

IRS COLLEGE AND UNIVERSITY EXAMINATION GUIDELINES  
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*Editor's Note:* The guidelines are generic rather than specific, but they do contain relevant information and are a good resource.

EXEMPT ORGANIZATIONS: FINAL EXAMINATION GUIDELINES REGARDING  
COLLEGES AND UNIVERSITIES

COLLEGE AND UNIVERSITY EXAMINATION GUIDELINES

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ATTACHMENT

Exempt Organizations Examination Guidelines Handbook 7(10)69

342 Colleges and Universities

342.1

As an introduction these guidelines describe areas that may warrant review in an examination of a college or university. The guidelines are not intended to require exhaustive review of every area. The issues described may not apply to every institution, and examiners or case managers should use professional judgment to determine the scope and depth of each examination.

(1) For purposes of these guidelines, the following definitions apply.

(a) A "university" is an institution for higher learning with teaching and research facilities comprising an undergraduate school that awards baccalaureate degrees and one or more graduate schools that award master or doctorate degrees.

(b) A "college" is an institution of higher learning that grants baccalaureate degrees, though the term is also frequently used by institutions to describe undergraduate divisions or schools of a university that offer courses and grant degrees in a particular field such as liberal arts or law. "College" as used in these guidelines also includes institutions that offer two-year educational programs, such as junior or community colleges.

(c) A "school" is a university division offering courses of instruction in a particular profession, such as a school of nursing, engineering, law or architecture.

(d) An "institution" is any of the above.

(2) Institutions of higher learning fall into one of four categories for tax and return filing purposes:

(a) Private institutions recognized exempt under IRC 501(c)(3) and classified as organizations described in IRC 170(b)(1)(A)(ii);

(b) Public institutions whose income is exempt from tax under IRC 115, but which are subject to the unrelated business income tax;

(c) Public institutions that have applied for and received recognition of exemption under IRC 501(c)(3); and

(d) Private institutions, whether nonprofit or for-profit, that are not recognized exempt.

(3) Key District offices conduct examinations of the first three types of institutions. The scope of an examination may vary, depending on the type of institution or other factors. For example, examiners of public institutions whose income is exempt under IRC 115 may not need to consider IRC 501(c)(3) issues.

(4) Examiners may use coordinated examination procedures to the extent those procedures are useful and appropriate, even if an examination is of limited scope or has not been approved as a CEP case. See IRM 7(10)(18)0.

### 342.2 General Considerations

(1) An important step in the pre-examination analysis is identifying an institution's organizational structure. There is no model structure. Some institutions conduct all academic activities in one corporation, while others operate separately incorporated departments or schools. Still others may combine most departments in one corporation and separately incorporate other departments. Informal structural arrangements may

extend to unincorporated associations or trusts. Accordingly, an institution's "structure" must be considered as a whole in determining whether an activity is subject to examination. See text 342.45 for disclosure of related entities in the institution's financial statements.

(2) Otherwise nonexempt activities may further an institution's exempt purposes when carried out in an educational context. For example, a course in political campaign methods that requires the students' participation in political campaigns of candidates of their choice serves educational purposes and does not constitute intervention in a political campaign by the university. Rev. Rul. 72-512, 1972-2 C.B. 246. Providing office space, financial support and faculty advisors for a campus newspaper that publishes students' editorial opinions on political and legislative matters does not constitute an attempt by the university to influence legislation or participate in political campaigns on behalf of candidates for public office. Rev. Rul. 72-513, 1972-2 C.B. 246. A fund set up by a university school of business administration and controlled by university faculty for the purpose of giving students experience in managing a securities portfolio has been held to further educational purposes. Rev. Rul. 68-16, 1968-1 C.B. 246.

(3) Institutions that perform sponsored research for federal agencies prepare detailed financial information to document their reimbursable indirect costs, as required by Office of Management and Budget (OMB) Circular A-21. The Department of Health and Human Services (HHS) negotiates the indirect cost rates with most institutions; the Department of the Navy negotiates with the rest. The HHS Office of Inspector General and the Defense Contract Audit Agency (DCAA), respectively, have audit responsibility. As discussed below, the institution's cost proposals, the government cost negotiator's negotiated indirect cost rate agreement and the audit reports by HHS, DCAA, other government auditors and independent accountants may provide insight into an institution's accounting system and practices and internal controls and may highlight activities that warrant particular study.

(4) Other federal agencies in addition to HHS and DCAA may also examine an institution or compile financial information concerning the institution. To identify and contact these agencies, consult the most recent edition of Selected Data on Federal Support to Universities and Colleges, published by the National Science Foundation. See text 342.(16).

(5) Review audit reports relating to private research contracts.

(6) Contact the institution's internal auditors and request any information that might assist in the examination.

(7) Determine whether the institution has adopted and operates in accordance with a racially nondiscriminatory policy as to students. See text 341.1.

(8) Consult the appropriate Examination Division, International Group, regarding potential problems related to withholding for and payments to non-resident aliens, such as failure to file Form 1042. See text 342.7(11).

### 342.3 Initial Contact Items

#### 342.31

The internal items listed provide an overview of an institution's size, structure and activities. compare descriptions in various publications and documents for consistency. When examining a large institution, request that a contact be designated to provide information about each part of the institution, including special programs and research projects.

(1) Bulletins and course catalogues. Large universities may have separate publications for each school.

(2) Telephone directories. These may be useful for identifying the institution's components and related organizations. In very large institutions, there may be several directories. For example, faculty and staff may be separate from the student body, or service and administrative departments may be listed in separate directories. Outlying campuses, city campuses and so-called extension campuses may also have separate directories.

(3) Minutes of meetings of an institution's governing board, committees and other groups. A large institution may have the following:

(a) Committees to address various academic or business matters that report directly to the president or vice-president. A list of committees and members may be found in faculty or student handbooks or bulletins, or in separate brochures.

(b) Committees that operate under the aegis of a specific college or school.

(c) Faculty senate or assembly.

(4) Student newspapers. These may explain, or provide a different perspective on, actions described elsewhere. Back issues are usually maintained in an institution's library or newspaper office.

(5) Alumni bulletins and magazines. Like student newspapers, these may offer a different perspective on the operations of the institution.

(6) Catalogs or lists of institution publications. Review the list to determine which publications merit attention. Each school may also have its own publications. If a list is not readily available, publications may be identified from other sources such as bulletins, faculty and student handbooks and various committee minutes.

(7) A description of an institution's accounting system, including a copy of the Chart of Accounts. The description of the accounting system should extend beyond the Chart

of Accounts. Many institutions use advanced forms of fund accounting, in which each school or college is further broken down into departments, and the departments into a number of separate funds, or budget lines. Each year, new accounts are established in response to appropriations approved by the board of directors.

(8) Requisition and purchase order files of the institution, located in either the business office or the purchasing department. Determine the scope of activities and check for possible questionable expenditures. Determine the extent to which services an institution would ordinarily provide to its campus population (e.g., maintenance, cleaning, trash collection, security) are "contracted out." If there are indications that the contracts are other than arms-length agreements, obtain the contracts for these services, ascertain how and by whom they were authorized and how the contracts were originally bid (competitive, sole source or both). Determine the relationship of the contractors to directors, officers, faculty and other employees of the institution and consider relevant employment tax issues. See text 342.45 and 342.5.

(9) Coaches' disclosures of outside income. The National Collegiate Athletic Association requires coaches to disclose to the institution's chief executive officer (via the athletic director) all "athletically-related income from sources outside the institution" (e.g., annuities, housing benefits, sports camps, complimentary-ticket sales or sporting-goods endorsements). Some of this "outside" income may, in fact be derived from the institution or its facilities or from affiliated organizations.

(10) With respect to sponsored research, financial disclosure reports filed by institution scientists and technology licensing employees and disclosures to any federal agency-sponsor. Examine possible conflicts of interest and employment tax issues.

(11) Descriptions of the computer hardware and associated software and formats of files and records maintained, when a computer audit specialist participates in the examination.

#### 342-32 Outside Documentation

(1) Audited financial statements, including the accountant's report and notes, for the year under examination and for any prior year that may contain information concerning the year or years under examination, including the following:

(a) Independent auditors' letters to management.

(b) Independent audit reports that summarize the institution's operations.

Accompanying footnotes may be especially informative.

