A Federal Income Tax Guide

for College & University Presidents

AMERICAN COUNCIL ON EDUCATION

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The nature of a college or university presidency creates special federal income tax issues for the institution's chief executive officer. Although presidents share many of the same tax problems as other college and university employees, they also confront a variety of additional tax considerations. This *Tax Guide* will address those federal tax considerations that a president faces as a college and university employee, as well as the special federal tax issues that arise by virtue of serving as the institution's chief executive officer. College and university presidents also should familiarize themselves with the state and local tax treatment of their income, but because those rules vary with each state and locality, this guide does not discuss these rules.

This *Tax Guide* was revised for the American Council on Education by the law firm of Morgan, Lewis & Bockius LLP. Morgan Lewis lawyers contributing to the *Tax Guide* include Celia Roady, Gregory L. Needles, Ann K. Batlle, John T. Boxer, Susan D. Brown, and Leslie DuPuy. Questions or comments should be directed to Susan Brown at susan.brown@morganlewis.com or Celia Roady at croady@morganlewis.com.

The *Tax Guide* was updated from prior versions prepared by the law firms of Baker and McKenzie and Drinker Biddle & Reath LLP.

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1. Federal Gross Income

A. Concept of Gross Income

Gross income is the starting point for determining the taxable income of any taxpayer. The definition of gross income under the federal income tax laws is extremely broad and includes all items of value (in the form of money, property, or services) that a taxpayer receives from whatever source derived, unless a specific provision in the tax laws excludes the item from gross income.

College and university presidents may receive funds in many different forms, including wages, bonuses, service awards, scholastic awards, and honoraria, as well as nonmonetary compensation, such as services or property. When considering whether a particular item is taxable, the IRS generally presumes that any payment from a college or university to its president constitutes taxable compensation. To rebut that presumption, the president must be able to point to a specific provision in the tax laws that expressly excludes the particular payment from gross income.

Because this guide discusses the federal income tax laws, subsequent references to the tax laws refer only to federal income tax laws. State and local tax consequences may, at times, differ from federal income tax treatment.

The federal tax issues discussed in this guide have particular relevance in 2009. As this *Tax Guide* went to press, Congress was debating the future of the federal estate tax, which currently is scheduled to be repealed for 2010 and then reinstated in 2011. The current estate rules and the prospects for future legislation are discussed in Chapter 6. Chapter 5 discusses the implications of Section 409A of the *Internal Revenue Code* for certain deferred compensation arrangements offered by colleges and universities. Finally, the release in 2008 of the redesigned IRS Form 990, Annual Information Return, has brought increased attention to the compensation arrangements of executives of tax-exempt organizations. Effective for 2008 and later years, private colleges and universities will be required to disclose on Form 990 additional information about the compensation (including deferred compensation) and benefits provided to officers, trustees, and high-level employees. This guide will help presidents of private colleges and universities understand the information reported on Form 990.

B. Compensation

Wages, salaries, and other forms of compensation for services paid by a college or university to its president are included in gross income. Compensation payments include sick pay, vacation pay, severance pay, and bonuses. Although colleges and universities may award bonuses without reference to any specific service rendered, the IRS generally views bonuses as payments made for prior or future services and therefore representing gross income and subject to tax.

C. Awards

College and university presidents often receive awards in connection with their service to the institution or for academic or civic achievements. As a general rule, awards are included as part of an employee's gross income in an amount equal to any cash received or, if the award consists of property or services, the fair market value of the property or services received.

There are, however, two exceptions to this general rule: employee achievement awards and awards given by the president to an organization eligible to receive tax-deductible charitable contributions.

1. Employee Achievement Awards

If an employee achievement award is to be excluded from an employee's income, the institution cannot present the award in cash; rather, it must be in the form of tangible personal property. In addition, the institution must present the award either for length of service or safety achievement.

The employee may exclude from gross income the value of a "length of service" award up to either $400 or $1,600 per year, depending on whether the award program discriminates in favor of more highly compensated employees (discriminatory plans are limited to the lesser amount). Also, a "length of service" award is excluded only if the recipient has completed at least five years of service and has not received a similar award in the current year or any of the preceding four years.

2. Gifts of Awards

If a college or university employee receives an award for religious, charitable, scientific, educational, artistic, literary, or civic achievement, the award can be excluded from the employee's gross income if the employee: (i) did not solicit the award; (ii) is not required to provide services in exchange for the award; and (iii) designates that the award be paid to a tax-exempt religious, charitable, scientific, literary, amateur sports, or education organization (such as a private education institution), or to a state college or university or other governmental organization. For example, a college or university president who receives a cash award for educational excellence and designates that the award be paid to his or her institution's scholarship fund can exclude the amount of the award from gross income.

D. Honoraria

An honorarium typically involves a payment that is made to a person in exchange for services for which no specific fees were required or requested. Assume, for example, that a college or university president delivers a speech at a business convention free of charge, and in appreciation, the sponsoring organization gives the president a cash honorarium. Arguably, the honorarium could be viewed as a "gift," which would be excluded from gross income. The IRS, however, most likely would consider the honorarium as taxable compensation on the grounds that the honorarium would not have been paid "but for" the services rendered (i.e., the president's speech). If, however, the business convention pays the honorarium directly to the president's college or university and never offers it to the president, the president would not be required to include the honorarium in gross income because he or she did not personally benefit from the payment. Note that the reimbursement by the sponsoring institution of the president's travel expenses would not be taxable to the president if the accountable plan rules described in Chapter 3 are followed.

E. Income from Affiliated Entities

College and university presidents may receive cash, goods, or services from organizations affiliated with their institutions, such as athletic organizations, booster clubs, alumni associations, foundations, and student societies. In general, the value of any item received from these organizations should be included in the president's gross income as compensation for services rendered. The issue that often arises in connection with these payments is which entity—the institution or the affiliated organization—should withhold taxes and file reports with the IRS. The answer depends on the facts and circumstances of each case but does not affect the president's obligation to include the payment in his or her income. The payment is subject to inclusion in the recipient's income regardless of who is the "true payor."

2. Fringe Benefits

A. Overview

In addition to taxable forms of remuneration for services, education institutions also provide their presidents with *fringe benefits*—any benefit paid or provided to an employee other than salary, wages, or bonuses. Most colleges and universities give the president basic fringe benefits, such as group term life insurance, health insurance, and pension plan contributions. In addition, many presidents receive more diverse benefits, such as complimentary tickets to athletic and cultural events, automobiles, campus housing, education benefits, club memberships, and discounted use of university athletic facilities.

Because the broad scope of *gross income* includes all items of value received in whatever form derived, these fringe benefits theoretically could be included in a president's gross income. However, numerous provisions in the *Internal Revenue Code* specifically exclude many of these fringe benefits. These statutory exclusions fall into two general categories: (1) "Section 132 fringe benefits," and (2) miscellaneous types of fringe benefits that Congress has determined should not be treated as gross income.

B. Section 132 Fringe Benefit Exclusions

Congress enacted Section 132 of the *Internal Revenue Code* in an attempt to create some consistency and simplicity in the treatment of fringe benefits. Section 132 states that a fringe benefit will be taxable to the employee unless it qualifies under one of the special provisions set forth in the section. The particular Section 132 provisions that are relevant to college and university presidents (and other employees) are described below.

1. The Working Condition Exclusion

Under this exclusion, a fringe benefit is excluded from an employee's income provided that the employee uses the fringe benefit to serve a business purpose in his or her capacity as a college or university employee. This "business purpose" test is met if the employee would have been entitled to a business expense deduction had he or she paid for the fringe benefit personally. For example, if a president receives a free airline ticket to attend a trustees' meeting, the value of the ticket can be excluded as a working condition fringe benefit because the president could have deducted the ticket cost as a business expense incurred in his or her capacity as the president of the institution. Similarly, if the president purchases the airline ticket and is reimbursed by the college or university, the reimbursement is tax-free if made under an "accountable plan" (discussed in Chapter 3). The exclusion does not apply, however, to benefits that are provided to the president for personal reasons, such as personal

entertainment expenses, because such expenses would not be deductible if the president had paid for them personally.

2. The No-Additional-Cost Service Exclusion

The no-additional-cost service exclusion allows employees to exclude from gross income the value of services provided by their employer for free or at a reduced cost, provided that doing so does not cause the employer to incur substantial additional costs or to forgo substantial revenue. For example, if a college or university owns a recreational facility used by its students, the fact that it permits faculty and staff to use the facility without charge will not result in taxable income to the faculty and staff, as long as the institution can show that it did not incur any substantial additional costs (or forgo any substantial revenue) in permitting faculty and staff use.

In order for any employee to qualify for the no-additional-cost service exclusion, the IRS regulations dictate that the service provided must be in the same "line of business" in which the particular employee performs services. Clearly, the IRS wrote this rule with for-profit corporations in mind. Consider, for example, a corporation that operates both a hotel and a financial services company. If the corporation provides free hotel rooms to employees who work in the financial services company, the free rooms will not qualify for the no-additional-cost service exclusion because the financial services company employees work in a different "line of business" from the hotel business. However, an employee performing substantial services in more than one line of business may exclude no-additional-cost services in all the lines of business in which he or she performs substantial services.

It is less clear how this "line of business" requirement should be applied in the nonprofit college and university context. For example, can athletic department employees receive tax-free services from the computer systems department, or do they fall into different "lines of business" within the university? There are sound arguments that all college or university employees who work in an area that is part of the institution's broad educational mission (e.g., library, athletic department, bookstore, etc.) work in the same "line of business" and therefore are eligible for the no-additional-cost service exclusion.

The no-additional-cost service exclusion does not apply to highly compensated employees, such as college and university presidents, if the program favors those highly compensated employees.

3. The Qualified Employee Discount Exclusion

Under the qualified employee discount exclusion, an employer can provide its employees with a limited discount on goods and services without causing the discounted amount to be included in the employees' income as additional compensation. Under this exclusion, the employer can discount "services" that it provides to employees at a rate of up to 20 percent on a tax-free basis, and it can sell "property" to employees at cost without generating taxable income for the employees.

To illustrate this provision with respect to "services," assume that a college permits its employees to purchase computer programming services at a 25 percent discount. Under the qualified employee discount rule, the full discount value will not be included in income; rather, the first 20 percent of the discount will be excluded as a "qualified employee discount," and only the excess discount (5 percent) will be treated as taxable income for the employees.

Where an institution sells property to its employees at a discount, the employees must report income to the extent that the employer sells the property below cost. For example, assume that a college or university buys computers for $2,000 each and sells them in the bookstore for $2,500. If the school sells the computers to employees for no less than $2,000, the discount arrangement will not generate income; however, to the extent that the computers are sold for less than $2,000, the difference would not fall under the qualified employee discount exclusion and would constitute taxable income to the employee.

Like the no-additional-cost service exclusion, the qualified employee discount exclusion requires that the employee work in the same "line of business" as the discounted goods and services. However, an employee performing substantial services in more than one line of business may exclude qualified employee discounts in all the lines of business in which he or she performs substantial services. Again, although it is unclear how college and university employees should apply this "line of business" requirement, solid arguments support the position that all college or university employees work in the same "line of business" and therefore are eligible for the qualified employee discount exclusion.

The qualified employee discount exclusion applies to highly compensated employees, such as college and university presidents, only if the program does not favor those highly compensated employees (for example, if such employee discounts are available to all employees on substantially the same terms).

4. The *De Minimis* Benefit Exclusion

A fringe benefit qualifies for exclusion as a *de minimis* fringe benefit if its value is too small to justify the administrative burden of accounting for the benefit. Examples include coffee, doughnuts, or soft drinks furnished to employees; occasional theater or sporting event tickets; local telephone calls; and occasional dinner money or taxi fare for overtime work. If, however, the institution provides these minor benefits frequently, then the aggregate value of those benefits may be substantial. When this occurs, a benefit of relatively small value will fail to qualify for the *de minimis* exclusion because the aggregate value is great enough to warrant accounting for the benefit.

5. Additional Fringe Benefit Exclusions

Section 132 also excludes qualified transportation expenses, qualified moving expenses, and qualified retirement planning services from gross income. An employer may provide limited transportation benefits in the form of transit passes or qualified parking to an employee on a tax-free basis. For January and February 2009, the amount of these benefits that may be provided tax free was $120 per month for transit passes and $230 per month for qualified parking.

For March through December 2009, the limit is $230 per month for each. The increase in the exclusion amount for transit passes is temporary and will expire after 2010. However, qualified parking does not include the value of parking that can be excluded as a working condition fringe or that can already be excluded as a reimbursement under an accountable plan. (Chapter 3 discusses this concept in greater detail.) Beginning in 2009, employees who commute by bicycle and who receive no other transportation benefit may receive a qualified bicycle commuting reimbursement of up to $20 per month. Qualified moving expenses that are paid or reimbursed by an employer also can be excluded from the employee's gross income, to the extent that they would have been personally deductible by the employee as moving expenses.

