UPDATE ON IRS EXAMINATIONS OF COLLEGES AND UNIVERSITIES

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I. Audits of Tax Exempt Organizations — History and Background.

A. Audits of tax exempt organizations are conducted by IRS field offices located throughout the U.S. Until the 1970’s, most field Agents did not have a great deal of background or experience with tax exempt organizations. During the 1970’s, however, the IRS began specialized training for Agents conducting audits of exempt organizations, and today most field offices have field Agents with experience and expertise in exempt organization issues.

B. The primary objectives of today’s IRS exempt organization audits are to (i) ensure that exempt organizations are operating in furtherance of their tax exempt purposes, and (ii) enhance tax revenues by identifying unrelated business income activities, income and employment tax issues, and other tax-generating areas.
C. If an organization is found not to be operating in furtherance of its tax exempt purposes, its tax exempt status can be revoked or the organization can be forced to sign a "closing agreement" with the IRS promising to cease or modify specific impermissible activities.

D. During the late 1980's, the IRS decided to focus its audit efforts on large tax exempt organizations, and in August 1991, the IRS issued the Coordinated Examination Procedures for Large Case Audits of Exempt Organizations. Those procedures are designed to coordinate an audit team of IRS specialists, including (i) income tax, international tax, and employment tax Agents, (ii) computer audit specialists, (iii) valuation and appraisal specialists, (iv) economists, and (v) exempt organization specialists. Each member of the audit team is responsible for auditing an organization's compliance with his or her particular area of expertise, and this movement from a "one-case, one-agent" approach to a "team" approach has significantly increased the scope and sophistication of exempt organization audits.

E. The Coordinated Examination Procedures have increased the importance of resolving issues at the audit level, rather than at the Appeals Office level. According to Marcus Owens, Director of the IRS Exempt Organizations Technical Division, the role of the Appeals Division may diminish because IRS attorneys and National Office specialists will likely be involved during the early stages of a large case audit.

F. The IRS's initial attempts at auditing large tax exempt organizations with multiple related entities and subsidiaries arose in connection with its examinations of tax exempt hospitals. In August 1992, the IRS issued its Hospital Examination Guidelines, which reflected a substantially more aggressive enforcement posture with respect to many of the practices and activities of tax exempt hospitals. The hospital examination guidelines signaled two significant changes in the IRS's approach to auditing large exempt organizations, namely, (i) the IRS will gather information on a broad range of issues during a single audit, and (ii) the examining Agents will readily refer issues to IRS attorneys and technical experts, usually located in the IRS National Office in Washington D.C.

G. The results of the hospital examinations have provided the IRS with a number of examination techniques and tools that are readily transferrable to audits of other large exempt organizations, such as college and universities.

H. According to the IRS, an enhanced college and university audit program is necessary because educational institutions have expanded into business-like activities. Thus, the Coordinated Examination Program (CEP) specifically targets colleges and universities that, in addition to their educational activities, conduct other operations, such as hospitals, television and radio stations, hotels, publishing activities, testing services, etc.

I. In early 1993, the IRS selected seven schools to serve as "pilot audits" for its new CEP audits, namely, Michigan, Stanford, Nebraska, Texas Christian, St. John's, Michigan State, and Vanderbilt. By the end of 1994, most of these initial seven audits were still in progress, and the IRS had initiated 11 new CEP audits. It has been
informally reported that the IRS has plans to conduct over 50 additional CEP audits over the next several years.

Comment: On January 17, 1994, Mr. Owens announced that colleges and universities will be the IRS's second most important audit priority in 1994 (the first priority is reserved for health care institutions).

II. The Colleges and University Examination Guidelines.

The College and University Examination Guidelines (hereinafter referred to as the "Guidelines") were issued by the IRS in proposed form on December 21, 1992. The Guidelines were issued in proposed form to allow colleges and universities and other international parties and organizations to file comments that the IRS would take into account before finalizing the Guidelines. In July, 1993, a public hearing on the Guidelines was held in Washington, D.C., at which a number of schools and educational associations submitted oral and written comments. The Guidelines were issued in final form on August 26, 1994.

The purpose of the Guidelines, according to the IRS, is to "provide a framework which Agents may follow in conducting the examination" of a college or university. The Guidelines are an attempt by the IRS to address a number of specific tax issues relating to colleges and universities in one comprehensive package.

The following discussion, which will describe the highlights of the Guidelines and comment on certain provisions, follows the organizational structure of the Guidelines.

A. Background and General Considerations.

1. The Guidelines are quite detailed and cover a broad range of different topics and issues; however, IRS Agents are not required to review each and every area described in the Guidelines. Rather, the scope and depth of any particular examination will depend on the issues raised in that case.

Comment: In practice, Agents assigned to audit even moderately sized schools will probably feel compelled to examine most or all of the areas covered by the Guidelines.

2. The institutions that are subject to the Guidelines are (i) private colleges and universities exempt under section 501(c)(3); (ii) public institutions exempt under either section 115 or section 501(c)(3); and (iii) private institutions, whether nonprofit or for-profit, that are not exempt under section 501(c)(3).

3. Agents are instructed to use the IRS Coordinated Examination Procedures where appropriate. Even if the examination is not conducted under the Coordinated Examination Procedures, Agents can use elements of these procedures as a guide for the particular areas that they are examining.
B. Internal Documents and Information.

Prior to commencing the audit, Agents are instructed to obtain the following basic documents and information maintained by the institution:

1. A description of the institution's organizational structure (for example, a single corporate entity under which all activities are conducted or several separately incorporated departments, schools, or hospitals, etc.);

2. Relevant information from the institution's internal auditors;

Comment: Institutions should take steps to ensure that tax issues and problems are not highlighted in reports of internal auditors, and that assessments of potential tax issues are protected from disclosure to the IRS by the attorney work product or attorney-client privileges, which are discussed below.

3. For institutions that perform research for federal agencies, correspondence between the institution and the applicable government agency, as well as audit reports prepared by any government auditors;

4. The school bulletin and course catalogue;

5. The school telephone directory (useful to obtain a better idea of how the institution is organized);

6. Minutes of meetings of the institution's governing board and other committees or groups;

7. Student newspapers, alumni bulletins and alumni magazines (useful to obtain what the Guidelines call "a different perspective" on the institution's activities and operations);

8. Alumni bulletins and magazines;

9. A list of all university publications;

10. A description of the institution's accounting system, including a copy of the chart of accounts;

Comment: The Guidelines warn that many universities utilize "advanced forms of fund accounting" and that the analysis of the accounting system should extend "beyond the chart of accounts" to include separate accounts or funds maintained by different departments as well as any new accounts established in response to Board of Director organizations.
11. Requisition and purchase order files;

<Comment: Agents are instructed to determine to what extent services provided by the university are "contracted out," whether the contracts reflect arm's length terms and conditions, and whether any contractors have a close relationship to the university, such as directors, officers, faculty, or other employees.

12. NCAA disclosure forms required to be completed by coaches to disclose all "athletically-related income from sources outside the institution," such as annuities, housing benefits, sports camps, complimentary-ticket sales, and sporting goods endorsements.

<Comment: Such "outside" income may be treated by the IRS as provided by the college or university, with corresponding withholding and reporting requirements imposed on the university.

13. Disclosure reports filed by university scientists and technology licensing employees with the university and with any federal agency that is sponsoring research at the institution.

<Comment: Agents are directed to look for "possible conflicts of interest and employment tax issues."

<Comment: The requests for items 12 and 13 do not address the privacy laws of several states that prohibit disclosure of such information to any outside party.

C. External Documents and Information.

Also, the Guidelines suggest that, prior to commencing the audit, the Agent should obtain and review the following basic documents and information maintained by third parties:

1. The institution's audited financial statements, including any letters to management or other reports prepared by the auditors;

<Comment: Agents are advised that "footnotes may be especially informative."

2. Reports prepared in connection with accreditation audits made by the appropriate accreditation organization;

3. State and local real estate property tax exemption letters and the results of state audits;

<Comment: The state and local property tax exemption rulings can be useful to determine whether, in the view of the local taxing authorities, property is being used by the university for non-educational purposes.
Such purposes may include the provision of faculty residences or the operation of a commercial enterprise.

4. National Cooperative Research Act filings are made by research joint ventures to limit potential antitrust exposure. Agents are advised to review the filings listed in the Federal Register and Department of Justice records to see "whether the institution or any subsidy participates in research joint ventures;"

D. Indirect Cost Proposals and Audits.

1. Information required to be prepared and filed by the institution in order to demonstrate its compliance with OMB Circular A-21, which governs the computation of indirect costs reimbursed to an institution by the federal government under sponsored research contracts, will be reviewed by the Agent.

Comment: The Guidelines state that OMB Circular A-21 information can provide the Agent with "valuable insight" into the institution's organizational structure, accounting system, and adequacy of internal controls, as well as other relevant issues such as the "reasonableness" of compensation, fringe benefits, unrelated trade or business, and illegal activities.

Note, however, that the IRS does not accept the provisions of OMB Circular A-21 as an appropriate methodology for the allocation of indirect expenses. In addition, costs that are not allowable under Circular A-21 are not necessarily excessive or inappropriate for tax purposes.

Note also that although the Guidelines mention "reasonable compensation" as a potential issue in connection with OMB Circular A-21, this concept is not described or defined in the Guidelines. This may refer to the salary cap imposed by the National Institute of Health, which is not relevant in determining whether the salary is unreasonable for tax purposes.

2. Agents are also advised to review the institution's (i) most recent cost proposal package, (ii) the cost negotiator's indirect cost rate agreement for the years under examination, and (iii) audit reports of governmental or independent auditors.

Comment: Agents are told to give "particular attention" to (i) the reconciliation of the cost proposal and the audited financial statement, and (ii) any adjustments for unallowable costs, including entertainment, personal expenses, etc.
E. Examination of Financial Statements.

Agents are directed to examine the institution’s financial statements and to prepare (i) an income analysis, (ii) an expense analysis, (iii) a balance sheet analysis, and (iv) a cash flow analysis.

1. Income Analysis.

   a. All income should be categorized and analyzed by source (e.g., tuition, contributions and grants, contracts, payments for the use of sky boxes, sales of educational materials, etc.).

   b. The institution’s investment portfolio should be reviewed to determine whether the investments resulted in any private benefit or inurement.

