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UPDATE
Education Law

NOVEMBER 2010

Dear Readers,

Robinson & Cole works closely with many educational institutions and educational associations in all areas of practice. As a way of giving back to our friends in the field of education, we are excited to present the latest edition of our Education Law Update. We hope that this newsletter provides you with news and information that is important to the physical and philosophical growth of your institution. If there is a topic of interest that you would like featured, please let us know. Moreover, if you have any questions or comments on what you read below, please contact us.

Gregory R. Faulkner
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IRS RELEASES INTERIM REPORT ON TAX COMPLIANCE BY COLLEGES AND UNIVERSITIES: BROADER IMPLICATIONS FOR THE TAX-EXEMPT SECTOR

By Melissa M. Mack

The IRS recently released its interim report on the Colleges and Universities Compliance Project. The project surveyed 400 public and private colleges and universities on (1) organizational structure and governance practices; (2) the conduct and reporting of exempt or other activities that may generate unrelated business taxable income; (3) the investment, management, and use of endowment funds; and (4) executive compensation practices.

The preliminary data suggests that the IRS will more closely scrutinize whether unrelated business income-generating activities are reported, whether offshore investments and other alternative investments are appropriate, whether comparability data is utilized to establish compensation, whether organizations have conflict of interest policies, and whether transactions with related entities occur at arm's length.

The project focused on colleges and universities because they comprise one of the largest segments of the tax-exempt sector based on revenue and assets. We presume, however, that any regulatory action or suggested best practices resulting from the IRS's analysis will apply to public and private schools in general, many of which resemble institutions of higher education in

their governance structure, administration, and activities, and, possibly, to the tax-exempt sector as a whole. Accordingly, we suggest that tax-exempt organizations critically examine their practices in the areas reflecting the IRS's preliminary conclusions, which include the following:

- **Related Organizations**. Most colleges and universities have related entities, including tax-exempt organizations, taxable corporations, trusts, disregarded entities, and partnerships. A controlled entity is a related entity in which the organization possesses more than 50 percent control. Tax-exempt organizations are required to report certain transactions with controlled entities on their annual Form 990, including making loans, transferring funds, and receiving interests, annuities, royalties, or rents. The report indicated that controlling organizations may well be underreporting these transactions.

- **Endowment Funds**. In most cases, investment committees invest endowment assets in a variety of investments, predominantly domestic fixed-income and equity securities, according to an endowment fund investment policy. The organizations expend endowment assets according to spending policies, which approximate 5 percent. The majority of colleges and universities reported investing endowment assets in foreign investments. In response to the IRS's report, Theresa Pattara, Senate Finance Committee Tax Counsel, commented that Congress pays attention to offshore investments because of their potential as abusive tax shelters or tax avoidance schemes.

- **Executive Compensation** . Many colleges and universities reported awards of executive compensation according to a policy adopted by the institution's governing body. The Internal Revenue Code imposes nondeductible excise taxes on certain persons and organizations benefitting from, or participating in, excess benefit transactions, which may include colleges and universities providing unreasonable compensation to insiders. Insiders include directors, officers, trustees, and certain highly compensated employees. A transaction with an insider is presumed to be reasonable if the participating tax-exempt organization follows certain parameters set forth in the Treasury Regulations, including receiving advance approval by the organization's governing body, obtaining and relying on appropriate comparability data, and adequately documenting the basis for the organization's decision. The burden then shifts to the IRS to prove that such a transaction is not reasonable. The IRS noted that colleges and universities did not consistently rely on comparability data to support the reasonableness of transactions with insiders.

- **Policies**. Most large colleges and universities reported having conflict of interest policies for members of a governing body, top management officials, and full-time faculty. Some large organizations reported having written policies to assure that transactions with their controlled entities were at arm's length. Smaller and medium-sized institutions were less likely to have such policies.

