the state of issuance. There are a number of different types of debt obligations that pay tax-exempt interest, but those of interest to colleges and universities are state and local bonds, which are debt obligations issued by a state, the District of Columbia, a U.S. possession, or a political subdivision of any of the foregoing.

The primary purpose of these bonds is to finance state and local governmental activities, and if all of the applicable tests are met, interest paid to the

[251]Gen. Couns. Mem. 38,283 (Feb. 15, 1980).

bondholders is tax-exempt. If, however, the bond is a ''private activity bond,'' the interest on the obligation is taxable. A private activity bond is one in which 10 percent or more of the bond proceeds are used in a trade or business conducted by a nongovernmental unit. For this purpose, a ''nongovernmental unit'' is any entity other than a state or municipal government; therefore, even the United States is treated as a nongovernmental unit.

The normal rule that private activity bonds are taxable does not apply, however, where the nongovernmental entity being benefited is a section 501(c)(3) organization. In most cases, the state or local government issues the bonds on behalf of the section 501(c)(3) organization, although it is possible for the organization to issue the bonds itself, if it is a governmental entity with the power under state law to do so. Whether issued by the state on the organization's behalf or by the organization itself, the proceeds of the section 501(c)(3) financing must be used in furtherance of the charitable or educational purposes for which the organization was created. Therefore, if a university were to issue tax-exempt bonds, it could not use the bond proceeds to construct low-income housing units in the city in which it is located, even though the low-income housing activity itself may be a charitable purpose within the scope of section 501(c)(3).[252]

(b) Qualified 501(c)(3) Bonds

In order for bonds benefiting tax-exempt organizations to be tax-exempt, they must be ''qualified 501(c)(3) bonds.'' In addition to having to meet the general tax-exempt bond rules set forth in the Code,[253] at least 95 percent of the net bond proceeds must be used in furtherance of the organization's exempt purposes. This means that if at any point that the bonds are outstanding, more than 5 percent of the facilities constructed with bond financing are used for unrelated or nonexempt purposes, the bonds will not be ''qualified 501(c)(3) bonds'' and the interest paid on the bonds will be taxable.

In determining the ''use of bond proceeds'' for purposes of the 95 percent rule, the IRS takes into account the indirect use of the proceeds—that is, whether the proceeds are used to finance facilities that are used by nongovernmental or nonexempt persons. A classic example of indirect use is the lease of the facility to a private person. For example, if a school issued bonds to build a hospital on campus, no more than 5 percent could be used to construct office space owned by or leased to private physicians who also work at the hospital.

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[252]*But see* Priv. Ltr. Rul. 200211003 (Mar. 15, 2002), in which the IRS concluded that the use of a state university's bond-financed recreation center by certain members of the general public, including families of students and faculty, employees of the university hospital, and participants in off-campus programs, is not private business use.

[253]IRC §§ 149, 150.

Use by the general public of the bond-financed facility is not, however, treated as improper ''indirect use'' for the purposes of these tests.[254] With respect to colleges and universities, the general public use question can arise in such areas as sporting event ticket sales, and short-term leases or licenses of space, such as receptions, summer camps, or events at coliseums. For example, assume that a for-profit corporation sends its executives to a university to obtain a master's degree. Although the executive is ''using'' school facilities as part of his or her business activities, such use is on the same basis as others attending the school and there is no improper ''trade or business'' use. Along the same lines, if a company buys season football tickets and uses the games to entertain clients, although the company is using the facility in its trade or business, there is no improper use, assuming that the tickets were sold to the company on the same basis as they are sold to the general public. If, however, the university sells long-term leases to luxury boxes to large corporations, an issue could arise as to the private use of these facilities. The IRS has issued a compliance guide related to post-issuance rules that apply to qualified 501(c)(3) bonds, including information filings, private activity bonds, and arbitrage.[255]

(c) Research Agreements

A major issue in the tax-exempt bond area for colleges and universities relates to research agreements. The issue can be easily understood in the following example: Assume that a private company contracts with a university to conduct research for the company. Although the school views the research as furthering its educational and reputational purposes, from the company's point of view, it is obtaining research results at a cost less than the cost of establishing its own research and development program. Under these circumstances, would the company be treated as ''using'' the research laboratory in its trade or business?

Prior to 1986, it was not clear what the answer would be, but as part of the Tax Reform Act of 1986, Congress took the approach that using sponsored research results is not to be considered to be private use if either:

- The license or other use of the resulting technology is permitted only on the same terms as the university would permit by a nonsponsoring, unrelated party—that is, the sponsoring party must pay an arm's-length price for its use of the technology.

  OR

- The following criteria are met: (1) multiple, unrelated sponsors agree to fund the research; (2) the type of research to be conducted and the manner in which it is performed is determined by the university;

[254]Priv. Ltr. Rul. 9142012 (July 17, 1991).
[255]IRS Publication 4077 (Tax Exempt 501(c)(3) Bonds Compliance Guide).

> (3) title to any patents or other technology remains exclusively with the university; and (4) the sponsors are entitled to nothing more than a nonexclusive, royalty-free license to use the product of the research.[256]

The IRS issued proposed regulations that generally followed this approach,[257] but in 1997 the IRS issued final regulations that merely provide for a facts and circumstances test.[258] Later that same year, however, the IRS issued a revenue procedure establishing safe harbors for determining when corporation-sponsored research agreements and cooperative research agreements do not give rise to private business use.[259] These safe harbor rules only apply to the conduct of ''basic research,'' which the revenue procedure defines as any ''original investigation for the advancement of scientific knowledge not having a specific commercial objective,'' and excludes from this definition product testing.[260]

Under these safe harbor guidelines, corporation-sponsored research will not be treated as private business use if:

> Any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), with the price paid for that use determined at the time the license or other resulting technology is available for use. Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any nonsponsoring party for those same rights.[261]

An important issue arises under this safe harbor guideline with respect to federally sponsored research grants. At the outset, it is clear that the federal government is not a ''qualified user'' of the bond-financed facilities and that federal research contracts will be held to the same safe harbor standards as commercial research contracts.[262] The problem arises from the fact that under federal law the federal government is granted a worldwide, nonexclusive, and royalty-free license in any invention that may result from federally sponsored research at a college or university.[263] Applying these safe harbor guidelines to federal research contracts, it is difficult to see how such contracts could ever qualify—first, because the price for the technology (royalty-free) is determined in advance of the contract. In addition, if, as is often the case, the college or university licenses the technology created under the federal grant to one or

[256]Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 1162–63 (J. Comm. Print 1987).
[257]Prop. Treas. Reg. § 1.141-3(d).
[258]Treas. Reg. § 1.141-3(b)(6).
[259]Rev. Proc. 97-14, 1997-1 C.B. 634.
[260]*Id*. § 3.01.
[261]*Id*. § 5.02.
[262]*Id*. § 3.02.
[263]Bayh-Dole Act (Pub. L. No. 96-517), § 202(c)(4), 94 Stat. 3021 (1980).

more commercial enterprises for a royalty of some kind, the guidelines would be violated because the sponsor of the research (the federal government) would be receiving more favorable terms (a royalty-free license) than a nonsponsoring party (the commercial enterprise). In a 1999 ruling, the IRS said that these safe harbor guidelines apply to federal research contracts, although it held that the federal contract in question met these guidelines because the organization agreed to license the technology obtained under the federal grant to third parties on the same nonexclusive, royalty-free basis that it licensed the federal government.[264]

This issue regarding the treatment of federally sponsored research continues to be a problem because of the substantial amount of federally sponsored research grants in which colleges and universities typically engage. One potential argument is to say that the guidelines in the revenue procedure are only safe harbor guidelines and that a non-private-use determination can be demonstrated outside the guidelines under the broad facts and circumstances test set forth in the regulations. But schools will have to convince bond counsel to sign on to this argument, which may prove difficult.

Another issue in the sponsored research agreement area is whether the entity for which the research is conducted is a ''sponsor.'' This is an issue because the safe harbor rules apply only to ''sponsored'' research agreements. In a 2003 ruling, a section 501(c)(3) research institute entered into a license agreement with a for-profit company under which the company received a worldwide exclusive license to all research and patents created at the institute's research facility.[265] In addition, the company received a portion of the institute's net income from the research. The IRS said that under these facts, the company was not a ''sponsor'' of the research for purposes of the safe harbor rules because it could not control the type or manner of the research conducted at the facility and did not provide the type of financial support that is normally associated with a research sponsor. The IRS went on to hold that the arrangement constituted private business use because it closely resembled the transfer by the institute to the company of an ownership interest in the research facility, which is considered a private business use transaction under the applicable regulations.[266]

(d) Management and Service Contracts

Another issue arises with respect to management and service contracts. In the college and university world, these commonly arise in connection with food service contracts, contracts with events managers, and contracts with doctors' groups and university hospitals where the doctors are treated as independent contractors. In 1993, the IRS issued safe harbor guidelines that can be used to

[264]Priv. Ltr. Rul. 199914045 (Jan. 8, 1999).
[265]Priv. Ltr. Rul. 200347009 (Aug. 14, 2003).
[266]*See* Treas. Reg. § 1.141-3(b)(7).

determine whether a management or service contract gives rise to a private use,[267] and updated these procedures in 1997.[268] Under these guidelines, the service or management contract is not to be treated as a private use if:

- The contract provides for reasonable compensation and is not based, in whole or in part, on a share of net profits from the operation of the facility.[269] In making this determination:
  - Reimbursement of direct or indirect expenses is not treated as compensation.[270]
  - Compensation that is based on a percentage of gross revenues or a percentage of expenses (or both), a capitation fee, or a per-unit fee is generally not regarded as based on a share of net profits.[271]
  - Productivity awards equal to a stated dollar amount based on increases or decreases in gross revenues or reductions in total expenses (but not both) are generally not considered to be compensation based on net profits.[272]
  - If the compensation provisions are materially revised, they must be retested.[273]
- The contract must satisfy one of several tests that look to the extent to which the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee, or whether the compensation is based on a per-unit or percentage of revenue or expense fee.[274]
- The service provider must have no relationship with the user that substantially limits the user's ability to exercise its rights.[275]

The IRS applied these management contract safe harbor rules in a private letter ruling issued in late 2001 and concluded that the safe harbor tests were met.[276] In a 2002 private letter ruling, the IRS applied these guidelines to find that a management contract between a section 501 (c)(3) organization and an unrelated service provider that was retained to manage a bond-financed hotel did not result in private business use.[277] The IRS reached a similar conclusion

[267]Rev. Proc. 93-19, 1993-1 C.B. 526.
[268]Rev. Proc. 97-13, 1997-5 I.R.B. 1.
[269]*Id*. § 5.02(1).
[270]*Id*.
[271]*Id*. § 5.02(2).
[272]*Id*. § 5.02(3).
[273]*Id*. § 5.02(4).
[274]*Id*. § 5.03.
[275]*Id*. § 5.04.
[276]Priv. Ltr. Rul. 200205009 (Nov. 2, 2001).
[277]Priv. Ltr. Rul. 200222006 (Feb. 19, 2002).

in a 2006 private letter ruling holding that a university's management contract with its wholly owned subsidiary that contracted to manage the university's dormitory facilities would not result in private business use.[278]

(e) Making "Private Use" Determinations

While the proposed regulations issued by the IRS generally provided that private business use is to be measured on an annual basis,[279] the final regulations issued in early 1997 generally provide that private business use should be measured over the term of an issue, specifically, by looking at the average percentage of private business use of that property over the "measurement period."[280] The measurement period begins on the later of the issue date or the date the property is placed in service, and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue.[281] There are exceptions to this general rule for refundings of short-term obligations, issues with reasonably expected mandatory reductions, and when the private business use results from ownership by a nongovernmental person.[282] Under a special "anti-abuse" rule, if an issuer extends the term of an issue for a principal purpose of increasing a permitted amount of private business use, the IRS may determine the amount of private business use according to the greatest percentage of private business use in any one-year period.[283]

In determining the average amount of private business use for a one-year period, the regulations provide that the amount of private business use during the year is compared to the total amount of private and nongovernmental business use during that year.[284] For a facility in which governmental and private business use occur at different times (for example, on different days), the average amount of private business use is based on the amount of time that the facility is used for private business use as opposed to total time for all actual use.[285] In determining the total amount of actual use, those periods of time during which the facility is not in use are disregarded.[286]

When a facility is used for both governmental and private business use at the same time, the regulations provide that the entire facility is treated as having a private business use.[287] For example, a governmentally owned

[278]Priv. Ltr. Rul. 200651012 (Sept. 12, 2006).
[279]Prop. Treas. Reg. § 1.141-3(i)(1).
[280]Treas. Reg. § 1.141-3(g)(1).
[281]Treas. Reg. § 1.141-3(g)(2)(i).
[282]Treas. Reg. § 1.141-3(g)(2)(ii) to (iv).
[283]Treas. Reg. § 1.141-3(g)(2)(v).
[284]Treas. Reg. § 1.141-3(g)(4)(i).
[285]Treas. Reg. § 1.141-3(g)(4)(ii).
[286]*Id*.
[287]Treas. Reg. § 1.141-3(g)(4)(iii).

facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as used entirely for private business use.[288] The regulations carve out an exception to this general rule, however, in those simultaneous use situations where the amount of private business use can be determined on a reasonable basis. For example, where a garage with unassigned spaces is simultaneously used for both governmental and private business use, the regulations permit the percentage of private business use to be determined based on the number of spaces used for private business use as a percentage of the total number of spaces.[289] The regulations illustrate these ''simultaneous use'' principles with the following example:

> University U, a state owned and operated university, owns and operates a research facility. U proposes to finance general improvements to the facility with the proceeds of an issue of bonds. U enters into sponsored research agreements with nongovernmental persons that result in private business use because the sponsors will own title to any patents resulting from the research. The governmental research conducted by U and the research U conducts for the sponsors take place simultaneously in all laboratories within the research facility. All laboratory equipment is available continuously for use by workers who perform both types of research. Because it is not possible to predict which research projects will be successful, it is not reasonably practicable to estimate the relative revenues expected to result from the governmental and nongovernmental research. U contributed 90 percent of the cost of the facility and the nongovernmental persons contributed 10 percent of the cost. Under this section, the nongovernmental persons are using the facility for a private business use on the same basis as the government use of the facility. The portions of the costs contributed by the various users of the facility provide a reasonable basis that properly reflects the proportionate benefit to be derived by the users of the facility. The nongovernmental persons are treated as using 10 percent of the proceeds of the issue. [290]

The issue of how to allocate between private use and nonprivate use activities arose in a 2001 ruling that involved a section 501(c)(3) university that operated a medical school at which private and nonprivate business use research activities were conducted.[291] The university proposed to issue tax-exempt bonds, the proceeds of which would be used to construct new research facilities, and it was expected both private and nonprivate business use activities will be conducted in the new facilities. The university requested that it be able to make the private/nonprivate business use determination based on a revenue-based allocation formula instead of looking to the percentage of actual use of the facility's space and equipment. In this connection, the university represented these points to the IRS:

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[288]Treas. Reg. § 1.141-3(g)(4)(iii).
[289]*Id*.
[290]Treas. Reg. § 1.141-3(g)(8), Example 1.
[291]Priv. Ltr. Rul. 200132017 (May 10, 2001).

- The private and nonprivate use activities would take place simultaneously in all research laboratories.
- All laboratory equipment would be continuously available to researchers working on both types of research.
- A researcher would often use a single laboratory to conduct both types of research.
- Many of the research procedures used in the new facilities would relate to both types of research.

The IRS accepted the university's argument that, based on the manner in which the new research facilities would be used, any allocation method other than a revenue-based method would be unworkable. Accordingly, it ruled that the university could make the private/nonprivate use allocation under the following revenue-based allocation formula: The bond proceeds would be allocated to nonprivate research activities based on the ratio of the present value of the nonprivate use revenue to the present value of total research revenue (received from both private and nonprivate research activities), using the yield of the bonds (as determined under section 148) as the discount rate.

The disqualifying private business use can be indirect as well as direct.[292] There are, however, some limits on the extent to which an indirect benefit will rise to the level of private business use. A ruling issued by the IRS in 2003 involved a tax-exempt organization that was controlled by colleges and universities and operated to promote access at federal laboratories and develop research programs at the member schools.[293] The organization had contracts with two federal agencies under which it performed various activities for the agencies. The organization intended to build a new facility in which it would conduct its activities and planned to finance the construction of the facility with tax-exempt bonds. The IRS held that the federal contracts would not cause the facility to be used for the private use of the federal agencies because the agencies would not receive a special economic benefit from the facility. In addition, the IRS said that the bonds would not be federally guaranteed under section 149(b).

In another ruling issued in late 2002, the IRS said the grant of naming rights to a bond-financed factory can result in private business use. The ruling involved a convention center constructed by a city and financed with tax-exempt bonds. The city leased the facility to an authority, which proposed to sell naming rights to the facility to a private party. Even though the purchaser of the naming rights had no right to use the facility, the IRS concluded that the naming rights contract resulted in private business use of the facility due to the naming-related rights granted to the purchaser in the contract. The

[292]Treas. Reg. § 1.141-3(a)(2).
[293]Priv. Ltr. Rul. 200309003 (Oct. 22, 2002).

IRS also held that, for purposes of making the 10 percent private business use calculation, the amount of private business use would be determined by comparing the fair market value of the contract in each year to the annual value of the facility, and the ruling explains how these computations are made.[294]

In some cases, after the issuance of the bonds, the bond issuer takes a deliberate action that causes the private business use test to be met, thereby jeopardizing the tax-exempt status of the bonds. The IRS has issued proposed regulations setting forth various remedial actions that an issuer that has engaged in such a deliberate action can take to cure any resulting private use issue.[295]

(f) Unrelated and Nonexempt Use

If bond-financed facilities are used by the section 501(c)(3) organization for purposes not related to its exempt purpose, the use is treated as impermissible private use. Accordingly, if a college or university is conducting unrelated trade or business income activities in bond-financed facilities, those activities are treated as a private use. Interestingly, the definition of an ''unrelated trade or business'' for purposes of the bond rules does not conform to the definition for income tax rules. The cross-reference from the tax-exempt bond statute is to section 513, and therefore does not include the exclusions for dividends, interest, royalties, rents, and research grants contained in section 512. Thus, if the college or university rents a portion of the bond-financed facility to another section 501(c)(3) organization, that rental will be treated as private use of the building by the school unless the rental activity itself is related to the school's exempt purposes.

(g) Arbitrage and Administrative Costs

Another issue in the tax-exempt bond area relates to arbitrage, which involves investing the proceeds received from the bond offering in a higher earning investment vehicle until the proceeds are needed for the purpose of the bond offering. The restrictions involving arbitrage are set forth in section 148 of the Code and related IRS regulations.[296]

One of the issues raised by these regulations involves prepayments for property or services, which can give rise to arbitrage if a principal purpose for the prepayment is to obtain an investment return from the time the payment is made until the time that the payment would otherwise be made.[297] For example, assume that a state university enters into a 10-year contract with a

[294]Priv. Ltr. Rul. 200323006 (Nov. 22, 2002). For a news article discussing this ruling, *see Chronicle of Higher Education*, Apr. 18, 2003, at A30.
[295]Prop. Treas. Reg. § 1.141-12.
[296]Treas. Reg. § 1.148-0 et seq.
[297]Treas. Reg. § 1.148-1(e)(2).

company to provide services in return for fixed annual payments. Two years into the contract, the university and the company agree that the university will prepay its remaining obligation under the contract, and it issues bonds to finance the prepayment. The principal reason for making the prepayment is to obtain an investment return from the time of the prepayment until the time that the prepayment would otherwise be made. In 1997, a federal appeals court held that when the prepayment occurs after the contract is entered into (or property is acquired), the prepayment will not be in violation of the arbitrage restrictions.[298] The IRS, however, disagrees with this decision and has issued proposed regulations that are intended to reverse the court's opinion.[299]

Another arbitrage issue relates to whether brokers' commissions or similar fees incurred in connection with the acquisition of guaranteed investment contracts can be treated as ''qualified administrative costs.'' The IRS issued proposed regulations clarifying and setting forth a safe harbor that can be used to determine which commissions and fees can so qualify.[300]

(h) Closing Agreement Programs

In 2001, the IRS released a detailed closing agreement program for tax-exempt bonds.[301] The program is intended to apply when there is no remedy under current regulations and existing tax-exempt bond closing programs. As with all other closing programs of this nature, it is inapplicable if the bond issue is under examination. The new procedure permits a bond issuer to enter into preliminary discussions on an anonymous basis; however, until the identity of the issuer is disclosed, it remains subject to an IRS audit.

§ 9.5 CONDUCTING ACTIVITIES OVERSEAS

For many years, involvement by colleges and universities in international activities was primarily limited to participation in foreign student exchange programs. Increasingly, however, colleges and universities are conducting activities and operations of their own in foreign countries, including opening their own branch campuses overseas, establishing research laboratories in foreign countries, and entering into partnerships with host country colleges and universities to provide joint educational instruction.

The problem, however, is that many institutions may be doing so with little thought or consideration to the special tax and other legal problems that arise when a U.S. legal entity conducts operations overseas. It is easy to forget that, from the perspective of the foreign country in which the activities are

[298] *City of Columbus v. Commissioner*, 112 F.3 d 1201 (D.C. Cir. 1997).
[299] Prop. Treas. Reg. § 1.148-1(e).
[300] Prop. Treas. Reg. § 1.148-5.
[301] IRS Notice 2001-60, 2001-40 I.R.B. 304.

conducted, a U.S. educational institution has no special tax or other status and will be treated, at least initially, no differently than any U.S. for-profit company trying to do business within the country's borders.