(c) Any other reports by independent auditors regarding internal audits or management reviews.

(2) Accreditation and reaccreditation reports prepared by the appropriate accreditation organizations. New institutions seeking accreditation must prepare a self-study that is a detailed analysis of the institution's operations for review by the accrediting organization.

In addition, all accredited institutions are subject to periodic reaccreditation audits. Self-studies and reaccreditation reports should be requested from the institution.

(3) State and local real property tax exemptions. Real property owned by colleges or universities is exempt from tax under many state and local statutes, if used "exclusively" for "educational" purposes (as defined in the state or local statutes), but may be subject to tax if used for "noneducational" purposes such as faculty residences or operating a trade or business (e.g., retail stores, power plants selling energy to non-university consumers or multi-purpose facilities used in commercial ventures open to the public). Exemption documents may assist examination of issues such as compensation, fringe benefits or unrelated trade or business. Review records of payment or accrual of real property taxes. Inquire whether any taxing authority has challenged the exemption of real property owned by the institution. Identify all nonexempt, or potentially nonexempt, real property and review the uses of that property.

(4) National Cooperative Research Act filings. To limit their potential antitrust liability, many research joint ventures file information on the venturers and the venture's objectives with the Federal Trade Commission and the Department of Justice (DOJ). Summary information from these filings is published in the Federal Register. The DOJ (Antitrust Division) maintains a summary information database. Federal Register notices or the DOJ database may reveal whether the institution or any subsidiary participates in research joint ventures. See The National Cooperative Research Act of 1984, 15 U.S.C. § 4301 et seq.

#### 342.33 Indirect Cost Proposals and Audits

(1) The information required by OMB Circular A-21 offers valuable insight into the institution's organizational structure, accounting system and adequacy of internal controls (reporting, accounting, cash management and procurement), as well as other relevant issues (e.g., reasonableness of compensation, fringe benefits, unrelated trade or business and illegal activities).

(2) The total costs that the federal government pays to an institution for sponsored research equal: the institution's allowable direct costs plus the allocable portion of allowable indirect costs, reduced by any applicable credits. Circular A-21 governs the computation of the indirect costs reimbursed by the federal government. The indirect costs are expressed in terms of one or more indirect cost rates negotiated between the institution and HHS (or the Office of Naval Research (ONR)) (as outlined below). Because HHS is responsible for most institutions, these guidelines principally reference HHS. See generally, Review Guide for Long-Form University Indirect Cost Proposals, HHS (1990), and Staff Handbook on Cost Negotiations, HHS (1977) in text 342.(16).

(3) An institution's indirect cost rate is agreed upon as follows: The institution submits an indirect cost rate proposal package to the Division of Cost Allocation (DCA), Regional Administrative Support Center in the appropriate HHS region. A DCA cost negotiator analyzes the indirect cost rate proposal and any prior HHS auditors' reports on

the institution, reviews the supporting documentation on-site, and makes any adjustments necessary to the institution's proposal. At the request of DCA, the Office of the Inspector General's Office of Audit Services will audit the institution's current cost proposal. HHS and the institution then complete negotiations and enter into an agreement establishing the institution's indirect cost rate for a fiscal year.

(4) Where appropriate, review the institution's most recent cost proposal package, cost negotiator's indirect cost rate agreement for the year or years under examination (and, if appropriate, for prior or subsequent years) and audit reports of government or independent auditors.

(a) The cost proposal package, a public document, should contain: (i) the indirect cost proposal, including detailed schedules on the composition and allocation of each indirect cost pool; (ii) audited financial statements; (iii) a detailed reconciliation between the indirect cost proposal and the audited financial statements, showing each reclassification and adjustment to the financial statement accounts; and, (iv) in some cases, an explanation of significant increases in individual rate components and other information requested by the cost negotiator. The following aspects of the cost proposal package warrant particular attention:

1 The reconciliation of the cost proposal and the audited financial statements. This provides insight into the institution's organizational structure and accounting system. Review of the institution's audited financial statements is discussed in text 342.4.

2 The institution's and the cost negotiator's adjustments for unallowable costs. Unallowable costs include entertainment, alcoholic beverages, country-club membership, housing and personal living expenses for university officers, employees' personal use of university-furnished automobiles, salaries in excess of \$125,000, donated services or property, fundraising, alumni activities, services to outside organizations, investment advice, capital expenditures, gains and losses on most capital asset dispositions, lobbying, bad debts, fines and penalties and defense and prosecution of criminal and civil proceedings. Note that although these costs may not be allowed for purposes of Circular A-21, they may be allowable for exemption or tax purposes.

(b) Where appropriate, review the audited financial statements prepared to comply with OMB Circular A-133. Effective for fiscal years beginning on or after January 1, 1990, institutions receiving \$100,000 or more under sponsored agreements must furnish annual financial statements and an audit report from an independent accounting firm. HHS (or DCAA) will also sample audit reports to review quality control and check and follow-up on system problems.

(c) Where appropriate, review any reports by HHS (or DCAA) auditors on the institution's cost proposal or sponsored agreements for information such as the institution's internal control structure, assessment of control risk, compliance with federal regulations and fraud or illegal acts, including questioned costs. These reports are public documents. For information on audit reports, contact the Inspector General's Office of Audit Services at HHS or the Inspector General's Office at the Department of Defense.

#### 342.4 Examination of Financial Statements

### 342.41 Income Analysis

(1) Analyze income sources and sort by category (e.g., tuition, other educational services income, contributions, grants, contracts from public and private sources, income related to athletics, payments for the use of sky boxes or other private luxury boxes and sales of educational materials). If an independent audit report exists, it should have income areas categorized, allowing for examination of unique items or sample examination of typical items.

(2) Review the institution's investment portfolio and the income it produces to determine whether the investments made resulted in impermissible private benefit or inurement. Consider, for example, whether investment advisers or brokers have any relationship to directors, officers, employees, or other insiders of the institution. At a minimum, review the institution's written investment policy. This policy will usually be promulgated or approved by the board of directors.

(3) To the extent possible, eliminate the effects of interdepartmental fund transfers. In many universities, the transfer of funds between departments is accomplished by a "line item amendment" bearing the appropriate authorized signatures.

(4) Separate accounts may be maintained for joint ventures (such as research "consortia") the institution has undertaken with other institutions or businesses. Obtain a copy of any certified audit of the activity and interview faculty members who administer the programs.

(5) Distinguish joint ventures from regular service departments of the institution. Centralized service departments may include purchasing, construction, carpentry shop, electrical shop, plumbing shop, decorating, furniture procurement and repair, transportation, food service and catering, maintenance, security, copying, printing, microfilming, mailing, book stores or other functions. In many instances, to determine actual "cost-centers", a university will place its academic departments, libraries, faculties, dormitories and other student facilities on a requisition system for basic services. Regular service departments may then charge the other departments for services against a particular budget line. The regular service departments may be indistinguishable from commercial businesses but for the fact they are totally "captive" operating units of the university.

(6) Determine which facilities are open to the public, and under what conditions. Identify instances of facilities rental or provision of goods and services to the general public. These activities may be a large source of unrelated business income. For example, a college that uses its tennis facilities in the summer for a public tennis camp may receive unrelated trade or business income. Rev. Rul. 80-297, 1980-2 C.B. 196. Similarly, a university that leases its stadium to a professional football team and provides utilities, grounds maintenance and security services is engaged in unrelated trade or business, and the income is not excludable as rent from real property. Rev. Rul. 80-298, 1980-2 C.B. 197. On the other hand, operation of a ski facility by an exempt school for

its physical education program and also for recreational purposes by students attending the school is substantially related to the school's exempt purpose. Income from the use of the facility by the public, however, is unrelated business income. Rev. Rul. 78-98, 1978-1 C.B. 167. In some situations, employee use of a university facility may constitute a taxable fringe benefit. See text 342.7.

(7) Examine athletic departments of institutions that compete and derive income from athletics. Income from advertising in game programs is frequently present. Analyze sponsorship agreements to determine whether income is advertising income that may be taxable. See Prop. Treas. Reg. § 1.513-4.

#### 342.42 Expense Analysis

(1) Expenses should be categorized in the same manner as income. In team examinations, the same examiners should review both income and related expenses.