Section 132 also excludes from gross income employer-provided qualified retirement planning services. Such services include "any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan," which includes 403(b) annuity and government plans. This exclusion is subject to nondiscrimination rules for highly compensated employees and does not include expenses for related services such as accounting, legal, or brokerage services.

The following discussion places these Section 132 fringe benefit provisions in the context of benefits that are commonly provided by colleges and universities.

a. Complimentary and Discounted Tickets to Athletic, Entertainment, and Cultural Events

Many colleges and universities provide their presidents with complimentary tickets to athletic, entertainment, or cultural events. If a college or university occasionally provides tickets to its president, then the value of the tickets or the discount may be excluded from the president's gross income as a *de minimis* fringe benefit. The *de minimis* fringe benefit exclusion does not apply, however, if an institution provides complimentary season tickets.

If a president is required to use the complimentary tickets to entertain persons having a business relationship with the college or university, then the tickets may be excluded as a working condition fringe benefit. However, this exclusion would not cover the value of any tickets used to entertain the president's spouse, family members, or personal acquaintances. Also, in order to qualify as a working condition fringe benefit, the president must maintain adequate records showing that the tickets were, in fact, used for business purposes.

Colleges and universities also may provide their presidents with discounted tickets to athletic, entertainment, or cultural events. Historically, the IRS has treated tickets as products under the qualified employee discount rules and has not taxed the employee if the institution sold the tickets at no less than cost. In some cases, however, IRS agents have treated tickets as "services," which would limit the tax-free discount amount to 20 percent of the tickets' normal selling price.

b. Club Memberships

Some colleges and universities provide their presidents with memberships in various types of clubs, such as country clubs, athletic clubs, and so forth, and the institution typically pays the dues on behalf of the president. Payments for club memberships can be excluded as a working condition fringe to the extent that a president can substantiate that the club was used for business purposes.

For example, if a college or university provides its president with a country club membership and the president substantiates that he or she used 40 percent of the membership for business purposes, then 40 percent of the value of the dues can be excluded as a working condition fringe. The remaining 60 percent, which represents personal use, will be treated as compensation to the president.

c. Personal Use of University Facilities

(i) RECREATIONAL FACILITIES

Many colleges and universities provide free or discounted use of recreational facilities to their employees, including the president. Recreational facilities may include athletic facilities, natatoriums, golf courses, racquet clubs, and so forth. It is usually possible to exclude from gross income the value of the president's personal use of these recreational facilities in a number of ways: as a no-additional-cost service fringe benefit, as a qualified employee discount, or under a special exclusion for an "employer-provided athletic facility."

The no-additional-cost service exclusion will apply if the employee's use of the facility does not result in any additional cost or forgone revenue for the college or university. This typically will be true provided that membership is not limited due to capacity. The qualified employee discount fringe benefit exclusion can apply if membership fees are discounted and, as previously discussed, the discount does not exceed 20 percent.

Under the special exclusion for an employee's use of an "employer-provided athletic facility," the value of the use of the facility is not included in the employee's gross income if: (1) the facility is located on the employer's premises; (2) the employer operates the facility; and (3) substantially all use of the facility is by employees or their families. Often, the third condition proves difficult to justify because use of the facility by nonemployee students or the general public will disqualify the facility. If all of the tests are met, however, the facility should qualify, and use of the facility by the school's employees will not result in taxable income.

(ii) PERSONAL USE OF UNIVERSITY VACATION, RETREAT, OR CAMPING FACILITIES

Some colleges and universities provide an apartment, vacation home, camping facility, or other retreat facility to the president for his or her personal use. According to IRS regulations, a president's personal use of such facilities, even for a few days, will not qualify as a *de minimis* fringe benefit, and no

other fringe benefit provisions apply that allow the president's personal use to be excluded from gross income. Therefore, a president generally will recognize gross income to the extent of the value of any personal use of such facilities.

d. Spousal Travel on Business Trips

It is not uncommon for a college or university to pay the travel costs for the president's spouse to accompany the president on a business trip. If there is no business purpose for the spouse's presence on the trip, the amounts paid for the spouse are included in the president's gross income.

However, the amount paid for the spouse can be excluded as a working condition fringe benefit if the president can adequately demonstrate that the spouse's presence on the trip has a bona fide business purpose and if the president substantiates the travel expenses. A bona fide business purpose is established when the dominant purpose of the spouse's presence serves the employer's business and when the spouse actually spends a substantial amount of time assisting the president in accomplishing the employer's purpose. Mere performance of social functions does not sufficiently meet these requirements.

e. Automobiles

Colleges and universities sometimes provide their presidents with automobiles that can be used for both business and personal purposes. The value of an automobile can be excluded from a president's income only to the extent that it is used in the discharge of the president's employment-related duties. The value of any personal use of the vehicle must be included in the president's gross income, unless the personal use is merely incidental to the president's employment-related duties, in which case the personal use can be excluded as a *de minimis* fringe benefit. If, however, the value of the president's personal use is included in gross income, the amount that must be included is generally determined either by the leasing cost of a comparable automobile or under a special valuation method set forth in the IRS regulations. If a college or university provides a chauffeur, the value of the chauffeur's services must be added to the value of the vehicle.

f. Computers

Many colleges and universities provide computers that presidents can use while traveling or at home. The use of a home or portable computer may qualify as a working condition fringe benefit and can be excluded from the president's gross income. However, if the president or his or her family also uses the computer for personal purposes, an allocation must be made between business and personal use based on hours of use, and the value of the personal use must be included in the president's income, unless it is excluded as a *de minimis* fringe benefit. Strict substantiation rules apply to the business use of a computer, which may not be excluded as a working condition fringe benefit unless the president maintains adequate records

as required under Section 274 of the *Internal Revenue Code*. The same strict substantiation rules apply to employer-provided cellular telephones and personal digital assistants (PDAs), but legislation has been introduced that would relieve the recordkeeping burden for those items.

g. Flights on Institution-Owned or -Chartered Aircraft

The value of flights taken by a president for personal purposes on an institution-owned or -chartered aircraft must be included in the president's income. Similarly, if family members or friends of the president use an aircraft for personal purposes, the value of such use will be included in the president's gross income.

Of course, a president does not use an institution-owned or -chartered aircraft solely for personal purposes. For example, presidents may use aircraft to travel among campuses or to attend fund-raising, alumni, or other official events. These uses are not included in a president's income because they typically are treated as working condition fringe benefits; that is, the president would be able to deduct the flight costs if he or she paid for them personally.

h. Subsidized Dining Rooms

The value of meals provided by a college or university to its employees in excess of the employees' cost can be excluded from the employees' gross income as a *de minimis* fringe benefit, provided that the dining facility is located on or near the institutions's premises and the revenue from the facility equals or exceeds its direct operating costs. In addition, the dining facility must not discriminate in favor of highly compensated employees, such as officers, directors, or trustees of the institution.

C. Miscellaneous Fringe Benefit Exclusions

In addition to the Section 132 fringe benefit exclusions discussed above, a number of other specific provisions in the *Internal Revenue Code* exclude particular types of fringe benefits from tax. Those specific exclusions that generally apply to college and university presidents are described below.

1. Personal Residence

Many colleges and universities provide a residence for their presidents. When the residence is provided under proper circumstances, its value can be excluded from the president's gross income.

The tax law specifically excludes from gross income the value of housing furnished to a president if the following requirements are satisfied: (a) the housing is furnished for the convenience of the college or university; (b) the president is required to accept such housing as a condition of his or her employment; and (c) the housing is located on the business premises of the college or university. Failure to meet any one of these conditions will render this exclusion inapplicable, thereby causing the value of the housing to be included in the president's income.

The "convenience of the employer" test requires a direct nexus between the lodging that is furnished to the president and the business interests of the college or university. The "required as a condition of employment" test usually is met if, due to the manner in which the institution conducts its educational activities, the housing is necessary for the president to be available for longer than normal work hours, such as for on-campus meetings, fund-raising activities, alumni events, and so forth. The president's acceptance of housing need not be expressly required as a condition of employment (such as pursuant to a written contract), provided that the proper performance of the president's duties objectively requires, as a practical matter, that the president live in the college- or university-provided residence.

The third test that the housing be "on the business premises" of the employer is obviously met when the housing is physically located on campus. The issue sometimes arises, however, as to whether off-campus housing meets this test. If the off-campus housing either constitutes an integral part of a college's or university's operations or is a place where the president performs a meaningful portion of his or her duties, it may qualify as "on the business premises." The duties performed by a president at off-campus housing must be significant and not merely incidental in order for the housing to be treated as "on" campus. For example, in a 1983 court case, a college provided its president with a residence located four miles from the main campus. The president entertained business guests and occasionally held meetings, made telephone calls, and conducted college-related business in the residence. The court held that these occasional activities did not constitute a sufficient quantum of employment-related activity to find that the off-campus residence constituted "business premises" for purposes of the housing exclusion.

Because of concerns raised by colleges and universities as a result of this case, Congress enacted a special provision that provides a partial exclusion for college- or university-provided housing. This provision limits the amount of housing benefits that will be included in an employee's gross income to 5 percent of the housing's appraised value. A president or other employee of an educational institutional will qualify for the 5 percent limitation if the housing constitutes "qualified campus lodging"— that is, located on or in the proximity of the campus and furnished for use as a residence. Thus, this provision partially alleviates income recognition for off-campus housing that does not meet the "on the business premises" test.

Some colleges and universities provide their presidents with lodging on more than one campus. The value of this housing also can be excluded from gross income provided that the president is required to use the campus residence in order to conduct business on behalf of the college or university, or on behalf of the particular campus.

2. Meals Provided for the Convenience of the Employer

In addition to the exclusion under Section 132 for subsidized dining rooms described above, the *Internal Revenue Code* excludes the value of meals provided to employees on an employer's business premises for the convenience of the employer. Under a special rule, if more than one-half of the employees to whom meals are provided are furnished those meals for the convenience of the employer (as defined in Section 119), all meals will be treated as provided for the convenience of the employer. Thus, if the test is satisfied, the value of all such meals would be excludable from the employees' income.

3. Educational Assistance Programs

Many colleges and universities have adopted written educational assistance programs covering some or all of the tuition costs of their employees, including the president or other senior officials. Currently, up to $5,250 of employer-provided educational assistance may be excluded from income each calendar year, assuming certain requirements are met. Among other requirements, the program may not favor highly compensated employees. Any amount received in excess of $5,250 for employer-provided educational assistance is included in an employee's gross income. This provision is temporary, but it has been extended through 2010.

4. Tuition Reduction Programs

Under a tuition reduction program, an institution reduces its own tuition for the benefit of an employee, an employee's spouse, or an employee's dependent or pays the tuition for any of these individuals to attend another educational institution. Benefits under a tuition reduction plan will be nontaxable to a highly compensated employee only if the plan does not discriminate in favor of highly compensated employees. In addition, the exclusion generally applies only to undergraduate education. A tuition reduction for graduate-level work will qualify for the exclusion only if the individual receiving the reduction is a graduate student engaged in teaching or research activities.

5. Life Insurance

Group term life insurance provided by a college or university to its president is, within certain limitations, not taxable to the president. Specifically, an employee can exclude from gross income the cost of up to $50,000 of group term life insurance on the employee's life under a policy directly or indirectly carried by the employer. This exclusion applies regardless of the fact that the employee can designate the policy's beneficiary. The cost of employer-provided coverage in excess of $50,000 less any amount paid by the employee must be reported as gross income. The exclusion does not apply to key employees, such as college and university presidents, if the plan favors those employees.

In addition to providing group term life insurance coverage, life insurance contracts sometimes are used by colleges or universities as financing mechanisms to provide additional compensation benefits to their presidents. These executive compensation arrangements include: (1) bonus life insurance plans;

(2) split-dollar insurance plans; and (3) salary continuation plans. Under a bonus life insurance plan, the college or university pays a bonus to its president to assist him or her in purchasing personal life insurance coverage. A split-dollar life insurance plan is similar, with the exception that the college or university may retain some rights or control over the policy. For example, a split-dollar life insurance plan may be used to finance the premium payments on a whole life insurance policy for a president, with the college or university retaining rights to a portion of the policy's death proceeds. Finally, salary continuation plans sometimes use life insurance to finance a deferred compensation plan.

It is important to note that although life insurance contracts are used to finance these benefits, the benefits received by employees under these plans do not qualify for the "life insurance" exclusion. These compensation devices are complex and involve difficult tax issues, and IRS rulings and regulations have made certain of these arrangements less desirable. A college or university president should have such plans carefully reviewed by a professional tax adviser before participating in any arrangement of this type.

3. Expense Reimbursements

Because gross income generally includes all items of value received by an employee, when an employee receives a reimbursement from his or her employer for business expenses incurred such as airfare, meals, or lodging, the reimbursement payment technically constitutes gross income to the employee. A reimbursed employee business expense can be excluded from gross income, however, only if it is made pursuant to a reimbursement or expense allowance arrangement (known as an "accountable plan"), under which the employer requires the employee to substantiate all expenses and repay any amounts received in excess of the substantiated expenses.