- **Activities and Unrelated Business Income**. The project's questionnaire listed 47 activities that may result in unrelated business activities, including facility rental, use of athletic facilities, personal property rentals, advertising and corporate sponsorships, operation of bookstores, food services, catering services, travel tours, and parking lots, conduct of commercial research and income from controlled entities. Few colleges and universities that indicated engaging in an unrelated business activity reported that activity as unrelated business income on a schedule to their Form 990 (i.e., Form 990-T).

- **Use of Outside Advisors**. The majority of colleges and universities surveyed reported that they did not rely on outside advice with respect to (1) unrelated business income issues, such as determining whether business activities were related or unrelated to their exempt purpose; (2) the allocation of expenses between related and unrelated business activities, and (3) intercompany pricing between the organizations and related entities.

The IRS's final report will provide further analysis in a number of areas, including (1) the

presence of organizations' policies and practices with respect to potential unrelated business activities, related organizations, and controlled entities; (2) the reporting of activities as exempt or unrelated and the allocation of expenses among activities and related organizations; (3) the reporting of recurring losses from certain exempt and unrelated activities and the reporting of incident to debt-financed property; and (4) the use of comparability data and compensation practices and procedures to establish compensation of executives and other insiders.

The IRS has initiated examinations of more than 30 colleges and universities, which were selected based upon their responses to the compliance questionnaire, largely focusing on executive compensation and unrelated business income. A summary of the findings and information learned from the examinations will be included in the IRS's final report.

NEW PRIVATE CONSTRUCTION REFORM REQUIRES PROMPT PAYMENT IN MASSACHUSETTS

By Alexandria E. Baez

Earlier this year, Massachusetts lawmakers approved the most significant legislation to the private construction industry in many years. The new law imposes prompt payment requirements on private construction projects, which, until now, were restricted to public works. The Prompt Pay Act, as it is known, will apply only to private construction contracts within the scope of a prime contract signed on or after November 8, 2010 that exceed $3 million. Regardless of the contract amount, the Prompt Pay Act will not apply to residential projects with fewer than five dwelling units. The act is expected to apply to private schools, colleges and universities.

Codified at M.G.L. c. 149, § 29E, the new law will impact the rights and duties of all parties in the construction chain by imposing strict time conditions on payment, processing requests for payment, and change order procedures. In addition, the statute, with few exceptions, invalidates "pay-when-paid" and "paid-if-paid" clauses. The law further limits contractual provisions requiring performance where payment has not been received within 30 days of becoming due, subject to disputes involving quality or quantity of work or notices of default. Clauses purporting to waive or limit any of the statute's provisions are void and unenforceable.

The Prompt Pay Act's key provisions are summarized as follows:

Mandatory Deadlines for Progress Payments

Construction contracts affected by the new law are now required to include "reasonable time" provisions for payment application processing. In general, the frequency of request for payment may not exceed 30 days. A request for payment must be approved or rejected within 15 days, which approval or rejection must be passed down within an additional 7 days for each tier. Issuance of payment must occur within 45 days of approval.

If a request for payment is neither approved nor denied within the specified time period, the law will treat the submission as "conditionally approved" unless subsequently rejected within the next billing interval and prior to when payment becomes due. Rejected requests for payment must also contain a written statement articulating the factual and contractual basis for the rejection.

Abbreviated Approval Periods for Change Order Requests

Contract provisions governing requests for change orders will be subject to similar deadlines. Under the new law, change order requests must be approved or rejected within 30 days after receipt, plus an additional 7 days for each tier below the party making the request. For example, a change order request submitted by a second-tier subcontractor will have to be approved or rejected within 37 days of receipt. Again, as with requests for payment, change order requests not rejected within the required time period will be presumed approved.

Invalidation of Pay-When-Paid Provisions

The Prompt Pay Act virtually eliminates "pay-when-paid" and "pay-if-paid" provisions by declaring them to be void and unenforceable, with only two exceptions. The first exception exists where a contractor does not receive payment as a result of a failure or non-performance by the party seeking payment and that failure or non-performance is not corrected within a contractually identified notice-and-cure period (14 days, if not otherwise specified in the agreement).