(2) The independent audit report should identify the various categories of expenses for each school, program or department. Analyze expenses according to those categories.

(3) Examine income and related expenses at the same time, because many institutions include in income for a particular year only the amounts expended during that year. For example, an endowment fund may be restricted to a special project. This project will be assigned a number, and a separate file will be kept for all project-related activity. In a particular year, endowment fund earnings may exceed project expenses. The income reported will equal the amount expended for the project, with the remainder of the fund's earnings carried over as a fund asset to be expended in the future. See generally FASB Statement No. 116.

(4) Expenses in school, department, or program accounts are generally shown in great detail, allowing a search for possible abuses. Payroll accounts under a particular fund may not appear excessive; however, when funds paid by multiple entities to the same individual are aggregated, there may be unreasonable compensation. Focus on unrestricted accounts for a designated official's use, especially travel funds. Examine accounts labeled "President's Reserve", "Dean's Office", "Official Entertainment Account", "Donor Affairs Account", "Fundraising Affairs Account", "Athletic Director's Account," and even "Liquor Account" to determine if any amounts should be included in the employee's gross income and reported as wages on Form W-2. Determine if the requirements of IRC 62(c) and the underlying regulations have been met for reimbursement or other expense allowance arrangements, (i.e., business connection, timely substantiation and timely return of amounts in excess of expenses). If these requirements are not met, the payments are considered paid under a nonaccountable plan, are required to be reported on the employee's Form W-2 and are wages for purposes of withholding and payment of employment taxes.

#### 342-43 Balance Sheet Analysis

(1) The balance sheet of a large institution is usually divided into funds, such as current funds (both unrestricted and restricted), endowment funds, student aid funds and physical plant funds. In a team examination, examiners may divide the various funds for purposes of analyzing fund assets.

(2) The independent audit report may be very helpful in identifying fund items. Summaries and supporting statements can save examiners from duplicating analyses. See generally FASB Statement Nos. 116, 117.

(3) Examining each of the institution's funds does not fundamentally differ from examining the balance sheet of an entity that uses conventional accounting. However, the institution's accounts may be much more detailed than those of other enterprises because the institution has a fiduciary responsibility to contributors who earmark contributions. There may be supplementary schedules for all assets and liabilities in each fund, and the equity portion of the fund may have supplementary schedules identifying the source (e.g., identified contributions or endowment fund income) of the equity that remains after subtracting liabilities. Endowment funds maintain detailed records of investments and sources of funds. Examine records of each endowment fund to determine any restrictions or indications that the fund must be (or are in practice) managed in a way that would constitute inurement. For example, compare contributor names with names of university suppliers or vendors to identify potential contracting abuses.

#### 342.44 Statement of Cash Flows

many institutions' financial statements already include a statement of cash flows. For larger institutions (with assets of \$5 million or more or \$1 million or more in annual expenses), a statement of cash flows is required in financial statements issued for fiscal years beginning after December 15, 1994. For smaller institutions, the effective date is fiscal years beginning after December 15, 1995. FASB Statement Nos. 95, 117. The statement of cash flows offers valuable insights into an institution's activities (e.g., the effects of cash and noncash investing or differences between net income and cash receipts/payments) revealing, for example, large cash investments in a joint venture, loans, major acquisitions or dispositions. Analyze the statement of cash flows (or, if a condensed statement of cash flows is used, a more detailed cash flows statement). Where appropriate, request the underlying work papers. See IRM 7(10)44.(10)4.

#### 342.45 Related Parties and Related Party Transactions

(1) All separately incorporated but related entities for which the institution is fiscally responsible (e.g., research organizations, university publishers) should be disclosed in the accountants' accompanying notes, in the financial statements or in separate financial statements accompanied by, and cross-referenced in, the institution's financial statements.

(2) The accountants' notes should disclose transactions between the institution and directors, officers and other related parties. See FASB Statement No. 57. Related party

transactions may raise questions of reasonable compensation, private inurement, private benefit or employment taxes.

### 342.5 Employment Taxes

(1) Follow the package audit procedures in IRM 7(10)44.5 and, if applicable, the employment tax procedures in IRM 7(10)(16)0. For general instructions regarding employment tax examinations and assessments of additional tax on fringe benefits, see IRM 7(10)(16)9.81.

(2) Be alert to arrangements in which taxable compensation paid to employees is not properly reflected on Forms 990, employment tax returns, or Forms W-2. For example, awards to faculty members (including those made by a related entity) and payments or taxable fringe benefits provided by booster clubs to members of the athletic staff should be reported as wages on the employee's Form W-2. Determine whether payments to individuals who are not employees are properly reported on Forms 1099.

(3) The employment tax rules provide limited exclusions from the definitions of employment and wages. For example, IRC 3121(b)(10) excludes from the Federal Insurance Contributions Act (FICA) services performed by a student in the employ of a school, college or university, or an IRC 509(a)(3) organization provided the student is enrolled and regularly attending classes. See also IRC 3121(b)(19), 3306(c)(10), and 3401(a)(3); Rev. Rul. 78-17, 1978-1 C.B. 306. Determine whether the institution is properly applying these exclusions. Note that under IRC 3306(c)(8), services performed for organizations described in IRC 501(c)(3) are excluded from the definition of employment for purposes of the Federal Unemployment Tax Act (FUTA), and services performed for governmental organizations may be excluded from the definition of employment for purposes of FICA and FUTA under IRC 3121(b)(7) and 3306(c)(7).

(4) Determine whether the institution has properly classified its workers. Be alert to efforts to treat employees, such as adjunct professors, as independent contractors. For a list of the 20 common law factors indicating an employment relationship, see Rev. Rul. 87-41, 1987-1 C.B. 296. In any questionable situation, determine whether a Form SS-8 has been filed by the institution or the employee. See IRM 7(10)(16)4.8.

(5) Be sure to raise employment tax classification issues. Under section 530 of the Revenue Act of 1978, an institution may be entitled to relief from employment taxes with respect to a particular worker if three requirements are satisfied: the institution must have filed all federal tax returns (including information returns) required to be filed on a basis consistent with treating the worker as not being an employee; the institution must not have treated any worker holding a substantially similar position as an employee for employment tax purposes after December 31, 1977; and the institution must have a "reasonable basis" for not treating the worker as an employee. Reasonable basis may exist if the institution's treatment of workers as independent contractors was in "reasonable reliance" on a past examination of the institution in which there was no assessment attributable to the treatment for employment tax purposes of individuals

holding positions substantially similar to the position held by the worker in question. The institution may be entitled to rely on a prior examination whether or not it was an employment tax examination. See Rev. Proc. 85-18, 1985-1 C.B. 518.

#### 342.6 Cafeteria Plans

(1) Under present law, compensation generally is includable in gross income when actually or constructively received. An amount is constructively received by an individual if it is made available to the individual or the individual has an election to receive the amount. Under one exception to the general principle of constructive receipt, no amount is included in the gross income of a participant in a cafeteria plan described in IRC 125 solely because, under the plan, the participant may elect among cash and certain employer-provided qualified benefits.

(2) In general, a qualified benefit is a benefit that is excludable from an employee's gross income by reason of a specific provision of the Code. Thus, employer-provided accident or health coverage, group-term life insurance coverage (whether or not subject to tax by reason of being in excess of the dollar limit on the exclusion for such insurance) and benefits under dependent care assistance programs may be provided through a cafeteria plan. However, a cafeteria plan may not provide qualified scholarships or tuition reduction, educational assistance or miscellaneous employer-provided fringe benefits. See IRC 117, 127 and 132. In addition, a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement. See IRC 401(k).

(3) Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. A salary reduction agreement is sufficient to satisfy the "cash" requirement of a cafeteria plan.

(4) A cafeteria plan must be in writing, must include only employees (including former employees) as participants and must satisfy certain nondiscrimination requirements. The employer maintaining a cafeteria plan is required to file an annual return for the plan.

(5) The cafeteria plan exception to the constructive receipt rules generally also applies for employment tax (FICA and FUTA) purposes.