   *Comment:* Any relationship between the institution’s investment advisors and its directors, officers, or employees can cause problems, and any "speculative investments" involving such individuals could be used as evidence of direct or indirect benefit to university "insiders."

   c. Any separate accounts maintained by the institution with respect to joint ventures that the institution has undertaken either with other institutions or business firms should be reviewed. In many cases, these ventures (sometimes referred to as "consortiums") are formed to conduct research, and income from these research activities may be unrelated business income. Agents are instructed to interview faculty members or other employees administering the programs to obtain a better idea of how the activity is conducted.

   d. Agents are cautioned to carefully distinguish between outside business activities and the regular services that an institution provides for its own departments. Many universities provide centralized services for activities such as purchasing, construction, electrical and plumbing, etc., and the Guidelines instruct the Agent not to confuse these "captive" operating units with similar functions that may be performed for parties unrelated to the university.

   *Comment:* The clear suggestion is that providing these types of services internally is acceptable, while providing them to unrelated parties may result in unrelated business income.

   e. All non-educational rental activities should be identified and examined. Examples include (i) renting a hall to the general public and providing food catering and bar service; (ii) using
tennis facilities in the summer for a public tennis camp; and (iii) leasing a football stadium to professional football teams.

Comment: The Guidelines state that these types of activities "may be a potentially large source of unrelated business income," and that employee use of such facilities "may constitute a taxable fringe benefit."

f. Athletic departments that compete at the major college level should be examined. Specific items to be examined include income received from advertising in game programs and agreements or contracts for the endorsement or sponsorship of products.

Comment: On January 19, 1993, the IRS separately issued proposed regulations dealing with "corporate sponsorship" income. The Guidelines contain a specific cross-reference to these regulations, and it is expected that the Agents will apply them in appropriate cases. See the discussion below regarding the corporate sponsorship issue.

2. Expense Analysis.

a. All expenditures should be divided into different expense categories.

b. Expenses listed in specific school, department, or program accounts are generally shown in great detail, thereby allowing "a search for possible abuses."

c. While payroll accounts under a particular school or department may not appear to be excessive, when funds are paid by multiple entities to the same individual, "unreasonable compensation may be present."

Comment: Again, note the reference to "unreasonable compensation" without any further discussion in the Guidelines as to how this determination should be made. Also, see the discussion below regarding "Related Entities" and how payments from multiple entities may result in unreasonable compensation.

d. Particular attention should be focused on unrestricted accounts for use by designated officials, for example, "President’s Reserve," "Dean’s Office Fund," "Official Entertainment Fund," and similar accounts. These accounts should be examined to determine whether any amounts paid to individuals should be included in the individual’s gross income and treated as taxable wages.
3. **Balance Sheet Analysis.**

   a. The Guidelines state that the balance sheet of a large institution is usually divided into different "funds," such as current funds (both unrestricted and restricted), endowment funds, student aid funds, physical plant funds, etc.

   **Comment:** Agents are instructed to carefully examine endowment funds to see whether the contributor has imposed any requirements or restrictions on the fund that might constitute "inurement." For example, the names of contributors to an endowment fund may be compared with names of suppliers or vendors of that fund to identify any contracting abuses.

4. **Cash Flow Analysis.**

   a. If a university maintains a statement of cash flows, Agents are instructed that this statement can offer "valuable insights" into the university's activities and can reveal, for example, large cash investments in a joint venture, loans, major acquisitions or dispositions.

F. **Related Parties and Related Party Transactions.**

   1. Agents are instructed to examine all separately incorporated but related entities for which the institution is "fiscally responsible," such as research organizations and university publishers. See below the discussion on the Guidelines' expansive definition of a "related entity."

   2. Agents are also advised to examine transactions between the institution and officers, directors and other related parties.

   **Comment:** The Guidelines state that such related transactions "may raise questions of reasonable compensation, private inurement, private benefit or employment taxes."

G. **Employment Taxes.**

   1. As a result of its examinations in the hospital area, the IRS has learned that substantial revenues can be generated from employment tax issues. Many exempt organizations provide numerous fringe benefits to employees, and the IRS has found substantial non-compliance by exempt organizations with respect to the reporting and withholding requirements for those fringe benefits. Accordingly, Agents are instructed to be "alert" to arrangements in which taxable compensation paid to employees is not properly reported on Form 990, employment tax returns, or Forms W-2, including (i) awards to faculty members (including those paid by a related entity), and (ii) payments or taxable fringe benefits provided to athletic staff by booster clubs.
Comment: Compensatory payments made to university employees by third parties is a controversial area -- see the discussion in Paragraph 9 below.

2. A college and university may be liable for (i) income tax that it failed to withhold, (ii) FICA and FUTA tax on the unreported compensation from fringe benefits, and (iii) penalties and interest for a failure to withhold, remit and report the income and employment taxes.

3. Agents are instructed to determine whether various exclusions for employment taxes are applicable, including the exclusion for (i) nonresident aliens holding F, J or M visas (section 3121(b)(19); and (ii) students enrolled and regularly attending classes at the institute (section 3121(b)(10).

Comment: In 1993, the IRS issued a significant letter ruling interpreting the student FICA tax exemption under section 3121(b)(10). In Letter Ruling 9332005, the IRS National Office stated that an undergraduate student enrolled in 12 or more credit hours and employed for 20 hours or less per week will qualify for the exemption. The letter ruling went on to say that an undergraduate student enrolled in less than 12 credit hours "significantly reduces, but does not automatically preclude" the availability of the exemption. This ruling has been severely criticized by the educational community and efforts are underway to revoke or modify this rule. Specifically, a coalition of educational institutions is working with the IRS National Office to modify this rule. The coalition is being assisted by NACUBO, and Baker & McKenzie serves as tax counsel for the coalition.

4. Employment arrangements should be carefully examined to determine if the institution has properly classified its workers as "employees" or "independent contractors."

Comment: Agents are instructed to "be alert to efforts [by institutions] to treat employees, such as adjunct professors, as independent contractors." See, in this connection, Revenue Ruling 87-41, which lists the 20 common law factors indicating the existence of an employment relationship. In addition, the Joint Committee on Taxation recently released a report on worker classification (JCX-6-94), and the Treasury Department has issued an administrative position on worker classification.

The status of individuals as independent contractors or employees is apt to be a significant focus of the audit. The IRS has expressed a serious concern that many colleges and universities are misclassifying employees as independent contractors and are failing to pay substantial amounts of employment tax. The IRS will closely examine individuals receiving both a Form W-2 and a Form 1099 within the same taxable year.
For a discussion of whether an individual should be treated as an employee receiving compensation for services rendered or as a scholarship or fellowship recipient, see Guidelines section 342.11 -- Scholarships and Fellowships.

5. Agents are told to "be sure to raise employment tax classification issues" because under section 530 of the Revenue Act of 1978 an institution may be entitled to relief from employment tax liability with respect to particular workers who are improperly classified, provided that the institution meets the following three requirements:

a. The institution must have filed all federal tax returns required to be filed on a basis consistent with treating the worker as not being an employee;

b. The institution must not have treated any worker holding a substantial or similar position as an employee for employment tax purposes after December 31, 1977; and

c. The institution must have a "reasonable basis" for not treating the worker as an employee.

Comment: The "reasonable basis" test can be met if a previous IRS audit failed to raise an employment tax classification issue with respect to the workers. This is why agents are told "be sure" to raise this issue during the audit.

H. Cafeteria Plans.

1. A general rule of U.S. tax law is that compensation is includable in income if the recipient has the choice to receive the amount, even if he does not elect to actually receive it. An exception to this doctrine of "constructive receipt" is found in section 125, which states that if under a cafeteria plan the individual is able to elect certain types of employer-provided benefits, the constructive receipt rule will not apply.

2. Only certain types of benefits can be elected under a section 125 cafeteria plan. They include accident and health insurance, group term life insurance and benefits under a dependent care assistance program.

3. A cafeteria plan may not provide qualified scholarships or tuition reduction, educational assistance, or deferred compensation.

4. Agents are advised that (i) contributions are generally made pursuant to a salary reduction agreement; (ii) the cafeteria plan must be in writing; (iii) certain nondiscrimination rules must be met; and (iv) an annual return for the plan must be filed.
I. Fringe Benefits.

1. The Guidelines point out that "any property or service (or cash under certain circumstances)" provided by a college or university to an employee in addition to or in lieu of regular wages will constitute a taxable fringe benefit to the employee, unless the payment can be excluded under a specific statutory exclusion. The exclusions mentioned in the Guidelines include section 79 (group term life insurance); section 105 (amounts received under accident health plans); section 106 (contributions to accident and health plans); section 107 (rental value of parsonages); section 117(d) (qualified tuition reductions); section 119 (exclusion for meals and lodging); section 120 (qualified group legal services plans); section 127 (educational assistance programs); section 129 (dependent care assistance programs); and section 132 (certain specified types of fringe benefits).

Comment: The Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") retroactively extended the exclusion for employer-provided educational assistance under Section 127 from June 30, 1992 through December 31, 1994. As of this writing, it has not been further extended.

2. The Guidelines note that fringe benefits provided by educational institutions to employees can take many different forms, including:

a. Automobiles (including chauffeurs);

b. Parking;

c. Flights on institution-owned or leased aircraft (see, in this connection, Treas. Reg. § 1.61-21(g) setting forth noncommercial flight evaluation rules);

d. Personal transportation and expenses associated with post-season athletic events;

Comment: These provisions target travel to bowl games that is provided to the spouse and family members of an institution’s athletic coaches. In that regard, the reader should be aware of section 274(m)(3), as added by OBRA '93, which provides that no deduction shall be allowed for travel expenses paid or incurred with respect to a spouse accompanying an employee on business travel, unless (i) the spouse is also an employee of the employee-spouse’s employer, (ii) the travel of the spouse is for a bona fide business purpose, and (iii) the travel expenses would otherwise deductible by the spouse.