In order to qualify as an "accountable plan," the following tests must be met: (1) reimbursements can be made only for business expenses incurred by the employee in connection with the performance of the employee's duties; (2) the plan must require employees to substantiate their expenses within a reasonable period of time; and (3) the plan must require employees to repay any reimbursements that exceed substantiated expenses within a reasonable period of time. If these tests are not met, the full amount of the reimbursement is included in the employee's income. The employee then may claim the reimbursed expenses as a miscellaneous itemized deduction, but such deductions are only allowed to the extent to which they exceed 2 percent of the employee's adjusted gross income.

4. Deductions

An employee can claim several different types of expenses as deductions to reduce his or her gross income. Some expenses are directly deducted from gross income, resulting in an amount referred to as *adjusted gross income*. Other so-called itemized expenses are deducted from adjusted gross income to determine *taxable income*. This latter category of expenses can be deducted only if the employee itemizes the expenses on his or her individual income tax return, and many of those expense deductions are subject to percentage limitations or other restrictions. As a result of these deduction "hurdles," some itemized expenses may be deducted only in part or possibly not at all. In addition, for a college or university president who is subject to the Alternative Minimum Tax (AMT), taxable income is calculated differently than for regular tax purposes. Under the AMT, certain income items are included that are not included for regular income tax purposes. Also, certain deductions, including state and local tax deductions, miscellaneous itemized deductions, and the standard deduction, are not permitted.

As previously discussed, if a president is reimbursed by an institution for expenses incurred in the carrying out of official responsibilities, those reimbursements are not included in the president's gross income (assuming that the "accountable plan" rules are met). Correspondingly, those reimbursed expenses cannot be deducted on the president's individual income tax return. A deduction may be available, however, for certain business-related expenses that are not reimbursed by the college or university or for expenses that are reimbursed but are not remitted under an accountable plan. Some of these expenses are "miscellaneous itemized deductions," which must be itemized and are deductible for regular income tax purposes only to the extent that, in the aggregate, they exceed 2 percent of the taxpayer's adjusted gross income. As noted above, such miscellaneous itemized deductions are not deductible under the AMT.

A. Travel, Meal, and Entertainment Expenses

In order for an employee to deduct expenses for travel, meals, and entertainment as business expenses, the *Internal Revenue Code* requires that the employee maintain extensive substantiation. In general, a taxpayer must substantiate with contemporaneous records the following elements for each expenditure: (1) the amount of the expenditure; (2) the date, time, and place of the travel, meals, or entertainment; (3) the business purpose served by the expenditure; and (4) the business relationship to the taxpayer of each person entertained. If these requirements are not satisfied, the IRS can disallow the claimed deduction in full.

In addition to the substantiation requirements, entertainment and travel expenses can be deducted only under limited circumstances, and lavish or extravagant entertainment expenses cannot be deducted. Moreover, entertainment expenses can be

deducted only if an employee is able to establish that the expenditure was directly related to, or associated with, the active conduct of his or her employment-related duties.

An entertainment expense is "directly related to" the active conduct of business if the employee actively engages in bona fide business discussions during the entertainment and does not provide the entertainment merely to create goodwill—in other words, the principal character of the combined business and entertainment activity must be the conducting of business. Accordingly, expenses incurred in connection with certain entertainment events during which there is little or no possibility of engaging in business discussions generally cannot be deducted.

An entertainment expense is "associated with" the active conduct of business when the entertainment activity directly precedes or follows a substantial and bona fide business discussion. Entertainment that occurs on the same day as a business discussion is treated as directly preceding or following the discussion. In order to qualify, the principal character of the combined business and entertainment activity must be the active conduct of business, i.e., the business discussion must be substantial as compared to the entertainment activity.

The expenses of a business meal, when the meal occurs under circumstances generally considered conducive to business discussion, are generally deductible so long as the employee is present during the meal. Although such meal expenses must bear some rational relationship to business pursuits, they are not subject to the rigorous "directly related to" or "associated with" tests that are applied to entertainment expenses.

Finally, assuming that a college or university president can satisfy all the above requirements for meal and entertainment expenditures, the *Internal Revenue Code* provides that only 50 percent of those expenses may be deducted for regular income tax purposes, subject to the 2 percent adjusted gross income (AGI) threshold for miscellaneous itemized deductions described above. Of course, these deduction limits are irrelevant if the president is reimbursed by the college or university for business-related meal or entertainment expenses under an accountable plan (as described in Chapter 3).

B. Other Limitations on Travel Expenses

An employee may deduct expenses incurred while traveling, including reasonable amounts expended for meals and lodging while away from home overnight in the conduct of business. For example, for a college or university president, the travel must be in furtherance of the institution's educational purposes. Travel that is undertaken primarily for personal purposes cannot be deducted. Generally, expenses for meals or lodging incurred in the course of non-overnight travel are not deductible, although transportation expenses maybe deducted.

If a president travels outside the United States for business purposes and also engages in personal activities, a portion of the travel costs may be disallowed, unless (1) the travel does not exceed one week or (2) less than 25 percent of the travel time is spent on personal activities. If those conditions are not satisfied, the IRS may allocate the travel expenses between deductible employee business expenses and nondeductible personal expenses. In addition, no deduction is allowed for expenses incurred

in attending a convention, seminar, or similar meeting held outside North America unless the taxpayer establishes that the meeting is directly related to his or her work as an employee and that it is as reasonable for the meeting to be held outside North America as within it.

The deduction for travel expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

C. Organization Dues and Club Memberships

Presidents of colleges and universities frequently incur dues for memberships in professional societies or associations as well as social, sporting, or athletic clubs. As a general rule, dues paid to business organizations, such as a labor union or professional association, will be an itemized deduction that is deductible to the extent that the dues (when combined with other employee business expenses) exceed 2 percent of the president's adjusted gross income.

Under Section 274, no deduction is currently allowed for membership dues paid to a club that is organized for business, pleasure, recreation, or other social purpose. Accordingly, a president may not deduct club dues as an employee business expense. Also, specific business expenses incurred while at a club (e.g., meals and entertainment) are deductible only to the extent that the expenses otherwise qualify as properly substantiated employee business expenses.

The IRS has released regulations that provide examples of what it considers social organizations; these include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered conducive to business discussion.

D. Charitable Contributions

A president, like any other individual taxpayer, may claim a deduction for contributions of cash or property to a charitable organization. The allowable deduction for a contribution of appreciated property held for more than one year generally equals the property's fair market value on the date of contribution, while the deduction for a cash contribution will be the amount of cash donated. These deduction amounts, however, may be limited in several respects.

A president's overall deduction for charitable contributions is subject to certain percentage limitations on his or her "contribution base," which is usually the president's adjusted gross income. The deduction is capped at either 30 percent or 50 percent of the contribution base, respectively, depending on whether the organization to which the contribution is made is a private foundation or a public charity. Contributions in excess of the applicable percentage limitation can be deducted in future years. There are additional limitations if a president makes charitable gifts of capital assets that have appreciated in value.

Under current tax law, no deduction will be allowed for a contribution of $250 or more unless the taxpayer is able to substantiate the contribution with a contemporaneous written acknowledgment from the donee organization. Contributions made during a year to the same charitable organization, however, generally will not be aggregated for purposes of meeting the minimum $250 threshold. The acknowledgment must include: (1) the amount of cash or a description (but not the value) of any property

contributed; (2) whether the charity provided any goods or services as consideration for any property contributed; and, if so, (3) a description and good faith estimate of the value of any such goods or services provided. A taxpayer's canceled check is not an acceptable substitute for an acknowledgment. These substantiation requirements will not apply, however, if the charitable organization itself reports the value of the contributions to the IRS.

In addition, a donor may not claim a deduction for any contribution of cash, a check, or other monetary gift made on or after January 1, 2007, unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

As noted above, the charitable contribution deduction for a donation of property is usually equal to the property's fair market value. Special rules, however, limit the deductibility of tangible property, unless the donee uses the property for a related purpose. Thus, as a general rule, a taxpayer who contributes appreciated property to a charitable organization is entitled to a charitable deduction for the fair market value of the property determined on the date of the contribution, and is not taxed on the appreciation in the property's value. Consequently, the taxpayer receives a substantial tax benefit by contributing appreciated property to a charitable or educational organization. Deductions for contributions of property in excess of $500 are subject to additional substantiation requirements, including a statement regarding the method of acquiring the property and its basis. Deductions for contributions of property (other than publicly traded securities) in excess of $5,000 generally are required to be substantiated by a qualified appraisal as well.

E. Interest Deduction for Residence Not Provided by the University

A college or university president may maintain a personal residence in addition to the residence provided by the institution. Moreover, not all institutions provide the president with residential housing, and consequently, the president may personally own a residence. Under either scenario, the president would be entitled to a deduction for interest paid on the home's mortgage.

Interest on indebtedness incurred in acquiring, constructing, or substantially improving a "qualified residence" and secured by the residence is deductible, provided that the aggregate amount of this indebtedness does not exceed $1 million. A *qualified residence* includes both a president's principal residence and a second residence designated as such by the taxpayer. A president may elect to have any residence treated as a second qualified residence, but may not have more than one second residence at any particular time.

In addition, interest on home equity indebtedness is deductible for regular income tax purposes. This includes any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent that the debt does not exceed the fair market value of the qualified residence, reduced by the amount of any outstanding acquisition indebtedness secured by such residence. The aggregate amount of home equity indebtedness may not exceed $100,000.

F. Education Expenses

A president may deduct educational expenditures incurred to: (1) maintain or improve skills required in his or her employment, or (2) meet any requirements of the college or university or applicable law that are necessary for the president to retain his or her employment, status, or rate of compensation. Any college- or university-imposed requirements must serve a bona fide business purpose. In this regard, expenditures incurred for courses dealing with current developments and academic courses are considered deductible, including expenses for tuition, books, supplies, laboratory fees, and certain travel and transportation costs. The deduction for these work-related educational expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

Other educational expenditures, however, are considered personal in nature and therefore are not deductible. Such personal education expenses include expenses incurred: (1) to meet the minimum educational requirements for qualification to hold the position of president, or (2) as part of a program of study that will qualify the president for a new line of employment.

Frequently, educational pursuits involve travel. Expenses for travel as a form of education in and of itself are not deductible. If a president travels away from home to obtain work-related educational training, however, expenditures for travel, meals, and lodging while away from home are deductible. The travel must occur primarily for work-related educational purposes; if a president's travel away from home is primarily for personal reasons, then the expenditures for travel, meals, and lodging (other than for meals and lodging during the time spent participating in educational pursuits) are not deductible. Even if the travel is primarily for work-related educational purposes, expenses attributable to incidental personal activities (e.g., sightseeing, social visiting, entertaining, or other recreation) are not deductible.

G. Automobile Expenses

An employee may deduct the portion of automobile expenses attributable to business (as opposed to personal) use. This deduction is determined by identifying the total amount of automobile expenses incurred during a taxable year and multiplying this amount by the percentage of the year's mileage devoted to business use. Deductible expenses would include such costs as fuel, oil, lubrication, washing, maintenance, repairs, tires, supplies, parking fees (but not fines), tolls, taxes, license tags, and insurance. Deductible costs do not include repairs that either prolong the useful life or increase the value of the vehicle; the cost of these items must be recovered through depreciation deductions, which are discussed below. In addition, the expense of commuting to and from work is not a deductible cost.

The *Internal Revenue Code* provides an optional method for computing an automobile expense deduction if the employee owns the automobile. Under this method, the deduction may be computed at a standard mileage rate, which is 55 cents per mile for 2009. A deduction computed under this optional method will preclude a deduction for other costs incurred in operating the vehicle during that year, other than parking fees, tolls, and state and local personal property taxes. The deduction for allowable automobile expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

H. Depreciation Expenses

When a president purchases an item that will be used in performing his or her duties as president and is not reimbursed for the cost of the item by the institution, the president can either: (1) deduct the full cost of the item in the year in which it was acquired under the "employee business expense" deduction rules described above, or (2) treat the item as a so-called capital asset and deduct its cost through annual depreciation deductions over a period of years. In general, an item having a useful life of more than one year must be treated as a capital asset.

The amount of the annual depreciation deduction is determined by the *Internal Revenue Code* and depends upon the type of property acquired. For example, automobiles and computers generally are depreciated over a five-year period, whereas office equipment, furniture, and fixtures are depreciated over a seven-year period. There are additional limitations on the depreciation of luxury automobiles, assets that are not used solely for business purposes, and assets that are used for only a portion of a year.

A president may also elect under *Internal Revenue Code* Section 179 to deduct some or all of an item's cost for the year in which it is first used for business purposes. Under this election, a president can deduct the cost of tangible personal property used in the performance of his or her duties as president, up to an annual limit. For 2009 and 2010, the annual limit is $125,000 per year. In 2011, the annual limit drops to $25,000. A president cannot claim a deduction under Section 179 that exceeds his or her taxable income from trade or business activities.