#### 342.7 Fringe Benefits

(1) A fringe benefit is any property or service (or cash, under certain circumstances) that an employee receives from the institution in lieu of or in addition to regular taxable wages. If a benefit is not specifically excluded from gross income by the Code (e.g., IRC 79, 105, 106, 107, 117(d), 119, 127, 129, and 132), its value must be treated as compensation and reported as wages in Box I of the employee's Form W-2. See IRM 7(10)(16)9.81. In 1989, the Service issued final regulations under IRC 61 and 132, setting

forth specific rules for valuing fringe benefits and for determining the applicability of the exclusions in IRC 132 (no-additional-cost services, qualified employee discounts, working condition fringes and de minimis fringes).

(2) Fringe benefits can take many forms. Examples of fringe benefits often provided by colleges or universities to employees include the following: automobiles, including chauffeurs; parking; flights on institution-owned or leased aircraft; personal transportation and expenses associated with post-season athletic events; awards or prizes; bonuses (cash or noncash); free or specially discounted tickets (including season tickets) to athletic, entertainment or cultural events; subsidized faculty dining rooms; meals; insurance; scholarships and fellowships; free or subsidized housing; housing allowances; club memberships; personal use of athletic facilities; tuition assistance; and educational assistance. For further discussion of fringe benefits, see the User's Guide to "More Basics: The Basics of Fringe Benefits", which was produced by the Office of Chief Counsel, IRS Technical TV (January 1994).

(3) Review minutes of finance, budget or executive committee meetings to find fringe benefits provided to institution officials or employees (including family members). Fringe benefits may also be mentioned in faculty handbooks and newsletters, brochures, campus newspapers or athletic event programs.

(4) For a fringe benefit to be taxable it need not be furnished directly to the employee by the institution, as long as the benefit is provided in connection with the performance of services for the institution. For example, an automobile provided to a university employee by an athletic booster club or an automobile dealer may be considered to have been provided in connection with the performance of services for the university. If the benefit was contemplated during the employment process or was provided by the third party through an arrangement with the institution, then the value of the personal use of the automobile is includable in the employee's gross income and must be reported as wages by the institution on the Form W-2. If the use of the automobile results from the unilateral initiative of the third party to promote its own business interests, then, although the employee may have income tax consequences, the institution has no reporting responsibility with respect to that automobile. A fringe benefit may be attributable to an employee even though the employee did not actually receive it. For example, personal transportation provided to an employee's spouse or child, such as to a bowl game, is treated as a benefit to the employee.

(5) If the institution has a tuition remission plan, determine whether the plan provides "qualified tuition reduction" within the meaning of IRC 117(d). Any tuition reduction that does not meet the requirements of IRC 117(d) constitutes additional compensation to the employee to whom, or for whose benefit, the reduction is provided, and the institution is responsible as an employer for withholding and reporting obligations.

(a) Where an institution's plan discriminates in favor of highly compensated employees within the meaning of IRC 117(d)(3) and 414(q), highly compensated employees who receive a tuition reduction are taxed on the value of the benefit. Benefits

provided under the plan to employees who are not highly compensated are excludable from income, even if the plan under which the benefits are offered is discriminatory.

(b) Except as provided in IRC 117(d)(5) for teaching and research assistants, the term "qualified tuition reduction" refers only to education below the graduate level. The IRC 117(d)(5) exception should be narrowly construed to be limited to graduate teaching and research assistants. A plan that provides graduate tuition benefits to faculty, staff, and their families is not a qualified tuition reduction plan. IRC 127(d) governs educational benefits provided to an employee.

(c) Employer-provided education is excludable from an employee's gross income as a working condition fringe benefit if the education maintains or improves skills required by the individual in his or her employment or other trade or business, or meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the individual's retention or the continuance of an established employment relationship, status or rate of compensation. See Treas. Reg. § 1.162-5.

(6) If the institution provides housing to any officers, faculty or staff, determine whether the housing qualifies as qualified campus lodging excluded from income by IRC 119(d).

(a) In order for the housing to qualify under IRC 119(d), the employee must pay rent that equals or exceeds five percent of its fair market value.

(b) Fair market value must be determined annually by a qualified independent appraiser. Although a new appraisal is not required every year, the appraisal must be reviewed annually.

(c) If the employee does not pay rent equal to at least five percent of the appraised value, the difference between the rent paid and the lesser of (1) five percent of the fair market value of the lodging and (2) the average rental paid by individuals not affiliated with the institution for lodging provided by the institution that is comparable to that provided the employee is includable in gross income.

(7) Review a sampling or list of Forms 1099 and W-2 issued by the institution. Compare then with a sample of expense entries to determine if the institution is consistently and properly issuing Forms 1099 and W-2.

(8) If the institution has a plan whereby employees receive reduced rates for insurance or other services provided by suppliers to the institution, determine the extent of the institution's involvement and whether the reduced rates constitute a fringe benefit.

(9) Discounts to faculty members on ticket sales to institution events constitute a "qualified employee discount" within the meaning of IRC 132(c) to the extent the discount does not exceed the amount described in IRC 132(c)(1), but only if the institution can demonstrate that the tickets constitute "qualified property or services" as defined in IRC 132(c)(4). Tickets should ordinarily be treated as services for purposes of IRC 132(c). To the extent such discounts are not qualified employee discounts, the employee must include the amount in income, and the employer must report the discount as wages in Box 1 of the employee's Form W-2.

(10) Determine whether the institution provides free or discounted parking to its employees. Under IRC 132(f), the fair market value of "qualified parking" in excess of the statutory exclusion is includable in an employee's gross income and must be reported as wages in Box 1 of Form W-2. See Notice 94-3, 1994-3 I.R.B. 14, for more information.

(11) Services performed by a nonresident alien temporarily in the United States as a non-immigrant under subparagraph "F" "J", or "M" of section 101(a)(15) of the Immigration and Nationality Act are not covered by FICA if the services are performed to carry out the purpose for which the nonresident alien was admitted to the United States. Accordingly, FICA and Medicare taxes are not withheld from payment for this very limited category of services. In addition to the following, consider the impact of possible international social security agreements (treaties) and section 218 agreements.

(a) If a nonresident alien is admitted to the United States as a student, the student generally is not permitted to work for a wage or salary or to engage in business while in the United States. In some cases, a student is granted permission to work, and that is noted on the student's copy of Immigration Form I-20, Certificate of Eligibility for Nonimmigrant Student Status, or Form I-688B, Employment Authorization Document. FICA and Medicare taxes are not withheld.

(b) The Immigration and Naturalization Service (INS) permits on-campus work for students on "F-1" visas if the hiring does not displace a U.S. resident. On-campus work means work performed on the institution's premises. On-campus employment includes work performed at an off-campus location that is educationally-affiliated with the institution. On-campus work under the terms of a scholarship, fellowship, or assistantship is considered part of the academic program of a student taking a full course of study, and is permitted by the INS. In this case, there is no notation on Form I-20 concerning the work, no Form I-688B is issued, and FICA and Medicare taxes are not withheld.

(c) Employment due to severe economic necessity is sometimes permitted for students with "F-1" visas. This requires approval by a Designated School official. Students granted permission to work due to severe economic necessity are issued Form I-688B by INS. FICA and Medicare taxes are not withheld.

(d) Students who have been in "F-1" status for at least one academic year may, under certain circumstances, work off-campus on a part-time basis without having to prove economic necessity. A notation is made by the institution on Form I-20. FICA and Medicare taxes are not withheld.

(e) Students who have been in "F-1" status (except students in English language programs) for at least nine consecutive months may accept employment for practical training related to the course of study. If the training is required or for credit or is part of a work-study or cooperative education program, it may be authorized by the institution with a notation on Form I-20. Otherwise, the training is considered optional. It requires approval by the institution and the issuance of Form I-688B by INS and is limited to 12 months. Students in "M-1" status who have completed a course of study may accept employment or practical training for up to six months and must have a Form I-688B

issued by INS. FICA and Medicare taxes are not withheld from "F-1" or "M-1" students' pay for these services.

(f) In all other cases, any services performed by a nonresident alien student are not considered as performed to carry out the purpose for which the student was admitted to the United States. FICA and Medicare taxes must be withheld from pay for the services unless the pay is exempt under other sections of the Code.

(g) Nonresident aliens are admitted to the United States as nonimmigrant exchange visitors under section 101(a)(15)(J) of the Immigration and Nationality Act through the sponsorship of approved organizations and institutions that are responsible for establishing a program for the exchange visitor, and for any later modification of that program. Generally, an exchange visitor who has the permission of the sponsor may work for the same reasons as the students discussed above. In these cases, permission is granted by a letter from the exchange visitor's sponsor or by endorsement from the program sponsor on Form IAP-66, Certificate of Eligibility.