On December 15, 1994, the IRS issued proposed regulations under section 132 addressing the question of whether an employee whose business-related spousal travel expenses are paid by the employer...
recognizes income in the amount of the expense reimbursement. (The proposed regulations also cover employer-paid club dues and business meal and entertainment expenses). While the proposed regulations generally state that these employer-provided payments will not result in additional income to the employee (assuming, of course, that they are business related), the regulations do not specifically state whether the rule also applies to nonprofit employers and their employees.

   e. Awards and prizes;

   f. Bonuses (both cash and non-cash);

   g. Free or specially discounted tickets (including season tickets) to athletic, entertainment, or cultural events;

Comment: Although the IRS has historically treated tickets as "products," the Guidelines state that tickets will generally be treated as "services." The maximum qualified employee discount for services is 20%. Note that if tickets are only occasionally provided to employees, the tickets may be excludable as a de minimis fringe benefit.

   h. Subsidized faculty dining rooms;

   i. Meals;

   j. Insurance;

   k. Scholarships and fellowships;

   l. Free or subsidized housing;

Comment: Under section 119(d), an employee generally can exclude the value of "qualified campus lodging" if the employee pays rent of at least 5% of the value of the lodging.

   m. Housing allowances;

   n. Club memberships;

Comment: OBRA ’93 added section 274(a)(3), which provides that no deduction shall be allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose. According to the Senate Finance Committee Report describing this provision, this rule is intended to apply to all types of business, athletic, luncheon, and sporting clubs. In 1994, the IRS issued proposed regulations classifying the definition of a "club" for purposes of this new rule.
For a discussion of whether a payment by a university of business-related club dues for an employee will result in additional income to the employee, see the commentary discussion in section II.1.2.d. above regarding the proposed regulations under Section 132.

o. Personal use of athletic facilities;

p. Tuition assistance; and

q. Educational assistance

3. To determine what specific fringe benefits are provided to employees, Agents are instructed to review minutes of finance, budget committees, faculty handbooks and newsletters, brochures, campus newspapers, and athletic event programs.

4. The Guidelines specifically state that it is not necessary that the benefit be furnished directly to the employee, as long as the benefit is provided to the employee in connection with the performance of services for the institution. For example, the use of an automobile provided to a college or university employee by an athletic booster club or by a local automobile dealer may be treated as a fringe benefit provided by the university. If the benefit was "contemplated" during the employment process or provided by the third party "through an arrangement with the institution," the benefit will be treated as paid by the institution. If, however, the benefits result from "the unilateral initiation of the third party," then the institution will not be treated as providing the benefit, even though the individual may have tax consequences.

Comment: This treatment of third party payments is a direct result of comments submitted by institutions who felt that the proposed guidelines were much too expansive in treating third party benefits as made by the university.

In addition to raising withholding and reporting issues, the IRS could also conclude that the third-party fringe benefits cause the total compensation package to be "unreasonable" in amount. See discussion in Section III.A below.

5. If the institution has a "tuition reduction plan," Agents should determine whether the plan meets the requirements of section 117(d). If it does not, the tuition payments will constitute additional compensation to the employee, and the institution is responsible for withholding and reporting on such tuition payments.

Comment: The Guidelines warn that the section 117(d)(5) exception permitting graduate level tuition reduction payments for teaching and research assistants should be "narrowly construed to be limited to graduate teaching and research assistants" only. For example, the IRS
recently ruled in PLR No. 9431017 that tuition reduction benefits do not extend to domestic partners under §117(d).

6. If the institution provides housing to its officers, faculty or staff, Agents should determine whether the housing qualifies as "qualified campus housing" under section 119(d).

7. Agents should obtain copies of all Forms 1099 and W-2 issued by the institution and compare these forms with a sample of expense entries to determine if the institution is consistently and properly issuing Forms 1099 and W-2.

Comment: Agents will closely review individuals receiving both a Form 1099 and W-2 within the same taxable year to determine whether the workers were improperly classified.

8. Agents should determine if the institution has a plan whereby employees receive reduced rates for insurance or other services provided by suppliers to the institution. If so, the benefit may constitute a taxable fringe benefit.

9. The Guidelines state that discounts to faculty members on ticket sales to college events usually constitute a "qualified employee discount" under section 132(c) but only if they qualify as "qualified property or services" under section 132(c)(4).

10. The Guidelines also state that the value of free or discounted parking to employees in excess of the statutory exclusion of section 132(f) is income to the employee.

11. The Guidelines indicate that under section 3121(b)(19), service performed by a nonresident alien who is temporarily present in the U.S. under a F, J, or M visa is not subject to FICA tax, provided that the service is performed to carry out the purpose for which the nonresident alien was admitted to the U.S. This latter requirement essentially requires the IRS agent to make a determination normally made by agents of the Immigration and Naturalization Service -- that is, whether the nonresident alien is working in compliance with the restrictions or limitations imposed by his visa classification. The Guidelines then proceed to describe a number of different rules and regulations regarding nonresident alien work classification, all of which the Agent will presumably apply in determining whether the section 3121(b)(19) exception is satisfied.

Comment: This particular provision is new in the final guidelines -- it was not contained in the proposed guidelines. The provision relates to a FICA tax exemption and, therefore, would seem to be more properly included under section 342.5 dealing with employment taxes. Query whether IRS Agents will, in fact, attempt to make immigration law determinations as part of their audit.
J. Retirement and Other Deferred Compensation Arrangements.

1. The Guidelines state that the most common plans offered by educational institutions to their employees are (i) section 401(a) qualified plans, (ii) section 403(b) annuities, and (iii) deferred compensation arrangements (either qualified under section 457 or non-qualified).

2. Agents are required to identify the particular retirement/deferred compensation plans that an institution maintains and to review the official plan and trust documents, any determination letters issued to the plan, private letter rulings, employer and employee contributions, account balances or accrued benefits, and employee compensation. Also, where appropriate, the Agent is directed to request assistance from the IRS District or the National Office to ascertain that there are no problems with participation, discrimination and benefit levels, vesting, funding, portability, or the security of the pension investments.

3. Agents should determine if the institution offers any other plans or arrangements that operate to defer the receipt of compensation to some future date, whether deferred benefit or deferred contribution plans, elective or non-elective plans, or funded or unfunded plans.

Comment: Such plans may be funded plans or simply be a contractual promise to make payments at a future time, but, in either event, the tax consequences to the employees under these plans will generally be governed by section 457. The IRS recently announced that it will issue new audit guidelines for section 403(b) plans maintained by exempt organizations, as well as a "voluntary compliance program" permitting plans to avoid disqualification by advising the IRS of any deficiencies in a plan's organization and operation. Current audits have revealed numerous violations of section 403(b) by exempt organizations, occurring primarily in the following areas:

1. Exceeding the applicable limitations on (i) the exclusion allowance under section 403(b)(2), (ii) benefits and contributions under section 415, and (iii) salary reduction contributions under section 402(g).

2. Noncompliance with the "required beginning date" rules.

3. Noncompliance with restrictions on distributions to participants.

4. Inadequate salary reduction agreements.

5. Failure to file Form 5500 (the annual report required for plans with 100 or more participants).
6. Noncompliance with the good faith, reasonable interpretation requirements of Notice 89-23, specifically, failure to (i) satisfy the nondiscrimination rules with respect to the non-salary reduction contributions, and (ii) provide universal availability of the salary reduction program because of eligibility restrictions, mandatory contributions, and impermissible participant exclusions.

K. Contributions to the Institution, Fund-Raising, and Debt Structure.

1. With respect to conditional or "earmarked" contributions by donors, Agents are instructed to review minutes of the institution’s governing board, as well as fund-raising, budget, finance, or development committees, to identify any such contributions that may have "questionable terms." For example, a gift to build a campus building that is conditioned on the use of a certain architect or specific construction firm may suggest that a private benefit exists for the donor.

2. The institution’s fund-raising program should be examined to determine if any benefits are provided that might affect the deductibility of the contributions. Specifically, Agents are instructed to obtain and review the following items:

   a. A list of the officials responsible for soliciting funds and a description of their activities and functions;

   b. Minutes of any committees (i.e., budget, finance, development, etc.) involved in fund-raising;

   c. All internal reports related to gifts, such as alphabetical lists of contributors, lists of donors by type (alumni, corporation, etc.), lists of restricted gifts, lists of in-kind gifts, etc.;

   d. All correspondence and agreements related to gifts to the institution (useful to identify restricted, earmarked, or conditional gifts);

   e. A list and description of all non-cash gifts;

Comment: With respect to gifts of property, the Agent will determine whether (i) the institution obtained its own appraisal or relied on the value assigned by the donor, and (ii) what the institution does if its valuation of the property is less than the value claimed by the donor.

Although not specifically included in the statutory provisions of OBRA '93, the Committee Report for this bill directs the IRS to develop procedures that would permit donors to obtain an agreement with the IRS regarding the value of tangible personal
property prior to its donation. In response, the IRS has recently released a proposed revenue procedure that allows taxpayers to obtain an IRS valuation statement for contributions of art to an exempt organization. This procedure applies to artistic items for which the taxpayer has obtained an appraisal of $50,000 or more.

Comment: Mr. Owens recently disclosed that the IRS will intensify its review of fund-raising activities to identify situations resulting in private benefit or private inurement. The IRS will focus on an exempt organization's accounting and income reporting procedures to determine whether fund-raising proceeds are under the organization's control and are properly reported to the IRS. The IRS will also review contractual arrangements between exempt organizations and professional fund-raisers to determine which party is the primary beneficiary of the fund-raising activities. See, for example, United Cancer Council, Inc. v. Commissioner, 100 T.C. 162 (1993).

The specific activities that have caught the IRS's attention include "casino night" events, direct mail campaigns, donations of goods to an organization other than the recipient charity, monies received from another exempt organization's fund-raising efforts, and arrangements where an exempt organization receives a percentage of the "net" proceeds from a fund-raising event.

3. For gifts of property in excess of $5,000, Agents should determine whether the institution has completed Form 8283. (Required to be filed only if the property is not used by the institution in furtherance of its exempt purpose);

4. If the institution has sold, exchanged, transferred, consumed, or otherwise disposed of donated property within two years of the date of receipt, Agents should determine whether the institution has properly filed Form 8282;

5. Determine if the institution has complied with the "quid pro quo" disclosure rules of section 6115.

Comment: The IRS recently issued Publication 1771 explaining these new disclosure rules and the new substantiation rules of section 170(f)(8).