This section sets forth an overview of the basic tax and other legal considerations that must be taken into account whenever a U.S. college or university contemplates conducting any activities outside the United States.

(a) Whether the U.S. Institution Is Subject to Tax in the Foreign Country

Perhaps the most fundamental issue that must be addressed whenever a U.S. educational institution plans to conduct operations of any kind in a foreign country is whether the activities will be of a sufficient scope and magnitude to cause the U.S. institution to be subject to the foreign country's income tax. Again, it is worthwhile noting that simply because a U.S. college or university enjoys income tax exemption in this country, it will not automatically enjoy such status in a foreign country. If the institution's activities in the foreign country cause it to have a sufficient permanent presence in the foreign country, it will generally be subject to that country's income tax, unless it can qualify for a local tax exemption, assuming that such an exemption exists under local law.[302]

In determining whether an institution's activities in the foreign country are of a sufficient scope or magnitude to cause it to be subject to income tax in that jurisdiction, the school must first determine whether the United States has entered into an income tax treaty with the country. Income tax treaties are bilateral agreements between two countries designed to avoid double taxation and foster international trade, and as of this writing, the United States has entered into tax treaties with more than 50 different foreign countries.[303] Note that these are income tax treaties—they apply only to taxes imposed on income, and as a general rule, do not apply to Social Security, value-added, or other types of taxes. Although a tax treaty is negotiated and entered into by the two countries primarily for the benefit of each country's business interests, the treaty is applicable to nonprofit institutions as well. These treaties do not carve out any special rules or exceptions for nonprofit institutions, and for the most part, a U.S. nonprofit institution is viewed, for tax treaty purposes, the same as a for-profit business entity.

Each income tax treaty has a ''permanent establishment'' article (tax treaty provisions are referred to as ''articles''), which overrides local law and defines the type and scope of activities that will give each country the jurisdictional nexus to tax the activities of the other country's residents. If under the treaty's permanent establishment article the U.S. institution is determined to have a

[302]For a more detailed discussion and analysis of the nonprofit laws in foreign countries, see Lester M. Salamon, *The International Guide to Nonprofit Law* (New York: John Wiley & Sons, 1997).
[303]The list and complete text of current U.S. income tax treaties can be found on the IRS web site at *www.irs.gov/businesses/international/article/0*,,id = 96739,00.html.

''permanent establishment'' in the foreign country, it is subject to income tax in that jurisdiction (unless it can qualify for a local exemption for educational institutions). By contrast, if the institution's activities in the foreign country do not create a ''permanent establishment,'' the country does not have the jurisdiction to subject the institution to its income tax.

For example, if a U.S. university is planning to conduct activities in Germany, the university would want to review carefully Article 5 of the U.S.-Germany tax treaty, which defines the nature and scope of the activities that will be treated as creating a ''permanent establishment'' in Germany. Although each tax treaty to which the United States is a party is different and must be individually examined, the ''permanent establishment'' article in the U.S.-Germany tax treaty is representative of the permanent establishment articles found in other tax treaties. Before reviewing Article 5 of the U.S.–Germany tax treaty, however, it is important to repeat the point made above—tax treaties in general, and ''permanent establishment'' articles in particular, are not drafted with nonprofit organizations in mind; rather, they are written from the standpoint of for-profit business enterprises. Therefore, many tax treaty provisions, by their very terms, are inapplicable to nonprofit organizations, and other provisions are unclear as to how they apply to nonprofit activities.

Keeping this in mind, the ''permanent establishment'' article of the U.S.-Germany tax treaty reads as follows:

1. For the purposes of this Convention, the term ''permanent establishment'' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term *permanent establishment* includes especially

- **(a)** A place of management
- **(b)** A branch
- **(c)** An office
- **(d)** A factory
- **(e)** A workshop
- **(f)** A mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

3. A building site or a construction, assembly or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the foregoing provisions of this Article, the term *permanent establishment* shall be deemed not to include

- **(a)** The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise

(e) The maintenance of a fixed place of business solely for the purpose of advertising, of the supply of information, of scientific activities, or of similar activities that have a preparatory or auxiliary character for the enterprise

(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (f), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character

5. Notwithstanding the provision of paragraphs 1 and 2, where a person (other than an agent of an independent status to whom paragraph 6 applies) is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State, or that carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Looking first at Paragraph 1, it could be argued that a college or university (or any nonprofit entity) cannot, by definition, have a ''fixed place of business through which the business of an enterprise is wholly or partly carried on''

because there is no ''business'' being conducted by the college or university in the context of an intent to earn a profit from the conduct of the activities. Such a position, if it has ever been asserted by a nonprofit entity, has never been upheld. In fact, there is authority to support the contrary position that a nonprofit entity will not ipso facto fail the ''fixed place of business'' test simply because it is organized and operated on a nonprofit basis.[304] Rather, a college or university conducting operations in a foreign country must test its operations against the terms of the applicable tax treaty's ''permanent establishment'' article without regard to its nonprofit status. Therefore, if a U.S. educational institution has an ''office'' or a ''branch'' in Germany, under Paragraph 2 of Article 5 of the treaty, it will be deemed to have a permanent establishment in that country, unless one of the exceptions in Paragraphs 4, 5, or 6 is applicable.

It is beyond the scope of this discussion to provide a detailed explanation and analysis of each of the permanent establishment provisions contained in the network of U.S. tax treaties. Nor is it the purpose of this overview to discuss the myriad of ''permanent establishment'' issues that can arise—for example, (1) whether in order to be ''fixed'' the activities must be actually carried on in the branch or office or whether is it sufficient that the branch office simply be the focal point or headquarters of the activities; (2) whether the activity must be carried on throughout the taxable year or whether is it sufficient that it be conducted at any time during the year; (3) whether, and to what extent, the business activities must be regular or continuous; and (4) what quantum of activity is required in order to be treated as a business activity.[305] Anyone researching this area of the law will quickly discover that there is very little case law in the area and virtually no guidance from the Treasury Department or the Internal Revenue Service. As a result, it is often necessary to make crucial ''permanent establishment'' decisions based on nothing more than an educated guess as to how the treaty provision may be interpreted by the foreign country.[306]

If the foreign country in which the college or university plans to conduct its operations does not have a tax treaty with the United States, a determination as to whether the operations will subject the school to the taxing jurisdiction

[304]*See* Rev. Rul. 83-144, 1983-2 C.B. 295 (holding that a nonprofit Philippine pension trust with an office in the United States does not have a U.S. permanent establishment under the U.S.-Philippine income tax treaty because it was trading for its own account, not because a nonprofit entity is definitionally unable to conduct a trade or business under the permanent establishment article).

[305]For an excellent discussion of these and other issues, see Joel Nitikman, ''The Meaning of 'Permanent Establishment' in the 1981 U.S. Model Income Tax Treaty,'' 15 *International Tax Journal* 159 (pt. 1), 257 (pt. 2) (1989).

[306]With respect to each tax treaty, the Treasury Department issues a technical explanation that sets forth a narrative explanation of each treaty provision. These explanations, while occasionally helpful, often do little more than repeat in more understandable English the substance of the tax treaty provision. These technical explanations can also be found on the IRS web site together with the text of the tax treaty itself.

of the foreign country depends on that country's local laws. To obtain an authoritative answer to this question requires the advice of local legal counsel, and the tests will vary from country to country, both as to the substantive ''doing business'' requirements imposed by local law and the practical extent to which those laws are actually enforced by the local tax authorities.

(b) Establishing a Legal Structure to Conduct Foreign Operations

If a college or university is planning to conduct operations in a foreign country, another issue to consider is how to structure the legal entity that will actually conduct these operations. There are two basic choices: the operations can be conducted by the institution itself operating through a branch in the foreign country, or the institution can create a separate, controlled legal entity in the foreign country to conduct the operations. If the latter choice is made, the different types of legal entities available in the foreign country must be analyzed to see which is best suited to conduct the contemplated activities. As just one example, if a U.S. college or university were planning to conduct for-profit operations in France, it could choose to conduct its activities through (1) a *société à responsibilité* (limited liability company); (2) a *société anonyme* (joint stock company); (3) a *société en nom collectif* (general partnership); or (4) a *société en commandite simple* (similar to a limited partnership under U.S. law). If the U.S. institution wanted to conduct its activities in France through an on profit entity, it would most likely use an ''association loi 1901,'' which has no shareholders and is required to transfer its assets only to another nonprofit entity.

Whether to operate through a branch or a local legal entity depends on a variety of different factors, but as a general matter, the advantages of operating through a branch include:

- A branch is generally simpler to operate and less expensive due to reduced filing and accounting costs. In addition, there are usually no foreign capital or stamp taxes imposed on a branch as there are with corporations.
- Most countries do not impose a withholding tax on branch profits that are remitted back to the United States.
- A foreign branch is generally not subject to ''local control'' restrictions. On the other hand, a local corporation may be required to have foreign shareholders and/or directors.
- Assets can generally be transferred between the branch and the institution free of any tax since there is no change in the ownership of the transferred assets.

However, there are several advantages of operating through a foreign corporate subsidiary, including:

- The subsidiary is generally afforded limited liability. A branch is an extension of the U.S. college or university; therefore, all tax and other liabilities to which the branch will be subject will constitute liabilities of the U.S. institution.
- Any disclosures to the foreign government will generally be limited to the subsidiary, while a branch may have to disclose information about the institution itself.
- A local subsidiary generally presents a better public image and is sometimes better able to obtain local borrowings, incentive payments, and grants.
- The subsidiary may be eligible for a local tax exemption, whereas it may be more difficult (administratively and substantively) for the U.S. institution, operating in the country through its branch, to obtain local tax-exempt status.
- As a general rule, the IRS views the activities conducted by the foreign subsidiary as activities conducted by a separate legal entity, not by the U.S. college or university. However, because a branch is considered to be an extension of the institution, foreign activities conducted by a branch are treated as conducted by the institution. Depending on the nature of the activities and the degree of control that the school is able to exercise over these activities, from a ''relationship with the IRS'' standpoint, the institution may feel more comfortable having the activities conducted by a separate legal entity.

(c) Taxation of U.S. Citizen and Foreign National Employees

In many instances, when a U.S. college or university conducts operations in a foreign country, the institution sends its own U.S. citizen employees (either existing or newly hired) to the foreign country to work. In addition, the school may hire local citizens to assist in the operations.

When a college or university has it own employees operating in the foreign country, an issue that arises is whether and to what extent these employees may be subject to tax in both the United States and the foreign country on the wages paid to them. A corollary question from the institution's standpoint is whether and to what extent the school may have U.S. or foreign country tax withholding and reporting obligations with respect to the wage payments. The answers to these questions depend, in the first instance, on the legal structure by which the U.S. college or university chooses to conduct its foreign operations.

(i) Tax Consequences of Operating through a Branch. If the U.S. college or university chooses to conduct its activities in the foreign country through a branch, the U.S. and foreign national employees are treated as employees of

the U.S. institution. Under this scenario, and looking first at the U.S. citizen employees, they continue to be subject to U.S. tax because the United States, unlike most other countries, taxes its citizens on their worldwide income.[307] Therefore, for a U.S. citizen it makes no difference whether the wages are paid for work done in the United States or abroad, with one important exception. That exception is the ''foreign earned income exclusion'' set forth in section 911 of the Code. Under this provision, if a U.S. citizen employee makes a timely election to claim the benefits of section 911,[308] the employee is able to exclude from his or her gross income (1) up to $80,000 per year of ''foreign earned income''; and (2) a ''housing cost amount,'' which is generally equal to the employee's actual housing costs less a housing base amount.[309]

Although there are a number of different issues that arise in determining the application of the section 911 exclusion to a particular situation, perhaps the most common is whether the U.S. citizen's presence in the foreign country is sufficient to qualify for the section 911 benefits. In this regard, there are two separate tests—either (1) the U.S. citizen must be a ''resident'' of the foreign country for an uninterrupted period that includes at least an entire taxable year, or (2) during a period of 12 consecutive months, the U.S. citizen must have been physically present in the foreign country for at least 330 full days.[310] Assuming that the individual qualifies for the section 911 exclusion (and, in all likelihood, the college or university's U.S. citizen employees will qualify), it is important to note that the employer-institution is not required to withhold any U.S. income tax on the amount of excluded wages, assuming that the employee properly notifies the institution of his or her intent to claim the section 911 exclusion.[311]

In addition to U.S. income tax, a question also arises as to whether the employee and the employer-institution are subject to U.S. Social Security taxes. Because the Social Security taxes apply to all U.S. citizens, regardless of where they are employed, the Social Security tax obligations of both the institution and the employee are the same as if the person were employed in the United States.[312]

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[307]IRC § 61.

[308]The election is made by filing Form 2555 (Foreign Earned Income) together with a timely filed tax return, or an amended return. Once made, the election remains in effect until revoked. Treas. Reg. § 1.911-7.

[309]The amount that can be excluded as foreign earned income is fixed by statute. Beginning in 2008, the $80,000 is indexed for inflation. IRC § 911(b)(2)(D). The term *foreign earned income* is defined in Treas. Reg. § 1.911-3(a). The qualified ''housing expenses'' are defined in Treas. Reg. § 1.911-4(b), and the calculation of the ''housing base amount'' is set forth in Treas. Reg. § 1.911-4(c). For a more detailed explanation of the IRC § 911 rules, see IRS Publication 54 (Tax Guide for U.S. Citizens and Resident Aliens Abroad).

[310]The individuals who qualify for the IRC § 911 exclusion are described in Treas. Reg. § 1.911-2.

[311]Treas. Reg. § 31.3401(a)(8)(A)-1. In order to avoid withholding, the employee must file with the employer a completed Form 673 (Statement for Claiming Benefits Provided by § 911 of the Internal Revenue Code).

[312]IRC § 3121(b).

If the U.S. institution operating through the foreign branch also employs foreign country nationals, there are no U.S. income tax obligations imposed on the foreign national employee and no U.S. tax withholding or reporting obligations imposed on the U.S. institution. This is because a nonresident alien is subject to U.S. income tax only on his or her ''U.S. source income,'' and payments received for personal services rendered by a nonresident alien outside the United States are considered under U.S. tax law to be ''foreign source income'' and not subject to U.S. income tax.[313] To the extent, however, that the foreign national employee comes to the United States to conduct any employment-related activities, the individual would be subject to U.S. income tax on the wages allocable to those activities, and the institution would be required to withhold U.S. income tax, unless the wage payment qualifies for an exemption under a tax treaty between the United States and the foreign country.[314] Likewise, foreign national employees are not subject to the U.S. Social Security taxes as long as their services are performed outside the United States; if, however, they conduct any activities in the United States, the Social Security tax provisions are applicable to both the employee and the employer-institution.[315]

Two final points regarding the employment by the U.S. institution of U.S. citizens or foreign nationals in the foreign country deserve mention. First, these individuals may be subject to the foreign country's income tax by reason of their conducting employment-related activities in that country. While they should be able to credit any foreign income taxes paid against their U.S. income tax liability, the fact that foreign income taxes have to be determined, foreign income tax returns have to be filed, and offsetting U.S. tax credits have to be computed are complicating factors for U.S. citizens working abroad. In addition, many countries have Social Security–type taxes,[316] and some countries have taxes on individuals residing and working in that country that have no U.S. counterpart. These taxes, if applicable, also have to be taken into account. Second, the local tax laws may impose an obligation on the part of the foreign employer (the U.S. institution) to withhold and pay over taxes to the local taxing authorities and file reports describing the nature and amounts of the payments made and the taxes withheld. In all cases in which a U.S. college or university makes wage payments to U.S. citizen or foreign national employees working in a foreign country, the institution must determine the extent to which it may have local tax withholding and reporting obligations. This can usually only be done by consultation with local accounting firms or legal counsel.

[313]IRC § 871 (limiting tax on nonresident aliens to U.S. source income); IRC § 861(a)(3) (setting forth the sourcing rule for personal services income).
[314]IRC § 861(a)(3).
[315]IRC § 3121(b).
[316]Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom.

(ii) Tax Consequences of Operating through a Local Legal Entity. If the U.S. college or university chooses to conduct its activities in the foreign country through a local legal entity of some type (e.g., a local nonprofit corporation), the U.S. and foreign national employees will, of course, be treated as employees of that legal entity.

Again, the U.S. citizen employees will be subject to U.S. income tax on the wages paid to them because of the U.S. practice of taxing its citizens on their worldwide income, regardless of the nationality of the employer. The U.S. citizen employees would still qualify for the section 911 ''foreign earned income'' exclusion, assuming they met either the ''residency'' or ''physical presence'' tests described above. One significant difference resulting from the fact that the employer is a foreign legal entity, however, is that the U.S. citizen employees would not be subject to the Social Security tax because that tax is only imposed on a U.S. citizen working overseas if the individual is working for a U.S. employer.[317] It may also be that the U.S. citizen will not be eligible to participate in a desired U.S.-based retirement plan because it is the practice of some retirement plans to limit participation to employees of U.S. employers only.[318]

The remaining tax issues—taxation of the U.S. citizen and foreign national employees in the foreign country, and the employer's local tax withholding and reporting obligations—are a matter of local tax law, and the U.S. institution contemplating operations in a foreign country through a local legal entity must use local accountants, or legal counsel, or both, to ensure that the legal entity, as the employer, and all its employees are aware of and in compliance with their local tax obligations.

§ 9.6 FORM 990 FILING ISSUES

Virtually all organizations that are exempt from income tax are required to file an annual information return with the IRS on Form 990.[319] The information required on the Form 990 is largely financial, but over the years the IRS has increasingly used the Form 990 to ask for ''self-audit'' operational information that indicates whether the organization (1) is still entitled to tax-exempt status, (2) has transformed itself into a private foundation, or (3) has engaged in any private benefit, private inurement, or intermediate sanction–type activities. A detailed explanation of how to complete the Form 990 is beyond the scope of this book, but there are other sources where good explanations can be found.[320]

[317]IRC § 3121(b).

[318]Although there is no legal prohibition against permitting employees working for a non-U.S. employer to participate in a U.S. retirement plan, some plans, including TIAA/CREF, limit participation to employees of U.S. institutions only.

[319]IRC § 6033.

[320]Obviously, the instructions to Form 990 should be consulted. The IRS has also included a detailed discussion of the Form 990 filing requirements in Internal Revenue Service, 2002

The law is clear that state institutions whose income is excluded from gross income under section 115 of the Code do not have to file Form 990,[321] but what about those state institutions that have also applied for and received tax-exempt status under section 501(c)(3)? The IRS answered this question in a 1995 ruling in which it determined that governmental units and affiliates of governmental units (both of these terms are defined in the ruling) are not required to file Form 990, even if they have been recognized as exempt from federal tax.[322] The ruling makes it clear, however, that the ruling does not apply to the requirement to file Form 990-T, the unrelated business income tax return.

Another Form 990 issue affecting colleges and universities relates to the public inspection requirements. For many years, all tax-exempt organizations have been required to make a copy of their Form 990 available to any individual for inspection at the organization's principal office during regular business hours for three years after the form is filed, to provide ''take-home'' copies of Forms 990, and provide copies in response to mail-in requests.[323] And in 2006, Congress expanded this disclosure requirement to include organization's unrelated business income tax return— Form 990-T.[324] A copy of the form must be provided immediately if the request is made in person and within 30 days if requested by mail, and an organization is able to charge a ''reasonable fee'' for copying and mailing the requested form.[325]

In 2000, the IRS issued regulations clarifying a number of different issues raised by these disclosure requirements.

A Description of the Documents that Must Be Disclosed: The documents that are subject to these new disclosure rules are applications for tax-exempt status, annual information returns (Form 990), unrelated business income tax returns (Form 990-T).[326]

Looking first at the exemption application, the different aspects of the application that must be disclosed are:

Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2002, at 227 (24th ed. 2001). *See also* Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 7th ed. (New York: John Wiley & Sons, Inc., 1998); Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures*, 3rd ed. (New York: John Wiley & Sons, Inc., 1999). Also, the IRS has posted on its web site a list of frequently asked questions regarding Form 990-T. *See www.irs.gov/charities/article/0*,,id = 156648,00.html.

[321]Treas. Reg. § 1.6033-2(g)(1)(v).

[322]Rev. Proc. 95-48, 1995-2 C.B. 418. For an example of a ruling in which the IRS relied on the principles of Rev. Rul. 95-48 in holding that an IRC § 501(c)(3) organization was not required to file Form 990 because it qualified as an affiliate of a governmental unit, *see* Priv. Ltr. Rul. 200607025 (Nov. 23, 2005).

[323]IRC § 6104(d)(1)(A) and (B).

[324]IRC § 6104(d)(1)(A)(ii).

[325]IRC § 6104(d)(1)(flush language).

[326]Treas. Reg. § 301.6104(d)-3(b)(4)(ii). This regulation also says that Form 990-T need not be disclosed, but this has been superseded by statute.