(h) FICA and Medicare taxes are not withheld on pay for services of an exchange visitor who has been given permission to work and who possesses or obtains a letter of authorization from the sponsor. In all other cases, services performed by an exchange visitor are not considered as performed to carry out the purpose for which the visitor was admitted to the United States. FICA and Medicare taxes are withheld from pay for the services unless the pay is exempt under other sections of the Code.

(i) A spouse or child of a nonresident alien temporarily in the United States as a non-immigrant under subparagraph "F", "M", or "M" of section 101(a)(15) of the Immigration and Nationality Act may be permitted to work in the United States with the prior approval of the INS and issuance of Form I-688B.

#### 342.8 Retirement or Pension Plans and Other Deferred Compensation Arrangements

(1) Institutions may provide several types of deferred compensation or retirement benefits for their employees, including qualified plans under IRC 401(a), IRC 403(b) annuities, and eligible and ineligible deferred compensation plans under IRC 457.

(a) A qualified plan is a funded, tax exempt plan. The employer makes contributions, which are generally held in trust. In some cases employees may also contribute. There is a wide variety of qualified plans, including pension and profit-sharing plans. They are subject to numerous qualification requirements under IRC 401. A plan may (but is not required to) obtain a determination letter from a Key District Office. This letter constitutes a ruling that the plan meets the qualification requirements in form. It does not assure that the plan meets all of the requirements for qualification in operation.

(b) An IRC 403(b) annuity, often called a "tax-sheltered annuity," is an annuity contract that may be purchased by an IRC 501(c)(3) organization or educational institution of a state or local government for its employees. Custodial accounts for regulated investment company stock (mutual funds) and retirement income accounts for

church plans may also be treated as annuity contracts for purposes of IRC 403(b), if they meet certain requirements.

(c) Qualified plans and IRC 403(b) annuities are subject to numerous complex rules governing discrimination in favor of highly compensated employees, limitations on contributions and benefits, coverage of employees, participation levels, vesting, funding, portability, holding of investments and other requirements.

(2) Identify the plans an institution maintains. Review the official plan and trust documents, determination letters issued to qualified plans, private letter rulings, employer and employee contributions, account balances or accrued benefits and employee compensation. Where appropriate, request assistance from an Employee Plans Specialist in the Key District or National Office to ascertain that there are no problems with participation, discrimination and benefits levels, vesting, funding, portability, or the security of pension investments.

(3) Determine if there are any other plans, agreements or arrangements deferring the receipt of compensation to some future date or event such as retirement or separation from service. These arrangements may be elective, salary reduction agreements or nonelective plans. They may be defined benefit or defined contribution plans. They may be unfunded plans where the participants have only a contractual promise from the employer that future payments will be made and any assets held to make payments are reachable by general creditors of the employer, or they may be funded plans where cash or other assets are transferred to a trust or other third party, such as an insurance company, for payment to participants at a later date.

(a) The tax consequences of unfunded plans are governed by IRC 457 and the regulations thereunder.

1 Under IRC 457(a), participants in an eligible plan described in IRC 457(b) are taxed on deferred amounts when those amounts are paid or made available to plan participants following separation from service or in the event of a distribution for an unforeseeable emergency.

2 If the plan is not an eligible plan, participants are taxed when amounts are deferred, unless there is a substantial risk of forfeiture (as defined in IRC 457(f)).

3 Employees of state or local governments or an agency or instrumentality thereof may participate in IRC 457 plans. Only a select group of management or highly compensated employees, however, may participate in a IRC 457 plan maintained by a tax exempt employer.

4 IRC 457(c) requires that deferrals under an eligible section plan be coordinated with certain other plans such as IRC 403(b) plans and IRC 401(k) plans. Note that after July 1, 1986, organizations described in IRC 501(c) may not adopt an IRC 401(k) plan.

5 Plans that are consistent with IRC 457(b) but are administered in a manner which is inconsistent with the requirements of IRC 457(b) may lose their status as eligible plans.

(b) The tax consequences of funded plans are governed by IRC 402(b), 403(c) and 83, which require that a participant recognize income when amounts are paid to a trust or insurance company, unless there is a substantial risk of forfeiture (as defined in IRC 83(c)(1)) and the participant's interest is nontransferable.

### 342.9 Contributions to the Institution/Fundraising/DebtStructure

(1) Many institutions require that large contributions, especially conditional or earmarked contributions, be formally accepted by a governing board. Review minutes of the governing board as well as the fundraising committees (budget, finance or development) to identify any conditional contributions that may have questionable terms. For example, a gift to build a campus building may be conditioned on the use of a certain architect or a specific construction firm. This condition may suggest a private benefit that could jeopardize the IRC 170 deduction if the donor and architect or builder have less than an arms-length relationship. If impermissible private benefit is possible, it may be appropriate to refer the matter to the Examination Division for a concurrent examination.

(2) Review the institution's fundraising program to determine if donors receive benefits that might affect the deductibility of their contributions.

(a) Identify the officials responsible for soliciting and accounting for gifts. Obtain a description of their activities and functions.

(b) Review the minutes of any committees (such as budget, finance or development) involved in fundraising.

(c) Review internal reports related to gifts. There may be alphabetical lists of contributors, lists of donors by category (e.g., alumni or corporate), lists of restricted gifts, lists of in-kind gifts, etc.

(d) Review agreements and correspondence to determine if there are restricted, earmarked, or gifts conditioned on benefits being provided to the donor.

(e) Determine how gifts other than cash are treated. Find out how property is valued. Determine whether the institution secures its own appraisal, and whether a value is assigned on the receipt given the donor. Determine any action taken by the institution if its valuation of the property is less than the value claimed by the donor.

(f) Determine whether the institution has completed Part IV of Section B of Form 8283 for gifts of property that are claimed to be in excess of \$5,000. Determine whether the institution has filed Form 8282, Donee Information Return, for any property reported on a Form 8283 that was sold, exchanged, transferred, consumed, or otherwise disposed of within two years of the date of receipt.

(g) As of January 1, 1994, an institution that receives payments over \$75 that are in part contributions and in part payment for goods or services ("quid pro quo contributions") must provide the donor with a written statement that the deductible contribution is limited to the excess of the amount of the payment over the value of the goods and services provided by the institution. The statement must include a good faith estimate of the value of the goods and services. IRC 6115, 6714.

(h) If property was accepted subject to a mortgage, consider whether the institution has unrelated debt-financed income within the meaning of IRC 514. With certain exceptions, IRC 514(c)(9) excludes from the definition of "acquisition indebtedness" real property acquired by an organization described in IRC 170(b)(1)(A)(ii) and its affiliated support organizations described in IRC 509(a)(3).

(i) Review agency agreements with financial institutions for management of various funds for possible inurement or impermissible private benefit.

(3) IRC 170(1) provides that 80 percent of an amount paid by a taxpayer to or for the benefit of an educational organization which would be allowable as a deduction under IRC 170 but for the fact that the taxpayer receives as a result of the payment the right to purchase tickets for seating at an athletic event in the institution's stadium is allowable as a deduction. Amounts paid for the purchase of tickets are treated as separate amounts for purposes of this subsection. IRC 170(1) is an exception to the general rule that where a taxpayer receives a significant benefit in exchange for a contribution to a charity, a deduction is disallowed to the extent of the fair market value of the benefit received. See Rev. Rul. 86-63, 1986-1 C.B. 88; Rev. Rul. 67-246, 1967-2 C.B. 104. However, IRC 170(1) applies only where the benefit received is the right to purchase tickets to an athletic event at the institution's facilities, not to all other benefits received in return for the contribution. If an individual or an organization claims an IRC 170 deduction for a contribution to an educational institution, inquire whether that individual or organization is using a sky box for athletic events. IRC 170(1) applies only to payments that accord an individual or organization the right to purchase tickets, not the right to lease a sky box. See IRC 274(1) for the rules on the extent to which a business deduction is allowed for sky box payments.