6. Determine whether any donated property was subject to a mortgage that might subject the institution to the "debt financed" rules under section 514; and

7. Obtain and review all agency agreements between the institution and financial institutions for the management of various funds.
8. Section 170(l) provides that 80 percent of an amount paid by a taxpayer to an educational institution, which would be allowable as a charitable contribution deduction under section 170 but for the fact that the taxpayer receives in return the right to purchase tickets for seating at an athletic event at the school's stadium, is allowable as a charitable contribution deduction.

Comment: The Guidelines state that section 170(l) applies only when the benefit received is the right to purchase tickets, and does not apply to other benefits received in return for the contribution, such as the use of a sky box for athletic events.

9. Agents should carefully examine any contributions made to an institution for the purpose of acquiring or constructing housing facilities that are rented by the institution to fraternities.

Comment: See Revenue Ruling 60-367 which holds that such contributions are deductible under section 170. Agents are instructed to determine whether the gift was, in fact, made to the college or university and was not simply a gift made to the fraternity using the college as a conduit.

10. Under section 170(e)(3), taxpayers are entitled to claim a charitable contribution deduction for contributions of books to a university. Agents are instructed to determine whether any contributed books are not, in fact, usable in the university's exempt activities because they are outdated, damaged, or unsuitable for reading by a majority of the reading public.

11. With respect to the institution's short and long-term debt, Agents should determine whether the lender has any other relationship to the university and, if so, the extent and nature of that relationship, and whether the lender might be benefiting inordinately as a result of the relationship. With respect to the university's financing arrangements, the Agent should 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. Agents are also instructed to review:

a. Interest rates and terms in loan agreements;

b. Promissory notes and security documents (e.g., financing statements, assignments, guarantees, indemnity agreements, and pledges of securities);

c. Loan commitment letters and attorneys' opinion letters to obtain a summary of the transaction;

d. The relationship between the institution and the lender;
e. Whether the lender has any other relationship with the institution and, if so, its nature and extent;

f. Whether the facts taken as a whole indicate that the lender or other party to the transaction benefitted inordinately from the relationship.

12. If "qualified private activity bonds" under section 103 (often referred to as "section 501(c)(3) bonds") were used to finance new facilities, Agents should determine whether the financed facility was related to the university's exempt purposes, the uses to which the facility is to be put, and the need of the university for the facility.

Comment: Agents are instructed to examine a variety of different issues and documents related to the bond issue.

13. Agents should determine the type of bond issued for the benefit of the university (i.e., governmental versus private activity) and whether the type of bond issue complies with the appropriate Code section (sections 141-150).

14. Agents should determine whether any of the restrictions of section 147 (restrictions applicable to private activity bonds) have been violated and whether any of the bond proceeds were used for purposes of arbitrage.

Comment: On February 16, 1993, the IRS released an Internal Revenue Manual Supplement that sets forth alternative procedures for processing applications of organizations that intend to issue tax-exempt bonds.

The IRS's current position regarding tax-exempt bonds is set forth in a 106 page chapter of the 1992 Exempt Organizations Continuing Professional Education Technical Instruction Program text book and in a 95 page chapter of the 1993 Exempt Organizations Continuing Professional Education Technical Instruction Program text book. To obtain a copy of these publications, send a request and a check in the amount of $40.80 for the 1992 text book and $79.95 for the 1993 text book to:

Internal Revenue Service
Freedom of Information Reading Room
P.O.Box 388
Ben Franklin Station
Washington, DC 20044

On June 14, 1993, the IRS issued its final simplified arbitrage rebate regulations. The final regulations provide greater coordination between the rules on yield restriction and rebate, and more uniform definitions, as
well as new guidance on many other topics that have not been previously addressed.

On January 10, 1994, the IRS announced a new tax-exempt bond compliance program that will increase the level of audit coverage and operate in close coordination with the Securities and Exchange Commission. The IRS also issued a "Tax Exempt Bond Action Plan" and has proposed creating a formal liaison structure between the IRS and the SEC in the exempt bond compliance area. In addition, each IRS District Office now has a designated specialist in exempt bond matters.

I. Research and Contracts.

1. The Guidelines state that almost all large colleges and universities conduct supported (or "sponsored") research, and that such research is usually funded by private firms or by the government.

2. The Patent and Trademark Amendments of 1980 encourage universities and businesses to collaborate and to "commercialize" and license federally-funded technology to U.S. businesses.

Comment: Notwithstanding this statutory encouragement, the Guidelines state that the relationship between the institution and government/business may create conflict of interest situations, for example, where a university scientist has a relationship to a particular licensee that may raise questions of impermissible private benefit. The Guidelines direct the Agent to review research activities for private inurement, private benefit, and unrelated business income.

The IRS also is reevaluating its position with respect to the exempt status of organizations formed to effect "technology transfers," i.e. transfers of technology developed by an exempt organization to commercial entities or for sale to the general public.

3. Under section 512(b)(8), unrelated business income does not include income derived from research by a college or university that is performed for any person.

a. The Guidelines direct the Agent to determine whether the research is conducted by a separately incorporated organization. If so, section 512(b)(9) may apply in lieu of section 512(b)(8).

Comment: The Guidelines cite G.C.M. 39196 as support for the IRS's position that a separately incorporated organization is not a "college or university" for purposes of section 512(b)(8).
b. The Guidelines also instruct the Agent to determine whether the research conducted by the university is, in fact, "research," rather than the conduct of an activity incident to a commercial enterprise.

**Comment:** *The Guidelines cite G.C.M. 39883, in which the IRS ruled that the taxpayer's operations were not scientific research, were incident to commercial operations, and were not carried on in the public interest. Agents are instructed to determine whether the methodology under which the research is conducted results in original conclusions or merely constitutes testing, sampling, or certifying of items to a known standard. See also, G.C.M. 39196 in which the IRS ruled that government safety or environmental testing is not "scientific research in the public interest."*

4. The Agent is directed to review the university's safeguards on managing and reporting conflicts of interest, as well as any conflict of interest requirements imposed by any federal agency that is sponsoring research to ensure that the institution is in compliance. In addition, the Agent will review any employment agreements between the institution and its scientist employees.

**Comment:** *If university scientists and technology licensing employees file any disclosures with the sponsoring agencies, the Agent is directed to review them, with the ultimate goal of determining whether any impermissible private benefit results to any private party.*

5. The Agent is directed to review research arrangements with government sponsors and joint venture or royalty-sharing agreements with industry sponsors.

**Comment:** *These reviews include arrangements between the institution and the sponsors and the institution's scientists and the sponsors. The IRS is obviously looking for evidence of private benefit or private inurement. In addition, the Agent is to determine whether a scientist's use of university facilities or employees for personal benefit was reported as compensation by the University.*

6. The Agent will determine whether the institution, scientist, or sponsor owns the patent or the right to license technology derived from the research. If the scientist hold extensive rights, the Guidelines recommend referral to the IRS National Office.

7. If an institution commercializes its research through a venture fund arrangement, the Agent is directed to determine whether payments received by an institution are royalties and whether those payments are ultimately paid to faculty. If a partnership arrangement is used, the Agent must determine whether payments are royalties or profits.
Comment: The Guidelines state that venture capital arrangements often give rise to private inurement, private benefit, employment tax, and unrelated trade or business issues.

8. If the institution conducts government-funded research, Agents should obtain copies of audit reports from the funding agency.

Comment: The Guidelines note that, although government-funded research does not raise any direct unrelated business income tax issues, findings in audit reports "may provide information about the institution's accounting practices that may be useful in considering other areas." Also, the reports may provide information about payments or benefits to individuals that raise income and employment tax issues.

9. Agents are directed to select sample closed research projects and conduct an in-depth review. Particular attention should be paid to (i) whether any scholarships or fellowships are involved in the project and whether such amounts were taxable or not, (ii) whether consultants were employed and, if so, whether these consultants were, in fact, "employees," and (iii) whether and how the results of the project were published.

M. Scholarships and Fellowships.

1. Agents are to determine if the scholarships and fellowships paid to students are "qualified scholarships" excludable under section 117. If the amount of the scholarship or fellowship grant is not a qualified scholarship, the institution maybe required to withhold tax and report the payments on Form W-2.

Comment: It is entirely possible that the audit may be expanded to the students to see if they reported and paid tax on any taxable scholarships and fellowships.

2. Where only a portion of the scholarship is granted in return for services, the institution must make a good faith allocation to determine what portion represents compensation for services rendered.

Comment: For a further discussion and examples of how this allocation should be made, see Prop. Treas. Reg. § 1.117-6(d).

3. Agents are directed to select a sample of the scholarship/fellowship recipients by amounts or percentage of the total and compare the payments made to them to the scholarship/fellowship payment authorization documents. The Agent will determine whether the recipients are degree candidates or were required to perform services in exchange for the payments.

4. The Guidelines state that "particular attention" should be given if the scholarship/fellowship recipient is a medical doctor. Grants to recent
medical doctors may, in fact, be for services rendered, and therefore taxable, even if described as a "scholarship/fellowship."

5. If the scholarship/fellowship funds were provided by a private firm, the Agent should determine if the recipient is required to provide future services as a condition of the award. If so, the section 117 exclusion may not be applicable.

6. If eligibility for scholarships is restricted to individuals of a particular race, the Agent should determine whether the scholarship granting program involved violates the public policy against racial discrimination. Such a determination will be based on all the facts and circumstances.

7. The Guidelines advise the Agent that in the view of the Department of Education, an institution may release information in response to an administrative summons without violating the Family Education Rights and Privacy Act. Accordingly, if information request by an Agent is covered by the Act, the Agent is advised to consider judicial enforcement of an administrative summons.

8. The Agent is directed to determine whether tuition reductions provided to graduate teaching and research assistants qualify for exclusion under section 117(d)(5). The Guidelines note that only amounts or waivers in excess of reasonable compensation for the assistant’s activities may be excluded from gross income, and that payment made for services are fully taxable to the recipients.

9. Research services performed to fulfill an institution’s contract with an outside grantor are not excludable.

Comment: The Guidelines encourage the Agent to challenge the exclusion of payments for research activities where the objectives of the research program are not solely focused on the education and training of the recipient.