1. The application form (Form 1023 for section 501(c)(3) organizations)

2. All documents and statements that are required to be filed with the form

3. All statements and supporting documents submitted by the organization in support of the application (e.g., legal briefs in support of exemption and responses to questions asked by the IRS official processing the application)

4. Letters or documents issued by the IRS, such as letters requesting additional information and the exemption letter itself.[327]

The Form 990 must be an exact copy of the return that was filed with the IRS. Although the organization is also required to disclose all schedules, attachments, and supporting documents filed with the Form 990, it is not required to disclose the names or addresses of contributors to the organization.[328] In addition, the regulations make it clear that other related forms need not be disclosed, including 4720 (Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code).[329] An organization, however, does not have to disclose a Form 990 after the expiration of three years from the date that the return was required to be filed (including any extensions that were granted), or the date that the return was actually filed, whichever was later. Amended returns, however, must be disclosed for a period of three years from the date that the return was filed with the IRS.[330]

Although the rules set forth in the regulations do not specifically apply to the Form 990-T because the requirement to disclose this form was enacted after the regulations were promulgated, it is reasonable to apply the same general Form 990 disclosure principles to the Form 990-T, at least until such time as the IRS issues clarifying regulations.

In-Person Requests for Documents: The organization must make the applicable documents available for in-person public inspection at its principal place of business during regular business hours.[331] During the in-person inspection, the organization may have an employee present in the room, and the inspecting individual is permitted to take notes

[327]Treas. Reg. § 301.6104(d)-1(b)(3). These regulations do not cover the Form 990-T disclosure requirements because they were added to the Code after the regulations were promulgated.
[328]Treas. Reg. § 301.6104(d)-3(b)(4)(i).
[329]Treas. Reg. § 301.6104(d)-1(b)(4)(ii).
[330]Treas. Reg. § 301.6104(d)-1(b)(4)(iii).
[331]Treas. Reg. § 301.6104(d)-1(d)(1)(i).

and make photocopies of documents for a reasonable fee.[332] A fee is considered reasonable if it is no more than the per-page copying charge levied by the IRS, and the organization is permitted to require the person to pay the fee before making the copies.[333] The organization is required to inform the requester of the fee that will be charged for photocopying, and the organization must accept payment in cash or a money order. At its discretion, it may also accept payment in the form of credit cards or personal checks.[334]

An in-person request for copies must be fulfilled on the day that the request is made. If, however, the organization is not able to do so because of ''unusual circumstances,'' it must provide the copies no later than the next business day following the day that the unusual circumstance ceases to exist or the fifth business day after the date of the request, whichever occurs first. Unusual circumstances include, but are not necessarily limited to, receipt of such a volume of requests that exceeds the capacity to make copies; a request made shortly before the close of the business day and requiring extensive copying; or a request made on a day in which the organization's staff are conducting special duties (e.g., student registration) and may not be able to fulfill their normal administrative duties.[335]

If the organization fails to provide the documents as required, the responsible person for the organization may be liable for a penalty of $20 for each day that the disclosure requirement is not satisfied, up to a maximum of $10,000.[336]

Written Requests for Documents: The organization must honor a written request for documents that is addressed or delivered to the organization (including by facsimile or electronic mail) and includes the address to which the requested copies should be sent. The copies must be provided within 30 days from the date that the written request is received. If, however, the organization requires payments for copies in advance, it must provide the copies within 30 days from the date that it receives payment.[337]

A mailed request for documents (or a payment for copying) is considered received by the organization seven days after the date of the postmark, and requests submitted by electronic mail or fax are considered received on the day the request

[332]Treas. Reg. § 301.6104(d)-1(c)(1).
[333]Treas. Reg. § 301.6104(d)-1(d)(3)(i).
[334]Treas. Reg. § 301.6104(d)-1(d)(3)(iv).
[335]Treas. Reg. § 301.6104(d)-1(d)(1)(ii).
[336]Treas. Reg. § 301.6104(d)-1(d)(1)(iii) and (f)(3); IRC §§ 6652(c)(1)(C) and (D).
[337]Treas. Reg. § 301.6104(d)-1(d)(2)(i).

is transmitted. In determining the date that the organization provides the requested copies, the date of the postmark or the private mail delivery service controls. In addition, copies may be sent by electronic mail, but only if the requesting party consents. In such cases, the copies are deemed delivered on the date the message is transmitted.[338] With respect to an organization's ability to charge a reasonable copying fee, the same rules described earlier with respect to in-person requests apply to written requests, except that the organization must also accept a certified check and either a personal check or a credit card.[339]

Disclosure by Regional and District Offices: If a college or university is deemed to have a ''regional or district office,'' that office must satisfy the same disclosure rules as the school's principal office, except that the Form 990 need not be made available and copies of the Form 990 need not be provided until 30 days after the date the return is filed.[340] An office will be treated as a regional or district office if it has paid full-time or part-time employees who, in the aggregate, work at least 120 hours a week.[341] But even if the office meets this test, it will not be regarded as a regional or district office for disclosure purposes if (1) the services provided at the site further only exempt purposes, and (2) the site does not serve as an office for management staff, other than those persons managing the exempt-function activities at the site.[342]

Making Exemption Applications and Forms 990 ''Widely Available'' on the Internet: The regulations provide that an organization is not required to comply with these disclosure rules if it makes the exemption application and the Forms 990 ''widely available.''[343] At present, the only methods for an organization to meet this ''widely available'' safe harbor are to post them on its own or another organization's World Wide Web page on the Internet, or have the documents included as part of a database of similar documents of other tax-exempt organizations.[344]

To qualify under this safe harbor, the World Wide Web page must (1) clearly inform the readers that the documents are available, and provide downloading instructions; (2) reproduce the documents exactly as they were filed with the IRS (excluding any information that is exempt from public disclosure); and

[338]Treas. Reg. § 301.6104(d)-1(d)(3)(iii).
[339]Treas. Reg. § 301.6104(d)-1(d)(3)(ii)(B).
[340]Treas. Reg. § 301.6104(d)-1(e).
[341]Treas. Reg. § 301.6104(d)-1(b)(5)(i).
[342]Treas. Reg. § 301.6104(d)-1(b)(5)(ii).
[343]Treas. Reg. § 301.6104(d)-2(a).
[344]*Id.;* Treas. Reg. § 301.6104(d)-2(c).

(3) allow anyone with access to the Internet to download, view, and print the documents without special software or hardware and without the payment of a fee.[345] The regulations also require that the entity maintaining the World Wide Web page have in place procedures that ensure the reliability and accuracy of the documents posted and take reasonable precautions to prevent alteration, destruction, or accidental loss of the documents when posted. If a posted document is altered, destroyed, or lost, the entity must correct or replace the document.[346] Also, when the organization has posted the documents on the Internet, it must provide persons requesting the documents with the web site address, immediately if it is an in-person request and within seven days if it is a written request.[347]

One final point with respect to documents posted on the Internet: The organization must still allow in-person public inspection of the documents at its place of business even if they are otherwise made ''widely available'' on the Internet.[348]

Subordinate Organizations and Harassment Campaigns: The regulations also cover situations not normally found in the college and university context: when an organization to which a request is made is part of a group exemption issued to the organization's parent,[349] and when the organization is the subject of a harassment campaign that involves multiple requests for copies of the exemption application and Forms 990.[350]

§ 9.7 STATE COLLEGES AND UNIVERSITIES

(a) Introduction

In many respects, state colleges and universities are treated for tax purposes in the same manner as private educational institutions are treated. But certain tax issues are unique to state schools, while other issues have a particular twist when state colleges and universities are involved. While the special tax treatment of state institutions is briefly discussed in other sections of this book,[351] this chapter pulls these provisions together in one place and contains

[345]Treas. Reg. § 301.6104(d)-2(b)(1). A software format that meets these criteria is Portable Document Format (pdf). See Announcement 99-62, 1999-25 I.R.B. 13.
[346]Treas. Reg. § 301.6104(d)-2(b)(2)(iii).
[347]Treas. Reg. § 301.6104(d)-2(d).
[348]Treas. Reg. § 301.6104(d)-2(a).
[349]Treas. Reg. § 301.6104(d)-1(f).
[350]Treas. Reg. § 301.6104(d)-3.
[351]*See* § 4.5 (impact of § 218 agreements on employment tax liability); § 9.1 (obtaining tax-exempt status); § 9.6 (Form 990 filing issues); § 9.1(d) (intermediate sections).

an expanded discussion and analysis of the special tax rules affecting state colleges and universities.[352]

(b) Exemption Issues

(i) Section 115. Because state colleges and universities are, by definition, part of a state government, the threshold exemption issue that faces all state institutions is whether the income that they receive is exempt from federal income tax under section 115 of the Code. This section carves out an exclusion from gross income for ''income derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia.'' It is important to note that, unlike section 501(c)(3), which grants the organization tax-exempt status, section 115 focuses on the income that the state entity receives and provides that such income is not subject to tax. In other words, section 115 does not convert the state college or university into an ''exempt organization''; rather, the income that it receives is excluded from its gross income for federal tax purposes.

The IRS routinely issues rulings as to whether entities created by or closely related to a state government are subject to federal income tax and are eligible to receive tax-deductible contributions.[353] These and other rulings raise an issue often faced by state colleges and universities: under what circumstances, if any, can the IRS tax the income earned by a state-created entity?

At the outset, a common misconception is that the doctrine of intergovernmental immunity precludes the federal government from taxing income earned by a state entity. Though this was the case at one time, this doctrine has eroded over the years to the extent that the Supreme Court, in 1988, questioned whether there is any extent to which the states are immune from federal taxation.[354] A year later, the Court said that the rule now appears to be that if a legal entity is an integral part or a political subdivision of the state government, the federal government can tax its income-generating activities as long as Congress has made a ''plain statement'' to do so.[355]One example of such a ''plain statement'' is section 511(a)(2)(B), which imposes the unrelated

[352]For a comprehensive discussion of the tax treatment of state and local governmental entities, *see* April, ''The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates,'' *Exempt Organization Tax Review*, Feb. 1999, at 263.

[353]*See*, *e.g.*, Priv. Ltr. Rul. 200303025 (Oct. 2, 2002), holding that a state-created entity should be treated as a state instrumentality and, therefore, be eligible to receive tax-deductible contributions; Priv. Ltr. Rul. 200305005 (Sept. 27, 2002), holding that an organization formed by a state to manage a state university hospital and related facilities was a state instrumentality; Priv. Ltr. Rul. 200307065 (Nov. 5, 2002), holding that an entity created by a state governor's executive order, and later made a part of the executive branch by the state legislature, was an integral part of the state government; and Priv. Ltr. Rul. 200507008 (Nov. 10, 2004), holding that a nonprofit state-created corporation formed to operate a charter school was a state instrumentality, and therefore, its employees are exempt from certain employment taxes.

[354]*South Carolina v. Baker*, 485 U.S. 505, 518 n.11 (1988).

[355]*Will v. Michigan Dep't of State Police*, 491 U.S. 58, 65 (1989).

business income tax on state colleges and universities, regardless of whether they may be an integral part of the state government, a political subdivision, or have some other status vis-à-vis the state.

A review of the IRS position with respect to the taxation of state governmental entities indicates that it will not subject these entities to federal income tax under the following circumstances:[356]

- *The entity is an ''integral part'' of the state*. To qualify as an ''integral part'' of the state government, the IRS first determines whether the entity is a cognizable legal entity in its own right. If so, it cannot be treated as an integral part of the state government. In determining whether the entity is a separate legal entity for tax purposes, the IRS looks to whether it (1) was established by a state statute or executive order or organized as a separate enterprise under state law, (2) has its own governing body, and (3) has its own internal governing instrument. If the entity is not a separate legal entity, the IRS looks at all the facts and circumstances to make an integral-part determination, the most important of which are the extent of state control over the entity and the state's financial commitment to the entity.
- *The entity is a political subdivision of the state*. The IRS says that a political subdivision is a separate legal entity that has been given the right to exercise at least one of three sovereign powers: the power to tax, the power of eminent domain, or police power.[357]
- *The entity is exempt from tax under section 501(a)*. This category of tax-exempt state entities includes traditional tax-exempt organizations under section 501(c)(3) as well as employee retirement plans described in section 401(a). Also, for the IRS to agree to grant tax-exempt status under section 501(a), the entity must be a legal entity separate from the state. See also the discussion in subsection (b)(ii).
- *The entity's income is excluded from gross income under section 115*.

Turning to section 115, the statute sets up two criteria in order for a state college's or university's income to qualify for the exclusion: First, the income must be derived from the exercise of an ''essential governmental function'' and, second, the income must accrue to the state itself.

With respect to the essential governmental function test, the Tax Court has held that this test is met when the activity is essential to the execution of the state's governmental functions and one that a state can only do itself.[358]

[356]These rules are described in 1996 FSA LEXIS 358.

[357]*See* Rev. Rul. 77-165, 1977-1 C.B. 21; *Philadelphia Nat'l Bank v. United States*, 666 F.2 d 834 (3 d Cir. 1981).

[358]*Troy State Univ. v. Commissioner*, 62 T.C. 493 (1974). *See also* Priv. Ltr. Rul. 200201001 (Sept. 20, 2001), holding that a fund established by a state government to hold and invest antitrust-related settlement funds is performing an essential governmental function.

However, those activities conducted by a state that are of a ''private character'' are not essential governmental functions.[359] To help illustrate this distinction, the court quoted from a 1911 Supreme Court decision:

> It is no part of the essential governmental functions of a State to provide means of transportation, supply artificial light, water and the like. These objects are often accomplished through the medium of private corporations, and, though the public may derive a benefit from such operations, the companies carrying on such enterprises are, nevertheless, private companies, whose business is prosecuted for private emolument and advantage. For the purpose of taxation they stand upon the same footing as other private corporations upon which special franchises have been conferred.[360]

The IRS has also discussed the types of activities that it believes should be treated as essential governmental functions in a technical advice memorandum involving a state university that provided utility services (telephone, electricity, and water) to the general public and, in addition, operated a hotel that was open to the general public.[361] In this ruling, the IRS accepted the fact that the state school's public education activities were an essential governmental function but, after quoting the same passage from the 1911 Supreme Court opinion, said that ''the provision [by a state university] of telephone, electricity, water and hotel services to the general public [does not constitute] the performance of activities essential to the preservation of the state as a sovereign entity.'' Thus, the IRS said that income derived by the state university from these activities was not exempt under section 115.

The second section 115 requirement— that the income must ''accrue'' to the state—can come into play when the income in question is not earned by a state but rather by a corporation (or other legal entity) that is owned by the state. In one case, the Tax Court said that because a corporation is considered a legal entity separate from its shareholders, the earnings of the corporation do not accrue to the shareholders, and ''when a corporation is owned by a State or political subdivision, its earnings do not 'accrue' to that State or political subdivision even if dividends have been declared.''[362]

Because section 115 only applies to states and their subdivisions, one final issue that can arise in determining whether a state college or university's income can be excluded under section 115 is whether the institution is a subdivision or an integral part of the state. In one ruling, the IRS determined that a state university was an integral part of a state because of ''the public purposes of the state university system, the control and financing of the system

[359] *Id*. at 500.

[360] *Flint v. Stone Tracy Co*., 229 U.S. 107, 172 (1911).

[361] Tech. Adv. Mem. 7904006 (n.d.).

[362] *Troy State Univ. v. Commissioner*, 62 T.C. 493, 498 (1974). The Court made a similar holding in a case involving a utility company that was owned by the University of California. *Bear Gulch Water v. Commissioner*, 40 B.T.A. 1281 (1939), *aff'd*, 116 F.2 d 975 (9th Cir. 1941). For a discussion of how the IRS applies the principles of IRC § 115, *see* Priv. Ltr. Rul. 200318058 (Jan. 24, 2003).

by the state and the existence of the regulatory powers and power of eminent domain accorded to the system by the state.''[363] One would expect that most state institutions would likewise be able to clear this hurdle, but as will be discussed below, if the state college or university is too integrated into the state government, it may not be able to qualify for exemption under section 501(c)(3).

(ii) Section 501(c)(3). The other method by which a state college or university can be exempt from federal income tax is to obtain official qualification as a tax-exempt organization under section 501(c)(3), and the IRS would routinely grant tax-exempt status to any state college or university that applied for such status.[364]

Many state institutions that qualify for the section 115 income exclusion have also opted to apply for and obtain official recognition as a tax-exempt organization under section 501(c)(3). Thus, state institutions that have been granted section 501(c)(3) status have two bases for not paying federal income tax—their income is excluded under section 115, and they are exempt from taxation under section 501(c)(3). It is not always clear why these schools choose to obtain both exemption qualifications, but in most instances the primary reason seems to involve a perception by the institution that having section 501(c)(3) status will make it easier to obtain tax-deductible contributions from donors.[365]

At one time, the IRS took the position that those state institutions that had their own section 501(c)(3) status remained subject to the section 4958 intermediate sanctions provisions that impose a 25 percent excise tax on ''excess benefit transactions'' between a section 501(c)(3) organization and officers, directors, and other persons having substantial influence over the affairs of the organization. In final regulations issued in 2002, however, the IRS reversed its position and held that state colleges and universities that look to section 115 for their exemption are not subject to the section 4958 intermediate sanctions provisions, regardless of whether the school is also exempt under section 501(c)(3).[366] This same issue has arisen in connection with the 2006 legislation requiring tax-exempt organizations to disclose their unrelated business income tax returns, Form 990-T.[367] Here, the result may be different since that statute requires all organizations that are recognized as exempt under section 501(c)(3) must disclose the form. There is no carve-out for state colleges and universities with section 501(c)(3) status; therefore, unless and until the IRS rules to the contrary, these state institutions will likely be required to disclose their Forms 990-T.

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[363]Tech. Adv. Mem. 7904006 (n.d.).

[364]This will be true unless, as discussed below, the institution does not have a sufficient ''counterpart'' existence.

[365]*See* Chap. 6.

[366]Treas. Reg. § 53.4958-2(a)(1). *See* § 9.1.

[367]IRC § 6104(d)(1)(A)(ii). See the discussion of this issue at § 9.6.

The IRS takes the position that a state itself cannot qualify for federal tax exemption because its powers are broader than those contemplated by section 501(c)(3).[368] Thus, a state subdivision or entity likewise cannot qualify for section 501(c)(3) status if it is such an integral part of the state government that it should be treated for tax purposes as inseparable from the state itself. On the other hand, if the IRS determines that the state institution has a sufficient ''counterpart'' existence of its own, it can be recognized as exempt under section 501(c)(3). In making this ''counterpart'' determination, the IRS generally applies three tests:

1. Whether the institution is separately incorporated
2. Whether the institution is part of a state or municipal government
3. Whether the institution possesses sufficient regulatory powers as to be regarded as part of a state or municipal government[369]

Looking at the first test, the IRS has said that when a state college or university is not a separate legal entity from the state, but is an integral part of the state government, it cannot qualify for exemption under section 501(c)(3) because it is essentially the state itself and, as such, has purposes broader than those contemplated by section 501(c)(3).[370] On the other hand, if the school is separately organized, it may be able to qualify under section 501(c)(3), provided that it is not ''clothed'' with powers that extend beyond those described in section 501(c)(3).[371]

The second test is a variation of the first and goes to the manner in which the entity was created by the state. For example, the IRS held in one ruling that a committee that was created as an ''official agency of the state'' was part of the state government and therefore could not qualify under section 501(c)(3).[372]

Finally, with respect to the ''regulatory powers'' test, the issue is whether the entity is vested with such broad regulatory powers that it is essentially a state political subdivision that is capable of conducting activities outside the scope of section 501(c)(3). In a 1977 ruling, the IRS identified the regulatory powers that, if granted to a state entity, can cause the entity to be treated as a state political subdivision—the power to tax, the power of eminent domain, and police power. The ruling involved a state university that had police power, but only on campus, as well as a limited power of eminent domain. The IRS held that because the university had no power to tax and because its police power and eminent domain authority were limited, it was not a

[368] *Estate of Slayton v. Commissioner*, 3 B.T.A. 1343 (1926).
[369] *See* § 9.1.
[370] Rev. Rul. 60-384, 1960-2 C.B. 172. See also Gen. Couns. Mem. 34,502 (May 21, 1971).
[371] *See* § 9.1(a).
[372] Rev. Rul. 62-66, 1962-1 C.B. 83. See also Rev. Rul. 87-2, 1987-1 C.B. 18; Gen. Couns. Mem. 39,004 (June 28, 1983).

political subdivision for tax-exempt bond purposes.[373] Presumably, although the ruling did not expressly so state, the university could have qualified for section 501(c)(3) status had it applied.

The Treasury regulations provide that one of the types of activities deemed to be charitable under section 501(c)(3) is an activity that ''lessens the burdens of government.''[374] State colleges and universities that are exempt under section 501(c)(3) are sometimes concerned that a particular nontraditional activity may jeopardize its exempt status or lead to an application of the unrelated business income tax. In some cases, these institutions may be able to argue that the activity is in furtherance of charitable or educational purposes because it lessens the burdens of government. Although private colleges and universities can theoretically make the same contention, from a practical standpoint, state educational institutions have a much greater likelihood of successfully advancing such an argument.

For an activity to be seen as lessening the burdens of government, the IRS requires that the activity in question be one that a governmental unit considers to be its burden; there must be an ''objective manifestation'' by the governmental unit that this is the case.[375] The facts that the government may undertake the activity in question itself from time to time, or that a governmental official states that the activity is a governmental burden, are in and of themselves insufficient. This test can be met by an activity that directly performs a normal governmental function, such as preserving a public lake[376] or beautifying a city,[377] or an activity that provides a service in cooperation with an existing government agency, such as assisting firefighters and police[378] or providing bus service to isolated areas of the community.[379]

Although most colleges and universities conduct activities that qualify under section 501(c)(3) as educational or scientific in nature, to the extent that an institution engages in more nontraditional activities that do not fit within the normal educational/scientific mold, it is worth considering whether the activity might fall within the ambit of section 501(c)(3) by lessening the burdens of government.