Under an additional limitation, property that is "listed property" may be depreciated and/or expensed only to the extent that such items are: (1) acquired for the convenience of the employer and (2) required as a condition of employment. Listed property includes, but is not limited to, automobiles, computers, and cellular telephones. The deduction for allowable depreciation expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

I. Home Office Expenses

A college or university president may reside in a home that is not provided by the institution but that is personally owned by the president. If the president also maintains an office in the home, a deduction may be available under very limited circumstances for expenses attributable to that home office. Among other requirements, the president must use the home office exclusively for college or university business, and the office must be used on a regular basis as the president's principal place of business and as a place where the president normally meets with persons having a business relationship with the college or university. Accordingly, the home office must be the most important and significant place in which the president conducts college and university business. If, as in most cases, however, the president maintains an office on campus or elsewhere, it is unlikely that a home office business deduction will be allowed. The deduction for allowable home office expenses also is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

5. Retirement, Deferred Compensation, and Savings Plans

Generally, retirement and savings programs are structured so that employees receive benefits in subsequent years for amounts of compensation earned currently. The scope of programs discussed in this chapter includes (a) defined contribution retirement plans (including 401(k) and 403(b) arrangements) and defined benefit pension plans, (b) deferred compensation plans subject to Section 457(b) (also referred to as "eligible plans") and deferred compensation plans subject to Section 457(f) (also referred to as "ineligible plans"), and (c) Individual Retirement Accounts (IRAs) and other deferred compensation arrangements. This chapter also discusses the applicable provisions of the *Internal Revenue Code* that govern these plans, including relatively new Section 409A, which imposes strict requirements on nonqualified deferred compensation arrangements (as described in more detail in subsection D below). The rules relating to these types of arrangements are complicated, so please consult your tax or financial adviser for more information about these types of arrangements.

A. General Background

Some of these retirement and savings plans are elective—those in which the president can choose to participate and elect to set aside current compensation for a later benefit. Under another type of plan, a nonelective plan, the amount of deferred compensation is determined by an established formula that the president cannot alter. If the president's contribution to the college or university's retirement plan is mandatory as a condition of employment, then it is considered an employer contribution. In evaluating the aspects of retirement and savings arrangements, a president should consider the source of contributions, the tax treatment of contributions and benefits, and any tax code requirements, as well as his or her rights to the benefits.

B. Defined Contribution and Defined Benefit Plans

1. Overview

Most presidents are covered by either a defined contribution retirement plan or a defined benefit pension plan. Depending on their employment history, some presidents eventually receive retirement benefits from both types of plans. In a defined benefit pension plan, the amount of benefit at normal retirement age is generally a pension to be paid to the president over his or her remaining life (or his or her remaining life and the life of his or her spouse) determined by a formula that relates years of service to earnings, multiplied by a percentage specified in the plan. Many state retirement systems that cover employees of public

universities and colleges are defined benefit pension plans. Using a different approach, a defined contribution plan sets aside an amount equal to a certain percentage of compensation in a retirement account. It grows with annual contributions and compound earnings over the years and then, at retirement, the account can be distributed, converted into a lifetime income, or converted into another form of payment. The majority of retirement plans offered at private colleges are defined contribution plans and almost all states have an option to the state retirement system allowing presidents, faculty, and other employees to participate in a defined contribution plan.

The *Internal Revenue Code* specifies the tax-deferred treatment of retirement savings plans. Some retirement plans such as 401(k), 403(b), and 457(b) are known by the specific section of the tax code that applies to these retirement plans. In higher education, 403(b) plans can serve a dual purpose. A 403(b) plan can operate either as an employer-sponsored defined contribution retirement plan, to which both employer and employee contributions are made, or as a tax-deferred annuity plan funded solely by voluntary pre-tax salary deferrals. Employee pre-tax and after-tax contributions are often referred to as "elective deferrals."

One important section of the tax code for defined contribution and defined benefit plans is Section 401(a), which describes the requirements for such plans, often referred to as "qualified" retirement plans. While most colleges use 403(b) plans to provide retirement benefits to their employees, in recent years a number of colleges, especially those in the public sector, have established their defined contribution plans as qualified plans under Section 401(a). Under qualified retirement plans, contributions to fund benefits are generally made by the institution and held in trust or an annuity contract until distributed to the participant at retirement or other termination of employment. Defined benefit pension plans, including state retirement systems, and a number of defined contribution plans such as those covering public higher education employees, as well as a smaller number of pensions at private colleges and universities, operate as qualified retirement plans.

As part of the set of rules that apply to qualified retirement plans, the tax code generally limits the amount of compensation that an employer can take into account when determining contributions and benefits. The compensation limit is $245,000 in 2009 and is adjusted annually for cost-of-living increases. Consequently, a president's compensation in excess of this limit must be disregarded in determining the amount of the retirement plan contributions that a college can make on his or her behalf. However, some presidents and other employees who started participating in a public sector retirement plan before 1996 may have their retirement plan contributions based on their full salary.

2. Defined Contribution Retirement Plans Under Section 401(a)

a. Overview

The tax code sets limits on the amount that an employer can contribute to a defined contribution retirement plan. In 2009, the annual limits of Section 415 restrict total cumulative contributions by the employer and employee to all defined contribution plans sponsored by the employer to the lesser of $49,000 or 100 percent of compensation. This $49,000 limit increases for the cost of living, generally in amounts of at least $1,000. The institutional retirement plan contribution percentages under the retirement plans at most colleges and universities fall below the 100 percent limit, but retirement benefits for some presidents may be restricted by the cap on total contributions (e.g., $49,000 in 2009).

If a president is covered under two or more defined contribution plans, then when applying the limitations on contributions, those contributions must be aggregated under certain circumstances. For example, contributions to 403(b) retirement and tax-sheltered annuity programs are generally aggregated with the president's contributions made to his or her personal Keogh plan, which is based on any outside self-employment income. However, if employer contributions for the president are allocated to an institution's retirement plan that is tax-qualified under Section 401(a), they generally do not have to be aggregated with contributions to the 403(b) annuity program of the same employer or the president's personal Keogh. The 403(b) program is considered to be sponsored by the employee under Section 415, rather than the employer, and thus, a separate Section 415 limit equal to the lesser of $49,000 or 100 percent of compensation applies. As a result, the president and other employees can possibly receive a larger total contribution under a combined retirement program consisting of a tax-qualified retirement plan and a 403(b) tax-sheltered annuity than would be the case if they were covered by both a 403(b) retirement plan and a tax-deferred annuity plan.

The president, like any other employee, can be covered by a university's retirement plan. However, because the president is likely to be considered a highly compensated employee, generally he or she cannot be treated more favorably than other employees covered by the retirement program. These nondiscrimination standards do not apply to public retirement plans. While many defined contribution plans specify a level percentage for contributions, some plans offer a "step formula," which increases the rate above a certain level of compensation (usually the Social Security Wage Base), or makes increased contributions because of age or service. Such differences are permitted as long as the retirement plan can demonstrate compliance with the nondiscrimination rules.

b. 401(k) Arrangements

Some private colleges also have adopted 401(k) plans due to a change in the tax law that allowed private sector nonprofit employees to sponsor such plans. Public employers cannot sponsor 401(k) plans, though a few states had established such plans before Congress restricted that option, and those plans operate on a grandfathered basis. Under a 401(k) arrangement, which is a type of defined contribution plan, a president may elect to have a portion of his or her compensation contributed to the plan on a pre-tax basis through a reduction in his or her salary. Like a 403(b) tax-deferred annuity, the amounts saved as pre-tax elective deferrals and the earnings in 401(k) plans are not included in gross income until they are distributed.

3. Defined Benefit Pension Plans

If the president is at a public college or university, he or she may participate in the state retirement system, which is normally a defined benefit pension plan. The defined benefit formula usually provides for a fixed monthly or yearly benefit based upon the participant's compensation and length of service with his or her employer. The tax code also subjects defined benefit pension plans to limits on the annual benefit payable to a participant. In general, a participant's projected annual benefit is limited to the lesser of 100 percent of the participant's average compensation in his or her three highest paid consecutive years of service or an annual limit ($195,000 for 2009, which is adjusted for increases in the cost of living, generally in $5,000 increments).

Many state and public retirement systems require employees to contribute to the plan. If the public pension plan allows the employer to "pick up" the employee's contribution under Section 414(h), the employee may make his or her contribution pre-tax. Section 414(h) is limited to public employers, and thus is only available to presidents at public colleges. Employees at private colleges cannot make "pick up" contributions to qualified plans. As a result, defined benefit plans operated by private schools are non-contributory. A private college may offer a defined contribution plan under Section 401(a) that accepts pre-tax contributions through a 401(k) arrangement. However, because an individual taxpayer is limited to a total of $16,500 (in 2009) of compensation that can be deferred from his or her salary into tax-deferred vehicles, such as 403(b) and 401(k) plans, if the college offers a 403(b) plan it is unlikely to sponsor a 401(k) plan as well.

4. Defined Contribution Retirement Plans Under Section 403(b)

When a college or university offers a 403(b) tax-deferred annuity (TDA) program for its employees, the president must generally be eligible to participate in the plan. Under a TDA plan, the president can exclude from his or her gross income, within limits, contributions to an annuity contract or to a custodial account.

Pre-tax elective deferrals to 403(b) plans fall under both the Section 415 annual limits described above and a separate annual dollar limit under Section

402(g). In 2009, elective deferrals are capped under Section 402(g) at $16,500, which will increase in future years for cost-of-living adjustments.

Since 1986, the tax code has offered a catch-up option for those employees covered by a 403(b) plan who have completed 15 years of service with an educational institution ("403(b) Special Catch-Up Contribution"). For those who qualify, the Section 402(g) limit may be increased by up to $3,000 for the year (subject to certain lifetime and contribution history caps).

For presidents who currently have their elective deferral retirement savings limited to the annual limit ($16,500 in 2009) and have attained age 50, an additional catch-up option is available, further increasing the amount of before-tax savings. In 2009, employees aged 50 and older can save an additional $5,500 above the $16,500 limit. Therefore, in 2009, a president aged 50 or older will have the potential to tax-defer up to $25,000 if he or she has more than 15 years of service and is otherwise eligible to contribute the maximum 403(b) Special Catch-Up Contribution of $3,000, as detailed above.

5. Elective Deferral Limits for 403(b) and 401(k) Plans

The *Internal Revenue Code* caps the amount of elective deferrals that can be contributed to a 401(k) or 403(b) plan, as set forth below.

Elective Deferral Limits for 403(b) and 401(k) Plans

Year	Section 402(g) Limit	403(b), 401(k), and Age 50 Catch-Up Opportunity	Total Tax-Deferred Opportunity for Workers Aged 50 and Older*
2008	$15,500	$5,000	$20,500
2009	$16,500	$5,500	$22,000

* Does not include the 403(b) Special Catch-Up Contribution

To satisfy nondiscrimination standards, the amounts contributed to 401(k) plans for highly compensated employees must be within a specified range of the average deferred amounts contributed by the non-highly compensated employees. As a result, many presidents may be able to put aside only a small percentage of salary in a 401(k) plan and may not be able to meet the limit ($16,500 in 2009) on elective deferrals in the 401(k) plan. Unlike 401(k) plans, the nondiscrimination rules that apply to elective deferrals under 403(b) plans focus only on the availability to make contributions and not the actual amount of TDA contributions. Thus, a president can take full advantage of his or her individual deferral possibility, irrespective of what other employees contribute. Additionally, elective deferrals made by a president to 401(k) and 403(b) plans of any employer must be combined for purposes of applying the annual limit ($16,500 in 2009) and the limit on age 50 and older catch-up contributions.

Pre-tax elective deferrals to the 403(b) and 401(k) plans are excluded from the president's gross income, and taxation of contributions and earnings on such amounts are postponed until benefit payments are made to the president or his or her beneficiary. Distributions can generally only be made when the president dies, attains age 59½, separates from service with the institution, or becomes disabled. However, loans may be available under the plan. In addition, hardship distributions of pre-tax and after-tax elective deferrals (generally not including earnings) may be permitted under the plan. In any event, distribution must generally commence when the president attains age 70½ or at actual retirement, if later than age 70½. A distribution that is made prior to age 59½ upon separation from service with the institution will generally be subject to a 10 percent penalty tax, unless the president: (1) dies or becomes disabled; (2) separates from service after age 55; (3) receives payments over his or her lifetime, or the joint lives of the president and his or her beneficiary; (4) rolls the distribution over to another tax-sheltered annuity plan or individual retirement account; or (5) makes payments for medical care, but not in excess of amounts allowable as a deduction under section 213.