N. Legislative and Political Expenses.

1. The Guidelines note that what may constitute prohibited legislative or political activities for many exempt organizations may not be treated as such in the college/university area. Example: In Revenue Ruling 72-512, the IRS held that a course in political campaign methods, which included time off for the student to work on the campaign of his or her choice, served educational purposes and did not constitute intervention in a political campaign. Example: Revenue Ruling 72-513 holds that a university, which provides office space and financial support to a campus newspaper with editorial opinions on political and legislative matters, is not attempting to influence legislation or participate in political activities.
Comment: Under OBRA '93, lobbying costs (including direct lobbying costs) generally will not be deductible, and to the extent an organization incurs such lobbying costs, either (i) the organization will incur a "proxy tax" or (ii) the members of the organization will not be permitted to deduct dues paid to the organization. The IRS has issued guidance for administering these provisions in Announcement 94-8 (proposed revenue procedure); T.D. 8511 and IA-60-93 (temporary and proposed regulations under section 162); and Prop. Treas. Reg. § 1.163-28 (allocation of internal costs to direct lobbying activities).

2. Agents are directed to review any written policy that the university may have on political activity undertaken on, near, or on behalf of the institution.

Comment: The Guidelines remind Agents that, as part of the institution's educational mission, the school may provide a forum for a wide variety of speakers, including candidates for public office. As long as the institution does not administer its speakers' program in such a way as to constitute intervention in a campaign, this will not be considered prohibited political activity.

3. Agents should review student newspapers for articles that may bear on political activities undertaken by the institution.

Comment: According to the Guidelines, a student newspaper of a large university reported the misuse of a "dean's discretionary fund" that took the form of political contributions.

4. Minutes of committee meetings should be reviewed to look for endorsements of or provisions of support for any political candidates.

5. Agents should pay particular attention to departments of a school that serve as the contact for legislative or political relationships. Often called the "university affairs" division or something similar, the activities of this office should be "reviewed thoroughly to determine if any abuses have occurred."

6. If the institution maintains an office in Washington, D.C. or the state capitol to lobby on behalf of the institution, the activities of the office should be reviewed for indications of abuse.

Comment: Of particular concern to Agents will be situations where the institution's legislative activities go beyond the institution's "self preservation" interest.
O. College and University Bookstores.

1. The Guidelines note that many institutions operate bookstores that sell items not related to the education of the students. Examples include wearing apparel, small appliances, stuffed animals, wall posters, pennants, wrist watches, candy, lotions, cosmetics, and similar items. Agents are instructed to determine whether the school has a policy regarding sales of such merchandise to members of the general public and, if so, how such a policy is enforced.

Comment: See G.C.M. 35811 and T.A.M. 8025222 involving the sale of items by college and university bookstores.

2. Section 513(a)(2) excludes from unrelated business income any sale that is primarily for the convenience of the institution’s students or employees. For example, this would include the operation of soft drink and food vending machines and laundromat facilities.

3. The IRS applies the "convenience" exception on a case-by-case and item-by-item basis.

Comment: See Revenue Ruling 73-105 which classifies sales of various items offered for sale by a tax exempt art museum.

4. The Guidelines specifically state that those items that are "required or are otherwise necessary" for courses of instruction will not constitute unrelated business income items. These include general school supplies, such as notebooks, paper, pencils, typewriters, and athletic wear used in physical education programs.

5. The educational purposes of a college or university are served by the availability of other educational materials that "further the unstructured intellectual life of the campus community." These items include such things as books, tapes, records, compact discs, and computer hardware and software.

6. Unless the "convenience" exception applies, the Guidelines specifically state that the regular sale of items not directly related to the institution’s educational purposes will result in unrelated business income. Examples include wearing apparel or novelty items bearing insignia, toilet articles such as toothpaste, and other items such as candy, cigarettes, newspapers and magazines, greeting cards, photographic film, cameras, radios, television sets, and other appliances.

Comment: The Guidelines state that the convenience exception does not extend to alumni.
7. With respect to the sale of computers by a college bookstore, the Guidelines note that, while the sale of a single computer to a student or faculty member may be related to the institution's exempt purpose, the sale of multiple computers to a single student or the sale of a computer to someone who is not a student, officer, or employee of the university may result in unrelated business income.

P. Other Unrelated Business Income Tax Considerations.

1. The Guidelines specifically state that it may not be proper in all circumstances to deduct OMB Circular A-21 costs in computing net unrelated business income.

2. Additional activities conducted by the institution that may result in unrelated business income include:

a. Sale of electricity to the public or to public utilities (see G.C.M. 38987);

Comment: This may also effect the state and local property tax status of college and university property.

b. Use of university facilities in unrelated activities (see GCM 39863, which holds that income derived from professional entertainment events sponsored by a university and held at its multipurpose facility constituted unrelated business income);

Comment: The IRS has asserted that public use of a University’s golf courses, recreational facilities, ice rinks, dormitories and similar facilities results in UBI. Also, the IRS has reversed its position in PLR 8340102 and is now treating alumni use of these facilities as unrelated public use.

c. Operation of hotels/motels (see G.C.M. 38060);

d. Operation of a parking lot (see G.C.M. 39825); and

e. Travel tours (see G.C.M. 38949).

Comment: The IRS is presently deliberating whether off-site educational programs for businesses or other organizations constitute unrelated business activities.

Comment: Interestingly, the Guidelines do not address affinity credit card arrangements and sales of mailing lists. At the time the Guidelines were released, a decision was pending in the Tax Court case of Sierra Club, Inc. v. Commissioner (Docket No. 8650-91), which involved affinity card and mailing list issues. In that case, the IRS maintained that income received by an exempt
organization from payments made by a bank for the right to use the organization's membership list constituted UBI.

Two interesting developments have occurred in the Sierra Club case. The Tax Court decided by summary judgement that the rental of mailing lists in this case constituted royalty income, but left open the question of whether the Sierra Club performed substantial services in connection with its mailing list activity. In a second partial summary judgment, the Tax Court also held that amounts received from the Sierra Club’s affinity card program were royalties for the use of the Club’s name, logo, and mailing lists. Nonetheless, briefs have been filed with the Tax Court in two other cases involving affinity credit card programs and educational organizations; Alumni Association of the University of Oregon v. Commissioner and Oregon State University Alumni Association v. Commissioner.

3. Note also that section 513(h)(1)(B) states that mailing list income is not UBI if the list is sold or exchanged to other exempt organizations. The IRS held in GCM 39727, however, that this exception does not apply to sales to for-profit entities, and the current position of the IRS is that income derived from these arrangements is taxable as UBI. After the Sierra Club decision, the IRS reasserted that it will treat income from exchanges with a commercial entity as UBI.

Comment: The IRS is also very interested in developing a case to challenge the Second Circuit's decision in the Rensselaer case involving cost allocation of dual use facilities. The IRS wants allocations to be based on facility availability, rather than on the days of facility usage. The IRS has indicated, however, that it will not challenge Rensselaer until new regulations are issued.

4. The "Corporate Sponsorship" Issue.

a. The "corporate sponsorship" issue will arise when a company makes a purported gift to a school, but requires that in return for the "gift," the company must receive certain publicity and exposure.

b. On January 19, 1993, the IRS issued Prop. Treas. Reg. § 1.513-4 under which an institution may "acknowledge" a sponsorship payment, but may not engage in "advertising" on behalf of the corporate sponsor. The Guidelines refer to these proposed regulations.
Comment: Recent sponsorship activity may raise numerous questions concerning this distinction. For example, it was recently reported that several soft drink companies have paid millions of dollars to various institutions in return for being the "official" drink of the schools and receiving certain publicity benefits.

Q. Related Entities.

1. For purposes of the Guidelines, the term "related entity" is interpreted broadly to include "any organization whose primary activity is to support the institution or its programs."

Comment: The Guidelines appear to acknowledge that an institution may operate as a single legal entity or that individual departments or "schools" may be separately incorporated. This broad definition would include an institution's related exempt and taxable subsidiaries, such as alumni associations, athletic booster clubs, and research ventures and partnerships. The IRS will closely examine the relationship between the university and any related entity that has potentially unrelated business activities.

2. All payments, including fringe benefits, to officers, directors, deans, or other officials should be examined in the aggregate to determine if unreasonable compensation is present. If one employee is compensated by several entities, the examiner should examine the total compensation paid by all entities, and determine if that total compensation is reasonable.

Comment: Again, the Guidelines mention the "unreasonable compensation" issue without any further discussion.

3. Sharing of facilities and allocation of expenses among related entities should be reviewed.

4. All payments, including fringe benefits, from athletic booster clubs to coaches, staff, and athletes should be reviewed to determine whether the payments were reported as income on Form 1099 of, if the amounts were reimbursed expenses, whether the substantiation rules of section 274 have been satisfied.

Comment: It is not clear why these should be reported on Form 1099. Elsewhere in the Guidelines [Section 342.5(2)], the clear implication is that they should be reported on Form W-2.

5. All separate funds administered by the institution should be identified and reviewed to determine that the funds are operated in furtherance of an exempt purchase. For example, the institution may have separate endowment funds for designated chairs or separate scholarship funds.
6. Any separate campus maintained by the institution should be reviewed and all allocations of payments to and from the campus should be evaluated. Payroll records should be checked to ensure that each campus is reporting income and employment taxes properly.

7. The Guidelines note that some institutions include certain "funds held by others" in their assets. All such funds should be reviewed carefully to determine the relationship between the institution and the contributor.

8. For those institutions that have a foundation through which they conduct various activities, the Guidelines note that in some instances these foundations are used to carry on activities that cannot be conducted on directly by the school, such as research activities carried on for private companies. The relationship between the institution and all such foundations should be carefully reviewed.

III. Issues Not Addressed by the Guidelines.

A. The "Unreasonable Compensation" Issue.

1. During a speech on September 16, 1992, James McGovern, Assistant Commissioner (Employee Plans and Exempt Organizations), noted two recent newspaper articles that have caught the attention of the IRS regarding "unreasonable compensation" in the academic community.

   a. The first article was in the May 8, 1992 issue of The Wall Street Journal, in which a Dartmouth spokesman stated that because universities are nonprofit institutions, they do not seek to keep salaries low.

   b. The second article mentioned by McGovern was in the September 11, 1992 issue of The Wall Street Journal, entitled "How Colleges Can Cash In on Their Coaches." In this article, the author concluded that the earnings of some athletic coaches may provide the IRS with an "unreasonable compensation" argument.