(c) Unrelated Business Income Tax Issues

For the most part, state colleges and universities are subject to the same unrelated business income tax rules as are private educational institutions,

[373]Rev. Rul. 77-165, 1977-1 C.B. 21. *See also* Rev. Rul. 67-290, 1967-2 C.B. 183; Priv. Ltr. Rul. 200619024 (Feb. 16, 2006).
[374]Treas. Reg. § 1.501(c)(3)-1(d)(2).
[375]Rev. Rul. 85-1, 1985-1 C.B. 177; Rev. Rul. 85-2, 1985-2 C.B. 178.
[376]Rev. Rul. 70-186, 1970-1 C.B. 128.
[377]Rev. Rul. 68-14, 1968-1 C.B. 243.
[378]Rev. Rul. 71-99, 1971-1 C.B. 151.
[379]Rev. Rul. 78-68, 1978-1 C.B. 149.

even if the state institution is not officially recognized by the IRS as exempt under section 501(c)(3). Because of the general perception that the unrelated business income tax is imposed only on ''tax-exempt'' organizations,[380] some have suggested that perhaps the tax cannot be imposed on those state colleges and universities that have never received official tax-exempt recognition under section 501(c)(3). But Congress plugged this potential loophole by specifically providing that the unrelated business income tax, in addition to applying to tax-exempt organizations, also extends to nonexempt state colleges and universities, including corporations that may be wholly owned by a state institution.[381]

Even though, from a legal standpoint, state colleges and universities stand on the same unrelated business income tax footing as do private institutions, there are at least two aspects to the manner in which many state institutions are organized and operated that may give them some additional protection against imposition of the unrelated business income tax.

First, the state itself normally has a strong interest in avoiding situations in which the state college or university is perceived as conducting noneducational activities that are in competition with for-profit enterprises. This type of competition can run the gamut from selling computers to sponsoring public entertainment events. Thus, it is not unusual to find a state statute, regulation, or board of trustees or regents policy that prohibits the state college or university from engaging in activities that compete with business enterprises.[382] While the existence of such a statute, regulation, or policy does not mean, of course, that the state institution might not in some instances act beyond the scope of the restriction, the existence of such a rule itself can be helpful in convincing the IRS that income from a particular activity should not be taxable. Even when the school conducts an activity that arguably competes with private enterprise, the existence of a state restriction against doing so can be used as evidence that the school did not conduct the activity with the primary purpose of earning a profit and therefore that the activity does not rise to the level of a ''trade or business.''[383]

The second advantage that a state institution may have in avoiding the unrelated business income tax relates to a potential argument that one of the school's missions (in addition to providing education) is to benefit the community.[384] If a school can successfully argue that ''community benefit'' is one of its exempt purposes, it might be able to contend that those activities

[380] *See* IRC § 511(c)(2)(A), which imposes the tax on all categories of tax-exempt organizations, including pension plans.
[381] IRC § 511(a)(2)(B).
[382] *See*, *e.g.*, N.C. Gen. Stat. § 66-58 (1993).
[383] *See* § 2.1(a)(i).
[384] *See* § 2.1(c).

in which members of the general public are eligible to participate (use of recreational facilities, parking, and so forth) are, in fact, related to the school's ''community benefit'' purpose. If so, the income from the activity would not be subject to tax because the activity is a related one. As a general rule, it would seem that a state institution would have an easier time in successfully showing that community benefit is one of its exempt purposes than would a private institution, although, given the right set of facts, a private school could also make such a showing. Also, it may be that community benefit is specifically mentioned in the legislation or other state action that first established the state institution. If so, and if the institution itself recognizes through its own internal policies that it has a community benefit mission, it may be able to pull within the ''related'' umbrella certain activities that, if conducted by other institutions, would be treated as unrelated.

(d) Employment Taxes

There are three different types of employment taxes imposed on educational institution employees—(1) wage withholding taxes, (2) Social Security (or FICA) taxes, and (3) federal unemployment (or FUTA) taxes.[385] State colleges and universities are subject to the same wage withholding taxes as apply to private institutions, but there are significant differences as to how the FICA and FUTA taxes apply.

State institutions are also subject to the same rules that are used to distinguish employees from independent contractors.[386] In this connection, the IRS ruled that elected state officials should always be treated as state employees because they can be removed from office by a supervisor or the general public; appointed state officials can be either state employees or independent contractors depending on the facts and circumstances.[387]

(i) FICA Taxes. Whether and to what extent FICA tax is imposed on a state employee's wages depends on the type of services that are performed, when the services began, and whether the person performing the services is covered by a state retirement program.

As a general rule, all services performed by a state employee are subject to the old age, survivor, and disability portion of the FICA tax,[388] unless the employee participates in a state-sponsored retirement program, in which case the individual is not subject to this portion of the FICA tax.[389] For these purposes, a state retirement program includes any pension, annuity, or similar

[385]For a more detailed description of these taxes, *see* § 4.1.
[386]*See* § 4.2.
[387]CCA 200113024 (Jan. 29, 2001).
[388]*See* § 4.5.
[389]IRC § 3121(b)(7)(F); Treas. Reg. § 31.3121(b)(7)-2(b).

program that provides certain minimum retirement benefits.[390] Even if the state employee is exempt from this portion of the FICA tax, the employee is still subject to the Medicare insurance portion, but only if the employment commenced (or recommenced) after March 31, 1986.[391] The IRS chief counsel's office held, however, that wages earned by state employees who, after they became eligible for retirement, elected to continue working and have their state retirement benefits paid into a separate plan are not subject to FICA tax, because they are still considered to be participants in the state retirement system and therefore are exempt from FICA tax.[392]

Even if the state employees are exempt from Social Security coverage under these rules, they may still be brought under the Social Security system (and required to pay FICA tax) pursuant to a voluntary coverage agreement entered into between the state and the Social Security Administration.[393] Under these agreements (known as ''section 218 agreements'' because they are authorized under section 218 of the Social Security Act), the state decides which categories of employees are to be covered by Social Security, and the agreement designates the specific ''coverage groups'' to which the agreement will apply.[394] Employees not included within a coverage group are not subject to FICA tax and do not obtain the benefits of the Social Security system.

There are two basic types of coverage groups—employees whose positions are not covered by the state retirement system,[395] and those employees who are already covered by the state retirement system.[396] The latter group can be brought under a section 218 agreement only if a majority of the members in the state retirement system vote for such coverage.[397] Notwithstanding these general rules, there are certain specific categories of persons to whom Social Security coverage cannot be extended by a section 218 agreement,[398] as well as categories of employees whom the state may, at its option, exclude.[399]

The section 218 agreements generally mirror the federal Social Security provisions and usually contain, for example, the same exemptions for student employees and nonresident alien employees. But this is not always the case, and certain states do not have a student FICA exception as part of their

[390]These minimum benefits are set forth in Treas. Reg. § 31.3121(b)(7)-2(e). *See also* Rev. Proc. 91-40, 1991 2 C.B. 697, which sets forth different formulas that can be used to determine whether these tests are met.
[391]IRC § 3121(v)(2). *See also* Rev. Rul. 88-36, 1988-1 C.B. 343; and Rev. Rul. 86-88, 1986-2 C.B. 172.
[392]ILM 199912001 (Nov. 6, 1998).
[393]*See* § 4.5.
[394]42 U.S.C. § 418(e).
[395]42 U.S.C. § 418(b)(5).
[396]42 U.S.C. § 418(d)(6).
[397]*Id*.
[398]42 U.S.C. § 418(c)(6).
[399]42 U.S.C. § 418(c).

section 218 agreement.[400] Regulations issued by the Social Security Administration provide that section 218 agreements cannot cover ''services other than agricultural labor or student services that would be excluded if performed for a private employer.''[401] This means that services performed by nonresident aliens on F, J, M, and Q visas cannot be covered under a section 218 agreement, even if the agreement is silent with regard to such individuals.

Finally, it is important to note that since 1983, section 218 agreements entered into between a state and the Social Security Administration cannot be terminated by either party with respect to any coverage group.[402]

(ii) FUTA Taxes. Services performed by state employees are entirely exempt from the FUTA tax.[403] Most services are, however, covered by the state's unemployment insurance program. In order for a state to be able to reduce its federal unemployment tax liability by the credits allowed for contributions to state unemployment funds, the states are required to provide unemployment benefits to virtually all categories of employees.[404]

(e) State College and University Systems—Who Is the Taxpayer?

Many state colleges and universities are organized on a ''system'' basis, with different campuses located in different cities around the state. There are three different organizational possibilities for these state systems. First, each campus could be a separate legal entity in its own right; second, the system could have a single main campus that is a legal entity, with each other campus operating as an integral part of the main campus; and finally, none of the campuses could be a separate legal entity, with all campuses operating as integral parts of the state government.

In these state system situations, it is important to know which (if any) of the various campuses are ''taxpayers'' for federal income tax purposes because this will impact such matters as who has to file Form 941 (the employer's

[400] At the end of 1998, Congress enacted a new statute permitting those states whose section 218 agreements did not provide for a student-employee exclusion to unilaterally modify their section 218 agreements to exclude students-employees from FICA tax coverage (Pub. L. No. 105-277, § 2023, 112 Stat. 2681-904, 1998). The amendment must have been made between January 1 and March 31, 1999, and will be effective for services performed after June 30, 2000.

[401] SSA Federal Old-Age, Survivors and Disability Insurance Rule, 20 C.F.R. § 404.1209(e). *See also* Priv. Ltr. Rul. 200123001 (Nov. 15, 2000), in which the IRS ruled that students who are enrolled and attending classes at a state university and working for an IRC § 509(a)(3) organization operated to support the state university are eligible for the student FICA exception because these services qualified under the state's section 218 agreement.

[402] 42 U.S.C. § 418(g).

[403] IRC § 3306(c)(7).

[404] IRC § 3304(a)(6)(A). Some categories can be excluded, however. These are set forth in IRC § 3309(a) and (b).

quarterly tax return on which wage and FICA withholding is reported), who should obtain employer identification numbers, and who can file claims for refunds of overpaid taxes.

Looking, for example, at who is required to withhold federal income and FICA tax, this responsibility is imposed by the Code on the ''person'' making the payment of wages—generally, the employer.[405] The term *person* is defined as an individual, trust, estate, partnership, association, company, or corporation.[406] Thus, in order to be required to withhold federal income and FICA tax, the payor must be a legal entity of some type. In those situations where only the main campus is a legal entity, and the other campuses are part of the main campus (akin to divisions of a corporation), only the main campus is the ''person'' who is required to withhold the federal income and FICA taxes and is the only ''person'' who can file Form 941. The IRS addressed a similar issue in a 1976 ruling involving a corporation that had employees working at a number of different divisions around the country.[407] The question was whether Form 941 should be filed by each different division or whether it had to be filed by the corporation. The IRS said that ''even though a corporation may be composed of different divisions in different locations, it is only one taxpayer.'' Relying on a regulation that says only one return can be filed by one taxpayer for a particular period,[408] the IRS ruled that only the corporation, and not each division, should file Form 941. A similar result pertains in those cases where it is the state that is the only taxpayer, with all of the campuses operating as integral parts of the state government. In these situations, Form 941 should be filed by the state, not by the individual campuses.

This can have an impact on the filing of refund claims. For example, when the IRS published its student FICA guidelines, it opened up the possibility for those schools that had overpaid student FICA taxes in earlier years to file claims for refunds of those taxes.[409] The question is, who is the taxpayer that is entitled to file the refund claim? If, for example, a state is the only taxpayer and files Forms 941 on behalf of all of the state campuses, then it should be the state that must file the refund claim, not an individual campus that may have overpaid student FICA taxes. There are reportedly situations where, for whatever reason, some campuses in a state system overpaid student FICA taxes, while other campuses in the same system underpaid student FICA taxes for the same time period. In these situations, it would seem that if the state were to file a claim for a refund, it would have to offset any refund claim for some campuses by the underpayment at the other campuses.

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[405] *See* IRC § 3402(a)(1) (wage withholding), and IRC § 3121(b) (FICA tax withholding).
[406] IRC § 7701(a)(1).
[407] Rev. Rul. 76-79, 1976-1 C.B. 370.
[408] Treas. Reg. § 31.6011(a)-7.
[409] *See* § 4.3 for a discussion of the student FICA guidelines.

In any event, this is a complicated area, caused in no small part by trying to determine under state law whether a particular campus is a legal entity for tax purposes. This will depend on how the campus was created by the state legislature, and whether and to what extent the campus, from an organizational standpoint, possesses the characteristics of a separate, taxable entity—associates, an objective to carry on a business and divide the profits, continuity of life, centralization of management, limited liability for debts, and free transferability of interests.[410]

§ 9.8 EDUCATION TAX INCENTIVES

As part of the Taxpayer Relief Act of 1997, Congress enacted a number of ''education tax incentive'' provisions to the Internal Revenue Code, which are briefly described below.

(a) HOPE Scholarship and Lifetime Learning Credits

These are separate elective income tax credits that can be claimed for ''qualified tuition and related expenses'' (essentially, tuition and fees, but not room, board, and travel). The first of these tax credits, the HOPE Scholarship credit, can be claimed for qualified education expenses incurred during the first two years of a taxpayer's postsecondary education (or such education of the taxpayer's spouse or dependent).[411] This credit is available for up to 100 percent of the first $1,000 and 50 percent of the next $1,000 of qualified tuition and related expenses paid during the taxable year.[412] The credit is available only for students enrolled in an educational institution and carrying at least one-half of the workload of a full-time student.[413]

The second tax credit for qualified tuition and related expenses, called the Lifetime Learning credit, is equal to 20 percent of up to $5,000 of expenses ($10,000 for tax years after 2002).[414] Unlike the HOPE Scholarship credit, the Lifetime Learning credit can be claimed at any time and is available for both undergraduate and graduate education expenses.

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[410]Treas. Reg. § 301.7701-2. *See also Barnette v. Commissioner*, 63 T.C.M. (CCH) 3201 (1992), in which the Tax Court used these factors to determine that an entity was a separate legal entity, not a branch of an existing corporation. The organization in question also maintained its own books and had its own employees. Both the regulation and the Tax Court case, however, assume that the entity in question is organized on a for-profit basis. In analyzing potential nonprofit legal entities, it would seem that at least two of these attributes—(1) objective to carry on a business and divide the profits, and (2) free transferability of interests—would likely have to be modified or ignored.

[411]IRC § 25A(b).

[412]*Id*.

[413]IRC § 25A(b)(3).

[414]IRC § 25A(c)(1).

The maximum amount of both the HOPE Scholarship and Lifetime Learning tax credits is subject to inflation adjustments[415] and certain phase-out rules for taxpayers who with adjusted gross income over certain amounts.[416]

When the person attending the institution is a dependent, both of these tax credits provide that if the person claiming the tax credit is someone other than the student (usually the student's parents), the dependent student cannot claim the credit.[417] Also, shortly after the enactment of these provisions, the IRS issued guidance in a question-and-answer format as to how these tax credits, as well as a number of other ''education incentive'' provisions, are to be implemented.[418] And in 2002, the IRS issued final regulations that further clarify and explain these tax credits.[419]

While educational institutions have an obvious interest in ensuring that their students (and their students' parents) fully understand and are able to take advantage of these new tuition tax credits, of more immediate concern for colleges and universities are the reporting requirements that Congress enacted as part of this legislation. These reporting requirements are set forth in section 6050 S and generally require that the institution report the following to the IRS and the student:

- The name, address, and taxpayer identification number of the student
- The aggregate amount of payments received or billed for qualified tuition and related expenses with respect to the student
- The aggregate amount of grants received by the student for payment of costs of attendance at the institution and administered and processed by the institution during the year
- The amount of any adjustments to the aggregate amounts under the previous two requirements
- The aggregate amount of any reimbursements or refunds paid to the student during the year
- Any other information prescribed by the IRS[420]

[415]IRC § 25A(h).
[416]IRC § 25A(d).
[417]IRC § 25A(g)(3). In ILM 200236001 (Dec. 18, 2001), the IRS Chief Counsel's office held that a student who filed as a single taxpayer and claimed a HOPE Scholarship tax credit on his return was entitled to the credit even though his parents filed a joint return and could have claimed the student as a dependent. The fact that they did not do so meant that he could claim the credit on his own return.
[418]IRS Notice 97-60, 1997-46 I.R.B. 8. These procedures were extended by IRS Notice 98-46, 1998-36 I.R.B. 21.
[419]Treas. Reg. §§ 1.25A-1 et seq. See also Coven, ''Who Should Be Entitled to Claim the New Education Credits,'' *Exempt Organization Tax Review*, Dec. 1999, at 383.
[420]IRC § 6050 S(b)(2).

Under these rules, a school may choose whether to report the amount paid by a student or the amount billed to the student.[421] Once a school decides to use one of these methods, however, it must continue to do so unless it obtains permission from the IRS to change.[422]

In addition, no reporting is required with respect to noncredit courses.[423] An example in the regulations illustrates this reporting exception:

> Student A, a medical doctor, takes a course at University X's medical school. Student A takes the course to fulfill State Y's licensing requirement that medical doctors attend continuing medical education courses each year. Student A is not enrolled in a degree program at University X and takes the medical course through University X's continuing professional education division. University X does not offer credit toward a post-secondary degree on an academic transcript for the completion of the course but gives Student A a certificate of attendance upon completion. University X is not subject to the information reporting requirements of section 6050S for the medical education course taken by Student A.[424]

The regulations also provide that an institution is required to report qualified tuition and related expenses with respect to payments received from (or amounts billed to) a nonresident alien only if the person requests the school to report such payments, and the school must honor that request for the calendar year in which it is made.[425] This means that the nonresident alien must request reporting on an annual basis; a single reporting request is not valid for any year other than the year it is made.

Any reimbursement or refund made with respect to a student during a calendar year is treated as a reimbursement or refund of qualified tuition and related expenses up to the amount of any reduction in charges for those expenses. For these purposes, a reimbursement or refund includes both amounts distributed to the student and any credits made to his or her account. The IRS illustrates these principles with the following four examples:

> **Example 1:** In early August 2003, University X bills enrolled Student A $10,000 for qualified tuition and related expenses and $6,000 for room and board for the 2003 fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 fall semester. In late September 2003, University X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses. In late September 2003, University X applies the $5,000 positive account balance toward current charges. The $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. The $5,000 credited to the student's account is treated as a reimbursement or refund of payments for qualified tuition and related expenses

[421] IRC § 6050S(b)(2)(B)(i).
[422] Treas. Reg. § 1.6050S-1(b)(1).
[423] Treas. Reg. § 1.6050S-1(a)(2)(ii).
[424] Treas. Reg. § 1.6050S-1(a)(2)(ii)(C).
[425] Treas. Reg. § 1.6050S-1(a)(2)(i).

because the current year charges for qualified tuition and related expenses were reduced by $5,000. University X is required to net the $10,000 payment received for qualified tuition and related expenses during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, [University] X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 2: The facts are the same as in Example 1 except that Student A pays the full $16,000 in late August 2003. In late September 2003, University X reduces the tuition charges by $5,000 and issues a $5,000 refund to Student A. The $16,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. The $5,000 refund is treated as reimbursement or refund of payments for qualified tuition and related expenses because the current year charges for qualified tuition and related expenses were reduced by $5,000. University X is required to net the $10,000 payment received for qualified tuition and related expenses during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, [University] X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 3: The facts are the same as in Example 1 except that Student A is enrolled full-time, and, in early September 2003, Student A decides to live at home with her parents. In late September 2003, University X adjusts Student A's account to eliminate room and board charges and issues a $1,000 refund to Student A. The $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. The $1,000 refund is not treated as reimbursement or refund of payments for qualified tuition and related expenses because there is no reduction in charges for qualified tuition and related expenses. Therefore, under paragraph (b)(2)(iii) of this section, University X is required to report $10,000 of payments received for qualified tuition and related expenses during 2003.