(4) Contributions to an institution for the purpose of acquiring or constructing college-owned housing facilities that are rented to fraternities at rates substantially equivalent to those charged for comparable housing facilities in the institution's dormitories are deductible under IRC 170. Rev. Rul. 60-367, 1960-2 C.B. 73. In order for the contribution to be deductible, it must in reality be a gift to the institution, not a gift to a fraternity using the institution as a conduit.

(5) Determine whether the institution acknowledges taxpayer contributions of books that are not usable in the institutions' exempt activities (e.g., books that are outdated, damaged, or unsuitable for reading by the majority of the reading public) with statements that the books will be used in compliance with IRC 170(e)(3). A contribution is not deductible under IRC 170(e)(3) unless the books are usable in the institution's exempt activities and are used for the care of the ill, needy or infants.

(6) Virtually all universities engage in financing arrangements in their normal operations. Identify all financing arrangements, including real property mortgages, equipment loans, term loans, lines of credit and other credit facilities, lease-purchase arrangements and capital leases. Where applicable, review interest rate(s) and terms in loans agreements, promissory notes and security documents (e.g., financing statements, assignments, guaranties, indemnity agreements and pledges of securities). See the loan commitment letter and attorneys' opinion letter for a summary of the transaction. Compare interest rate(s) and terms (e.g., compensating balances, lender's security and remedies) to rates and terms available when the debt was incurred. Determine the relationship between the institution and the lender. Inquire whether the lender has any other relationship with the institution and, if so, its nature and extent. Determine whether the facts taken as a whole indicate that the lender or other party to the transaction benefits

inordinately from the relationship (other than obtaining commercially reasonable interest rate and terms, for example).

(7) If "qualified private activity bonds" under IRC 103 (sometimes referred to as IRC 501(c)(3) bonds) or governmental bonds issued on behalf of a state university were used to finance new facilities, determine whether the issuance complies with IRC 141 through 150. Determine whether the financed facility is related to the university's exempt purposes. Determine the uses to which the facility is to be put. Ascertain whether any third parties will receive a direct or indirect benefit from the construction of the new facility. Contact the Key District Bond Coordinator if compliance is unclear.

#### 342.(10) Research and Contracts

(1) Almost all large colleges and universities conduct supported (sponsored) research, funded by industry or government. The Patent and Trademark Amendments of 1980, 35 U.S.C. § 200 et seq., encourage the institutions to collaborate with business and to "commercialize" and license federally-funded technology to U.S. businesses. The relationship between institutions and these licensees is growing more complex. To gain access to research and/or faculty and students, industry may fund university research through many forms, such as research contracts, joint ventures, venture capital funds, industry liaison programs, spinoff companies, consortia, jointly-owned research facilities, material transfers, commercial licenses, consultations and clinical trial agreements. Examine research activities for private inurement or impermissible private benefit and for unrelated business taxable income.

(2) IRC 512(b)(8) excludes from the computation of unrelated business taxable income all income derived from research performed for any person by a college or university. Determine whether the research is conducted by the institution directly or by a separately incorporated organization. If the research is performed by a separate corporate entity, the IRC 512(b)(8) exclusion is not available to the research organization, although IRC 512(b)(9) may apply. See GCM 39196.

(3) Determine whether purported research is actually the conduct of an activity incident to a commercial enterprise (e.g., testing, sampling or certifying of items to a known standard). See GCM 39833.

(4) Review the institution's safeguards for managing and reporting conflicts of interest and complying with requirements imposed by federal agencies that sponsor research. Review employment agreements between the institution and its scientist employees. Review disclosures filed by the institution's scientists and technology licensing employees concerning their relationships to research sponsors or licensees and all disclosures supplied to the sponsoring agency. If the conflict of interest guidelines adequately protect the interests of the institution and are adhered to by the scientist employees, the potential for substantial private benefit is significantly reduced.

(5) Faculty inventors are entitled to a share of royalties on patents developed through federally sponsored research. 35 U.S.C. § 202(c)(7). Review for possible private benefit the institution's policy regarding ownership of intellectual property such as inventions or computer software and any arrangements to share income derived from patents and copyrights with faculty.

(6) Research arrangements.

(a) Review research arrangements with government sponsors and joint venture or royalty-sharing agreements with industry sponsors, including contracts between the institution and the sponsor and contracts between institution scientists and the sponsor (which should appear in scientists' financial disclosure reports). See text 342.31(11). Determine whether the institution has correctly reported as compensation scientists' use of institution employees, facilities and equipment for personal benefit and whether that use constitutes private inurement or impermissible private benefit.

(b) Determine whether the institution, the scientist or the sponsor holds the patent or right to license technology derived from the research. Patent licenses may be exclusive or nonexclusive and may or may not be royalty-bearing. Exclusive licensees are obligated to commercialize the technology. If the scientist or the sponsor has rights to the technology, ascertain the type of rights (exclusive or nonexclusive) and their duration. If the rights of the scientist are extensive, referral to the National Office may be appropriate.

(7) Venture capital funds.

(a) In addition to licensing patents, many institutions seek to profit from the commercialization of their research through investment in the licensee firms. Investment may be direct or through a venture capital fund (usually a stock corporation or partnership) owned by the institution or a subsidiary, industry and, sometimes, faculty. Some institutions grant exclusive patent licenses to the venture capital fund which in turn licenses patents to other firms.

(b) Review the venture capital fund's capital structure (e.g., classes of stock, options, warrants, debt (including convertible debt)), stock ownership, stockholder agreements, investment management agreements, consulting agreements, patent license agreements and financial statements. Royalties from patent licensing may be paid in cash or in kind (the licensee corporation's stock or products, or rights to use the licensee's technology). Determine whether royalties are paid to the institution, its subsidiaries or affiliated foundations, or faculty and whether royalties received by the institution, its subsidiaries or affiliates are ultimately paid to faculty-Determine whether payments from any partnerships are royalties or a share of profits. Treas. Reg. §§ 1.512(b)-1, 1.512(c)-1; Rev. Rul. 79-222, 1979-2 C.B. 236; Rev. Rul. 54-420, 1954-2 C.B. 128. Venture capital funds may raise issues of private inurement, private benefit, employment tax or unrelated trade or business. Other sponsored research arrangements may also present these issues.

(8) Obtain a list of all publications that discuss the institution's research activities. These may include the institution's own research newsletter, the OFHR (Office of Federal Health Relations) newsletter, which covers the health sciences, and Federal Notes, which provides information on nationwide meetings on federal grants, contracts and regulations.

(9) If the institution conducts government-funded research, obtain copies of audit reports from the funding agency with oversight responsibility. See text 342.33. Although government-funded research does not in itself raise unrelated business income tax issues, findings in audit reports may provide useful information about the institution's accounting practices. In addition, the reports may provide information about payments or benefits that raise income or employment tax issues. Contact the government officials who administer the contracts to discuss any concerns or questions about the institution's practices. See text 342.2(4).

(10) Review sample closed research projects. Review administrative files for information about the bid, award and carrying out of the project, and accounting files for a financial accounting of the project. Closed, non-continuing grants or contracts are preferable for this purpose because they allow examination of the entire history of a project.

(a) Both grants and contracts should be examined, as they may have been treated differently. For contract projects, review both fixed-price and cost-reimbursable contracts if the institution has both, as they are handled differently.

(b) Review manually prepared expense control work papers. These describe in detail the expenses listed in the independent audit report.

(c) Reconcile the expense files with the appropriation analysis and the supplemental audit report.

(d) After the files are reconciled, analyze individual expenses. Focus on the following areas:

1 Compare scholarship or fellowship conditions to conditions specified in the grant or contract and the application for the grant or contract to determine if the conditions were followed or if any conditions affect whether the scholarship or fellowship amounts are excludable from tax.

2 If consultants were hired, determine if an employer-employee relationship existed. The consultants may have been students, faculty members, or outside individuals.

3 Review the project's "product." Determine where and how the results were published.

(11) Payments to individuals as fellowships or stipends for research activities may be compensatory, imposing certain reporting and withholding obligations on the grantor institution. See text 342.(11).

#### 342.(11) scholarships and Fellowships

(1) IRC 117(a) provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational

organization described in IRC 170(b)(1)(A)(ii). To be considered a scholarship, an amount need not be formally designated as such. For purposes of IRC 117, the term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, the amount was used for study or research at the undergraduate or graduate level.