2. There are three clear references in the guidelines to "reasonable compensation," namely, sections 342.33, 342.42(4), and 342.(15)(2).

Comment: There is a strong likelihood that new "intermediate sanction" legislation will be adopted in 1995 imposing new "self-dealing" and "private inurement" penalties on charitable and educational organizations. Under present law, the only sanction that the IRS has to punish an organization for engaging in a self-dealing or private inurement transaction is revocation of the organization's exempt status - - a sanction that is not normally imposed because it is exceedingly harsh.
During 1994, the Treasury Department proposed legislation that would impose a new "two-tiered" excise tax on any "excessive" benefit that is provided by an exempt organization to an insider. Specifically, the excise tax would apply to both the payment of unreasonable compensation and to any non-fair market value transfer to or from an insider. The term "insider" includes an individual who has influence over an organization's affairs, and the excise tax would extend to any excess benefits provided to an insider's family. Under the proposal, the insider would be subject to an initial excise tax of 25% of the excess benefit. If the insider does not repay the excess benefit within the prescribed period, the insider would be subject to a second excise tax of 200% of the excess benefit. In addition, any manager who knowingly approves the payment of the excess benefit would be subject to tax of 10% of the excess benefit, up to a maximum of $10,000.

It is difficult to evaluate the impact of the proposed legislation on colleges and universities until actual legislative language is developed. Potential issues, however include (i) whether "reasonable compensation" will be defined, (ii) whether in determining "reasonable compensation" institutions will be precluded from using for-profit company compensation as a comparable for establishing an appropriate compensation amount, and (iii) the definition of an "insider" and whether, for example, the term will cover academic faculty and staff. The proposal was not enacted during 1994, but is expected to be revisited by the Congress during 1995.

3. The entire compensation package of administrators and faculty staff will be reviewed by the IRS for reasonableness, including deferred compensation and fringe benefits packages. The IRS is particularly concerned about individuals who receive income from a number of different entities associated with the college or university, and this is one reason that Agents are directed to apply the term "related" in a broad manner.

Comment: See G.C.M. 39670 in which the IRS considered whether a deferred compensation arrangement resulted in unreasonable compensation and prohibited private inurement or other private benefit.

4. Compensation paid to athletic coaches may be a major issue. The IRS will look not only to the salary and fringe benefits package provided to the athletic coach, but also at certain fringe benefits that are outside the coach's formal salary structure. For example:

a. Sports camps. The coach may have an ownership interest in a for-profit company that leases space from the university at favorable rates to conduct a basketball camp during the summer.

b. Automobiles. These could involve automobiles provided by the school, or could involve the free use of an automobile provided by a local car dealer. In the latter situation, the IRS has taken the
position that the school, in substance, provides the automobile and must treat it as a fringe benefit of employment, if the automobile is held out as a benefit of employment with the university.

c. Free use of college or university facilities or services, such as free meals or season tickets. For example, coaches eat for free with the team and each coach is provided with two season tickets for his family.

d. Family/spousal travel to games.

5. Also, recruitment and retention arrangements for professors or administrative staff may create an unreasonable compensation issue. Examples of questionable arrangements include:

a. Loan guarantees or other subsidies used as part of a recruiting incentive that do not require repayment must be supported by evidence of a compelling need to further an educational purpose.

b. Loans to professors or other key employees should:

   (1) reflect a "reasonable" rate of interest, for example, two percent above prime;

   (2) have adequate security;

   (3) have Board approval;

   (4) be reflected as income to the borrower to the extent that any variance from the actual terms of the loan results in a benefit that the borrower could not otherwise obtain.

6. The payment of unreasonable compensation to an officer or employee can legally serve as the basis for revoking a college or university’s tax exempt status.

Comment: During 1994, the IRS revoked the tax exempt status of a teaching hospital because of alleged private inurement and private benefit.

7. If compensation is "unreasonable," it raises a private inurement or private benefit issue, depending upon the degree of control exerted by the affected employee. The ability of an individual to control or influence the amount of compensation is a critical factor.

a. The IRS will require that a dispassionate and independent group must set each element of the compensation package.
b. Problems would arise, for example, if the Board approves salary and fringe benefits, but other benefits are provided to the individual (free car, meals, etc.) on an ad hoc basis.

**Comment:** Treasury officials, in commenting on the proposed intermediate sanctions legislation, have indicated that their concern is not so much with the amount of the compensation, but rather with the method in which the compensation is determined and the degree of control exercised by the recipient.


B. Scholarships and Fellowships Paid to Foreign Students and Scholars.

1. In IRS Notice 87-31, 1987-1 C.B. 475, the IRS held that no withholding or reporting was required with respect to scholarship/fellowship payments made to U.S. students. This ruling did not apply, however, to payments made to foreign students. Thus, colleges and universities are required to withhold tax on payments made directly to foreign students (e.g., per diem) and on payments made to third parties on the student’s behalf (e.g., payment to airlines for travel). Also, annual reporting on Form 1042 and 1042S is required with respect to these payments.

2. If the institution fails to withhold tax and file the required reports with the IRS, the institution may be liable for the tax involved, and for interest and penalties on the amount of under-withheld tax. In addition, there are penalties for failure to properly and timely filed the required information returns.

**Comment:** The Guidelines direct the Agent to consult the International Group Examination Division regarding potential problems related to withholding for and payments to nonresident aliens, including failure to file Form 1042.

The IRS is stepping up its enforcement of these provisions and has targeted colleges and universities for compliance audits. A few years ago, press reports indicated that the IRS issued a summons to Harvard demanding information on more than 3,000 scholarship and fellowship students. A similar subpoena was issued to MIT demanding information on over 1,500 students.
IV. Contesting Issues Beyond the Audit Level

A. Technical Advice Requests.

1. A "technical advice request" is a request that the Agent seek advice on a legal issue from the IRS National Office. The request must technically be initiated by the Agent; however, Agents generally abide by taxpayer requests to seek technical advice assistance.

2. Under the technical advice procedure, the taxpayer files a legal memorandum setting forth the facts and legal arguments in support of his position with the National Office. The National Office reviews the memorandum and the arguments submitted by the Agent, and issues a "technical advice memorandum" to the Agent setting forth its conclusions.

3. Technical advice memoranda are released by the IRS to the public in sanitized form. While they technically have no precedential value, they are often used as authority by other taxpayers and IRS agents.

4. The procedures for requesting technical advice are set forth in Revenue Procedure 93-2.

B. Appeals Office Consideration.

1. At the conclusion of an audit, the Agent will issue a "30-day letter" and a Revenue Agent’s Report (RAR) to the taxpayer.

2. The taxpayer can either agree with the deficiencies proposed by the Agent or file a Protest Brief with the Appeals Office.

3. The Protest Brief must be filed within 30 days of the date appearing on the 30-day letter, unless the IRS district office grants an extension of time.

Comment: The Agent will usually require, as a condition of issuing a 30-day letter, that the taxpayer extend the statute of limitation for assessing tax. A taxpayer may extend the statute on a Form 872, which extends the statute for a fixed period of time, or on a Form 872-A, which is an open-ended extension that allows either party to terminate the extension 90 days after proper notification.

4. The Protest Brief must contain:

   a. A statement that the taxpayer wants to appeal the findings to the Appeals Office;

   b. The taxpayer’s name, address and taxpayer identification number;

   c. The date and symbols appearing on the 30-day letter;
d. The taxable years involved;

e. An itemized schedule of the proposed adjustments with which the taxpayer disagrees;

f. A statement of facts supporting the taxpayer’s position on any contested factual issue;

g. A statement outlining the law or other authorities upon which the taxpayer is relying for any contested legal issues; and

h. A penalties of perjury statement attesting to the accuracy of the facts set forth in the Protest Brief.

5. Before sending a Protest Brief to the Appeals Office, the Agent and other district office officials will review it.

6. Depending on the circumstances, the district office may forward the case directly to the Appeals Office, return it to the Agent for further development, or, if the Protest Brief is inadequate, return it to the taxpayer for perfection. Usually, however, the district office will forward the case directly to the Appeals Office.

7. In forwarding the case to the Appeals Office, the Agent will prepare a written report commenting on the Protest Brief. As a matter of course, the taxpayer should request a copy of this report from the Case Manager or the Appeals Officer.

8. The Appeals Office will settle a case based upon the IRS’s hazards of litigating the case. In determining these "hazards of litigation," the Appeals Officer will usually consider the likelihood of the IRS prevailing in court and the adverse collateral consequences to the IRS of a loss in court.

a. An Appeals Office may also settle issues based on a percentage of the proposed assessment or by "trading" issues, but this practice is usually not invoked if an issue carries over into a taxpayer's subsequent years.

9. If a case is settled at the Appeals Office, the terms of the settlement will be set forth in writing on a Form 870 or 870-AD. A Form 870 is the standard settlement agreement form, and is used when the IRS makes no settlement concessions. Use of this form however, does not bar the taxpayer from later claiming a refund of the taxes paid.

10. The Form 870-AD is used when mutual concessions are made by the IRS and the taxpayer, or when the settlement is made with certain conditions or reservations. This form may also be used to prevent the IRS (or a taxpayer) from reopening settled issues.
11. Taxpayers may also enter into "closing agreements" with the IRS. Under these agreements, a taxpayer may agree to alter its tax procedures or practices and conclusively dispose of a particular tax issue for future years. Closing agreements are executed on a Form 866, Agreement as to Final Determination of Tax Liability, or Form 906, Closing Agreement in Final Determination Concerning Specific Matters.

C. Docketing a Case in the Tax Court.

1. If a taxpayer fails either to file a Protest Brief or pay the proposed tax deficiency before the due date, the district office will issue a Notice of Deficiency, also called a "90-day letter."