Example 4: In early December 2003, College Y bills enrolled Student B $10,000 for qualified tuition and related expenses and $6,000 for room and board for the 2004 spring semester. In late December 2003, Student B pays 16,000. In mid-January 2004, after the 2004 spring semester classes begin, Student B drops to half-time enrollment. In mid-January 2004, College Y credits Student B's account with $5,000, reflecting a $5,000 reduction in charges for qualified tuition and related expenses, but does not issue a refund to Student B. In early August 2004, College Y bills Student B $10,000 for qualified tuition and related expenses and $6,000 for room and board for the 2004 Fall semester. In early September 2004, College Y applies the $5,000 positive account balance toward Student B's $16,000 bill for the 2004 fall semester. In late September 2004, Student B pays $6,000 toward the charges. In the reporting for calendar year 2003, the $16,000 payment in December 2003 is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2003. In addition, College Y is required to indicate that the payments reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

In the reporting for calendar year 2004, the $5,000 credited to Student B's account is treated as a reimbursement or refund of qualified tuition and related expenses because the charges for qualified tuition and related expenses were reduced by 5,000. The $5,000 reimbursement or refund of qualified tuition and related expenses must be separately reported on Form 1098-T because it relates to payments of qualified tuition and related expenses reported by College Y for 2003. The $5,000 positive account balance that is applied toward charges for the 2004 fall semester is treated as a payment. Therefore, College Y received total payments of $11,000 during 2004 (the $5,000 credit plus the $6,000 payment). The $11,000 of total payments are treated as a payment of qualified tuition and related expenses up to the $10,000 billed for such expenses. Therefore, for 2004, College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2004 and a $5,000 refund of payments of qualified tuition and related expenses reported for 2003.[426]

If a school elects to report qualified tuition and related expenses under the ''amount billed'' method, it must net the amounts billed against any reductions in charges made during the calendar year that relate to amounts billed during that year.[427] In addition, the school must separately report on Form 1098-T any reductions in charges made during the calendar year that relate to amount billed and reported for a prior year. These amounts cannot be netted against amounts billed for the current year. The IRS illustrates these rules with the following two examples:

> **Example 1:** In early August 2003, University X bills enrolled Student A $10,000 for qualified tuition and related expenses and $6,000 for room and board for the 2003 fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 Fall semester. In late September 2003, University X adjusts Student A's account and reduces the charges for qualified tuition and related expenses by $5,000 to reflect half-time enrollment. In late September 2003, University X applies the $5,000 account balance toward current charges. University X is required to net the $10,000 amount of qualified tuition and related expenses billed during 2003 against the $5,000 reduction in charges for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 in amounts billed for qualified tuition and related expenses during 2003.
>
> **Example 2:** The facts are the same as in Example 1 except that, in early December 2003, College X bills Student A $10,000 for qualified tuition and related expenses and $6,000 for room and board for the 2004 spring semester. In early January 2004, Student A pays 16,000. In mid-January 2004, after the 2004 spring semester classes begin, Student A drops to half-time enrollment. In mid-January 2004, College X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses but does not issue a refund check to Student A. In early August 2004, College X bills Student A $10,000 for qualified tuition

[426]Treas. Reg. 1.6050 S-1(b)(2)(vii).
[427]Treas. Reg. 1.6050 S-1(b)(3)(iii).

and related expenses and $6,000 for room and board for the 2004 fall semester. In early September 2004, College X applies the $5,000 positive account balance toward Student A's $16,000 bill for the 2004 fall semester. In late September 2004, Student A pays $6,000 toward the charges. In the reporting for calendar year 2003, College X is required to report $15,000 billed for qualified tuition and related expenses during 2003 ($5,000 for the 2003 Fall semester and $10,000 for the 2004 Spring semester). In addition, College X is required to indicate that some of the amounts billed for qualified tuition and related expenses reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

In the reporting for calendar year 2004, the $5,000 reduction in charges for qualified tuition and related expenses must be separately reported on Form 1098-T because it relates to amounts billed for qualified tuition and related expenses that were reported by College X for 2003. College X is required to report $10,000 in amounts billed for qualified tuition and related expenses during 2004.[428]

(b) Education Income Exclusion

As an alternative to claiming either the HOPE Scholarship or Lifetime Learning tax credits, a taxpayer may instead elect to exclude from income amounts withdrawn from a Coverdale education savings account (discussed below) that are used to pay the qualified education expenses of the taxpayer or the taxpayer's spouse or dependents.[429] This income exclusion, however, is not available for any year in which either the HOPE Scholarship or Lifetime Learning tax credits were claimed.[430] The types of expenses that qualify for this exclusion are much broader than those allowed for the two tax credits and include not only tuition and related fees but also room and board and books.[431]

(c) Coverdale Education Savings Accounts

Since 1998, taxpayers have been able to establish and make contributions to Coverdale education savings account, which are trusts created solely for the purpose of paying qualified higher education expenses.[432] When the taxpayer withdraws funds from a Coverdale education savings account and uses those funds to pay qualified education expenses, the withdrawals are excluded

[428]Treas. Reg. § 1.6050 S-1(b)(3)(v). The IRS used Example 2 as the basis for the holding in Priv. Ltr. Rul. 200521011 (Feb. 15, 2005) that a university may report on Form 1098-T amounts billed to students for an academic year that begins in the fall term of calendar year 1 and runs into calendar year 2. The IRS cautioned, however, that the student may not be able to claim an education tax credit for those expenses that relate to periods after March 31 of calendar year 2 and recommended that the university advise students of this situation.
[429]IRC § 530(d)(2).
[430]IRC § 530(d)(2)(C).
[431]IRC § 530(b)(2).
[432]IRC § 530.

from the taxpayer's income, provided that neither the HOPE Scholarship nor the Lifetime Learning tax credits are claimed.[433] In late 1997, the IRS issued guidance on when taxpayers may begin using funds from their education IRAs to pay for higher education expenses.[434]

Contributions to a Coverdale account may not exceed $2,000 subject to certain adjusted gross income phase-out rules.[435] In addition, the contribution may not be made for the benefit of an individual who has reached the age of 18.[436] If the balance of the Coverdale account is not distributed before the beneficiary reaches age 30, the balance must be distributed by that time, in which case the earnings in the account are taxed and subject to a 10 percent penalty because they were not used for qualified education expenses.[437]

(d) Deduction for Student Loan Interest

An annual deduction is available for interest paid on qualified education loans up to a maximum of $2,500 a year.[438] This amount is not indexed for inflation but is subject to an adjusted gross income phase-out.[439] A taxpayer is not entitled to claim this interest deduction in any year that the taxpayer is claimed as a dependent by another taxpayer.[440]

A qualified education loan for purposes of this deduction is indebtedness that is incurred to pay for the qualified higher education expenses of the taxpayer, a spouse, or any dependent. Qualified higher education expenses include tuition, fees, room, and board.[441]

(e) Forgiveness of Certain Student Loans

Beginning after August 5, 1997, an individual can exclude from his or her gross income the amount of the forgiveness of a student loan by an educational or charitable organization when the loan was made on the condition that the individual perform certain public service.[442] In order to qualify for this provision, the student must work for a charitable organization or governmental entity in an occupation or area with unmet needs.[443]

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[433]IRC § 530(d).
[434]IRS Notice 97-53, 1997-2 C.B. 306.
[435]IRC § 530(b)(1)(A), (c)(1).
[436]IRC § 530(b)(1)(A)(ii).
[437]IRC § 530(d)(4).
[438]IRC § 221(a), (b).
[439]IRC § 221(b)(2)(B).
[440]IRC § 221(c).
[441]IRC § 221(d)(2).
[442]IRC § 108(f). For a more detailed discussion of the IRC § 108(f) rules, *see* § 7.7.
[443]*Id*.

(f) State Tuition Programs

In order to resolve a continuing controversy between the IRS and prepaid tuition trusts established by various state governments, in 1996 Congress enacted section 529 of the Code, which provides that a ''qualified state tuition program'' is exempt from federal income tax. In 2001, Congress expanded the availability of these prepaid tuition plans to include ''eligible educational institutions,'' which are institutions described in section 481 of the Higher Education Act of 1965[444] and eligible to participate in federal student loan programs under title IV of that Act.[445] Amounts paid into these programs, however, must be held in a trust that meets certain conditions, and the program must receive from the IRS a ruling or determination letter that it meets the requirements of section 529.[446]

The IRS has expanded on the manner in which these plans can be structured and still qualify under section 529. In one ruling, it held that an LLC formed by a consortium of private educational institutions and operated for the benefit of the LLC's members was a qualified tuition program under section 529.[447]

A ''qualified state tuition program'' is one under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses or (2) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary.[448] For these purposes, *qualified higher education expenses* were initially defined in the 1996 legislation as tuition, fees, books, and equipment required for enrollment or attendance at a college or university but were expanded as part of the Taxpayer Relief Act of 1997 to also include room and board expenses.[449]

These state tuition programs are subject to a number of restrictions, including requirements that (1) contributions only be made in cash, (2) contributors or beneficiaries not be allowed to direct any investments, and (3) a specified individual be designated at the beginning of participation in the program.[450] Also, no amount will be included in the gross income of a contributor to, or the beneficiary of, a qualified state tuition program with respect to any distributions from, or earnings of, the program, except to the extent that the educational benefits provided exceed the contributions made on behalf of the

[444]IRC § 529(b).
[445]IRC § 529(e)(5).
[446]IRC § 529(b)(1) (flush language).
[447]Priv. Ltr. Rul. 200311034 (Dec. 17, 2002).
[448]20 U.S.C. 1088.
[449]IRC § 529(e)(3).
[450]IRC § 529(b).

beneficiary.[451] The income is includable in the gross income of the distributee in the same manner as annuity income is included under section 72.[452]

In late 2001, the IRS released guidance with respect to the record keeping, reporting, and other obligations imposed on section 529 qualified tuition programs by the 2001 tax act.[453]

§ 9.9 PROHIBITED TAX SHELTER TRANSACTIONS

In 2005, Congress enacted section 4965, which imposes an excise tax penalty on certain tax-exempt entities for being a party to a prohibited tax shelter transaction. The statute defines a ''prohibited tax shelter transaction'' as one that the IRS has determined to be a ''a listed transaction'' (as defined in section 6707A(c)(2)) or a ''prohibited reportable transaction.''[454] A prohibited reportable transaction is either (1) a confidential transaction, or (2) a transaction with contractual protection (as to be defined by the IRS in regulations) that is also a reportable transaction as defined in section 6707A(c)(1).

For purposes of this excise tax penalty provision, a *tax-exempt entity* is an entity that is described in section 501(c), 501(d), or 170(c) (not including the United States), Indian tribal governments, and tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).[455]

Under section 4965, if a tax-exempt entity becomes a party to a prohibited tax shelter transaction during a taxable year it is subject to a tax to the highest unrelated business taxable income rate times the greater of (1) the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction, or (2) 75 percent of the proceeds received by the entity that are attributable to the transaction for such year. [456]

In addition, if the entity knows or has reason to know that the transaction is a prohibited tax shelter transaction at the time that it entered into it, the entity is subject to a tax for such year in an amount equal to the greater of (1) 100 percent of the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction, or (2) 75 percent of the proceeds received by the entity that are

[451]IRC § 529(c).
[452]*Id*.
[453]IRS Notice 2001-81, 2001-52 I.R.B. 617.
[454]IRC § 4965(e)(1). The term also includes a ''subsequently listed transaction,'' which is a transaction that becomes a listed transaction after the tax-exempt entity enters into the transaction. [2]IRC § 4965(e)(2).
[455]IRC § 4965(c).
[456]IRC § 4965(b)(1)(A).

attributable to the transaction.[457] In order for an entity to have reason to know that a transaction is a prohibited tax shelter transaction, the entity must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction. If there is justifiable reliance on a reasoned written opinion of legal counsel (including in-house counsel) or of an independent accountant with expertise in tax matters that a transaction is not a prohibited tax shelter transaction, then the reason to know standard is not met.[458]

These same provisions apply if a transaction is not a listed transaction at the time the tax-exempt entity becomes a party to the transaction (and is not otherwise a prohibited tax shelter transaction), but the transaction subsequently is determined by the IRS to be a listed transaction. In these cases, however, the excise tax is allocated to reflect any portion of the year that the transaction was not a listed transaction.[459]

Also, the statute imposes a tax ($20,000 for each approval or other act causing the entity to participate) on an ''entity manager'' that approves or otherwise causes a tax-exempt entity to be a party to a prohibited tax shelter transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction.[460] An entity manager in the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans) is the person that approves or otherwise causes the entity to be a party to a prohibited tax shelter transaction. In all other cases, the entity manager is the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, and with respect to any act, the person having authority or responsibility with respect to such act.[461]

As part of this excise penalty tax regime, Congress also required that a taxable party to a prohibited tax shelter transaction disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction.[462]

§ 9.10 ALLOWING CHARITABLE REMAINDER TRUSTS TO PARTICIPATE IN ENDOWMENT INVESTMENT RETURN

Most colleges and universities, as part of their overall development program, encourage alumni and others who are interested in providing financial assistance to the institution to establish charitable remainder trusts

[457]IRC § 4965(b)(1)(A).
[458]Pub. Law 109-222, Conf. Rept. No. 109-455, pp. 130–131.
[459]IRC § 4965(a)(1)(B).
[460]IRC § 4965(b)(2).
[461]IRC § 4965(d).
[462]IRC § 6011(g).

under which the college or university is both the trustee and the charitable beneficiary of the trust. As the trustee, the institution invests the corpus of the charitable remainder trust (CRT) and pays the income to the noncharitable beneficiary (for example, the donor) for a period of time with the college or university receiving the remainder interest. (For a more detailed discussion of charitable remainder trusts, see section 6.9).

It is in the interest of both the donor and the institution that the CRT invest its assets in a manner that maximizes the investment return on such assets. But if a CRT earns any unrelated business income on its investments, it is required to pay a penalty excise tax equal to 100 percent of the amount of such unrelated business income.[463] This rule prevents a college or university from investing the CRT's assets in the more aggressive investment vehicles—such as those involving private equity, venture capital, real estate, and energy—that the school's endowment typically invests its assets. Thus, the investment return of a typical CRT is normally substantially less than the return of a professionally managed endowment fund.

In 2003, Harvard University submitted a ruling request to the IRS asking that the agency approve a proposed investment program that would effectively allow Harvard's CRTs to receive an investment return on their assets commensurate with the return experienced by the school's endowment fund.[464] The manner in which this proposed investment program would operate is described in the IRS ruling letter to Harvard as follows (where ''M'' is Harvard and the ''Trusts'' are CRTs):

> M seeks to enable the Trusts to invest in the unit in a manner similar to a department or school of M. A Trust would acquire units from M's endowment, which would give the Trusts a contractual right against M, but no interest whatsoever in the underlying investment assets of the endowment. The contract between M and the Trusts would provide that the price of the units would equal their value at the time of acquisition. The value of the units would be based on the value of all the underlying investment assets held by the endowment and would have the same unit value that M uses for internal accounting purposes.

The contract would provide that each Trust would receive payments on the units held by it equal to the payout rate M establishes for the endowment, with payouts made quarterly. A Trust could choose either to reinvest part of the payout, or redeem additional units, depending on its cash requirements. The Trusts will treat payouts as ordinary income, regardless of the character of the underlying income of the endowment, whether capital gain, ordinary income, or return of capital. The Trusts will treat redemptions of units as generating

[463]IRC § 664(c)(2)(A). Prior to 2006, a CRT lost its tax-exempt status if it received any unrelated business income.
[464]Priv. Ltr. Rul. 200352019 (n.d.).

long- or short-term capital gain (or loss), depending on the holding period of the unit.

Under the contract, the Trusts would not have any ownership interest in the underlying assets of the endowment, or any contract rights with respect to the other trusts. The Trusts would have no power or right of any kind to control, direct, supervise, recommend or review M's business activities, operations, or decisions with respect to the endowment, except the right to review the payout computation. They would not have the right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of units, M is neither a partner nor an agent of the Trusts; that the Trusts would never be or become liable for any cost, expense, or payment incurred or due by M or for which M is liable or responsible relating to the endowment (or the underlying endowment assets), and M would indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by M with respect to the endowment (or the underlying endowment assets).

The IRS ruled that the income earned by the CRTs from these ''endowment units'' would not be treated as unrelated business income to the CRTs. Once this ruling letter was released to the general public, several other universities filed ruling requests seeking approval of a similar ''endowment unit'' investment program for their CRTs. Because of some internal concerns raised by the IRS chief counsel's office regarding the propriety of the ruling issued to Harvard, the IRS placed all such subsequent ruling requests in suspense pending a study of the issues raised.

The study was completed in 2006, and the IRS began issuing additional ruling requests in that year.[465] The issue raised by the three-year study seems to relate to whether charitable lead trusts (a trust where the charitable beneficiary receives income during the life of the trust with the noncharitable beneficiary receiving the remainder interest) should be able to participate in the endowment unit investment program. In late 2006, the IRS issued a supplemental letter to Harvard saying that, while its 2003 ruling letter remained in effect, this letter would not apply to any ''new money'' invested by charitable lead trusts in the endowment unit program.[466] At the same time, the IRS issued a ruling saying that it will not issue rulings involving charitable lead trusts until it conducts a study of the issues relating to such investments.[467] The specific concern raised by the IRS was whether ''noncharitable beneficiaries may benefit inappropriately from deferrals that can be controlled and designed for tax benefit'' when charitable lead trusts are involved.

[465] *See, for example*, Priv. Ltr. Rul. 200703038 (Oct. 23, 2006), reportedly issued to Stanford University, and Priv. Ltr. Rul. 200703037 (Oct. 23, 2006).
[466] Priv. Ltr. Rul. 200702036 (Oct. 17, 2006).
[467] Priv. Ltr. Rul. 200702040 (Oct. 17, 2006).

But the IRS will approve the basic investment program under which a CRT can receive an investment return on its assets commensurate with the investment return experienced by the college or university's endowment fund without any portion of the income treated as unrelated business income, although a school would be wise to obtain its own ruling letter in this regard and not rely on rulings issued to other institutions.

CHAPTER TEN

IRS Audits of Colleges and Universities

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This chapter focuses on the audit itself—the types of audits, what information the IRS asks for, the issues and problems that arise during the course of

the examination, and how cases can be settled with the examining agents or appealed if an agreement cannot be reached. In addition, this chapter discusses a key principle relating to tax audits and litigation—the attorney-client and work product privileges.[1]

§ 10.1 TYPES OF AUDITS

An IRS audit of a college or university could be one of two basic types. It could be a limited audit of a particular area (e.g., employment taxes, unrelated business income, withholding/reporting on payments to nonresident aliens), or the audit could be conducted under the IRS Coordinated Examination Program, commonly known as a CEP audit. CEP audits are long (lasting two to three years), voluminous (typically involving hundreds of different requests for documents and information), and require the dedication of an extraordinary amount of the school's personnel and financial resources.

The CEP audit is conducted by a team that includes a case manager, a team coordinator, and one or more agents with different specialties, including income tax agents, exempt organization tax specialists, employment tax agents, international agents, excise tax agents, and computer audit specialists. The case manager is responsible for organizing and controlling the agents, developing the audit plan, and determining the scope and depth of the audit. The team coordinator is usually a senior agent in charge of coordinating the day-to-day activities of the other revenue agents. In most audits, a school will have only minimal contact with the case manager (usually limited to the initial meetings and discussions of major issues) but will have significant day-to-day contact with the team coordinator. It is also quite common for the case manager to involve IRS district counsel attorneys in a CEP audit to help develop audit strategies, identify issues for examination, describe which issues should be pursued and which should be dropped, and help develop certain issues for possible litigation.

§ 10.2 THE INITIAL CONTACT

A school's first notice that it is going to be audited by the IRS usually comes by way of a letter, normally addressed to the institution's chief financial officer. If the audit is a limited one, the letter may contain a list of documents or information that the school should have ready for the agent to inspect. If, however, it is a CEP audit, the initial letter usually simply advises the school that the audit will be conducted and states that specific information and documents will be requested at a later date.

[1] *See* Chapter 1 for the history behind, and the reasons for, the intense IRS scrutiny of colleges and universities that began during the early 1990s.

The CEP audit normally commences with an initial introductory meeting at which the IRS agents who will be involved in the audit meet the college and university officials with whom they will be working, as well as any legal counsel or accounting professionals that the school may have retained. In addition to introductions, the initial meeting usually covers various ''housekeeping'' matters, for example, how much time the school will need to respond to the information requests; whether the agents will be permitted to conduct the audit from the school's premises and, if so, where; how the agents should make telephone calls and copies of materials; and similar matters relating to how the audit will be conducted. Also, if the school has retained legal counsel and/or an accounting firm to represent it during the audit, the method and manner of communication with the outside legal professionals is normally covered at the initial meeting. Some of these seemingly innocent housekeeping matters can raise important substantive issues. For example, in some audits the IRS attempts to make arrangements as to how its computer audit specialists can ''hook into'' the school's computer system. Whether a school should permit access to ''live'' computer data is highly questionable, and in most cases it is prudent not to give the IRS such access.

The IRS may ask to formalize some of these procedural understandings in a document that agents informally call a ''communications agreement.'' Sometime after the beginning of the audit, the IRS agent in charge of the audit prepares a draft agreement that sets forth:

- The names, titles, and telephone numbers of the IRS personnel assigned to the case
- The names, titles, and telephone numbers of the university personnel, and its legal counsel or other representatives, to be contacted with respect to various aspects of the case (requests for information, closing agreements, etc.)
- The anticipated dates that the examination will begin and end
- A description of the office space and facilities that the university will make available to the IRS during the course of the audit, together with rules regarding access to this space
- Various details regarding how the examination will take place, to include how the requests for information will be communicated to the university, the time period in which the university is to respond to such requests, how tours of facilities and interviews will be handled, how proposed tax deficiencies that the IRS might raise will be communicated to the university, how the university will respond to those proposed deficiencies, and how parking on campus will be handled

The communications agreement is submitted to the university in draft form, and the school is given the opportunity to make suggested additions

and deletions. The IRS is normally fairly flexible as to the different items that are contained in the agreement and, for the most part, will agree to reasonable changes suggested by the school. These agreements are not binding contracts to the extent that one party could sue the other for failure to satisfy one or more provisions; however, they are quite helpful in identifying and resolving procedural issues at the beginning rather than later on in the audit when the relationship between the parties may not be so conducive to reaching an agreement on these items.

§ 10.3 THE EXAMINATION

In the examination itself, the agent (1) requests documents and information from the school; (2) reviews and analyzes that information in light of the applicable tax law; (3) presents the school with a description and analysis of any tax deficiencies discovered; and (4) attempts to settle the issues with the school or, alternatively, passes the case on to the next level of administrative review, the appeals office.