(2) IRC 117(c), implementing changes made by the Tax Reform Act of 1986, Pub. L. No. 99-154 (TRA 86), provides that the exclusion for qualified scholarships does not apply to that portion of the amount received which represents payment for teaching, research or other services by the student required as a condition for receiving the grant. A scholarship or fellowship grant conditioned upon past, present or future services that are subject to the direction or supervision of the grantor constitutes payment for services. A requirement that the grantee pursue studies, research or other activities primarily for the benefit of the grantor constitutes a requirement that services be performed.

(3) A scholarship or fellowship grant includable in gross income pursuant to IRC 117(c) constitutes wages for purposes of IRC 3401(a). The grantor is subject to the provisions of IRC 6051 (relating to the reporting of wages of employees) and must file Form W-2 with respect to such amounts. Whether FICA or FUTA apply depends on the nature of the employment and the status of the grantor organization. See text 342.5(3); Notice 87-31, 1987-1 C.B. 475. Where only a portion of the scholarship is granted in return for services described in IRC 117(c), the grantor must make a good faith allocation, based on all the facts and circumstances, to determine the amount that represents compensation for services. Only those amounts allocated to compensation for services provided by the recipient are subject to reporting and withholding requirements.

(4) Compare a sampling of the recipients (selected by amounts or percentage of the total) to payment authorization documents. Determine the grant source, whether recipients are candidates for degrees and whether any services are required.

(5) Certain information about grant recipients is protected by state or federal privacy laws. The Family Educational Rights and Privacy Act (FERPA) (the Buckley Amendment) provides federal protection against certain student information being released by an institution. Institutions may release this information only in response to a lawfully issued subpoena. According to the Family Policy Compliance Office of the Department of Education, the institution may release the information in response to an administrative summons (pursuant to IRM 7(10)22) without violating FERPA. Note that under FERPA, before the institution releases records, it may be responsible for notifying individually those persons whose records will be released. Accordingly, consider the effect on the institution when requesting information. If the institution will not release the information pursuant to the administrative summons, judicial enforcement of the summons should be considered.

(6) Grant or contract files for federally-funded programs may provide information about whether scholarships or fellowships are granted, the type of grant and whether recipients are required to perform services.

(7) Note that payments to recently graduated physicians may be for services rendered, and thus taxable, even if they are described as a scholarship or fellowship grant.

(8) If scholarship or fellowship funds were provided by a private firm and future employment or other services are a condition of the award, exclusions may not apply.

(9) If so-called scholarship payments are disqualified, Form 941 may need to be revised.

(10) Where eligibility for scholarships is restricted to individuals of a particular race, focus on whether the scholarship program actually fosters racial discrimination in education, thus violating the public policy against racial discrimination. See *Bob Jones University v. United States*, 461 U.S. 574 (1983). A determination on the effect of a racial restriction requires a review of all the facts and circumstances. For example, a scholarship awarded only to caucasian students to attend a predominantly minority college could discourage racial discrimination in education. On the other hand, scholarships for caucasian students to attend a college that has a racially discriminatory policy foster racial discrimination in education and do not further exempt purposes. Similarly, if the college has a racially nondiscriminatory policy but awards scholarships under a racially restrictive trust, and those scholarships account for a comparatively large share of the total financial assistance available to students, then the trust might detract from the college's nondiscriminatory policy and not operate exclusively for charitable and educational purposes within IRC 501(c)(3).

(11) IRC 117(d)(5) provides that qualified tuition reductions may be provided to graduate teaching and research assistants for graduate level tuition expenses. The exclusion is subject to the compensation limitation of IRC 117(c). Thus, only amounts or waivers in excess of reasonable compensation for the assistants' activities may be excluded from gross income. Determine whether amounts representing reasonable compensation for the assistants' services have been properly reported as "wages" by the grantor institution and whether all reporting and withholding obligations have been satisfied.

(12) The tax treatment of compensatory scholarships is the same under present and prior law, with one exception. Prior to TRA 86, IRC 117(b)(1) provided for the possible exclusion of stipend income in the nature of part-time employment. An exception to the general rule that amounts representing payment for services are includable in gross income provided that where teaching, research or other services were required of all degree candidates (whether or not recipients of scholarship or fellowship grants) as a condition to receiving a degree, and the primary purpose of the grantor-institution in making the stipend payment was to further the education and training of the recipient in his or her individual capacity, the services were not considered part-time employment

and the payments were not precluded from scholarship treatment. This exception typically affected graduate students. See section 1.117-2(a)(1) and (2) of the prior regulations. Under prior law, therefore, research stipends usually qualified for total or partial exclusion from income.

(13) TRA 86 retained the rule that scholarships are includable in gross income to the extent that they represent compensation for services and eliminated the exception for services required of all degree candidates. Currently, therefore, amounts received for services are includable in income even if the services are required of all degree candidates. Amounts received for study or research, even where the primary purpose of the study or research is to further the education and training of the recipients in their individual capacities, are includable if they are payment for services.

(14) Not all payments for research activities represent payment for services. Grants for student research activities may qualify for exclusion to the same extent as formal classroom studies. Whether or not a particular research grant is compensatory in nature is a factual determination. Amounts granted individuals to enable them to pursue programs of independent research, interpretation, or original study generally qualify as scholarships or fellowship grants under IRC 117. See Rev. Rul. 76-351, 1976-2 C.B. 34; Rev. Rul. 76-463, 1976-2 C.B. 35; and Rev. Rul. 76-251, 1976-2 C.B. 33. Where the objectives of the research program under which a grant is awarded are not focused solely on the experience to be gained by the recipient, excludability may be questioned. See Rev. Rul. 74-95, 1974-1 C.B. 39. Where a grantor reserves publishing, copyright, licensing or other use privileges with respect to the research results, exclusion is not warranted. See Rev. Rul. 74-95; Rev. Rul. 76-351. Research services performed in furtherance or fulfillment of an institution's contract obligations with outside grantors are clearly no longer excludable, since such services were considered, but for the IRC 117(b)(1) exception, compensatory even under prior law, and the sole exception which permitted the exclusion was repealed by TRA 1986.

#### 342.(12) Legislative and Political Expenses

(1) Colleges and universities exempt under IRC 501(c)(3) are subject to restrictions on legislative and political activities. However, not all legislative or political activities conducted "on campus" can be classified as activities conducted by the institution. Otherwise prohibited or restricted activities may be in furtherance of an institution's educational mission. See text 342.2(2).

(2) Many institutions, especially large universities, have a written policy on political activity that may be undertaken on, near, or on behalf of the institution. Review this policy and determine how it is applied.

(3) Determine if the institution's written policy covers on-campus speeches or other appearances by candidates. Institutions often provide, as part of their educational mission, a forum for a wide variety of speakers. Candidates for public office may speak on

campus so long as the institution does not administer its speakers' program in a manner that constitutes intervention in a campaign.

(4) Review student newspapers for reports of administrative actions. For example, the student newspaper of one large university reported on misuse of a "Dean's Discretionary Fund" for political contributions.

(5) Review minutes of various committee meetings for endorsements or other support of political candidates. Minutes may also help explain the purpose of other activity, such as a speakers' program.

(6) Review the activities of the institution's "University Affairs" or similarly named department for political or legislative relationships.

(7) An institution may maintain an office in Washington, D.C. or the state capital to lobby on its behalf. These offices are frequently under the supervision of the institution's department responsible for political or legislative affairs. Determine whether legislative activities extend beyond the institution's "self-preservation" interests. Determine whether legislative activities are substantial or exceed the amount allowed in IRC 501(h) (if an election has been made).

#### 342.(13) College and University Bookstores

(1) Many institutions operate bookstores that sell books and materials that are required for course instruction or that otherwise further the education of the students at the institution. Some bookstores also sell items unrelated to the education of students. Such items may include wearing apparel, small appliances, stuffed animals, wall posters, pennants, wristwatches, candy, lotions, cosmetics, and a variety of other retail offerings. Examine the institution's policy on sales to students/faculty and the general public.

(2) The sale to students, officers and employees of books, supplies, and other items that are necessary for courses at the institution is an activity substantially related to the institution's educational purposes. Thus, the sale of books that are required or recommended for courses at the institution and general school supplies such as notebooks, paper, pencils, typewriters, and athletic wear necessary for participation in the institution's athletic and physical education programs, does not constitute unrelated trade or business. Similarly, educational purposes are served by the availability of other materials that further the intellectual life of the campus community. In general, the sale to students, officers, and employees of an institution of books, tapes, records, compact discs, and computer hardware and software (whether or not required for courses) is considered an activity substantially related to educational purposes.