2. Upon receipt of a Notice of Deficiency, the taxpayer must either file a Petition with the Tax Court within 90 days of the date of the letter or pay the proposed tax deficiency. I.R.C. § 6213(a).

   a. The 90-day deadline is a statutory requirement and neither the Tax Court nor the IRS has the power to extend it. See e.g., Kahle v. Commissioner, 88 T.C. 1063 (1987); Shipley v. Commissioner, 572 F.2d 212 (9th Cir. 1977).

   b. Under section 7502(a)(1), a Petition mailed on the 90th day will be considered timely filed if it is properly addressed and is postmarked no later than the 90th day.

   c. Taxpayers who intend to rely on the "timely mailed, timely filed" rule should get evidence of a timely postmark from the United States Postal Service. See e.g., Lindemood v. Commissioner, 566 F.2d 646 (9th Cir. 1977); Kahle v. Commissioner, 88 T.C. 1063 (1987).

D. Docketing Case in District Court or U.S. Court of Federal Claims.

1. In lieu of the Tax Court, a taxpayer can choose to pay the tax deficiency, file a claim for a refund of the tax, have the refund claim denied by the IRS, and bring an action in either the local district court or the U.S. Court of Federal Claims seeking a refund of the tax. I.R.C. § 7422.

2. An action in the district court or Court of Federal Claims for refund of the tax cannot be filed (i) before six months from the date of filing the claim for refund with the IRS, or (ii) after two years from the date the IRS mailed the notice of disallowing the refund claim. I.R.C. § 6532.
E. Deciding Whether to Contest a Case at Appeals Office or in Court.

After receipt of a 30-day letter, a taxpayer must determine whether to contest the deficiencies raised by the Agent at the Appeals Office or instead permit the IRS to issue a Notice of Deficiency and contest the deficiencies in court. A number of factors should be taken into account:

1. Under Revenue Procedure 87-24, 1987-1 C.B. 270, a case docketed in the Tax Court may be referred to the Appeals Office for consideration. Therefore, the taxpayer will normally have at least "one bite" at the Appeals Office "apple" even if the taxpayer intentionally by-passes the Appeals Office and proceeds to the Tax Court.

2. The burden of proof on any new issues raised by an Appeals Officer and subsequently included in a Notice of Deficiency will be on the taxpayer. Conversely, if the IRS raises new issues after the issuance of a Notice of Deficiency, the burden of proof will fall on the IRS. See Tax Ct.R. 142(a).

3. The taxpayer should carefully examine any pending cases raising the same issues as in its case. It may be prudent to let the case proceed at the Appeals Office if it is felt that a pending Tax Court or other court case on the same issue will subsequently be decided favorably to the taxpayer.

4. The taxpayer should consider its prior experience at settling issues at the Appeals Office. For example, the taxpayer may have an existing relationship with an Appeals Officer from prior audits that can be helpful (or harmful) to the chances of settling the case with the Appeals Office.

5. It is important to consider facts that may be involved in years subsequent to the years in controversy. Assuming that more favorable facts exist in future years, the taxpayer may benefit from proceeding to the Appeals Office, waiting for the audit of the later years to be finalized and then moving to consolidate all taxable years into one case. Conversely, when the facts in the later years are less favorable, it may be to the taxpayers advantage to proceed directly to court. Then, if the case must be litigated, the subsequent years will not be "before the court."

6. Generally all pleadings filed in a judicial forum are a matter of public record, while information regarding cases before the Appeals Office are kept confidential.

F. Choosing Between the Tax Court, the District Court, and the U.S. Court of Federal Claims.

1. In the Tax Court (i) jury trials are not available, (ii) trials proceed under the Federal Rules of Evidence and the Tax Court Rules of Practice and Procedure, and (iii) the government is represented by an attorney from the Internal Revenue Service.
2. In the United States District Courts (i) jury trials are available at the request of either litigant, (ii) trials proceed under the Federal Rules of Evidence, the Federal Rules of Civil Procedure, and the local rules of the district court, and (iii) the government is represented by an attorney from the Civil Trial Section of the Tax Division of the United States Department of Justice.

3. In the United States Court of Federal Claims (i) jury trials are not available, (ii) trials proceed under the Federal Rules of Evidence and the Rules of the United States Court of Federal Claims, and (iii) the government is represented by an attorney from Federal Claims Section of the Tax Division of the Department of Justice.

4. In choosing the best forum in which to try a case, the following factors should be taken into account:

a. Payment of Tax -- The Tax Court is the only forum in which a taxpayer can litigate is case without payment of the tax at issue. In order to litigate a case in either the district court or the Court of Federal Claims, the tax must be paid before litigation can begin.

b. Precedence -- One of the most important considerations in forum choice is the existence of favorable or unfavorable precedent available in each forum, since the various courts may have opposite holdings on the same issue. In analyzing precedent, the Tax Courts follows the Court of Appeals for the circuit to which the taxpayer could appeal, and the Court of Federal Claims follows the Court of Appeals for the Federal Circuit.

c. Timing -- The Tax Court is probably the best for taxpayers who want a speedy resolution of the case, since Tax Court judges normally are receptive to taxpayer requests for the earliest possible trial dates.

d. Technical Capability -- Tax Court judges handle only tax cases and typically have substantial tax experience. Thus, Tax Court judges usually have a better understanding of the technical issues than judges in the district courts or the Court of Federal Claims. Depending on the legal issues involved in the case, and the strengths and weaknesses of those issues, a taxpayer may be better (or worse) off with a judge who has substantial tax experience and expertise.

e. Discovery -- Discovery is more restricted in the Tax Court. The Tax Court relies heavily on informal discovery and limited formal discovery techniques, while the district courts and the Court of Federal Claims use the same discovery procedures that govern in other civil litigation.
f. **Place of Trial** -- In the Tax Court, the taxpayer normally has the flexibility to designate as the place of trial its city (or nearby city), its counsel's city, or in Washington, D.C. See Tax Ct. R. 140(a). A district court trial takes place in the district in which the taxpayer has its principal office or place of business, and a trial in the U.S. Court of Federal Claims takes place at a location selected by the Court "with a view to securing reasonable opportunity to citizens to appear . . . with as little inconvenience and expense . . . as is practical." 28 U.S.C. § 173.

V. **Asserting and Maintaining the Attorney-Client Privilege and Attorney Work Product Doctrine.**

A. **The Attorney-Client Privilege.**

1. **Elements of the Attorney-Client Privilege.**

   a. The attorney-client privilege protects confidential communications from a client to an attorney if such communication is made for the purpose of securing legal advice.


   c. The privilege only applies if the following requirements are satisfied:

      (i) The asserted holder of the privilege is a client (or seeking to become a client);

      (ii) The person to whom the communication was made is a member of the bar of the court and the individual is acting as a lawyer;

      (iii) The communication relates to a fact of which the attorney was informed by his client, without the presence of strangers, for the primary purpose of securing an opinion of law or legal services or assistance in some legal proceeding and not for the purpose of committing a crime or tort; and

      (iv) The privilege has been claimed and has not been waived by the client.

   d. With respect to corporations (including nonprofit corporations), the attorney-client privilege extends to all levels of corporate employees where confidential communications are made to an

e. Documents that are protected by the attorney-client privilege need not be produced in discovery. Fed.R.Civ.P. 26(b)(1); Tax Ct.R. 70(b).

**Comment:** In tax litigation, the IRS frequently seeks to discover documents protected by the attorney-client privilege.

f. The attorney-client privilege is limited to confidential communications made for the purpose of securing legal advice and does not provide a blanket of secrecy over all of the client’s affairs in which the attorney is involved. *In re Fishel*, 557 F.2d 209, 211-12 (9th Cir. 1977). For example, the privilege does not extend to documents intended to be disclosed to third parties. *U.S. v. Johnson*, 465 F.2d 793, 795 (5th Cir. 1972).

g. The attorney-client privilege does not apply to communications made in connection with an attorney’s business advice rather than legal advice. *Olender v. U.S.*, 210 F.2d 795, 806 (9th Cir. 1954); *Karmen v. Commissioner*, 73 T.C. 1163, 1183 (1980), aff’d 673 F.2d 1062 (9th Cir. 1982).

h. The privilege does not apply to communications made in the presence of third parties unless the third party’s presence is a "necessary aid to the rendering of effective legal service to the client." *U.S. v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972).

2. Waiver of the Attorney-Client Privilege.

a. If a document or communication is found to be within the scope of the attorney-client privilege, the communication or document remains privileged until such time that the privilege is waived by the client.

b. Waiver most commonly occurs when the privileged communications or documents are disclosed to persons outside the privileged relationship. Therefore, an individual can waive the attorney-client privilege by disclosing privileged documents to an adversary in discovery or during settlement or to a third-party.

c. Of particular importance is the fact that disclosure of privileged communications or documents to independent auditors can act as a waiver of the attorney-client privilege. *U.S. v. El Paso Co.*, 682 F.2d 530, 539-41 (5th Cir. 1982).
The attorney-client privilege protects from disclosure only the communications between the attorney and the client, not the underlying facts. Therefore, the attorney-client privilege will never serve to preclude discovery of underlying documents or facts such as contracts or loan agreements. At the same time, however, mere disclosure of the facts contained in the communication between the attorney and the client will not constitute a waiver. In order to waive the privilege, the confidential communication itself must be disclosed.

d. Difficult problems arise in connection with inadvertent disclosures of privilege communications to third parties. The traditional view of waiver held that any disclosure, whether intentional or inadvertent, waived the attorney-client privilege. Because of the harsh consequences of this doctrine, many courts, but certainly not all, have held that inadvertent disclosures do not necessarily waive the attorney-client privilege. See, e.g., U.S. v. Zolin, 809 F.2d 1411, 1417 (9th Cir. 1987), modified, 491 U.S. 554 (1988); Hartford Fire Insurance Co. v. Garvey, 109 F.R.D. 323, 329-30 (N.D. Cal. 1985); Transamerican Computer Co. v. International Business Machines Corp., 573 F.2d 646, 650-51 (9th Cir. 1978).