The second exception applies where the third party from whom payment is due is insolvent or becomes insolvent within 90 days following submission of the payment application. The availability of this "insolvency exception" is conditioned, however, upon a contractor filing and perfecting a notice of contract (and for lower tiers, the additional filing of a Notice of Identification) under Massachusetts' lien laws, and the pursuit of "all reasonable legal remedies" against whom payment is sought.

A party intending to take advantage of pay-when-paid or pay-if-paid conditions by way of either statutory exception is required to include language explicitly identifying the same within their contract documents. Such parties will also bear the burden of proof as to each element of the applicable statutory exception invoked in withholding payment.

Given the prospective application of the Prompt Pay Act, private educational institutions as owners are well advised to review their Massachusetts construction contracts to ensure that provisions governing payment processing, change order approvals, and conditional payment restrictions comply with the new law's mandates. The construction attorneys of Robinson & Cole LLP have extensive experience advising our education clients on these issues.

FIRM NEWS & NOTES

In the News

Attorneys Megan R. Naughton and Gregory R. Faulkner attended the National Association of College and University Attorneys (NACUA) Annual Conference in Washington, D.C., from June 27 to June 30. NACUA educates attorneys and administrators about legal issues on campuses and provides continuing legal education to higher education counsel.

Robinson & Cole Construction Practice Group partners Gregory R. Faulkner and Martin A. Onorato were presenters at the Eighth Annual Higher Education Real Estate Lawyers (HEREL) Conference on October 14 and 15 at Princeton University. Garry C. Berman , a partner in the Real Estate and Leasing Practice Group, also attended the conference. HEREL comprises attorneys who practice real estate and construction law at higher education institutions as well as outside counsel who have experience in real estate and construction law. HEREL conferences have attracted practitioners from some of the country's leading higher education institutions, including Harvard, Yale, Duke, Stanford, the University of Pennsylvania, and MIT.

In addition, Mr. Faulkner and Mr. Onorato led the session "Managing Liability Issues in Green Buildings and Sustainable Construction," which explored how to allocate risk and assess responsibility with regard to identifying duties of the design and construction team, scheduling, budgeting, and the consequences of failing to achieve specified certification levels. They also discussed the future of LEED (Leadership in Energy and Environmental Design) and other building certifications.

Robinson & Cole attorneys Edward J. Samorajczyk, Melissa M. Mack, and Britt-Marie K. Cole-Johnson attended the annual WALKS Foundation Scholars luncheon held October 12 at The Hartford Club. The WALKS Foundation provides scholarships to inner-city children so that they can attend the five private secondary schools that are members of the Foundation, namely Westminster, Avon Old Farms, Loomis Chaffee, Kingswood Oxford, and Suffield Academy. Attorney Samorajczyk is a member of the WALKS Advisory Board.

Attorney Gregory R. Faulkner participated in a panel discussion during the Professional Women in Construction (PWC) program "Getting What You Bargained For in a Tough Economy." Mr. Faulkner and the rest of the PWC panel discussed legal and practical options to ensure payment and performance on construction projects. Founded in 1980, PWC is a nonprofit 501(c)(3) organization committed to advancing professional, entrepreneurial, and managerial opportunities for women and other non-traditional populations in construction and related industries.

Attorney Gregory R. Faulkner was recently appointed as a commissioner to the Rocky Hill, Connecticut, Planning and Zoning Commission for a two-year term. Mr. Faulkner previously served as an elected member of the Rocky Hill Zoning Board of Appeals for two separate terms. The Planning and Zoning Commission is the primary agency responsible for overseeing development with the town and must approve all new development prior to construction. The commission also has an educational role in which it serves to stimulate interest in planning. In addition, it performs a coordinator role in working with other public and private agencies to integrate the total governmental planning effort.

Attorneys Megan R. Naughton, Joshua S. Mirer, and Natalia A. Sharubina were named Pro Bono Legal Champions by the Center for Children's Advocacy (CCA) for their pro bono case support to help CCA with immigrant children and family clients.

For more information on our Education Law Practice, please contact Gregory R. Faulkner in our Hartford office at (860) 275-8288 or Megan R. Naughton in our Hartford office at (860) 275-8263.