(a) The Information Document Request Process

A fundamental principle in the tax law is that taxpayers (including nonprofit organizations that may be technically exempt from tax) are required to maintain and keep books of account or records that are sufficient to substantiate all items of income and deductions.[2] The IRS has extremely broad authority under the law to compel a college or university to produce any information that ''may be'' relevant or material to the examination.[3] If the school fails to provide the information requested, the agent is authorized to issue a summons directing the school to comply with the request.[4] Failure to comply with the summons leads the IRS into federal district court to enforce the summons, with the court ultimately deciding whether to order production of the requested information.

The IRS conducts its information-gathering process through the use of a Form 4564, known as an Information Document Request, or IDR. The information that the IRS requests through the IDR process runs the gamut from basic and fundamental information regarding the school (e.g., copies of brochures describing the school, the school's telephone directory, a list of related organizations) to detailed and specific information focusing on particular tax issues (e.g., how certain indirect cost allocations were made, a list of all nonresident aliens to whom the school made scholarship/fellowship payments). In some cases, it can take a school weeks or months to provide the information requested by a single IDR.

[2]IRC § 6001.
[3]IRC § 7602.
[4]Id.

A school should make certain that it responds only to the precise question asked in the IDR and should not provide either more or less information than is requested. If the IDR is unclear, the school should ask the agent to create a new and clearer IDR as a substitute for the original one, rather than having the clarification made orally. Oral amendments or modifications to the IDR may be forgotten months or years later when the issue becomes important.

Although the IDR process is designed to permit the IRS to obtain the documents and information that it needs in order to determine whether any tax deficiencies exist, it is not unusual for the agents to ask the school in an IDR to set forth its legal position with respect to an issue. For example, if the school has engaged in an activity that the IRS believes might result in unrelated business income, the agent might ask the school in an IDR ''why'' the activity should be viewed as related to its educational purposes. Most tax practitioners recommend that the school decline to provide legal positions of this nature because the background facts have not been fully developed; the school has not normally had a chance to fully prepare its legal position with respect to the issue; and the response to the issue may have an adverse impact on other issues not yet identified. However, there are situations in which the school may be able to eliminate an issue altogether early in the audit by providing a clear and persuasive statement of its legal position. This is a difficult strategic area and often calls for careful thought and analysis as to how to respond.

For a short period of time, IRS agents were issuing IDRs and accepting IDR responses via electronic mail. Not only was this an efficient method for a school to be able to transmit copies of the IDR to various personnel involved in preparing the response, but also the school could follow up with an e-mail to the IRS agent asking any clarifying questions regarding the IDR. And the IRS could respond to these questions by e-mail. Unfortunately, however, in late 2000, the IRS ceased the practice of using electronic mail in this fashion, primarily because of privacy concerns associated with the fact that such mail can, in theory, be accessed by third parties. Many practitioners have expressed the hope that the IRS can overcome these privacy problems and return to the use of electronic mail as part of the information collection process.

(b) Tours of Facilities and Interviews of Personnel

It is common during the course of a CEP audit for agents to request that the school provide them with a ''tour'' of the campus, focusing particularly on those facilities and activities that might raise unrelated business income issues, such as recreational facilities, coliseums and auditoriums, and research laboratories. As part of the tour, the agents also generally ask to speak with employees who work in the particular facility to get a better idea of how it operates. It is generally a good idea for the school to assign one person as ''tour guide'' for all these tours to make sure that the tour is limited to the specific facilities for which a tour has been requested and to take notes as to all questions asked

and answers given. The tour guide should listen to the discussions carefully to ensure that the agents limit their questions to relevant factual inquiries and do not venture into areas outside the scope of the specific area they are examining. Also, the tour guide should contact and brief the individuals in the facilities with whom the agents will speak well in advance of the visit and should instruct them to answer only the questions asked and not to volunteer information.

Similarly, as part of the audit, the IRS routinely asks to interview certain school officials who work in different areas under examination. They may ask to meet and speak with, for example, the president of the school, the athletic director, the individual in the payroll or other office responsible for identifying nonresident aliens, and the head of the research laboratory. Again, before the interview, these individuals should be fully briefed with respect to what the IRS agents will be looking for and should be told to answer the questions asked, but no more and no less.

It is imperative that an institution have at least one other person in attendance at the interview. This person should take complete and accurate notes of the questions asked and the answers given, ensure that the IRS agent stays within the subject matter boundaries of the interview, and make sure that the interviewee answers only the questions asked and does not volunteer additional information. Whether the institution's legal or outside accounting representative needs to be at the meeting probably depends on the significance and sensitivity of the issues being discussed. In many interviews focusing on relatively straightforward matters, there is probably no need for outside representatives to be present.

The details regarding how tours and interviews are to be conducted should be set forth in as much detail as possible in the communications agreement between the IRS and the college or university under audit.

(c) Requests for Information on Students

One of the issues that comes up frequently in audits of colleges or universities is whether the school should respond to an IRS request for information with respect to the school's students. This usually arises in the context of requests for information on scholarship and fellowship recipients, including the name and Social Security number of all students who received scholarships and fellowships during the years under audit. Most legal counsel advise that to provide this information to the IRS would cause the school to violate the Family Educational Rights and Privacy Act, which generally prohibits a school from disclosing to third parties a student's education records.[5] There is an exception under the statute if the information is provided in compliance with a lawfully issued subpoena, provided that the school notifies the parent or student of the

[5]Family Educational Rights and Privacy Act of 1974, Pub. L. No. 93-380, 88 Stat. 571, Buckley Amendment, 20 U.S.C. § 1232g.

subpoena in advance of compliance.[6] Because of these statutory requirements, most schools refuse to comply with an informal request for this type of information and advise the IRS agent to issue a summons demanding production. The IRS will normally comply with such a request with no problem.

(d) Information Requests by the IRS during the Examination

The IRS normally requests a broad range of information as part of a CEP audit of a college or university. The different types of information requested are described below.

(i) Internal Documents. Agents will ask to see a wide variety of documents produced by the college or university itself, including:

- Bulletins, course catalogues, and telephone directories (useful in identifying the institution's components and related organizations).
- Minutes of meetings of the institution's board of trustees or other governing board.
- Student newspapers, alumni bulletins, and magazines (which may sometimes provide a different perspective on actions taken by the university).
- Catalogues and lists of institution publications.
- A description of the institution's accounting systems, including a copy of the chart of accounts.
- Requisition and purchase order files, located in either the business office or the purchasing department. The agents will look for questionable expenditures and determine the extent to which services that an institution would ordinarily provide to its campus population (e.g., maintenance, cleaning, trash collection, security) are contracted out. If this is the case, agents will examine the contracts to see whether they are at arm's length and whether there are any close relationships between the contractors and the directors, officers, faculty members, or other employees of the institution.
- Coaches' disclosures of outside income. The NCAA requires coaches to disclose all athletics-related income from sources outside the institution to the school's athletic director. This income can include annuities, housing benefits, sports camps, complimentary ticket sales, or sporting-goods endorsements. In addition, agents will check to see if of this ''outside'' income may come from the institution itself or from affiliated institutions.

[6] *Id.* 1232g(b)(2).

- Financial disclosure reports filed with respect to sponsored research projects conducted by institution's scientists and technology licensing employees, as well as disclosures to any federal agency/sponsor. Agents examine these reports for possible conflicts of interest and employment tax issues.
- Descriptions of the computer hardware and associated software and file formats.

(ii) External Documents. The agents also ask the school to provide documents that the school obtained from outside sources, including:

- Audited financial statements, including the accountants' report and notes, independent auditors' letters to management, independent audit reports that summarize the institution's operations, and other reports by independent auditors regarding internal audits or management reviews.
- Accreditation reports prepared by the appropriate accredited organizations. (Also, the agents may review any self-studies and reaccreditation reports.)
- State and local real property tax exemptions. If certain property is not exempt from state and local tax, this may be an indication that the property is not used exclusively for educational purposes. These documents may also assist the examination of such issues as reasonable compensation, fringe benefits, or unrelated trade or business activities.
- National Cooperative Research Act filings. These are filings made by joint ventures with the Federal Trade Commission and the Department of Justice in an attempt to limit their potential antitrust liability.

(iii) Documents Relating to Indirect Cost Allocations. Allocation of costs in the unrelated business income tax area, and particularly indirect cost allocation, is a major focus of any IRS audit. In pursuing this issue, the agents will ask to see:

- The information required by OMB Circular A-21, which can offer some insight into the institution's organizational structure, accounting system, adequacy of reporting, and accounting, cash management, and procurement controls, as well as shed light on other issues such as reasonableness of compensation, fringe benefits, unrelated trade or businesses, and any illegal activities
- The institution's most recent cost proposal package, cost negotiator's indirect cost rate agreement, and audit reports of government or independent auditors with respect to sponsored research projects

(iv) Financial and Other Information. The agents also review and analyze financial data and certain other information, including:

- A list of income sources and expenses by category (e.g., tuition, other educational services income, contributions, grants, income related to athletics, etc.).
- The institution's investment portfolio, in an effort to find private benefit or private inurement (e.g., are the investment advisers or brokers related to any directors, officers, employees, or other insiders?).
- Separate accounts that may be maintained for joint ventures, such as ''research consortia.''
- A list and description of those facilities that are open to the public and under what conditions.
- Athletic department income, particularly from advertising.
- The school's independent audit report to identify various categories of expenses for each school, program, or department.
- Unrestricted accounts set up for a designated official's use, especially travel funds. These types of accounts are sometimes labeled ''president's reserve,'' ''dean's office,'' ''official entertainment account,'' ''donor affairs account,'' ''fund-raising affairs account,'' or ''athletic director's account.''
- All independent audit reports, which may be helpful to the agents in identifying different funds (e.g., endowment funds, student aid funds, physical plant funds) and the composition of each.

(e) Review and Analysis of Factual Information

As the audit progresses and the agents receive more and more factual information through the IDR process, they become better able to identify and analyze potential tax issues in light of the information provided. Institutions can often see an issue develop simply by paying attention to the scope and content of the IDRs. Typically, the early IDRs ask for broad and general information, with later IDRs focusing on specific aspects of, for example, an unrelated business income tax activity or payments of certain fringe benefits. This reflects the fact that the agents are identifying, analyzing, and reaching conclusions on various issues as the audit progresses.

§ 10.4 PRESENTATION OF IRS FINDINGS

After the agents have received and analyzed all the factual information gathered during the IDR process, in most cases they will find various tax deficiencies. Although it is possible for the agents to describe their findings

orally at a conference, it is usually a good idea for the school to insist that all proposed tax adjustments be set forth in writing on Form 5701 (Notice of Proposed Adjustment), the form that the IRS has developed for this purpose. In this manner, the school can learn the agents' precise legal position with respect to an issue as well as the facts upon which the position is based. In most cases, the communications agreement will provide that all proposed tax adjustments be set forth on a Form 5701, and if such a provision is not in the IRS first draft of the agreement, the school should insist that it be included.

If a school disagrees with the IRS position set forth in Form 5701, it is entitled to submit a written response setting forth the reasons for its opposition. The agents then review these responses and will usually schedule a conference to discuss each of the proposed tax adjustments.[7] In some cases, it is possible to settle these issues with the agents during this conference, although, as a general rule, the agents do not have a wide latitude of settlement authority. Agents are supposed to apply the tax law as they see it to a specific set of facts, and not concede or compromise issues because they believe the IRS position may be ''weak'' or because of other technical or practical reasons. Nevertheless, there are agents who will engage in settlement negotiations that are virtually indistinguishable from the issue-swapping that takes place at the appeals office.

§ 10.5 CONCLUSION OF THE AUDIT

At the end of the conference(s) relating to the issues raised by the agents, there are four possible ways that the audit can conclude:

1. On a ''no-change'' basis, in which the agents conclude that there are no tax deficiencies or other changes to the school's federal tax status
2. On an ''agreed'' basis, in which the agents assert certain proposed tax adjustments, and the school agrees with their conclusions
3. On an ''unagreed'' basis, in which the agents assert proposed tax adjustments, and the school disagrees with their conclusions
4. On a ''partially agreed'' basis, in which the agents assert various proposed tax adjustments, some of which the school agrees with and some of which it does not

After the conclusion of the conference, the agents prepare a written examination report of their findings, together with a form that the school can sign if it agrees with the proposed tax adjustments. In agreed cases, the school signs the form and pays the asserted tax adjustments. If the case is unagreed, the IRS prepares a ''30-day letter'' advising the school that it has 30 days within which

[7]Depending on the number of issues involved, more than one conference may be necessary.

to request appeals office consideration of the case. A copy of the examination report is attached to the 30-day letter. In the partially agreed cases, the school signs an extension of the statute of limitations with respect to the agreed issues, and receives a 30-day letter with respect to the unagreed issues. In both the unagreed and partially agreed situations, the case then moves forward to the appeals office.

§ 10.6 EXTENDING THE STATUTE OF LIMITATIONS

Because the IRS is required to assess any tax within three years from the date that the applicable tax return is filed, the issue of when this period expires often arises during the course of an audit. For example, assume that a school operates on a calendar-year basis and filed its 2004 unrelated business income tax return (Form 990-T) on May 15, 2005. The statute of limitations with respect to the return expires on May 15, 2008. If the school is notified by the IRS in 2006 that its 2004 tax year is going to be audited, the statute of limitations with respect to the 2004 Form 990-T will expire approximately two years after the audit begins. If the audit is a CEP audit, which can easily last for two or three years, the school can expect sometime during the course of the audit to receive a request from the IRS to extend the statute of limitations on the 2004 Form 990-T so the audit can be completed.

As a general rule, the IRS makes its first communication requesting a statute extension about six months before the date that the statute will run. So, in this example, the school would be contacted sometime in late 2007 and asked to extend the statute.

There are three types of statute of limitations consent:

1. An open-ended consent, in which the statute is extended for an indefinite period of time[8]
2. A fixed-period consent that has a specified ending date[9]
3. A restricted consent that extends the statute of limitations, but only with respect to one or more specific issues[10]

While the IRS prefers and usually asks for an open-ended consent, most tax practitioners prefer the fixed-period consent option. This is because virtually the only weapon that a taxpayer has to expedite the conduct of an IRS audit or obtain some other advantage is a refusal to extend the statute of limitations. By always keeping in place a fixed future date when the statute will expire (as opposed to an indefinite date), a taxpayer who agrees to extend the statute will again have some leverage when the extended period approaches the expiration

[8]IRS Form 872-A.
[9]IRS Form 872.
[10]IRS Form 872-A or Form 872.

date. A restricted consent is often the best alternative of all, but the IRS is often reluctant to enter into this type of extension because of its limited nature.

Although a school can refuse to agree to extend the statute of limitations, such action will almost guarantee that the IRS will issue a notice of deficiency for that year to preserve its ability to assess tax. (The issuance of the notice of deficiency suspends the running of the statute until the case is resolved in court.[11] Therefore, whereas a refusal to extend the statute can be used as a weapon to try to convince the IRS to expedite the audit, drop an issue, or gain some other type of advantage, a school should be aware that this refusal, if actually carried out, will result in the issuance of a notice of deficiency in which the IRS will resolve any and all questionable issues against the school.

§ 10.7 CLOSING AGREEMENTS

A closing agreement is a binding contract between the IRS and a taxpayer with respect to a specific issue or tax liability. The closing agreement is specifically authorized by the Code, which permits the IRS to negotiate a written closing agreement with any taxpayer to make a final resolution of the taxpayer's tax liabilities.[12] After the IRS approves a closing agreement, it is final and conclusive. Unless there is a showing of fraud, malfeasance, or misrepresentation of material fact, it cannot be reopened, annulled, modified, set aside, or disregarded in any suit, action, or proceeding.

The IRS generally agrees to enter into a closing agreement with a taxpayer if the following elements are present:

- There is an apparent benefit in having the case permanently and conclusively closed.
- There exist good and sufficient reasons on the part of the taxpayer for desiring such an arrangement.
- There is evidence that the fulfillment of the agreement will not be detrimental to the IRS, although there need be no showing that the resulting closing agreement will confer an advantage on the IRS.[13]

If the closing agreement relates to one or more tax years prior to the date of the agreement (e.g., the agreement is reached in 2007 covering tax years 2004 and 2005), it can either cover the entire tax liability for the prior year or can be limited to a specific tax item. As a general rule, if there is a change in the law that was the subject of the closing agreement, the change will generally not

[11]Treas. Reg. § 601.105(f); IRS Publication 1035 (Extending the Tax Assessment Period).
[12]IRC § 7121.
[13]IRM 4.75.25.4 (Oct. 1, 2002).

affect this type of ''retroactive'' closing agreement.[14] For example, if a school and the IRS agree that in prior years a certain activity will not be treated as an unrelated business income activity, the enactment by Congress of a new statute requiring such treatment will not change the application of the closing agreement to those prior years. Also, a closing agreement that covers the entire tax liability for a prior year is not automatically binding on the constituent elements of the tax as they may relate to the computation of tax for other years. For example, a closing agreement entered into in 2007 that determines the total unrelated business income tax liability of a school for 2005 would not, without a specific provision so stating, bind the IRS to accept the same calculation method in subsequent years. Thus, to ensure future compliance with the requirements of the law, closing agreements concerning unrelated business income tax should specify allocation methods and deductions to the extent possible with respect to subsequent years.

Closing agreements can also cover tax years after the date of the agreement. These agreements, however, are limited to how a specific item will be treated in the later year. For example, a school and the IRS might agree that in future years a certain classification of student-employees will be exempt from Social Security tax. Unlike closing agreements for prior years, agreements that cover subsequent years are subject to changes in the law enacted subsequent to the date of the agreement; however, a subsequent court decision interpreting and clarifying the law is not a ''change in the law'' for this purpose. To avoid any possibility of confusion, however, each closing agreement determining specific matters should set forth exactly what constitutes a change in the law for purposes of the agreement.

Closing agreements can also be ''combined agreements'' that cover both prior and subsequent years, and most of the closing agreements that the IRS enters into with colleges and universities are combined agreements that cover the events (and tax liability) that gave rise to the IRS's concern, and also provide for specific future conduct by the institution in later years. For example, the IRS and a school might agree that no income tax withholding will be required for the prior three years under audit with respect to payments made to a certain type of graduate research assistants, but that the school will agree to withhold income tax in subsequent years.

In early 1999, the IRS issued in its Internal Revenue Manual closing agreement procedures specifically applicable to disputes involving tax-exempt organizations and the IRS district offices and the national office.[15]

[14]Rev. Rul. 56-322, 1956-2 C.B. 963, provides that a valid closing agreement establishing a final determination of federal tax liability for a prior taxable period is not affected by subsequent legislation retroactively applicable to the taxable period covered by the agreement if the legislation is silent as to its effect on closing agreements.
[15]IRM 4.75.25 (Oct. 1, 2002).

There is no revenue procedure specifically applicable to closing agreements concerning exempt organizations, but the IRS has said that the general revenue procedure governing closing agreements can be adapted to exempt organizations cases.[16]

§ 10.8 TECHNICAL ADVICE PROCEDURES

There is an administrative procedure that the IRS has used for decades that, in some circumstances, can be useful to a college or university that is having problems convincing the IRS of the correctness of the school's position with respect to a particular issue. These procedures, known as the ''technical advice procedures,'' can also work to the school's disadvantage, and great care should be exercised in their implementation.

The term *technical advice* means guidance furnished by the IRS national office in Washington to a field or an appeals office in response to a direct request for assistance from that office. While the procedures can be implemented by the appeals office, in most cases it is the IRS agent in the field office who initiates the technical advice request during the course of an audit examination. The IRS publishes a set of technical advice guidelines designed specifically for exempt organizations matters, and they generally describe the procedure as one in which the national office provides guidance with respect to a substantive or procedural question regarding the interpretation or proper application of the tax laws or an IRS regulation or ruling to a specific set of facts.[17]

The technical advice procedures are designed to respond to legal questions and issues, not factual disputes. They are typically used when an agent during the course of the audit raises an issue where (1) there is a lack of uniformity throughout the country as to how the issue is being treated, or (2) the issue is so unusual or complex as to warrant national office review.[18]

As a general rule, the national office does not conduct its own factual inquiry into the facts underlying the issue raised and confines itself to the legal issue raised. Therefore, those issues that raise primarily factual questions (e.g., whether an individual should be treated as an employee or an independent contractor) do not ordinarily lend themselves to the technical advice process, although the national office, in its discretion, may still accept the case.

All requests for technical advice must be requested by the IRS—but the taxpayer under audit may ask that the agent request technical advice from the national office.[19] Once the school and the IRS agent have agreed to refer the issue under consideration to the national office, there is a detailed set

[16]Rev. Proc. 68-16, 1968-1 C.B. 770.
[17]Rev. Proc. 2006-2, 2006-1 I.R.B. 89.
[18]*Id.*, 1.02.
[19]*Id.*, 7.01, 7.02.

of procedures that must be followed.[20] Essentially, the agent provides the school with a statement of facts and the issue to be submitted. The school then indicates its agreement or disagreement with the agent's statement of facts (usually, the school simply sets forth its own statement of facts) and prepares a legal analysis of why its position with respect to the issue is correct. It submits its factual and legal position to the agent, who then transfers the entire case file (usually with the agent's own memorandum setting forth his or her legal rationale) to the national office.