6. Roth 403(b) and 401(k)

Plans may offer a plan participant the ability to choose to make all or a portion of his or her elective deferrals to a 403(b) plan or a 401(k) plan under the familiar before-tax method or under an after-tax Roth arrangement. Roth contributions will receive "back-loaded" tax incentives like those currently afforded to Roth IRAs, i.e., there will be no immediate income tax deferred, but distributions from the account will be tax-free. While Roth contributions create a new option for the tax treatment of elective deferrals, they do not increase the actual amount of elective deferrals. For example, the Section 402(g) limit ($16,500 in 2009) that can be saved in 2009 does not increase, but it could be split between tax-deferred or Roth contributions. As in the case of the Roth IRA, the individual's Roth 401(k) or 403(b) account will have to be established for five taxable years in order for the distribution to be tax-free. Conversions of existing 401(k) or 403(b) account balances into Roth account balances are not allowed. Distributions from the Roth account can be rolled over by the participant to another Roth account or into a Roth IRA.

C. Deferred Compensation Plans Under Section 457

Generally, deferred compensation arrangements in the public and nonprofit sectors are governed by Section 457 and its limitations, and thus are much more limited than those available to for-profit employers. For this reason—and because the tax laws are changing rapidly in these areas—presidents and boards considering forms of deferred compensation should consult private counsel to identify the best arrangement. For example, IRS rulings and regulations made split-dollar life insurance a less desirable vehicle for executive compensation of college presidents.

1. Eligible 457(b) Plans

While both public and private sector nonprofit employers may sponsor 457(b) deferred compensation plans, these plans have been more prevalent in the public sector as a way of offering public employees the opportunity to save for retirement on a before-tax basis. Public sector and tax-exempt employees have two separate limits, so that up to an annual limit on elective deferrals can be saved in a 403(b) plan ($16,500 in 2009) or 401(k) plan, and an additional amount ($16,500 in 2009) can be saved in a 457(b) plan, for a pre-tax total of $33,000, with catch-up amounts on top of that figure, if applicable.

The tax rules for 457(b) plans of governmental entities differ from those that apply to the private tax-exempt employers. 457(b) plans for private, tax-exempt employers must be limited to a select group of highly compensated and/or management employees. Governmental 457(b) plans can be made broadly available to all employees. Public employees (but not employees of tax-exempt organizations) aged 50 and older can also use a catch-up election similar to that available for 403(b) and 401(k) plans. All eligible deferred compensation plans also have a special catch-up rule that permits a president higher contributions if he or she is within three years of the plan's normal retirement age.

Section 457(b) Contribution Limits

Year	Limit Under Section 457(b) for Both Governmental and Nongovernmental Plans	Age 50 Catch-Up for Governmental 457(b) Plans Only	Special 457(b) Catch-Up for Both Governmental and Nongovernmental Plans
2008	$15,500	$5,000*	Available in the last three years before retirement plan's normal retirement age. Special 457(b) catch-up amount is twice the annual limit, subject to historical underutilization.
2009	$16,500	$5,500*	

* Or special 457(b) catch-up, if greater.

Distributions from nongovernmental 457(b) plans are taxed when they are received or made available. This means that a plan participant in a nongovernmental plan can be taxed on the accumulation in the plan when he or she has a right to take it, even if it has not yet been distributed. IRS rules allow a plan to permit accumulations to be deferred for a period of time after they are made available, with certain limitations. In contrast, distributions from governmental 457(b) plans are taxed only when they are distributed to participants. Thus, even after amounts are made available, participants can continue to defer receipt and taxation of their accumulations. However, both governmental and nongovernmental plans are subject to the required distribution rules: Distributions from the plan must begin by April 1 of the calendar year following the year the president attains age 70½ or retires (whichever is later).

Funds in a governmental 457(b) plan can be rolled over into a qualified retirement vehicle such as an IRA or a 401(a) plan. In addition, plans are permitted to offer loans.

Prior to 1999, 457(b) plans were required under the *Internal Revenue Code* to be unfunded promises to make payments in the future. Subsequently, Congress required 457(b) plans of public employers to be funded by a trust (or annuity) for the exclusive benefit of participants, so as to protect the benefits from the claims of creditors. However, nongovernmental 457(b) plans are required to remain unfunded promises to pay and any assets set aside to fund future benefits are available to the claims of creditors of the employer.

Most 457(b) plans are elective, although they may be offered on a non-elective basis such as when a board determines to add an additional deferred amount. Compensation deferred under a 457(b) plan may not be paid or made available to a president prior to the calendar year he or she attains age 70½, separates from service, or is faced with an unforeseeable emergency.

2. Ineligible 457(f) Plans

Because of the limits on contributions to eligible 457 plans, many college and university presidents have considered so-called ineligible plans under 457(f). The contributions to 457(f) plans are not limited in amount. To avoid inclusion as taxable income, all contributions and earnings to an arrangement under 457(f) must be subject to a "substantial risk of forfeiture." Generally, this means that there must be a future service requirement stated as a condition of receiving the benefits, such as continuing to work for an organization until a future age or date, or the employee will forfeit all rights to the benefits. These arrangements are required to be unfunded promises to pay benefits in the future and, accordingly, any assets set aside to pay future benefits must be part of the general assets of the employer and be subject to the claims of its creditors. However, set aside assets could be used to fund a trust arrangement referred to as a Rabbi Trust, which can, by its terms, prohibit the employer from using the assets for non-plan purposes (the funds would still be subject to the claims of creditors). The operation of the Rabbi Trust would add to the plan's expense. A

president must weigh the risk of forfeiting his or her benefits against the benefit of deferring taxation. A board may find that 457(f) arrangements encourage a president to remain at the college or university, creating a "golden handcuff."

Compensation deferred under a 457(f) plan must be included in the employee's gross income in the first year it is not subject to a substantial risk of forfeiture. In the year that the substantial risk of forfeiture lapses, the employee must include the deferred compensation in income for tax reporting purposes and earnings accrued through that date.

Ineligible 457(f) plans are subject to Section 409A, as described in more detail below.

D. Application of Section 409A to 457(f) Plans

As mentioned above, 457(f) plans are subject to Section 409A (although qualified plans, 403(b) plans, and 457(b) plans are not). Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includable in gross income to the extent they are not subject to a "substantial risk of forfeiture" unless the plan meets specified restrictions set forth in Section 409A. One issue raised by the overlapping coverage of Section 457(f) and Section 409A is that certain events constituting a substantial risk of forfeiture under Section 457(f) are disregarded in determining whether a substantial risk of forfeiture exists under Section 409A. In addition, Section 457(f) does not apply to "bona fide severance pay," whereas Section 409A does not have such an exception but instead includes an exception for compensation payable upon an "involuntary termination." As a result of these differences, compensation that is deferred under a 457(f) plan may need to comply with additional rules to avoid serious tax consequences under Section 409A (including immediate taxation of amounts sought to be deferred, a 20 percent penalty, and interest on such amounts).

A plan or arrangement generally provides deferred compensation under Section 409A if an employee has a legally binding right to compensation in one tax year that is or may be paid to the employee in a later year. It is important to note that a legally binding right to such compensation can exist even if the right is subject to a substantial risk of forfeiture, such as a vesting requirement. Nonqualified deferred compensation plans subject to Section 409A must meet certain key requirements, including (but not limited to) requirements regarding distributions, the timing of initial deferral elections, and changes in the timing and form of benefits. For example, nonqualified deferred compensation plans subject to Section 409A may not distribute deferred amounts prior to one of the following: (1) reaching a specified time (which must be specified when the amounts are deferred), (2) the participant's separation from service, (3) the participant's death, (4) the participant's disability, (5) a change in control, or (6) an unforeseeable emergency. Section 409A generally prohibits the accelerated payment of deferred amounts, except as specifically permitted by the regulations.

Because failure to comply with Section 409A will result in serious tax consequences, colleges and universities must be careful to consider both Sections 457(f) and 409A when reviewing existing deferred compensation plans and in preparing new plans. Given the complexity of these rules, presidents and boards considering these forms of

deferred compensation (or that think that an arrangement may be subject to Section 457(f) and/or Section 409A) should consult counsel to ensure that the arrangements comply with the applicable *Internal Revenue Code* requirements.

E. Other Deferred Compensation Arrangements

Some other forms of deferred compensation include the following:

1. Qualified Governmental Excess Benefit Arrangements

As noted above, Section 415 limits the amount of contributions that a college or university may set aside for an employee under its retirement plan or tax-deferred annuity. In 1996, Congress created Qualified Governmental Excess Benefit Arrangements to allow state and local entities to contribute amounts that would have been contributed to a qualified retirement plan, but for the Section 415 limits. A Qualified Governmental Excess Benefit Arrangement cannot provide benefits calculated using compensation amounts that exceed the appropriate compensation limits that apply to the employee: either the general $245,000 limit or the grandfathered amount for public employees participating before January 1, 1996. Retirement benefits generally would be distributed according to the underlying retirement plan.

Recently, there has been an uptick in presidential contracts that incorporate Qualified Governmental Excess Benefit Arrangements into the president's compensation structure. Specifically, the structure allows for the president to participate in the university's 403(b) plan, and a separate 401(a) plan. Any amounts in excess of the $49,000 limit (for 2009) for the 401(a) plan (there is a separate $49,000 limit for the 403(b) plan) are then reallocated to the Qualified Governmental Excess Benefit Arrangement, which preserves the tax deferral on the contributions that would have been in excess of the $49,000 limit (for 2009).

2. Benefits for Former Employees

An employer may make post-termination contributions to a 403(b) plan on behalf of a former employee for five years subsequent to the employee's termination date. The Section 415 limit is based on 100 percent of compensation paid in the final 12 months of employment or the annual limit ($49,000 in 2009), whichever is lower. Thus, over the five-year period, the cumulative maximum would be more than $245,000 because the current $49,000 annual limit will increase with inflation.

Public sector college and university 403(b) retirement plans might easily incorporate such a benefit into their plans, because the *Internal Revenue Code's* non-elective nondiscrimination rules do not apply to them. Private employers who adopt this provision will need to make sure that the plan complies with the nondiscrimination rules for highly compensated employees. In conducting these nondiscrimination tests, the contributions for former employees would be tested separately from the other plan contributions made for active employees. Thus, a sufficient number of non-highly compensated former employees will need to benefit as well.

F. Non-Employment–Related Retirement Savings Incentives

Included below is a high-level overview of traditional IRAs and Roth IRAs. The rules relating to IRAs are complicated, so please consult your tax or financial adviser for more information about IRAs.

1. Traditional IRA

A president of a college or university who has not attained age 70½ and who has earned income during the year may make deductible contributions to an individual retirement account (IRA) for that year. A president may also contribute to an IRA for his or her non-working spouse under age 70½ if the president and spouse file a joint income tax return for the year and the compensation, if any, of the non-working spouse for the year is less than the compensation of the working spouse (the president). Contributions to an IRA, in 2009, may not exceed $5,000 per year per individual or $10,000 total for both spouses, and may be made as late as the due date for filing the taxpayer's federal income tax return for that year (excluding extensions). An IRA catch-up for workers aged 50 or older adds $1,000 (in 2009). These dollar limits are generally increased annually for the cost of living.

The deductibility of IRA contributions depends on: (1) whether the IRA owner or, in some cases, the spouse of the IRA owner, was an "active participant" in a retirement plan sponsored by his or her employer, and, if so, (2) the amount of his or her modified adjusted gross income (AGI). Usually, a president who is an active participant may not deduct contributions to his or her IRA, because the president's AGI will typically exceed the income limits for deducting IRA contributions. (For example, the deduction for such contributions for 2009 phases out at AGI of more than $89,000 and is eliminated at $109,000 for a person filing a joint return.)

Amounts held in an IRA are not subject to federal income tax until distributed from the account. Distributions from a traditional IRA must begin by April 1 of the year following the year the account owner attains age 70½.

2. Roth IRA

Although contributions to a Roth IRA are not deductible, distributions are excludable from income tax if the Roth IRA has been established for at least five years and if the distribution is for a "qualified" reason, which includes distributions after the attainment of age 59½, distributions attributable to the account owner's death or disability, and distributions used to pay certain "first-time home buyer" expenses.

The annual contribution limit to a Roth IRA is $5,000 through 2009 per individual ($10,000 for both spouses). A catch-up for workers aged 50 or older adds $1,000 (in 2009). These dollar limits are generally increased annually for the cost of living. The limit on contributions gradually reduces to $0 for single individuals with AGI between $105,000 and $120,000, and for joint filers, between $166,000 and $176,000. The contribution limit is also reduced by the amount of any contributions made to the account owner's traditional IRA.

A president may convert an amount held in his or her traditional IRA to a Roth IRA if the president's AGI (single filers or joint filers) for the tax year is $100,000 or less. Conversion is not available to single or joint filers with AGI in excess of $100,000 or to a married individual filing separately. The taxable amount of the conversion is included in the president's gross income in the year of conversion.