The attorney-client privilege can also be waived where a party relies on advice of counsel but asserts the privilege with respect to communications underlying or related to that advice. Under this theory, waiver is justified based upon fairness considerations requiring the full disclosure of all communications in order to avoid the truth being "garbled." For example, if a party discloses an opinion letter or has counsel make representations to the court or opposing parties, courts have held that the attorney-client privilege is waived. Hyde Construction Co. v. Koehring Co., 455 F.2d 337, 342-43 (5th Cir. 1972).

g. Once waiver has occurred, the privilege is generally treated as relinquished for all purposes and in all circumstances thereafter. Parties are not generally entitled to selectively choose to waive the privilege with respect to certain third parties and reassert it with respect to others. For example, disclosure of confidential communications to one federal agency has been held to constitute a waiver of the attorney-client privilege thereby allowing other federal agencies to obtain previously privileged documents. Permian Corp. v. U.S., 665 F.2d 1214, 1221 (D.C. Cir. 1981).

Traditionally, a waiver of the privilege was not confined to the particular communication disclosed but extended to all communications on the same subject matter. 8 Wigmore, Evidence, section 2328 at 638. Despite this traditional view, some courts have limited the subject matter of the waiver and have at times narrowly restricted the scope of the waiver. See, e.g., Weil
3. Dissemination of Privileged Information Within an Organization.


   b. The Supreme Court has suggested a need-to-know limitation on sharing privileged information with employees who are not members of the control group. *Upjohn Co. v. U.S.*, 449 U.S. 383, 394-95 (1980).

   c. Dissemination of confidential communications to non-control group employees has been held not to waive the attorney-client privilege where "the communication is not disseminated beyond those persons who, because of the corporate structure, need to know its contents." *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 609 (8th Cir. 1978).


   a. The doctrine was originally formulated by the Supreme Court in *Hickman v. Taylor*, 329 U.S. 495 (1947).

   b. The work product doctrine provides that materials prepared by an attorney in anticipation of litigation are not generally subject to discovery.

   c. The work product doctrine is designed to provide the attorney with a "zone of privacy" in which to prepare his or her client's case for litigation.


   e. The work product doctrine has been codified in Fed.R.Civ.P. 26(b)(3), which sets forth aqualified protection from discovery in civil actions in Federal District Courts where materials (i) constitute documents and intangible things otherwise discoverable; (ii) are prepared in anticipation of litigation or for trial; and (iii) are prepared by or for the party or for its representative.
f. To overcome this qualified protection, the party seeking discovery must make a showing of (i) substantial need for the materials, and (ii) inability to obtain the substantial equivalent of the information without undue hardship.

g. Even upon a showing of substantial need and undue hardship, however, courts are required to protect the attorney's mental processes ("opinion work product") from disclosure to the adversary. Opinion work product is discoverable only upon a showing of more than substantial need and undue hardship. Upjohn Co. v. U.S., 449 U.S. 383, 400-02 (1981).

2. The "Anticipation of Litigation" Standard.


b. A lawsuit need not already have been filed in order for the "in anticipation of litigation" requirement to be met. Upjohn Co. v. U.S., 449 U.S. 383, 386-87, 397-402 (1981).

c. While no clear test defines what constitutes a "likelihood" of litigation, a claim of work product will generally be upheld if the prospect of litigation is fairly obvious, imminent or probable. In re Special Sept. 1978 Grand Jury (III), 640 F.2d 49, 61-62 (7th Cir. 1980); In re Grand Jury Proceedings, 601 F.2d 162, 171-72 (5th Cir. 1979); Sylgab Steel & Wire Corp. v. Inmoco-Gateway Corp., 62 F.R.D. 454, 457 (N.D. Ill. 19784), aff'd without opinion, 534 F.2d 330 (7th Cir. 1976).

3. The "Prepared by or For a Party or Its Representative" Standard.

a. Although the Supreme Court in Hickman was concerned about providing a zone of privacy within which the attorney could prepare his or her case for trial, in recognition of the attorney’s need for assistance from non-lawyers in preparing the case, the Supreme Court extended work product protection to include the work product of agents for the attorney. U.S. v. Nobles, 422 U.S. 225, 238-39 (1975).

b. Fed.R.Civ.P. 26(b)(3) expands the scope of work product to include materials prepared in anticipation of litigation by any representative of the client, regardless of whether the representative is acting for an attorney.
c. As a practical matter, however, the absence of an attorney's supervision may lead a court to conclude that the documents or other materials were prepared in the ordinary course of business rather than in anticipation of litigation. See, e.g., APL Corp. v. Actua Casualty & Sur. Co., 91 F.R.D. 10, 16 (D.Md 1980).

Comment: In the recent case of United States v. Jack Bell, Baker & McKenzie prevailed in an attempt by the IRS to obtain an accountant's reports which contained sensitive information with respect to a taxpayer's income tax position. In that case, our firm had been engaged by the taxpayer to provide legal advice concerning the taxpayer's compliance with certain tax law provisions, and in that connection, we retained an accounting firm to provide accounting assistance and economic analysis. In connection with its examination of the taxpayer, the IRS issued a summons to obtain the accounting firm's reports. The U.S. District Court for Northern California denied enforcement of the IRS's summons, however, on the grounds that the reports were protected from disclosure under the attorney-client and attorney work product doctrines.

This case underscores a point that we have repeatedly emphasized to our college and university clients and friends; if documents are prepared in assessing an institution's potential tax exposure or in connection with (or in anticipation of) an IRS examination, it is imperative that all such documents be protected from disclosure to the IRS under the attorney-client or attorney work product doctrines. As this case clearly demonstrates, the IRS is very aggressive in seeking accounting and consulting reports, and the courts will not protect reports that are prepared outside of these privileges.

4.

Qualifications on Work Product Protection.

a. The work product doctrine is generally considered a "qualified" protection from disclosure. Both the Supreme Court in Hickman and Fed.R.Civ.P. 26(b)(3) clearly envision discovery of work product under certain circumstances. In order to obtain discovery, the party must show substantial need and undue hardship.

b. With respect to the "substantial need" standard, the Supreme Court in Hickman said that the requisite work product materials must be "essential to the preparation of one's case." Hickman v. Taylor, 329 U.S. at 511. While the courts do not define the substantial need requirement with precision, courts generally require a party seeking discovery to articulate a particularized need for the material and not be engaged upon a mere "fishing expedition." In re Grand Jury Subpoena Dated Nov. 8, 1979, 622 F.2d 933, 935 (6th Cir. 1980); Delco Wire and Cable, Inc. v. Weinberger, 109 F.R.D. 680, 689-90 (E.D.Pa. 1986).
c. The "undue hardship" test requires that a party be "unable without undue hardship to obtain this substantial equivalent of the materials by other means." Fed.R.Civ.P. 26(b)(3).

d. In Hickman, the Supreme Court suggested that the "inability" factor was satisfied when the witnesses are no longer available or can be reached only with difficulty.

e. Therefore, where the party seeking discovery has the ability to interview or depose a witness, courts have held that such party has failed to establish the undue hardship necessary to obtain witness statements taken by the opposing party. See, e.g., U.S. v. Chatham Citicorp, 72 F.R.D. 640, 643-44 (S.D.Ga. 1976).

5. Tax Court View of Work Product Doctrine.

a. The Tax Court has historically taken the position that its rules prohibit discovery of work product materials even upon a showing of substantial need and undue hardship. See Tax Court Rule 70(b); Zaentz v. Comm'r, 73 T.C. 469, 478 (1979); Devorak v. Comm'r, 64 T.C. 846, 850-51 (1975); P.T. & L. Construction Co. v. Comm'r, 63 T.C. 404, 408 (1974).

b. The Tax Court seems to have retreated from its absolute protection of work product in Hartz Mountain Industries, Inc. v. Comm'r, 93 T.C. 521 (1989). Relying on the use of the word "generally" in the advisory committee to the Tax Court rules report, the Court concluded that there must be instances when work product is discoverable in the Tax Court.


b. Waiver by disclosure of work product materials is generally held to have occurred only where disclosure to a third party substantially increases the possibility that an adversary could get the information. See, e.g., U.S. v. American Tel. & Tel. Co. 642 F.2d 1285, (D.C. Cir. 1980).

c. Work product may also be waived by affirmative use of work product materials by a party. For example, in the Hartz Mountain case, the Tax Court concluded that the petitioner had made "testimonial use" of the work product material in an in-house counsel's affidavit in support of a motion for summary judgment.
The Tax Court held that such testimonial use constituted a waiver of the work product doctrine.

d. A party may also waive work product protection through use at trial and through in use in witness preparation. U.S. v. Salsedo, 607 F.2d 318, 320-21 (9th Cir. 1979); Fed.R.Evid. 612; Berkey Photo, Inc. v. Eastman Kodak Co., 74 F.R.D. 613, 616-17 (S.D.N.Y. 1977).

7. Scope of the Waiver.

a. Disclosure of specific work product materials does not necessarily constitute a waiver permitting discovery of all work product prepared in the same litigation. In determining the scope of work product waiver, courts will generally consider the circumstances and reasons motivating the disclosure. Courts, however, are not in complete agreement as to the scope of waiver under the work product doctrine. Some courts hold that waiver of the work product protection covers only those particular documents disclosed -- not all work product on the subject matter. Burlington Industry v. Exxon Corp., 65 F.R.D. 26, 45-46 (D.Md. 1974). Other courts take a broader view of waiver, typically citing fairness considerations. The Fourth Circuit, for example, takes the position that the extreme broad concept of subject matter waiver applies to non-opinion work product but not to opinion work product. In re Martin Marietta Corp., 856 F.2d 619, 625-26 (4th Cir. 1988), cert. denied, 490 U.S. 1011 (1989).

C. Attorney-Client Privilege and Attorney Work Product Guidelines.

In order to preserve and maximize a taxpayer’s claims of attorney-client privilege and attorney work product doctrine, the following guidelines should be followed:

a. All materials containing privileged information should be clearly marked and the applicable privilege identified.

b. Privileged material should be provided on a need-to-know basis to non-control group management and employees.

c. Taxpayers should avoid providing privileged documents to outside third parties, including independent auditors.

d. A taxpayer should not discuss confidential communications with third parties.

e. To the extent practical, a taxpayer should maintain privileged materials in separate files with limited access. The purpose of separate files is to avoid inadvertent disclosure of privileged materials caused by the intermingling materials with ordinary company records.
f. Because of the potential for extremely broad waiver, any disclosure or intentional waiver of privileged material should be discussed with either in-house or outside counsel prior to such disclosure of waiver.

g. Prior to production of documents, counsel should conduct a "privilege screen" of the documents to be produced to ensure against unintentional disclosure.