Once the case arrives in the national office, it is given high priority and processed ''out of order'' as expeditiously as possible. The national office specialist assigned to the case reviews the case file and makes a determination as to the issue raised. If this determination goes against the agent, the national office prepares a technical advice memorandum to the field or appeals office advising it of its decision. If, however, the decision is in favor of the agent's position and against the school, the school is so notified and invited to attend a conference in the national office to protest this initial determination.[21] At the conference, the school is given an opportunity to present any new legal arguments and supplement its prior legal arguments with an oral presentation. Because the national office has already reviewed and rejected the school's legal position, these arguments are usually unpersuasive. If, however, the school is able at the conference to provide additional or clarifying facts, there is a far greater likelihood of changing the position of the national office officials. If, after the conference, the decision is still adverse to the school, the national office prepares a similar technical advice memorandum to the field or appeals office, the only difference being that this memorandum agrees with the agent, not the school. Perhaps the most famous (or infamous) technical advice memorandum in the college and university tax area involved the issue of which student-employees qualify for the so-called student FICA exemption and set forth, for the first time, the 12/20 rule.[22]

If the agent independently decides to seek technical advice with respect to an issue, there is not much that the college or university can do to alter that result. The technical advice procedures, however, are not terribly popular with IRS agents because they tend to slow down the progress of the audit. Therefore, such agent-initiated requests tend to be relatively rare. As a tactical matter, whether a school should ask the agent to seek technical advice with respect to an issue is often a difficult decision to make. As a general rule, the national office takes very conservative and pro-IRS positions with respect to issues raised through the technical advice process and, unless the school feels extremely confident with respect to its legal position, it is probable that the national office decision will be adverse. An adverse decision causes a

[20] *Id*., 9, 10, 11.
[21] *Id*., 11.
[22] Priv. Ltr. Rul. 9332005 (Aug. 13, 1993). See § 4.3.

significant problem during the rest of the audit since the agent is now locked in to the national office position. Likewise, if the case is later appealed to the IRS appeals office, the appeals officer will generally find it quite difficult to conduct any meaningful negotiations with respect to an issue that the national office has already decided adversely against the school.

§ 10.9 TIPS ON PREPARING FOR, AND PARTICIPATING IN, AN AUDIT

Although a college or university has no control over whether or when it will be audited by the IRS, once it receives the audit notice, it has a great deal of opportunity to minimize its final tax liability by adequate preparation and by making sure that it acts appropriately during the course of the audit. Most tax practitioners believe that a good audit from the taxpayer's standpoint is one that moves as quickly as possible, with the taxpayer controlling what the agents see and keeping detailed records as to what information was requested by the agents and what information was provided to them. Any school under audit has to walk a fairly fine line between being cooperative and staying on friendly terms with the agents, but at the same time making sure that all of its rights as a taxpayer are protected.

Some principles and rules to keep in mind in preparing for and undergoing an audit are:

- To the extent possible, make sure that all books and records are complete and well organized before giving them to the agents to examine. This helps speed up the examination. It also gives the agent the impression that the school is well organized and on top of its tax affairs—always a good impression to make, even if not totally accurate.
- Remove from the files all opinions of counsel or other documents that may be protected under the attorney-client or work product privileges.
- If the agents are going to occupy space on campus during the conduct of the audit, take some time to determine the most appropriate space in which to house them. Ideally, the space should be sufficient for their needs, but not so comfortable or scenic that they prefer working on campus to their home office. Also, if possible, the space should not be located near individuals who are involved in the school's day-to-day, tax-related functions—such as the business or accounting office. It is all too easy for agents working in such close proximity to these individuals to strike up friendships that ultimately can lead to the inadvertent (or even advertent) disclosure of information beyond the information requested in the IDRs. If this is the only space available, monitor the agents carefully and instruct school personnel (strongly and often) not to enter into any discussions with the agents.

- Make sure that all logistical ground rules are agreed upon in advance, such as (1) how to handle long-distance telephone calls, fax, and photocopying charges, and (2) the normal time period that the school will need to respond to IDRs, with an agreed-upon procedure for those instances when the normal time period cannot be met. These items should be covered in the written communications agreement.
- Reach an understanding with the agents as to their right to visit different areas of the campus. Although a school may have no problem with the agents eating at the cafeteria or making purchases at the bookstore (although other schools might), most schools do not want to give the agents unrestricted access to campus facilities. Again, this should be clearly spelled out in the communications agreement. Some schools go so far as to deny the agents any right to set up office facilities on campus. While the IRS has broad rights to inspect books and records and obtain documents and information, it has no inherent right to physically inspect the school's premises without first issuing a formal request and has no right to set up its audit operation on campus without the school's permission.
- Advise the agents that all requests for information must be in writing in a formal IDR. It is all too common during the course of a lengthy audit for the agents and the school officials to forget that there must be a written record of all information requested by the IRS agents and all information provided to them. This includes any clarifications or modifications to already-issued IDRs—they should also be reduced to writing. The school must constantly guard against falling into situations in which the agents begin to informally ask for information, and the school personnel informally comply.
- All IDRs should be read carefully, and the school should provide the IRS with only the information requested, no more and no less.
- The principle that all requested information must be set forth in an IDR pertains equally to requests for campus tours and interviews of the school's personnel. Not only should tours and interviews be requested in writing, but the request should set forth the specific areas that the agents wish to see or discuss.
- The school should carefully prepare all individuals whom the IRS may interview individually or as part of a campus tour. The areas that will be discussed should be described in detail to the personnel to be interviewed, and the individuals told to answer all questions completely and honestly, but not to volunteer any information not specifically requested.

- As a general rule, IDRs should request only factual information, not statements of the school's legal opinion. If a school receives an IDR requesting a legal opinion with respect to an issue, it should advise the agents that it will provide its legal response at the proper time, unless the school thinks that it can eliminate the issue from the case with a brief explanation of its legal position.
- Schools should avoid resolving issues as they arise during the audit, and instead should tell the IRS to hold all issues until the end of the examination at which time they can be discussed and resolved one way or the other. Unlike a discussion of the facts of a particular issue, a discussion of the legal merits can easily lead to confrontation with the agent, and it is always best to have any such confrontations (if they occur at all) at the end of the examination since they can lead to reprisals by the agents. Also, by delaying a discussion of all issues at one time instead of as they arise, the school is better able to resolve issues through ''issue swapping.'' This technique is not available if the issues are taken up seriatim.

§ 10.10 THE APPEALS OFFICE PROCESS

If, at the conclusion of the audit examination, one or more issues remain unresolved through concession or settlement, the agent will issue what is known as a ''30-day letter,'' setting forth the issues still in controversy and giving the college or university 30 days within which to lodge an appeal with the IRS appeals office. It is quite common for taxpayers to request an extension of the 30-day time period, and the IRS routinely grants such requests.

Although most cases are referred to the appeals office after the conclusion of the audit, the IRS has issued procedures that permit taxpayers to take one or more unagreed issues to the appeals office before the audit is over.[23] These procedures are intended to streamline the audit to permit negotiation and resolution of certain issues without having to wait until the full audit has been completed. This early referral process is entirely voluntary and can be implemented only if the taxpayer agrees to do so.

It is also possible to reach the appeals office through a different route. In those cases in which the audit has become contentious or in which the school feels that the agents are taking an inordinate amount of time to complete the audit, the school may refuse to extend the statute of limitations for the year or years under audit, thereby forcing the IRS agent to issue a ''90-day letter.'' The 90-day letter (also known as a ''statutory notice of deficiency'') gives the school 90 days within which to either pay the applicable tax or file a petition in the Tax Court. If the school files a petition in the Tax Court, the case is referred by

[23]Rev. Proc. 99-28 I.R.B. 109.

the IRS district counsel's office (the office responsible for trying the Tax Court case) to the appeals office for settlement negotiations.

There are pros and cons involved in selecting this route to the appeals office. On the pro side, it may be the only way that a school can escape a contentious or drawn-out audit. Also, to docket the case in the Tax Court sends a clear message to the IRS that these are important issues to the school and that the school is ready and able to litigate them if required. This showing of resolve can later be of benefit during the appeals office negotiations. Finally, because the Tax Court and IRS district counsel are involved in the docketed case, the appeals office process tends to move with more dispatch and can usually be resolved more quickly than through the normal appeals office channels. However, under this procedure the school's case will, in fact, be docketed in the Tax Court, and if settlement negotiations break down, actual litigation is a real possibility, although it is still possible to later settle the case prior to actual trial with the IRS attorney assigned to the case. Most tax practitioners advise taxpayers not to choose to go to the appeals office through the docketed Tax Court case route unless the taxpayer is actually willing to litigate the issues set forth in the 90-day letter. Also, it is important to keep in mind that the petition filed in the Tax Court is a public document. If a school is concerned about having its tax case made public, it may not want to bypass the appeals office and go directly to court.

The IRS has published a set of procedures that must be followed in order to contest a 30-day letter in the appeals office.[24] Essentially, these procedures require the college or university to prepare a written ''protest,'' which is the equivalent of a legal brief that would be filed in court. The protest must contain a complete statement of the applicable facts relating to each issue and an analysis of the legal position supporting the school's position. The protest is submitted to the district office, which reviews it and adds its own comments before forwarding it to the appeals office.

The case is then assigned to an appeals officer, who is usually a senior IRS official, often with prior experience as an agent. The appeals officer reviews the case file and sometimes asks the agent to obtain additional factual information. After this review, the appeals officer schedules a conference with the school to begin discussing the issues raised by the agent to see if they can be settled. Unlike the agents who have very limited power to settle issues, this is the appeals officer's primary function. Therefore, the appeals officer can be quite creative as to how he or she decides to settle the issues raised by the agent and generally has fairly wide latitude in this regard. In most cases, the appeals officer analyzes the issue on the basis of likely success in court should the school decide to litigate. The appeals officer reviews all IRS regulations, rulings, prior cases, and other legal authorities and arrives at a ''hazards of litigation''

[24]Treas. Reg § 601.106.

percentage with respect to each issue. For example, the appeals officer may decide that, if the school decides to take a particular issue to the Tax Court, the precedent in that court is such that the government may have only a 50 percent chance of prevailing. In this instance, the appeals officer may be willing the settle the issue on a 50-50 basis—that is, agreeing to take only half of the deficiency originally asserted by the agent. Because these are settlement ''negotiations,'' however, the chances are that the appeals officer's first offer will be more along the lines of agreeing to take 80 percent of the deficiency, and then eventually negotiating down to 50 percent. Another technique that is often used by an appeals officer is ''issue swapping.'' This involves agreeing to concede, say, Issues 1 and 2 in return for the school's agreeing to concede Issues 3 and 4.

In short, the appeals officer has a great deal of discretion and latitude as to whether and how to settle a case with the taxpayer. This is normally a very effective procedure, and most issues that survive the audit examination are resolved at the appeals office level.

§ 10.11 BEYOND THE APPEALS OFFICE—LITIGATION OF THE TAX CASE

Volumes could be (and have been) written on how and where tax cases are litigated. The purpose here is to provide only a general overview of how this process works. The vast majority of issues that are raised by the agents during the examination never reach court—they are settled either at the examination level, with the appeals officer, or with the government attorney prior to trial.

The issues arising out of college and university audits are almost always either income tax issues (relating to unrelated business income tax adjustments) or employment tax issues (relating to, for example, employee/independent contractor classifications, or Social Security tax exemptions for student-employees and nonresident aliens). With respect to any income tax issues that cannot be settled at the appeals office level, the appeals officer issues a 90-day letter (sometimes referred to as a ''statutory notice of deficiency'') that sets forth the nature and amount of the asserted tax deficiencies and advises the school that it has 90 days within which to either file a petition in the Tax Court or pay the asserted tax. In employment tax cases, however, because the Tax Court does not have jurisdiction over these taxes, a 90-day letter is not issued; rather, the appeals office issues a letter advising the taxpayer of its employment tax liability and demanding payment.[25]

[25]In 1997, Congress expanded the jurisdiction of the Tax Court and granted it jurisdiction over IRS determinations as to whether workers are employees for employment tax purposes and whether the section 530 relief provisions are applicable. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1454, 111 Stat. 788, adding new IRC § 7436. In IRS Notice 2002-5, 2002-1 C.B. 320, the IRS has set forth the procedures that taxpayers must follow to invoke this new Tax Court jurisdiction.

In the 90-day letter cases, it is the letter itself that is the ''ticket'' to the Tax Court—that is, if the petition is properly filed within the 90-day period, the payment of the tax is delayed until the Tax Court decision is final, which can take years in some cases. In the employment tax cases, the ''ticket'' to court is quite different. The school is required to pay the assessed tax and then file a claim for a refund of that tax. When the claim for refund is denied, the school can sue on the denial of the refund claim in either the local federal district court or the Court of Federal Claims, located in Washington, D.C.[26]

The difference between the two routes to litigation—and it is a major difference—is that the tax does not have to be paid in order to litigate the case in the Tax Court; in order to litigate the case in either the district court or the Court of Federal Claims, the tax must be paid. Not coincidentally, most tax cases are tried in the Tax Court. It is still possible, however, to litigate the case in the district court or the Court of Federal Claims in 90-day letter cases. The school need only fail to file the Tax Court petition within the 90-day period, pay the tax, file a claim for a refund, and sue on the claim for refund as in the employment tax cases.

§ 10.12 THE ATTORNEY-CLIENT AND WORK PRODUCT PRIVILEGES

During the course of the audit of a college or university, or if the case ultimately proceeds to litigation, the school's ability to assert and maintain the attorney-client and work product privileges can be critical to the successful resolution of unagreed issues.[27] A successful assertion of the attorney-client and work product privileges is dependent on a set of complex and ambiguous rules with the ever-present chance that they will inadvertently be waived. Thus, it is vital for a college or university to know the basic parameters of the attorney-client and work product privileges. This section outlines these basic parameters and provides guidelines for asserting and maintaining their protections.

(a) Attorney-Client Privilege

(i) Elements of the Privilege. The attorney-client privilege protects a confidential communication from a client to an attorney if the communication was made for the purpose of securing legal advice. The purpose of the attorney-client privilege is to encourage full and frank communication between an attorney and the client without fear of future disclosures of such

[26] *See* generally Gerald A. Kafka & Rita A. Cavanaugh, *Litigation of Federal Tax Controversies*, 2nd ed. (Shepard's/McGraw-Hill, 1995).

[27] Actually, there is only an attorney-client ''privilege.'' Work product is technically a ''doctrine'' of case and statutory law. For ease of reference, however, each will be referred to as a privilege.''

confidences.[28] The privilege is generally extended to advice given by the attorney to the client, provided the advice is based on and might tend to reveal the client's confidential communications.[29] The privilege applies only if:

- The asserted holder of the privilege is, or has sought to become, a client.
- The person to whom the communication was made is a member of the bar of a court.
- In connection with the communication, the person is acting as an attorney.
- The communication relates to a fact of which the attorney was informed (1) by the client, (2) without the presence of strangers, (3) for the purpose of securing primarily an opinion of law, legal services, or assistance in some legal proceeding, and (4) not for the purpose of committing a crime or tort.
- The privilege has been claimed and not waived by the client.[30]

As a general rule, the attorney-client privilege extends to all levels of the client's employees where confidential communications are made to an attorney for the purpose of securing legal advice.[31] The attorney-client privilege is limited, however, to confidential communications made for the purpose of securing legal advice and does not provide a blanket of secrecy over all the client's affairs in which the attorney is involved.[32] For example, the privilege does not extend to documents intended to be disclosed to third parties[33]; to communications made in connection with an attorney's business advice rather than legal advice[34]; or to communications made in the presence of third parties, unless the third party's presence is a ''necessary aid to the rendering of effective legal services to the client.''[35]

(ii) Issues Relating to In-House University Counsel. At the outset, it is clear that qualified communications with a college's or university's in-house counsel are protected by the attorney-client privilege.[36] And when lower-level university employees are directed to communicate with in-house counsel so as to permit the attorney to give legal advice, those communications are

[28] *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).
[29] *Fischel v. Margolis*, 557 F.2d 209, 211 (9th Cir. 1977).
[30] *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358–359 (D. Mass. 1950).
[31] *Upjohn*, 449 U.S. at 383–84.
[32] *Fischel*, 557 F.2d at 211–212.
[33] *United States v. Johnson*, 465 F.2d 793, 795 (5th Cir. 1972).
[34] *Olender v. United States*, 210 F.2d 795, 806 (9th Cir. 1954); *Karme v. Commissioner*, 73 T.C. 1163, 1183 (1980), *aff'd*, 673 F.2d 1062 (9th Cir. 1982).
[35] *United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972).
[36] *Resolution Trust Corp. v. Diamond*, 773 F. Supp. 597 (S.D.N.Y. 1991); *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357 (D. Mass. 1950).

protected under the privilege.[37] But the courts have held that the privilege does not apply (that is, it is not a ''qualified communication'') when an attorney furnishes business rather than legal advice,[38] and because in-house counsel are often involved in business decisions together with senior management, it is sometimes difficult to distinguish business from legal advice. In addition, the courts have held that the in-house counsel cannot be used simply to create a protected sanctuary for corporate records and that a balance has to be struck between upholding the privilege to encourage organizations to seek legal advice and using in-house counsel as a shield to prevent discovery.[39]

Therefore, while the attorney-client privilege applies as much to in-house as outside counsel, there are some special considerations that need to be reviewed when the communication is either to or from in-house counsel.

(iii) Waiver of the Attorney-Client Privilege. Once a document or communication has been found to be within the scope of the attorney-client privilege, it remains privileged until such time as the privilege is waived by the client. Waiver most commonly occurs when the privileged communications or documents are disclosed to third parties outside the privileged relationship. The rationale for waiver in these circumstances is that once the information has become public, the communication is no longer confidential, and the policies underlying the attorney-client privilege are therefore no longer applicable. A client can waive the attorney-client privilege, for example, by disclosure to the IRS in discovery or during settlement of a case, by disclosure to third parties, or by disclosure to independent auditors.[40]

The attorney-client privilege protects from disclosure only the communications between the attorney and the client. It does not protect the underlying facts, such as copies of contracts or loan agreements. By the same token, however, mere disclosure of the facts contained in the communication between the attorney and the client does not constitute a waiver. In order to waive the privilege, the confidential communication itself must be disclosed.

With respect to those waivers that occur when the client inadvertently discloses privileged communications to third parties, the traditional view of waiver held that any disclosure, whether intentional or inadvertent, waived the attorney-client privilege. Under this traditional view, once confidentiality had been breached for whatever reason, the underlying policy was no longer served by continued protection from discovery. Because of the harsh consequences of this doctrine, many courts, but certainly not all, have held that inadvertent

[37] *Thomas v. Pansy Ellen Prod. Inc.*, 672 F. Supp. 237 (W.D.N.C. 1987).
[38] *United States v. United Shoe Mach. Corp.*, at 359–360.
[39] *United States v. Davis*, 131 F.R.D. 391 (S.D.N.Y. 1990); *First Chicago Int'l v. United Exch. Co.*, 125 F.R.D. 55 (S.D.N.Y. 1989).
[40] *United States v. El Paso Co.*, 682 F.2d 530, 539–41 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984).

disclosures do not necessarily waive the attorney-client privilege.[41] In one case, for example, the court stated that:

> The modern trend seems to be towards a case-by-case determination of waiver based on a consideration of all the circumstances. . . . [The inadvertence] of the production is considered as one factor in determining whether there's been a waiver. . . [42]

This waiver issue arose in a case involving a taxpayer who was being audited by the IRS and received a request from the IRS agents for certain information. In response, the taxpayer provided the agents with several boxes of documents, and some of the documents in the boxes were clearly protected under the attorney-client privilege. The agents reviewed these privileged documents during the course of the audit, and when the taxpayer discovered what happened, he asserted that they were still privileged because the disclosure was a mistake. The agents asked the IRS chief counsel's office to review the issue. That office reviewed the law in this area and responded in a memorandum that began by summarizing the three different legal theories on the question whether the privilege should be waived with respect to inadvertently disclosed privileged documents.[43] The first theory is the ''lenient approach,'' under which any mistaken disclosure will not cause the privilege to be waived.[44] Not surprisingly, the IRS attorneys rejected this theory. They then moved to the other two theories—the ''middle-of-the-road approach'' and the ''strict approach.''[45] Under the latter theory, all inadvertent disclosures operate to waive the privilege, but the middle-of-the-road approach takes into account several considerations, such as the precautions taken by the taxpayer to protect inadvertent disclosure, the number and extent of the inadvertent disclosures, the promptness of the measures taken by the taxpayer to rectify the disclosure, and whether equity would be served by relieving the taxpayer of his or her error. The chief counsel's office did not say which of these two

[41] *See, e.g., United States v. Zolin*, 809 F.2d 1411, 1417 (9th Cir. 1987) (sufficiently involuntary and inadvertent disclosures are inconsistent with the theory of waiver), *aff'd in part, rev'd in part, and remanded*, 491 U.S. 554 (1989).

[42] *Hartford Fire Ins. Co. v. Garvey*, 109 F.R.D. 323, 329–30 (N.D. Cal. 1985).

[43] FSA 200042007 (Oct. 20, 2000).

[44] *In re Southeast Banking Corp. Sec. & Loan Loss Reserves Litig.*, 212 B.R. 386 (S.D. Fla. 1996); *Smith v. Armour Pharm. Co.*, 838 F. Supp. 1573, 1576 (S.D. Fla. 1993); *Georgetown Manor, Inc. v. Ethan Allen, Inc.*, 753 F. Supp. 936, 938 (S.D. Fla. 1991). *See also Mendenhall v. Barber-Greene Co.*, 531 F. Supp. 951, 954 (N.D. Ill. 1982) (holding that the better rule is that mere inadvertent production does not waive attorney-client privilege).