3. Combination of Traditional IRA and Roth IRA

A president may split contributions between a traditional IRA and a Roth IRA; however, the limits described above may not be exceeded in the aggregate.

6. Estate Taxes

A. Transfer Taxes and the Relationship to Estate Planning

A discussion of tax issues and planning would not be complete without an understanding of the transfer tax system. Transfer taxes include gift, estate, and generation-skipping transfer taxes. Gift taxes are imposed upon lifetime taxable gifts. Estate taxes are imposed upon property transferred at death. Generation-skipping transfer (GST) taxes are imposed upon property transferred by gift or at death to any person who is assigned to a generation that is two or more generations below that of the transferor.

The most common goals of the estate planning process are to preserve and transfer wealth in accordance with one's wishes. Understanding the transfer tax rules is important to each of these goals. The estate planning process includes making arrangements for the disposition of assets to heirs or charities, identifying the taxes and other costs that might reduce the value of these assets, and then arranging for one or more of the estate planning tools, such as wills, trusts, beneficiary designation forms, and insurance policies, to accomplish these goals.

The *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) had a significant effect on the transfer tax regime, most notably the systematic repeal of the estate and generation-skipping transfer taxes. EGTRRA provided for a series of increases in the estate tax applicable exclusion amount and GST tax exemption from $1 million in 2002, to $1.5 million in 2004, to $2 million in 2006, to $3.5 million in 2009, and to a complete repeal of both tax regimes in 2010. Together with the increase in the applicable exclusion amount and GST tax exemption, EGTRRA reduced the highest marginal estate, gift, and GST tax rates to 45 percent in 2009. Although EGTRRA repeals the estate and GST taxes for 2010, it maintains the gift tax but provides for a gift tax exclusion amount of $1 million and further reduces the top marginal gift tax rate to 35 percent. Like many provisions of EGTRRA, these provisions are scheduled to expire after 2010. Accordingly, the estate and GST tax repeal terminates after December 31, 2010, and the pre-EGTRRA transfer tax regime will be reinstated in 2011. The current economic and political realities, however, make it a near certainty that Congress will pass new legislation making the estate and generation-skipping transfer taxes permanent in 2009.[1]

1. At the time this *Tax Guide* went to press, legislation had been introduced in the U.S. House of Representatives and the U.S. Senate to make the 2009 federal estate tax and GST tax exemption and rate structure permanent. While it is premature and beyond the scope of this section to analyze the proposed bill, the reader should be aware of the legislative momentum toward the retention of the estate and GST tax regimes.

It is important to note that estate planning is a uniquely personal process and that there is no such thing as a "standard plan." Each and every estate plan is specific to the individual and his or her family. The purpose of the following discussion of planning techniques is designed to be general in nature and to stimulate thought and consideration. Any action generated by the following discussion should be taken only after consultation with a qualified professional.

B. Basics of Transfer Tax Laws

In calendar year 2009, each individual is entitled to transfer a certain amount of property, during life or at death, free of transfer tax. The amount that can be transferred tax free is commonly referred to as the *applicable exclusion amount*. Prior to EGTRRA, the applicable exclusion amount for lifetime transfers and at-death transfers was the same, or "unified." EGTRRA "de-unified" or bifurcated the estate and gift tax regimes and the applicable exclusion amounts. The gift tax exclusion amount in 2009 is $1 million, while the estate tax exclusion amount is $3.5 million. Any amount of the applicable exclusion for gift tax purposes used by a taxpayer for lifetime transfers will reduce the exclusion amount available at death.

Estate and GST Tax Applicable Exclusion Table

Year	Exclusion Amount
2009	$3.5 million
2010	Estate and GST taxes scheduled repeal
2011*	$1 million

The top marginal tax rate for estates of decedents in calendar year 2009 and for gifts made in 2009 is 45 percent. After the scheduled repeal of the estate and GST taxes in 2010, absent further legislation, the gift tax will be retained, but the top marginal rate for gifts made in 2010 will be 35 percent.

Estate, Gift, and GST Highest Marginal Tax Rates

Year	Tax Rate
2009	45%
2010	Estate and GST taxes scheduled repeal Gift tax rate 35%
2011*	55%

* Unless Congress enacts new legislation, the transfer tax regime as it existed prior to EGTRRA will be reinstated beginning in 2011.

C. Gift Taxes

There are several important concepts to understand when considering lifetime gifts. On an annual basis, a president can gift up to $13,000 each to any number of donees. A president and his or her spouse as a married couple (if both are U.S. residents) can jointly give $26,000 per year to each donee. This annual exclusion amount is indexed for inflation.

In addition to the annual exclusion, an unlimited gift tax exclusion for medical expenses and tuition costs paid by the donor on behalf of the donee exists. To qualify for this exception, the payments must be made directly to the medical service provider or a qualifying educational institution.

> ***Example:*** Chancellor Jones's parents have a large estate and wish to reduce their taxable estate through lifetime gifting. Their grandchildren attend private education institutions. The grandparents pay for their grandchildren's tuition by making payments directly to the education institutions. In addition, they each give $13,000 in annual exclusion gifts to each child and grandchild.

Contributions to Education Savings Accounts and Qualified Tuition Programs (Section 529 plans) are counted toward a donor's annual exclusion amount for federal gift tax purposes. Distributions from such plans are not treated as taxable gifts.

There is an unlimited marital deduction for gift and estate tax purposes. Therefore, U.S. citizen spouses may freely transfer property between one another. The marital deduction provides a planning opportunity by allowing spouses the potential to equalize their estates through lifetime gifting without incurring federal gift taxes. For gifts made to spouses who are not U.S. citizens, the annual exclusion amount is $133,000, adjusted for inflation.

If a president makes taxable gifts in excess of $13,000 per donee (or $26,000 per donee if his or her spouse joins in the gift), he or she must file a federal gift tax return by April 15 of the following year. The filing requirements contain some limited exceptions. The amount due is the calculated tax less the tax credit based on the $1 million exclusion amount. (See Estate, Gift, and GST Highest Marginal Tax Rates table on the previous page).

For individuals with significant assets, it should be noted that making gifts during life, instead of at death, carries a benefit. The primary advantages are: (1) post-gift appreciation is not subject to gift or estate taxes, and (2) gift taxes paid on gifts made more than three years before death will not be included in the estate for estate tax purposes.

> ***Example:*** College President Smith has already made lifetime gifts using up her entire applicable exclusion amount of $1 million. After annual exclusion gifts, Smith gifts stock with a tax basis and fair market value of $30,000 to her son. Smith is in a 45 percent transfer tax bracket and pays $13,500 in gift tax for the gift. Smith dies five years later. The stock gifted to the son is then worth $110,000. Therefore, no transfer taxes were paid on the asset appreciation of $80,000. In addition, transfer taxes were minimized because the $13,500 gift

tax payment worked to reduce the overall taxable estate. The son will incur an income tax on the gain of $80,000 ($110,000-$30,000 of basis) if the stock is sold at this point.

There are, however, some obvious disadvantages to outright lifetime gifting. First, the donor will lose the enjoyment and control of the property forever. In order for a gifted asset to be excluded from a donor's estate, the gift must be a complete transfer and he or she cannot retain beneficial enjoyment of the property. Second, the donor may have to pay transfer taxes that could otherwise be deferred. Third, the income tax basis to the donee will generally be a carryover basis, the same as the donor's cost. For determining a loss on the sale of gifted assets, the donee's basis will be the lesser of the donor's basis or the fair market value of the property at the date of the gift.

When evaluating lifetime gifting that is at a level to incur a gift tax, donors should consider the changes made by EGTRRA to the estate tax system and the chances of Congressional action. The estate and GST taxes are scheduled for repeal in 2010. A donor should consider whether to incur gift taxes on property that could transfer free of estate tax if death occurs in 2010. Lifetime gift-giving strategies should be considered as part of a comprehensive estate plan that should include various factors including the health of the donor.

The tax basis issue is an important factor to consider in lifetime gifting. For gifts made during an individual's lifetime, the donee's tax basis is the donor's tax basis ("carryover basis"). For transfers at death, the donee's tax basis is the fair market value of the property at the decedent's date of death ("stepped-up basis"). Therefore, the individual receiving a gifted asset may have a larger gain when selling the asset than if it had been received through an estate. However, in the absence of Congressional action, EGTRRA will repeal the stepped-up basis rule for transfers during 2010, the year of estate tax repeal, and replace it with a modified carryover basis rule. The recipient of property from a decedent during 2010 will receive a basis equal to the lesser of the adjusted basis of the property in the hands of the decedent or the fair market value on the date of the decedent's death. There are some significant exceptions to these rules, noted in Estate Taxes beginning on the next page. Beginning in 2011, the step-up in basis rule for transfers at death will be reinstated. When evaluating the use of lifetime gifting, the basis rules should be considered in light of the differences between step-up and carryover basis, and the differences between capital gain tax rates and estate tax rates.

Estate and Gift Tax Rates for Tax Year 2009			
Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	$1,250,000	$345,800	41%
$1,250,000	$1,500,000	$448,300	43%
$1,500,000	$2,000,000	$555,800	45%
$2,000,000	$3,500,000	$780,800	45%
$3,500,000	————	$1,455,800	45%

D. Estate Taxes

A president's gross estate includes both his or her probate and nonprobate assets. Probate assets are those assets titled in the president's name alone and pass under the president's will. Assets that pass outside the will are nonprobate assets and include beneficiary designation assets, such as life insurance, retirement plans, and joint assets. To estimate the value of one's gross estate, add up the value of all liquid assets (such as cash, checking and savings accounts, and money market accounts), stocks and bonds, personal effects and other assets, real estate, death benefits from retirement plans, and life insurance policies.

For annuities that are in the accumulating stage, the value of the annuity on the date of death will be included in the gross estate. If a president is currently receiving annuity income, the value of the survivor benefit or of the remaining income through the guaranteed period will be included in the gross estate.

Life insurance is also included in the gross estate if the decedent had the right to name the beneficiary, transfer the policy, borrow from the policy, or exercise other powers associated with ownership. Specialized estate planning tools, such as the irrevocable life insurance trust (ILIT), can be used to remove life insurance from the estate. But, until an ILIT is implemented, life insurance must be considered a part of the gross estate.

Although certain deductions can be made from the gross estate before determining the taxable estate, these are generally more limited than income tax deductions. Generally, the taxable estate is determined by subtracting from the gross estate the unlimited marital deduction for bequests to spouses and the deduction for bequests to qualified charities. Deductions include final medical expenses, funeral costs, and other related expenses. Administration costs such as attorney, accountant, executor, and appraisal fees may also be deducted. Debts also reduce the taxable estate and include mortgages, income tax liabilities, and state death taxes.

Individuals should understand the estate or inheritance tax laws of the state or states in which they own property. This is especially important because of the repeal of the state death tax credit. Under pre-EGTRRA law, a decedent's estate was entitled to a federal credit for state death taxes paid. EGTRRA eliminated the state death tax credit and replaced it with a deduction for decedents dying in 2009. Prior to EGTRRA, a majority of the states had a "pick-up" or "sponge" tax designed to collect the maximum amount of the federal death tax credit. Before the elimination of the credit, a decedent's estate would pay the amount of this credit to the particular state and his or her federal estate tax liability would be correspondingly reduced by the same amount. Faced with dwindling tax revenues because of the elimination of the credit, many states have restructured their estate tax systems. For states with an inheritance tax (a tax on the portion of an estate received by a beneficiary, depending upon his or her relationship to the decedent), this is not an issue.

As noted in Gift Taxes on page 37, property acquired from a decedent after December 31, 2009, will be subject to a modified carryover basis rule. Thus, property acquired by bequest, devise, or inheritance after that date (but subject to the EGTRRA "sunset," as discussed below) will have a basis equal to the lesser of the adjusted basis of the property in the hands of the decedent, or the fair market value of the property on the date of the decedent's death. One effect of this change is that executors of estates, during 2010 only, will have to determine the tax basis of noncash property that will pass to a decedent's heirs. Because this may be a difficult task for certain types of property that have been held for a significant length of time, establishing basis during the decedent's lifetime is generally preferable to having the IRS make its own determination of basis. Thus, an investigation of the tax basis of all significant assets should be an important element of estate planning.

There are some important provisions in EGTRRA that simplify the recordkeeping and minimize the tax cost of assets passing at death in 2010. Under the modified carryover basis provisions, executors will have the authority to increase the basis of assets passing from the decedent from their carryover value to a stepped-up, date of death value. This new "step-up" will be subject to a total increase of $1.3 million, which can be allocated among assets, passing to any heir or heirs. An additional $3 million of basis step-up will be available for property passing to a decedent's surviving spouse but only if the property is transferred outright or is qualified marital deduction property. In no event can such step-up in basis exceed the fair market value of the property as of the date of the decedent's death. As noted, unless Congress takes affirmative legislation action before the sunset date for EGTRRA, the pre-EGTRRA stepped-up basis rules will return, effective January 1, 2011.

