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# CHAPTER ONE

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## Overview of College and University Taxation

§ 1.1 Historical Overview	1	(f) Announcements and Notices	8
§ 1.2 Tax Resource Material	4	(g) Private Letter Rulings	8
§ 1.3 Description of Legal Authorities	5	(h) Determination Letters	8
(a) Court Cases	5	(i) Technical Advice Memorandums	8
(b) IRS Regulations	6	(j) Exempt Organizations (EO)	
(c) Revenue Rulings	7	Continuing Professional Education	
(d) Revenue Procedures	7	Texts	9
(e) Internal Revenue Manual	7		

### § 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

## OVERVIEW OF COLLEGE AND UNIVERSITY TAXATION

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.<sup>1</sup> 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.

<sup>1</sup>See the discussion in Chapter 8.

## 1.1 HISTORICAL OVERVIEW

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.<sup>2</sup> 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.<sup>3</sup> 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

<sup>2</sup>See the discussion in Chapter 10.

<sup>3</sup>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).

## OVERVIEW OF COLLEGE AND UNIVERSITY TAXATION

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.

### 1.3 DESCRIPTION OF LEGAL AUTHORITIES

- 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

## OVERVIEW OF COLLEGE AND UNIVERSITY TAXATION

by publishing the decision in the *Internal Revenue Bulletin*.<sup>4</sup> 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<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> The procedural regulations are considered to be directive and not mandatory and are generally considered not to have the force and effect of law.<sup>9</sup>

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.<sup>10</sup> Even though they are only

<sup>4</sup>See, e.g., 1980-1 C.B. 1.

<sup>5</sup>IRC § 7805.

<sup>6</sup>See, e.g., IRC § 1502.

<sup>7</sup>*Rowan Cos. v. United States*, 452 U.S. 247 (1981).

<sup>8</sup>See *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496 (1948).

<sup>9</sup>See *H.G. Lurhing v. Glotzbach*, 304 F.2d 560 (4th Cir. 1962).

<sup>10</sup>See, e.g., the temporary regulations issued under the IRC § 4958 "intermediate sanctions" provisions discussed in Chapter 9.

### 1.3 DESCRIPTION OF LEGAL AUTHORITIES

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.<sup>11</sup> 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.<sup>12</sup>

#### (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.<sup>13</sup>

#### (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.<sup>14</sup> Nevertheless, the *Internal*

<sup>11</sup>Treas. Reg. § 601.601(d)(2).

<sup>12</sup>See, e.g., *Stubbs, Overbeck & Assoc. v. United States*, 445 F.2d 1142 (5th Cir. 1971).

<sup>13</sup>*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).

<sup>14</sup>*First Fed. Sav. & Loan Ass'n of Pittsburgh v. Goldman*, 644 F. Supp. 101 (W.D. Pa. 1986).

## OVERVIEW OF COLLEGE AND UNIVERSITY TAXATION

*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.<sup>15</sup>

### (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.<sup>16</sup> The Internal Revenue Code specifically prohibits a taxpayer or the IRS from relying on private letter rulings as precedent in other cases.<sup>17</sup> 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

<sup>15</sup>See Archie W. Parnell, Jr., "The Internal Revenue Manual: Its Utility and Legal Effect," 32 *Tax Lawyer*, No. 3, at 687 (Spring 1979).

<sup>16</sup>Treas. Reg. § 301.6110-2(d).

<sup>17</sup>IRC § 6110(j)(3); Treas. Reg. § 301.6110-7(b).

### 1.3 DESCRIPTION OF LEGAL AUTHORITIES

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.<sup>18</sup>

#### (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](http://www.irs.gov/charities/article/0,,id=161088,00.html).

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<sup>18</sup>For a detailed discussion of the technical advice procedures, see § 10.8.