[45] The middle-of-the-road test is described in *Hydraflow, Inc. v. Enidine Inc.*, 145 F. R. D. 626, 637 (W. D. N. Y. 1993), while the strict test was applied in *In re Sealed Case*, 877 F.2d 976 (D.C. Cir. 1989); *In re Mine Workers of Am. Employee Benefits Plan Litig.*, 156 F.R.D. 507, 512 (D.D.C. 1994) (the holder of the privilege bears the burden of maintaining the confidentiality of privileged information and absent ''extraordinary circumstances,'' disclosure waives the privilege with respect to the privileged documents, regardless of whether the disclosure is voluntary or inadvertent). *See also Carter v. Gibbs*, 909 F.2d 1450, 1451 (Fed. Cir. 1990) (the court, in adopting a strict approach with respect to the disclosure of attorney work product document, ruled that it was ''irrelevant'' whether the disclosure was inadvertent).

approaches it favored but noted that, under the facts of this case, the privilege would be waived under either because very few of the middle-of-the-road tests were met. Accordingly, it advised the agents that they should treat the privilege as waived, and if the taxpayer wished to litigate the issue, the chief counsel's office would support their position.

This case dramatically illustrates the recommendation by most inside and outside counsel that all privileged documents not only be clearly marked with a ''Privileged'' legend on the front of the document but also be maintained in their own filing cabinets separate from nonprivileged documents. It is interesting to note that in this case many of the privileged documents were clearly marked with an ''Attorney-Client Privilege'' legend, but because they were mixed in with a large number of nonprivileged documents, the taxpayer did not notice that the privileged documents were part of the documents provided.

In the event of a waiver of the attorney-client privilege, the privilege is generally treated as relinquished for all purposes and in all circumstances thereafter; parties traditionally have not been entitled to choose to waive the privilege with respect to some communications or documents but not others. Disclosures of confidential communications to one federal agency has, for example, been held to constitute a waiver of the attorney-client privilege, thereby allowing another federal agency to obtain previously privileged documents.[46] In addition, a federal district court held that, in response to an IRS summons, the Massachusetts Institute of Technology (MIT) was required to provide to the IRS copies of legal bills and minutes of executive and audit committee meetings reflecting advice of legal counsel.[47] The court held that MIT had waived any attorney-client privilege that attached to these documents because it had previously provided copies to another government agency, the Defense Contract Audit Agency.

The waiver of the privilege is not generally confined to the particular communication disclosed, but extends to all communications on the same subject matter.[48] This traditional broad scope of the waiver rule is based on fairness principles—a party should not be able to disclose selectively those portions of its privileged communications that suit its version of events without forfeiting the right to keep other communications on the same subject matter privileged.[49]

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[46] *See, e.g., Permian Corp. v. United States*, 665 F.2d 1214, 1221 (D.C. Cir. 1981). *Contra Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (en banc).

[47] *United States v. Massachusetts Inst. of Tech.*, Civ. Action No. 96-10412-MED (D. Mass. Jan. 10, 1997), *aff'd*, 129 F.3d 681 (1st Cir. Nov. 25,1997).

[48] 8 *John H. Wigmore*, Evidence, § 2328, at 638 (McNaughton rev., Little Brown, 1961).

[49] *E.g., United States v. Shibley*, 112 F. Supp. 734, 742 (S.D. Cal. 1953) (''when the client and the attorney themselves, for purposes beneficial to the client, lift the veil, they cannot lower it again''). In *Weil v. Investment/Indicators, Research & Management, Inc.*, 647 F.2d 18 (9th Cir. 1981), the Ninth Circuit limited waiver of the privilege only to a particular communication made

(iv) Dissemination of Privileged Information within the College or University. A question often arises as to whether disclosure of privileged information to other employees within the college or university constitutes a waiver of the attorney client privilege. As a general matter, dissemination of the attorney's advice in any confidential communications among the school's ''control group'' does not waive the attorney-client privilege. For example, in one case, the court stated[50]

> A privileged communication should not lose its protection if an executive relays legal advice to another who shares responsibility for the subject matter underlying the consultation ... It would be an unnecessary restriction of the privilege to consider it lost when top management personnel discuss legal advice.[51]

The Supreme Court has indicated that there is a ''need-to-know'' limitation on sharing privileged information with employees who are not members of the control group.[52] In another case, a court similarly concluded that dissemination of confidential communications to non-control-group employees did not waive the attorney-client privilege where ''the communication is not disseminated beyond those persons who, because of the corporate structure, need to know its contents.''[53]

(v) Maintaining the Privilege with Respect to Tax-Related Work by Accountants. As a general rule, the law is clear that a college's or university's in-house and outside counsel can retain and supervise experts, such as outside accountants, and that these individuals can communicate with the institution's employees within the scope of the attorney-client privilege.[54] To ensure that the attorney-client privilege extends to such communications, however, it is critical that the communications are intended to be confidential and used exclusively to assist counsel in rendering legal advice. The privilege does not attach to communications that will be disclosed or used in the course of tax return preparation, an audit of the client's books, or financial statement preparation.[55] It likewise does not apply in the course of obtaining general business advice.[56]

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to opposing counsel and not to the entire subject matter. In that situation, the disclosure had been made to opposing counsel early in the proceedings, rather than to the court, and was not considered prejudicial to the other party. *Id.* at 25.

[50] *SCM Corp. v. Xerox Corp.*, 70 F.R.D. 508, 518 (D.Conn.), *appeal dismissed*, 534 F.2d 1031 (2d Cir. 1976).

[51] *See also Barr Marine Prods. Co. v. Borg-Warner Corp.*, 84 F.R.D. 631, 634 (E.D. Pa. 1979) (circulation among top management of management memorandum memorializing discussions with counsel did not waive attorney-client privilege).

[52] *Upjohn Co. v. United States*, 449 U.S. 383, 394–395 (1981).

[53] *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 609 (8th Cir. 1978) (en banc).

[54] *United States v. Kovel*, 296 F.2d 918, 922 (2d Cir. 1961).

[55] *Olender v. United States*, 210 F.2d 795, 806 (9th Cir. 1954); *Reisman v. Caplin*, 61-2 U.S.T.C. ¶ 9673 (D.C. Cir. 1961); *In re Fisher*, 51 F. 2d 424 (S.D.N.Y. 1931).

[56] *United States v. Vehicular Parking, Ltd.*, 52 F.Supp. 751, 753–754 (D.Del. 1943).

The issue of a client's ability to maintain the attorney-client privilege with respect to work performed by accountants retained to assist in an IRS audit was raised in an important case that illustrates some of the pitfalls in this area.[57] In this case, the IRS issued a summons to a corporate taxpayer demanding production of a memorandum that had been prepared by the company's accountant and auditor at the request of the company's vice president for taxes, who was also an attorney. The company argued that the memorandum was protected under the attorney-client privilege because the company employee was acting in the capacity as an attorney when he retained the accounting firm to prepare the memorandum. In rejecting the claim of privilege, the lower court noted that the company had not produced any ''contemporaneous evidence, such as a separate retainer agreement, distinguishing this memo from other work which [the accounting firm] had performed.''[58] In upholding the lower court's decision that the privilege did not apply, the Second Circuit said the evidence strongly suggested that the company had consulted the accounting firm for tax advice, as opposed to having the company's in-house counsel consult the firm for the purpose of assisting him in the provision of his own legal advice to the company.[59]

In addition to affirming the district court on the attorney-client privilege issue, the Second Circuit remanded the case to the district court for reconsideration of whether the memorandum was protected under the work product privilege. The district court held that this privilege did not apply because the memorandum was not prepared in anticipation of litigation. The Second Circuit reversed, saying that the work product privilege applies to documents prepared ''because of'' existing or expected litigation and that this privilege is not lost merely because it is also created to assist with a business decision.[60]

If outside accountants are retained to assist in a tax case, this case underscores the importance in making sure that the record is very clear that the work prepared by the accounting firm not be viewed as the direct provision of tax advice to the school; rather, the work should be prepared under the direction and control of counsel, and counsel must clearly use that work in the rendering of legal advice to the client.[61]

(b) Work Product Privilege

(i) Elements of the Work Product Privilege. The work product privilege, originally formulated by the Supreme Court in 1947,[62] provides that materials

[57] *United States v. Adlman*, 68 F.3d 1495 (2d Cir. 1995).
[58] *Id*. at 1499.
[59] *Id*. at 1499–1500.
[60] *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998).
[61] *See also Bernardo v. Commissioner*, 104 T.C. 677 (1995), in which the Tax Court determined that an accountant was not engaged by the taxpayers to assist their attorneys and therefore the attorney-client privilege did not apply to the accountant's communications to the attorneys.
[62] *Hickman v. Taylor*, 329 U.S. 495 (1947).

prepared by an attorney in anticipation of litigation are not generally subject to discovery. Unlike the attorney-client privilege, the work product privilege is designed to provide the attorney with a zone of privacy in which to prepare his or her client's case for litigation.[63] Also, materials prepared in anticipation of litigation maintain their work product status even in subsequent unrelated litigation.[64]

The work product privilege has been codified in the Federal Rules of Civil Procedure,[65] which provide a qualified protection from discovery in civil actions in federal district courts when materials are:

- Documents and tangible things otherwise discoverable
- Prepared in anticipation of litigation or for trial
- Prepared by or for the party or for its representative

To overcome this qualified protection, the party seeking discovery must show:

- A substantial need for the materials
- An inability to obtain the substantial equivalent of the information without undue hardship

Even upon a showing of substantial need and undue hardship, however, courts are required to protect the attorney's mental processes (''opinion work product'') from disclosure to the adversary. Opinion work product is discoverable only upon showing of more than substantial need and undue hardship.[66]

(ii) The ''In Anticipation of Litigation'' Standard. In order for the work product privilege to apply, the document must be prepared ''in anticipation of litigation,'' but the Federal Rules of Civil Procedure do not define this term. Courts have held, however, that the proceeding for which documents are prepared need not be for actual litigation in a court of record so long as the proceeding is adversarial in nature.[67] Moreover, a lawsuit need not already have been filed in order for the ''in anticipation of litigation'' requirement to be

[63] *Id*. at 510–511.
[64] *FTC v. Grolier, Inc*., 462 U.S. 19, 25–27 (1983).
[65] Fed. R. Civ. P. 26(b)(3).
[66] *Upjohn*, 449 U.S. at 400–02.
[67] *E.g*., Special Masters'' Guidelines for the Resolution of Privilege Claims, *United States v. AT&T Co.*, 84 F.R.D. 603, 627 (D.D.C. 1980) (''Special Masters'' Guidelines '') (litigation defined to include a proceeding in court or administrative tribunal in which the parties have the right to cross-examine witnesses or to subject an opposing party's presentation of proof to equivalent disputation). *Cf. Hickman*, 329 U.S. at 510–511 (work product doctrine designed to protect the special place of the attorney in the adversary process).

met.[68] While no clear test defines what constitutes a likelihood of litigation, a claim of work product privilege is generally upheld if the prospect of litigation is fairly obvious, imminent, or probable.[69] For example, the Fifth Circuit had stated:'' We conclude that litigation need not necessarily be imminent, as some courts have suggested,...as long as the primary motivating factor behind the creation of the document was to aid in possible future litigation.''[70] A ''mere possibility'' or ''remote prospect'' of litigation, however, is generally not sufficient to invoke work product protection.[71]

Because of the lack of a clear definition of when a document is prepared in anticipation of litigation, it is important for a college or university to create a clear written record that the materials have, in fact, been prepared in anticipation of litigation.[72]

(iii) The Preparation of Work Product. In its initial formulation of the work product privilege in 1947, the Supreme Court was concerned about providing a zone of privacy within which the attorney could prepare his or her case for trial. In recognition of the attorney's need for assistance from nonlawyers in preparing the case, the Supreme Court extended work product protection to include the work product of agents for the attorney.[73] In addition, the Federal Rules of Civil Procedure expand the scope of work product to include materials prepared in anticipation of litigation by any representative of the client, regardless of whether the representative is acting for an attorney.[74] Despite the broad reach of this rule, as a practical matter, the absence of an attorney's supervision may lead a court to conclude that the documents or other materials were prepared in the ordinary course of business rather than in anticipation of litigation.[75]

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[68] *Upjohn*, 449 U.S. at 386–387, 397–402.

[69] *In re Special Sept. 1978 Grand Jury (II)*, 640 F.2d 49, 61–62 (7th Cir. 1980) (documents prepared to comply with board of election reporting requirements were found to have been prepared in anticipation of litigation where circumstances indicated imminent litigation with respect to the reports); *In re Grand Jury Proceedings*, 601 F.2d 162, 171–72 (5th Cir. 1979) (accountant's financial analysis prepared to assist broker's potential criminal liability was protected even though no indictment yet issued); *Syglab Steel & Wire Corp. v. Imoco-Gateway Corp.*, 62 F.R.D. 454, 457 (N.D. III. 1974), *aff'' d without opinion*, 534 F.2d 330 (7th Cir. 1976) (opinion letters prepared by defendant's attorney several years before formal commencement of litigation were prepared with ''an eye toward litigation'' and constituted work product).

[70] *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981).

[71] *In re Special Sept. 1978 Grand Jury (II)*, 640 F.2d at 65; *Detection Sys., Inc. v. Pittway Corp.*, 96 F.R.D. 152, 155 (W. D. N. Y. 1982).

[72] *E.g., United States v. IBM Corp.*, 71 F.R.D. 376, 379 (S.D.N.Y. 1976) (''[a]ll documents which do not disclose that they were prepared for use in this litigation'' were treated as outside the work product doctrine). Thus, all materials prepared by the corporation in anticipation of litigation should be clearly marked as attorney work product.

[73] *United States v. Nobles*, 422 U.S. 225, 238–39 (1975).

[74] Fed. R. Civ. P. 26(b)(3).

[75] *E.g., APL Corp. v. Aetna Cas. & Sur. Co.*, 91 F.R.D. 10, 16 (D. Md. 1980).

(iv) Qualifications on Work Product Protection. As noted previously, the work product privilege is generally considered a qualified protection from disclosure, and both the Supreme Court and the federal rules clearly envision discovery of work product only under certain circumstances.[76] As the Supreme Court stated:[77]

> Where relevant and non-privileged facts remain hidden in an attorney's file and where production of those facts is essential to the preparation of one's case, discovery may properly be had. Such written statements and documents might, under certain circumstances, be admissible in relevant facts. Or they might be useful for the purposes of impeachment or corroboration.

The federal rules also reflects a similar qualification of the work product doctrine, permitting discovery of work product materials upon a showing of substantial need and undue hardship.[78]

With respect to the ''substantial need'' test, the Supreme Court has stated that the materials must be ''essential to the preparation of one's case''[79] and suggested that such essential items might include admissible evidence or documents that might lead to the existence or location of admissible evidence, or might be used for either impeachment or corroboration.[80] While not defining the substantial need requirement with precision, courts generally require a party seeking discovery to articulate a particularized need for the materials and not to be engaged in a mere ''fishing expedition.''[81]

The ''undue hardship'' factor requires that a party be ''unable without undue hardship to obtain the substantial equivalent of the materials by other means.''[82] The Supreme Court expressed this idea as follows:

> [P]roduction might be justified where the witnesses are no longer available or can be reached only with difficulty. Were production of written statements and documents to be precluded under such circumstances, the liberal ideals of the deposition-discovery portions of [the federal rules] would be stripped of much of their meaning.[83]

If a party has access to equivalent information from other sources, courts generally conclude that the undue hardship test is not met. Thus, where a party seeking discovery has the ability to interview or depose a witness, courts have

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[76]Both views of work product are relevant, as the Federal Rules of Civil Procedure control summons enforcement actions and refund suits in the district courts while the Tax Court Rules govern cases in Tax Court.
[77]*Hickman*, 329 U.S. at 511.
[78]Fed. R. Civ. P. 26(b)(3).
[79]*Hickman v. Taylor*, 329 U.S. 495, 511 (1947).
[80]*Id.*
[81]*In re Grand Jury Subpoenas Dated Nov. 8, 1979*, 622 F.2d 933, 935 (6th Cir. 1980); *Delco Wire & Cable, Inc. v. Weinberger*, 109 F.R.D. 680 (E. D. Pa. 1986).
[82]Fed. R. Civ. P. 26(b)(3).
[83]*Hickman*, 329 U.S. at 511–512.

held the party has failed to establish the undue hardship necessary to obtain witness statements taken by the opposing party.[84] If a witness is unavailable, is hostile, or lacks current recollection, however, courts have found the inability factor to have been established.[85]

(v) Waiver of the Work Product Privilege. Waiver of the work product privilege operates differently from waiver of the attorney-client privilege because the primary purpose of the work product privilege is to safeguard the adversary system, not to protect a client's confidences.[86] Waiver by disclosure of work product materials is generally held to have occurred only where disclosure to a third party substantially increases the possibility that an adversary could get the information.[87] Thus, courts have held work product protection to be retained when there has been disclosure to persons with a common interest or to persons in the course of a business relationship. Courts generally focus on (1) the extent to which the relationship is an adversarial one, and (2) the efforts made to keep adversaries from obtaining the work product materials.[88]

Work product may also be waived by affirmative use of work product materials by a party. In one case, for example, the Tax Court concluded that the taxpayer had made ''testimonial use'' of the work product materials in an in-house counsel's affidavit in support of a motion for summary judgment and that such testimonial use constituted a waiver of the work product doctrine. Because of the wide-ranging nature of the in-house counsel's affidavit, the Tax Court held that fairness considerations required complete waiver of the work product privilege.[89] A party may also waive work product protection through use at trial,[90] and through use in witness preparation.[91]

(vi) Scope of Waiver. Unlike the traditional rule under the attorney-client privilege, disclosure of specific work product materials does not necessarily constitute a waiver permitting discovery of all work product prepared in the same litigation. In determining the scope of work product waiver, courts generally consider the circumstances and reasons motivating the disclosure. Courts,

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[84] *E.g., United States v. Chatham City Corp.*, 72 F.R.D. 640, 643–44 (S.D. Ga. 1976) (a substantial equivalent of the witnesses' statements can be obtained by personal interview, by deposition, or by written interrogatories).

[85] *E.g., In re Grand Jury Investigation*, 599 F.2d 1224, 1231–1233 (3d Cir. 1979) (witness unavailable); *In re Grand Jury Subpoena*, 81 F.R.D. 691, 695 (S.D.N.Y. 1979) (hostile witness); *United States v. Murphy Cook & Co.*, 52 F.R.D. 363, 364 (E.D. Pa. 1971) (lack of recollection).

[86] E.g., Handgards, Inc. v. Johnson & Johnson, 413 F. Supp. 926, 930 (N.D. Cal. 1976).

[87] *E.g., McCormack Terminal Co. v. F.A. Potts & Co. (In re F.A. Potts & Co.)*, 30 B.R. 708, 711–712 (Bankr. E.D. Pa. 1983); *United States v. AT&T Co.*, 642 F.2d 1285, 1298 (D.C. Cir. 1980).

[88] *E.g., AT&T Co.*, 642 F.2d at 1299–1300.

[89] *Hartz Mountain Indus. Inc. v. Commissioner*, 93 T.C. 521, 528 (1989).

[90] *United States v. Salsedo*, 607 F.2d 318, 320–321 (9th Cir. 1979).

[91] Fed. R. Evid. 612; *Berkey Photo, Inc. v. Eastman Kodak Co.*, 74 F.R.D. 613, 616–617 (S.D.N.Y. 1977).

however, are not in complete agreement as to the scope of waiver under the work product privilege. Some courts, for example, hold that waiver of the work product protection covers only those particular documents disclosed—not all work product on the subject matter.[92] Other courts take a broader view of waiver, typically citing fairness considerations.[93] It is also important to note that providing work product materials to a testifying expert generally waives the work product doctrine.[94]

(c) Guidelines

In order to preserve and maximize a college's or university's claims of attorney-client and work product privilege, the following guidelines may be helpful:

- All materials containing privileged information should be clearly marked and the appropriate privilege identified as to content:
  - Privileged and confidential
  - Attorney-client privilege
  - Attorney work product
- Privileged materials should be provided only on a need-to-know basis to non-control-group management and employees. This should not prevent the accounting office, for example, from providing privileged information, status reports, or memoranda summarizing meetings with counsel to upper-level management. Prudence dictates, however, that copying and distributing of sensitive materials should be kept to a minimum.
- A school should avoid providing privileged documents to outside third parties, including independent auditors. Similarly, school officials should not discuss confidential communications with third parties.
- To the extent practical, a school should maintain privileged materials in separate files with limited access to avoid inadvertent disclosures of privileged materials with ordinary school records. These files should clearly be marked as containing privileged materials. Access to the privileged materials should be on a need-to-know basis.
- Because of the potential for extremely broad waiver, any disclosure or intentional waiver of privileged materials should be discussed

[92] *See Burlington Indus. v. Exxon Corp.*, 65 F.R.D. 26, 45–46 (D. Md. 1974); *S & A Painting Co. v. O.W.B. Corp.*, 103 F.R.D. 407, 409–410 (W.D. Pa. 1984).
[93] *See, e.g., United States v. Pollard*, 856 F.2d 619, 625–26 (4th Cir. 1988), *cert. denied*, 490 U.S. 1011 (1989) (subject matter waiver applies to nonopinion work product).
[94] Fed. R. Civ. P. 26(b)(4); *Heitmann v. Concrete Pipe Mach.*, 98 F.R.D. 740, 742–743 (E.D. Mo. 1983).

with either in-house or outside counsel prior to such disclosure or waiver.

- Before producing documents to the IRS, counsel should conduct a privilege screen of the documents to be produced, to ensure against unintentional disclosures.

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