E. Generation-Skipping Transfer Taxes

Another type of federal tax that may affect a president's estate is the generation-skipping transfer tax. It is applied to gifts or bequests that "skip" a generation—a gift of property from grandparent to grandchild, for example. A *skip person* is defined as any relative two or more generations below the transferor (e.g., a grandchild or great-grandchild), or a person not related to the transferor who is more than 37½ years younger than the transferor. The GST exclusion amount for 2009 is $3.5 million and the top marginal tax rate is 45 percent. The GST tax is scheduled for repeal in 2010. After 2010, the GST tax and the top marginal rate are reinstated at their pre-EGTRRA level. See the chart in Gift Taxes on page 36.

F. Forms of Property Ownership

As noted above, only "probate assets" pass under a decedent's will. The various forms of property ownership are described below:

Sole Ownership. Title is held in one individual's name, for example, Jane Smith. These assets are subject to probate and will be distributed pursuant to the terms of Jane's will.

Joint Tenancy with Right of Survivorship. Title is held in the name of two or more owners as joint tenants with right of survivorship. Each joint tenant owns an undivided interest in the property. At one joint tenant's death, the property automatically passes by operation of law to the surviving joint tenant(s). For example, Jane Smith and John Doe are joint tenants with right of survivorship (JTWROS). After Jane's death, John owns the property by operation of state law and the property will not be subject to probate through Jane's will.

Tenancy by the Entirety (available in some states). Many states provide that property jointly held between a husband and wife is presumed to be tenancy by the entirety. This form of ownership is very similar to joint tenancy, except that it can only be created between a husband and wife. At the first spouse's death, the property will automatically pass by operation of law to the surviving spouse.

Tenancy in Common. If property is jointly held as tenants-in-common, each tenant (owner) owns an undivided interest in the property. However, the interest of a tenant-in-common does not terminate at his or her death, but passes to his or her estate or heirs. After the death of a tenant-in-common, the decedent's property interest passes as he or she has designated in his or her will (or revocable trust, if the property interest is held in the name of the trust or transferred to the trust by will).

Community Property. Community property is a characterization of property ownership based on state law. Community property is all property acquired during marriage, except by gift or inheritance. When characterized as such, community property is owned in common by a husband and wife, each having an undivided interest because of their marital status. If the applicable state law provides for community property ownership, the character of the property as such will typically apply, even if the property happens to be titled in one spouse's name. Nine states are "community property" states: Alaska (elective), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Wisconsin has a form of community property called "marital

property." At death, each spouse can dispose of his or her half interest in community property as he or she wants (similar to tenants-in-common).

Transfer on Death/Payable on Death (TOD/POD). Some states also provide that certain property can be held with a "transfer on death" or "pay on death" designation. When held in this form, the property passes to the person named on the account or title at the property owner's death. An example is a checking account in a state recognizing this form of ownership and titled as: Jane Smith, POD John Doe. At Jane's death, John automatically owns the checking account without the account going through probate or by the terms of Jane's will.

Beneficiary Deeds. Some states also recognize beneficiary deeds (also called transfer on death deeds). A beneficiary deed is filed with the deed to real estate. The beneficiary deed states who is to receive the real estate following the owner's death. The designation is typically fully revocable during the owner's lifetime. If still in place at the owner's death, the property automatically passes to the designated beneficiary without going through probate.

G. Estate Planning Tools

Although each person's estate plan is unique, there are basic estate planning tools that, used together, may be appropriate for many plans. It is helpful to have a basic understanding of these tools when forming an estate plan.

1. The Last Will and Testament

Even the simplest of estate plans usually start with the drafting and execution of a will. Without a will, the laws of the state will determine how a person's assets are distributed following death (referred to as *intestacy*). A will is an "ambulatory" document, meaning it is only effective at death, but it can be amended or revoked at any time prior to death. The will allows a person to direct the transfer of assets after his or her death, to designate a personal representative (or executor), and to nominate a guardian for any minor children. A will does not dispose of nonprobate assets, such as jointly owned property, life insurance with a named beneficiary, or any asset or account that will automatically pass to a named beneficiary.

If a person is married, his or her will should name a presumed survivor. If the individual and his or her spouse were to die simultaneously, the presumed survivor clause would answer the question of whose will should be interpreted first. The selection of a presumed survivor could have significant tax implications, which should be discussed with an estate planning professional. A will may address only part of an individual's basic estate planning needs. Although a "simple will" (an expression that usually means a will without a testamentary trust) may say who the executor is and how the property is to be distributed, it will not do much to save taxes or expenses associated with settling the estate.

2. The Trust

A trust is a legal device designed to hold the property of an individual (the "grantor") for the sake of one or more beneficiaries. The grantor names a

"trustee," an individual and/or institution, to manage the trust's assets according to his or her instructions for the benefit of the trust beneficiaries. Trusts are useful for resolving different kinds of estate planning issues. They can be used to avoid probate on assets transferred to the trust during an individual's lifetime or to reduce the taxes associated with the estate. They can help support a surviving spouse and children, assist family members with special needs, or provide for an individual's future care. Revocable trusts allow one to control his or her assets and change the terms of the trust at any time; irrevocable trusts do not.

3. Beneficiary Designation Forms

One of the most common estate planning problems occurs when a will is rewritten but the individual neglects to coordinate the various beneficiary designation forms applicable to insurance policies, annuities, retirement plans, stock option plans, and so forth for changes made under the will. Because the law does not presume that a rewritten will is intended also to amend beneficiary designations, they must all be reviewed when revisions are made to a will or revocable trust.

4. The Marital Deduction and Credit Shelter Trust

One fundamental estate planning technique is the proper use of the marital deduction. The marital deduction is equal to the fair market value of qualifying property passing to a surviving spouse, provided he or she is a U.S. citizen. (Note: There are two ways a non-citizen spouse can receive assets tax-free or tax-deferred. Assets can be left at death in a "qualified domestic trust," or QDOT. Or, an individual can give a non-citizen spouse up to $133,000 (in 2009) per year free of gift tax. This amount is indexed for inflation.)

Because the marital deduction only defers the estate tax until the surviving spouse dies, a significant tax obligation could remain after the survivor's death. If a president and his or her spouse have a large estate, it may be worthwhile to do some careful planning now.

> ***Example****:* Using their respective tax credits, a president and her spouse can each shelter up to $3.5 million from federal estate taxes in 2009. She may therefore think that, together, they have exemptions totaling $7 million. This is not automatic. For instance, suppose she and her spouse have combined assets worth $7 million, and one of them dies, leaving everything outright to the other. While there's no federal estate tax at that time because of the unlimited marital deduction, the surviving spouse has the full $7 million in his or her estate, though only $3.5 million can be sheltered from estate tax. The exposure of half of the family's net worth to estate tax liability could have been easily eliminated with proper estate planning.

To use the applicable exclusion amount more effectively, an individual should consider not leaving property to his or her spouse outright or in a marital trust—at least not the amount that can be sheltered from estate tax by the

applicable exclusion amount. It should be left instead to a trust that does not qualify for the marital deduction, such as a credit shelter trust.

A credit shelter trust (also known as a bypass trust or family trust) is specially designed to give a surviving spouse the benefit of an individual's assets during his or her lifetime, while not including them in his or her estate. Each spouse can write the same kind of document, so that no matter who dies first, the respective unified credits will be fully utilized. This trust protects the tax shelter benefit of the applicable exclusion amount for the first spouse to die. It's sometimes called a "B" trust, to distinguish it from the marital deduction trust, which is called an "A" trust, into which one would put the excess of his or her estate over the applicable exclusion amount currently in effect.

Many misunderstandings about this type of trust exist. One should be clear at the outset that its purpose is usually not to keep assets away from a spouse, but only to keep them from being taxed to his or her estate. This trust can provide income to the surviving spouse (and, if desirable, can even give the surviving spouse some limited power of disposition to other people and/or the power to take out each year the greater of $5,000 or 5 percent of the trust principal), and property in this trust will generally escape taxation at the survivor's death.

> ***Caution***: One of the most important things to do after signing a will or trust that creates a credit shelter trust is to make sure each spouse has sufficient assets in his or her name to fund the applicable exclusion amount ($3.5 million in 2009). If all assets are jointly owned or titled to the spouse who survives, then the credit shelter trust provisions are worthless. That's because all the assets will automatically go outright to the survivor or will already be owned by him or her, and nothing will automatically go into the trust. It is possible through the use of disclaimer planning to work around this issue, but the surviving spouse must be very careful to avoid any benefits of disclaimed property and there are very technical rules related to the proper execution of a disclaimer. From a tax standpoint, the ideal scenario is for each spouse individually to own enough property to take advantage of the credit shelter trust. The tax advantage of owning property in one's own name must be weighed against creditor and divorce laws.

5. Qualified Terminable Interest Property Trust

A marital trust ("A" trust) can come in a variety of forms that qualify for the unlimited estate tax marital deduction. A common form of a marital trust for a U.S. citizen spouse is a "qualified terminable interest property" (QTIP) marital trust. To qualify for the unlimited gift or estate tax marital deduction, the marital trust must require that the surviving spouse receive all of the trust income at least annually. With a QTIP marital trust, an individual can designate where the trust assets will go after the surviving spouse's death. The primary benefit to using a QTIP marital trust is that an individual will defer all estate tax on the marital trust assets until the surviving spouse's death (leaving all of these assets available for his or her benefit), and the individual can fully control the ultimate disposition of any remaining assets following his or her death.

A QTIP marital trust might be ideal, for example, when spouses feel differently about how assets should be distributed following the survivor's death, or simply if an individual wants to ensure that assets go to the individual's children following the surviving spouse's death (and not to a new spouse or the new spouse's children).

6. Irrevocable Life Insurance Trust

The proceeds of any life insurance policies on an individual's life that are owned or controlled by that individual at his or her death may be included in the gross estate for estate tax purposes. If a president owns a significant amount of life insurance, he or she should consider the benefits from this form of trust as a way to remove the life insurance policy proceeds from the taxable estate. An irrevocable insurance trust is an irrevocable trust designed to hold title to life insurance policies during an individual's lifetime. An irrevocable insurance trust can also be used to provide a funding source for any estate taxes due at death if, for example, the estate contains unmarketable assets that cannot be easily sold to pay the estate taxes. With an insurance trust, the trust is typically the owner of the life insurance policy and the beneficiary of the policy proceeds after one's death. When properly structured, the trust terms will determine how the policy proceeds are used or distributed, but the individual won't be deemed to "own" it for estate tax purposes. For newly acquired insurance, the trust should be the initial applicant, owner, and beneficiary for the insurance and the proceeds will be excluded from the estate. If an existing policy is transferred to the trust, the original owner must survive the transfer by at least three (3) years for the proceeds to be excluded from the estate for estate tax purposes.

The gift tax value of a life insurance policy is generally much lower than the face value of the policy. The sum of the cash surrender value and unearned premium of a policy often approximates the gift tax value of a policy. Therefore, the transfer can be made for gift tax purposes at a very low cost, but the amount of estate taxes avoided may be substantial. Another advantage of the gift of a life insurance policy is that losing control of this asset is generally not a significant issue for the owner, compared to the gifts of other types of assets.

> ***Caution***: Prior to canceling a life insurance policy, a president should confirm that he or she is still insurable and that a new policy has been issued.

7. Charitable Bequests and Trusts

Lifetime transfers to charitable organizations are not subject to gift taxes, and estate transfers to charitable organizations reduce the overall taxable estate. A charitable bequest is written into an individual's will or trust and takes place at his or her death.

Charitable trusts can be created during a donor's life or at his or her death. A charitable remainder trust pays an annuity or unitrust amount to a non-charitable beneficiary for life or term of years, and the remainder is distributed to the charity. The donor receives a charitable deduction based on the actuarial-computed remainder interest. A charitable lead trust provides annuity income to the

charity as an income interest. Non-charitable beneficiaries receive the remainder interest. In certain cases, the donor receives a charitable deduction based on the actuarial-computed income interest. Assets used to fund these types of trusts generally have a low yield and substantial built-in gain. This allows an individual to make a charitable gift while creating a greater income stream from the asset without recognizing income taxes on the sale of the asset.

Another planning opportunity is found in using retirement benefits for charitable giving. Retirement benefits remaining after an individual's death are included in his or her estate for estate tax purposes. Heirs of retirement assets will have to pay income taxes on any income received. Directing that retirement benefits, including annuity death benefits, be used for charitable bequests is an effective strategy because the donor's estate will receive an estate-tax charitable deduction, and the charitable organization is not subject to income tax. Distributions to non-charitable heirs can then be funded with assets that do not have a significant income tax liability associated with them.

> ***Note***: When evaluating the use of charitable bequests and lifetime charitable gifts, a gift that is made during a donor's lifetime will generally provide greater overall tax savings. This is because of the fact that an individual receives an income tax deduction in the year of the gift. Thus, overall taxes are reduced. Income taxes are reduced by the charitable income tax deduction, and the estate is reduced by funding the charitable gift with assets that would have been part of the taxable estate.