(3) The regular sale of items not directly related to the institution's educational purposes constitutes unrelated trade or business, unless one of the specific exceptions to the definition of unrelated trade or business applies. IRC 513(a)(2) excepts any trade or business carried on primarily for the convenience of students or employees. In

determining whether the "convenience exception" applies, all relevant facts and circumstances must be considered.

(a) Excepted merchandise may include toilet articles (such as toothpaste), wearing apparel or novelty items bearing the institution's insignia, and other items such as candy, cigarettes, newspapers and magazines, greeting cards, photographic film, cameras, radios, and television sets or other appliances. See Rev. Rul. 73-105, 1973-1 C.B. 264, for an analysis of merchandise sold by a museum's retail sales operation.

(b) Operation of food and drink vending machines and laundromat facilities on campus by an organization formed to assist an exempt university generally is not unrelated trade or business. Rev. Rul. 81-19, 1981-1 C.B. 354.

(c) Items that are low in cost and in recurrent demand may be considered for the convenience of students, officers and employees of an institution. GCM 35811.

(d) The convenience exception does not apply to sales to alumni.

(4) In the absence of clearly established special circumstances, items not directly related to the educational purposes of an institution that have an ordinary useful life of more than one year are not encompassed by the exception. GCM 35811.

(5) Although the sale of one computer to a student or faculty member may be substantially related to exempt purposes, the sale of multiple computers, in a single year, to a single student or the sale of a computer to someone who is not a student, officer or employee of the institution may result in unrelated business income.

#### 342.(14) Other Unrelated Business Income Tax Considerations

(1) Deducting OMB Circular A-21 costs to compute unrelated business taxable income may fail to clearly reflect income.

(2) Additional activities that may result in unrelated business income tax include the following.

(a) Sale of electricity to the general public or to public utilities. See GCM 38987.

(b) Use of university facilities in unrelated activities. See GCM 39863

(c) Operation of hotels/motels. See GCM 38060

(d) Operation of a parking lot See GCM 39825.

(e) Travel tours. See GCM 38949.

(3) The annual CPE Books and "Marketing of Goods and Services by Institutions of Higher Learning," p. 214 (ATRI 1980) are good references.

#### 342.(15) Related Entities

(1) Identify exempt and taxable entities related to the institution and prepare an organizational chart. For purposes of these audit guidelines, the term "related entity" should be interpreted broadly. It includes any organization whose primary activity is to support the institution or its programs.

(2) Review payments (including fringe benefits) to officers, directors, deans, or other officials in the aggregate to find unreasonable compensation. If an employee is compensated by several entities, even if the entities have independent boards or representatives, examine the total compensation paid to such person by all entities over which the institution has significant control or influence.

(3) Review shared facilities and allocation of expenses among the related entities.

(4) Review payments (including fringe benefits) from athletic booster clubs to coaches, staff and athletes to determine whether the payments were reported as income on Forms 1099 or whether, if the amounts were reimbursements of expenses, the substantiation rules under IRC 274 have been satisfied.

(5) Identify any separate funds administered by the institution, such as endowment funds for designated chairs or separate scholarship funds, and determine that the funds are operated in furtherance of exempt purposes.

(6) Determine that payments from separate campuses have been properly allocated. Examine payroll records to ensure that each campus correctly reports income and employment taxes.

(7) The institution may be involved in joint ventures with unitrusts. Assets are separately held, with income paid to the contributor until death, when the assets pass in full to the institution. The institution usually controls the joint venture and is responsible for accounting and filing returns.

(a) Review the returns to determine if examination is warranted.

(b) Determine whether the institution issued Forms 1099 to beneficiaries.

(c) Consider referral to the Examination Division for a determination as to whether the contributor properly deducted the charitable deduction or whether annuity income was properly reported.

(8) Institutions may include certain "funds held by others" in assets. These funds may be similar to unitrusts. If an institution has such an account, identify the nature of the funds and the terms of the arrangements. Focus on the relationship between the contributor and the institution and whether the contributor has deducted the proper amount.

(9) Institutions may have numerous foundations through which they conduct activities, some of which cannot be carried on directly by the institution. These include research activities carried on for private companies that private schools may not be able to undertake because of state laws that prohibit commercial research. Often, large contributions are channeled through foundations.

#### 342.(16) References

(1) Internal Revenue Service

(a) Exempt Organizations continuing Professional Education: Technical Instruction Program (1977-present).

(b) Office of Chief Counsel Telephone Directory and Code and Subject Matter Directory (Publication 7801).

(c) "More Basics: the Basics of Fringe Benefits" and User Guide (Chief Counsel Technical T.V.) (Document 7977, Rev. 1-94).

(2) Office of Management and Budget

(a) OMB Circular A-21, "Cost Principles for Educational Institutions," 44 Fed. Reg. 12368 (1979); revised, 47 Fed. Reg. 33,658 (1982); 51 Fed. Reg. 20,908, 43,487 (1986); 56 Fed. Reg. 50224 (1991).

(b) OMB Circular A-133, "Audits of Institutions of Higher Learning and Other Non-Profit Institutions," 55 Fed. Reg. 10019 (1990).

(c) Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions (1991).

(3) Department of Health and Human Services

(a) Review Guide for Long-Form University Indirect Cost Proposals, Office of Grant and Contract Financial Management (1990).

(b) Staff Handbook on Cost Negotiations (1977).

(4) Audit Manual, Defense Contract Audit Agency.

(5) Contractor Procurement System Review Guide (1989), Department of the Navy, Office of Naval Research (guidance in evaluating adequacy of procurement systems, including competitive pricing, selection of sources and subcontractors).

(6) Federal Support to Universities and Colleges: Fiscal Year 1990, National Science Foundation, NSF 92-310, Selected Data Tables (1992) (survey of federal funding to all colleges and universities for science and engineering and research and development, arranged by federal agency/audit jurisdiction).

(7) American Institute of Certified Public Accountants

(a) Audit and Accounting Guide: Colleges and Universities (1992).

(b) Audit and Accounting Guide: Consideration of Internal Control Structure in a Financial Statement Audit (1990).

(c) Audit and Accounting Guide: Certain Nonprofit Organizations (1992).

(d) Checklist and Illustrative Financial Statements: Colleges and Universities (1992).

(e) Annual Audit Risk Alert -- Not-for-Profit Organizations Industry Developments (update on economic, industry, regulatory and accounting and auditing matters; supplements Audits of colleges and Universities).

(f) Statement of Position 92-9, Audits of Not-for-Profit Organizations Receiving Federal Awards (1992).

(8) Internal Auditor, The Institute of Internal Auditors.

- (9) Internal Auditing, Internal Auditing Alert, Warren, Gorham & Lamont.
- (10) The Ledger, Association of College and University Auditors.
- (11) Single Audit Information Service, Thompson Publishing Group, Inc. (loose leaf service on compliance with the Single Audit Act, OMB Circulars A-128 and A-133).
- (12) The Chronicle of Higher Education (weekly publication for colleges and universities covering general news, business and fundraising issues).
- (13) The Chronicle of Higher Education Almanac (statistical information on universities, including salaries and fringe benefits).
- (14) National Association of College and University Attorneys
- (a) Journal of College & University Law.
  - (b) The Practical Aspects of Technology Transfer: A Legal Compendium, J. Kelley Wiltbank et al. (ed.) (1990).
- (15) For the Record - Official Newsletter of the National Sports Law Institute, Marquette University Law School.
- (16) Journal of the Association of University Technology Managers (published annually; ownership and licensing of institution-developed technology).
- (17) les Nouvelles, Journal of the Licensing Executives Society.
- (18) National Association of College and University Business Officers
- (a) College and University Business Administration, 5th ed. (1992).
  - (b) College and University Business Administration-Administrative Service (loose-leaf).
  - (c) Financial Accounting and Reporting Manual for Higher Education (1990).
- (19) Financial and Accounting Guide for Not-For-Profit Organizations, 4th ed., Malvern J. Gross, Jr. et al. (1991).

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