8. Other Common Planning Trusts and Entities

There are many types of estate planning techniques that use trust instruments. Examples of these tools are qualified personal residence trusts (QPRT), grantor retained annuity trusts (GRAT), and grantor defective trusts. These tools tend to have more complex provisions and some can be subject to increased IRS scrutiny and review. Many trusts include provisions that utilize generation-skipping transfer tax exclusion opportunities.

The last several years have seen an increase in the use of family limited partnerships and limited liability companies. At the same time, the IRS has been actively scrutinizing these transactions because of the substantial tax savings that can be achieved. These techniques can result in valuation discounts based on certified appraisals. To be recognized for tax purposes, the entity and its owners must meet business and tax entity classification rules. The assets contributed to the entity and diversification rules can affect the amount of the discount and other income tax provisions.

H. Non-tax Estate Planning Issues

Although estate planning usually involves planning for the disposition of one's assets following death, there has been a growing interest in contingency planning for incapacity.

Living Will and Durable Power of Attorney for Health Care

A living will or health care directive provides general health care instructions to an individual's doctor or treating physician when the individual is incapacitated and unable to make health care decisions. If an individual has specific wishes with respect to certain medical procedures (e.g., typically, the administration of certain life-sustaining procedures or life support systems if the individual is terminally ill), the individual should consider executing a living will or health care directive.

Similarly, a durable power of attorney for health care decisions appoints someone to act for an individual (an *attorney-in-fact*) to make medical decisions for the individual if he or she becomes incapacitated and unable to make these decisions for him or herself. The attorney-in-fact for medical purposes need not be the same person designated as the attorney-in-fact for general (or business) purposes. Obviously, the person selected to act in making medical decisions in the event an individual is incapacitated and unable to make decisions for him or herself should either be a family member or other close friend who is familiar with and will respect the individual's wishes. Due to the importance of these documents, an individual should consult his or her professional estate planning advisers for advice on specific issues relative to this matter. It is possible in some states to execute these documents separately or combine them into a single legal document.

Durable Power of Attorney

In addition to a will and any trust planning that may be appropriate, a thorough estate plan should consider the advisability of implementing a durable power of attorney for general or business purposes. A durable power of attorney for general or business purposes designates someone to act on another's behalf (i.e., an *attorney-in-fact*) to manage the person's day-to-day financial affairs in the event he or she becomes incapacitated and unable to continue managing his or her own affairs. One should keep in mind that even if he or she has already executed or chooses to execute a revocable trust, the trustee of that trust will only have authority to act on the individual's behalf with respect to assets placed in the trust prior to incapacity. An attorney-in-fact under a durable power of attorney for general purposes will have the authority to act with respect to assets in the person's name, and typically will be authorized to receive income on his or her behalf, write checks, and pay expenses and other day-to-day matters. As with any other estate planning document, one should consult professional estate planning advisers for advice on specific issues relative to a durable power of attorney.

Long-term Care Considerations

The need for long-term care services can place a heavy financial burden on families. The chance of needing long-term care increases with age; thus, estate plans should take this possibility into account.

I. Most Common Estate Planning Mistakes

Many individuals do not realize that, regardless of whether they have wills and/or trusts, estate planning has already been done for them. This is because state laws operate when documents do not address transfer issues. Many issues can be easily addressed by consultation with an estate planning attorney. The cost of professional fees can be minimal in comparison to the tax savings that can be achieved and the comfort of knowing that one's goals will be achieved.

Understanding What Is in the Estate

Every individual should evaluate his or her estate. This includes details such as fair market value, tax basis, ownership titling, and beneficiary designations.

Lack of Estate Documents

Every individual should have a will and/or trust document that addresses issues such as asset disposition, executor and trustee appointments and duties, guardianship of children, and payments of estate expenses. Durable powers of attorney and health care directives are critical to ensure that management of financial affairs during incapacity and at death are made in accordance with individual wishes.

Changes in Tax Laws or Family, Personal, and Economic Circumstances

Changes in the federal and state estate tax laws, the birth of children or grandchildren, retirement, serious illness, change of state residence, divorce, and receipt of an inheritance are examples of events that may affect existing estate documents or require the drafting of new ones.

Asset Ownership

The titling of assets is critical to the determination of a taxable estate. Assets with beneficiary designations or rights of survivorship will operate outside of estate documents. Trusts that are drafted to meet certain estate planning goals will not achieve those goals if they are not funded with the assets intended for them. This would also include the improper use of jointly held property. The effect of state creditor and divorce laws should be taken into consideration.

Liquidity Needs

After an individual's death, a certain amount of cash or liquid assets may be needed to cover taxes and other costs of transferring property at death. This would include planning for the proper amount of life insurance coverage and insurance ownership.

Trustee and Executor Selection

Naming the wrong person to administer a trust or estate can be disastrous. The person who administers the trust and/or estate must collect assets, pay obligations, and distribute assets to beneficiaries. This is no easy task. It can be highly complex, time consuming, and in some cases technically demanding.

7. Other Compensation Issues

A. Federal Intermediate Sanctions Rules

Tax-exempt colleges and universities, like all Section 501(c)(3) organizations, are prohibited from making payments to insiders that constitute "private inurement." Excessive compensation paid to a president or other non–fair market value transactions between a college or university and its president could result in private inurement. Before enactment of the intermediate sanction rules (IRC §4958) in 1996, the sole remedy for violation of the private inurement prohibition was revocation of the organization's tax exemption—a draconian remedy that was seldom used. IRS regulations implementing the intermediate sanctions rules were issued in January 2002. This section briefly considers the effect of these rules on college and university presidents.

Section 4958 imposes an excise tax on "excess benefit transactions" engaged in by certain tax-exempt organizations, including colleges and universities that are tax-exempt under Section 501(c)(3). State colleges and universities that are tax-exempt as governmental entities are generally exempt from Section 4958. An excess benefit transaction is a transaction in which an organization such as a college or university provides an economic benefit directly or indirectly to or for the use of any "disqualified person" if the benefit provided exceeds the value of the consideration, including the performance of services, received for providing such benefit. The payment of reasonable compensation does not, however, constitute an excess benefit transaction.

Under these rules, an economic benefit will not be treated as compensation unless the organization clearly indicates its intent to treat it as such by contemporaneously reporting the compensation on relevant forms, such as Form W-2, Form 1099 (reporting the payment to the recipient), or the Form 990 (Annual Information Return). An organization's failure to properly report an economic benefit as compensation can result in an automatic excess benefit to the recipient because the benefit could not be considered part of an overall reasonable compensation arrangement. This means that organizations must be careful to treat all economic benefits paid to a "disqualified person" as compensation, unless a specific exclusion applies. Most nontaxable fringe benefits need not be reported, although such benefits will be included in total compensation when analyzing the reasonableness of the compensation. An organization cannot wait until an IRS audit to establish that it intended to treat economic benefits as compensation for services, and the IRS regulations so provide.

The excess benefit tax applies only to excess benefits provided to disqualified persons, who are defined as:

- Any person who at any time during the five years preceding a transaction was in a position "to exercise substantial influence over the affairs of the organization."
- A family member of such individual.
- A corporation, partnership, or trust or estate in which persons with substantial influence or members of their family own more than 35 percent of the total combined voting power, profit interest, or beneficial interest.

While it may be difficult to determine whether some employees are disqualified persons, a college or university president clearly has substantial influence over his or her institution, and the IRS regulations hold that any president or CEO will be a disqualified person. There is, however, an important "initial contract exception" that covers persons who are not disqualified persons at the time they are hired. This exception applies to newly hired college and university presidents coming from another institution, but only if there is a binding written agreement executed before the new president assumes the position. Under the exception, the excess benefit tax is inapplicable to fixed payments made to the president during the term of the initial contract.

The tax consequences of providing an excess benefit to a disqualified person are severe. First, the disqualified person must pay an initial excise tax equal to 25 percent of the excess benefit. In addition, organization managers (defined as trustees and officers) are subject to a tax of 10 percent of the amount of the excess benefit (limited to $20,000 for any one transaction on a joint and several basis) if they approve the transaction knowing the benefit to be excessive. Thus, a college or university president could be liable both for receiving excessive compensation and for participating in the decision to pay excessive compensation to other disqualified persons. Furthermore, if the excess benefit transaction is not "corrected," an additional 200 percent penalty tax is imposed on the disqualified person receiving the benefit. Under the statute, correction means "undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." In essence, this requires repaying the amount of the excessive benefit, with interest.

Although the intermediate sanction rules heighten the possibility that a penalty will be applied to private inurement transactions, the IRS regulations also provide a significant planning opportunity for organizations subject to the rules. The IRS regulations state that parties to a transaction will be entitled to a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if the arrangement is approved by the organization's board of directors or trustees (or a committee of the board), as long as the board or committee:

- Is composed entirely of individuals who do not have a conflict of interest with respect to the proposed transaction.
- Obtains and relies upon appropriate data as to comparability (e.g., compensation levels at similar organizations, the availability of similar services in the geographic area, compensation surveys by independent firms, or actual written offers from similar institutions competing for the services of the person).

- Contemporaneously documents the basis for its determination by noting the terms of the transaction and the date of approval, the members of the board or committee present during discussion and those who voted, the comparability data obtained and relied upon and how they were obtained, and actions taken by any board or committee member who had a conflict of interest with respect to the transaction.

A special rule for small organizations (with annual gross receipts of less than $1 million) permits them to establish comparable data by obtaining data on compensation paid for similar services by three comparable local organizations.

Once the rebuttable presumption is established, the IRS may impose penalty excise taxes only if it can develop sufficient contrary evidence to rebut the presumption. A similar rebuttable presumption is also available with respect to the reasonableness of the valuation of property sold or transferred, if the sale or transfer is approved by an independent board or committee that uses appropriate comparability data and adequately documents its determination.

In addition to heightening the importance of listing all compensation on Form W-2, the intermediate sanctions rules also require organizations to report on their annual Form 990 the amount of any tax paid by any disqualified person on excess benefit transactions and any other information required by regulations regarding the transactions and the disqualified persons.

The newly redesigned IRS Form 990 (applicable to fiscal years beginning in 2008 and later) requires significant new disclosures about executive compensation practices and procedures, the nature of fringe benefits and perquisites, and the components of compensation arrangements. The new form also requires organizations to report on bonus and incentive compensation arrangements and to disclose whether any executives are covered by the "initial contract exception" described above.

B. Estimated Tax Payments Required for Income Not Subject to Withholding

Unlike salaries and wages, some types of income are not subject to automatic withholding. These include interest, dividends, and realized capital gains on sales or exchanges of real or personal property. The IRS requires that the income taxes on such items be remitted during the course of the year.

In general, an individual must remit, in quarterly installments, either 90 percent of the tax shown on the return for that year or 100 percent of the tax of the preceding year in order to avoid a penalty for underpayment of estimated taxes. However, in the case of individuals with adjusted gross income in excess of $150,000 ($75,000 for married individuals filing separately), the estimated tax safe harbor for the preceding tax year is 110 percent of the prior year's tax liability.

Generally, an individual is required to pay 25 percent of this annual amount in quarterly installments due on April 15, June 15, September 15, and January 15 of each year. If, however, an individual does not receive income evenly over the course of the year, then an "annualized" method can be employed to determine the amount of estimated taxes that should be remitted. This method usually evens out the tax liability over each quarter to reflect more accurately the actual receipt of income during the course of the year.

C. Accounting and Recordkeeping Requirements

Like most employees, college and university presidents report their income and deductions to the IRS according to the "cash basis" method of accounting. Under the cash basis method, income is reported to the IRS during the year in which it is actually received, and deductions are claimed during the year in which the expenses are actually paid. Under the doctrine of "constructive receipt," however, amounts that are not actually received may nonetheless be included in income. Under this doctrine, an amount must be included in an employee's taxable income when it is effectively within the control of the employee, such as when income is set aside for the employee or otherwise made available so that he or she may use the income at will.

Every person subject to federal income tax must maintain complete and accurate records of income and expenses, and the form of those records will depend upon the type of income or expense being substantiated (e.g., charitable contributions or entertainment expenses). Records for a particular tax year should be maintained for at least as long as the statute of limitations for that year will run.

The statute of limitations limits the number of years in which the IRS can assess additional taxes on a taxpayer. In general, the IRS must assess additional income taxes for a particular year within three years after an individual files an income tax return for that year. For example, if a taxpayer files his or her 2008 tax return on April 15, 2009, the statute of limitations for the 2008 tax return will expire on April 15, 2012. If, however, a taxpayer omits from gross income an amount that is more than 25 percent of the gross income reflected on the tax return, then the IRS has six years after the filing of the return to assess additional taxes. Accordingly, a college or university president, like any other individual taxpayer, should maintain tax records for at least three years after a return is filed; to be safe, the records should be kept for at least six years. Copies of the tax returns themselves should be kept permanently.


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