

**Remarks of Lois G. Lerner
Director, Exempt Organizations
April 25, 2013**

Good morning and thank you for the kind introduction. It is always a pleasure to be here. I really appreciate the opportunity to talk to you about what is going on within the IRS Exempt Organizations (EO) office and get your questions and comments. I continue to believe that dialogue between the regulator and the regulated provides the best vehicle for enhancing our understanding of one another, as well as encouraging compliance.

I'll start with the theme of my "[Letter from the Director](#)" in the 2013 EO Work Plan. Going forward, EO is trying to better match expectations about when work plan projects will be completed, with the reality of what it takes to execute and finalize those projects. In past work plans we have provided general descriptions of the projects without much information about what we do behind the scenes to implement and finalize them. Many of our projects are complex, require sophisticated planning, and go through many phases over their lifetimes – including questionnaire development, statistical sample design, training, data gathering and analysis, and exams. Add to that, that all new work must be coordinated among our different offices in a way that accommodates already on-going work. So projects rarely, if ever, fit conveniently into a one-year work-plan cycle. In recognition of that, going forward our goal is to better match our annual work-plan description with what we actually intend to accomplish in that particular year. In many cases, this approach should also enable us to share information as we finish a phase rather than waiting until the entire project is completed.

So, how will this work in real life? Well, the work plan might announce the initiation of a project on a particular topic, but it also would tell you what exactly we plan to do regarding that topic in the current year. For example, in year one, we might say we are interested in UBIT, and we will be developing a questionnaire on that topic this year. In year two, we might tell you we are sending out the questionnaire, and will be analyzing the responses. Then, in year three, we might report the results of the analysis, and tell you that based on the findings we plan to look more closely at some organizations by initiating exams.

I believe that providing this level of communication will make this process less frustrating for you, and for us. Furthermore, providing you with better more timely information about what EO is thinking about and seeing enables exempt organizations and their advisors to make better compliance related decisions.

Colleges and Universities

That is a good segue into my next topic — highlights from the long awaited [final report](#) on the Colleges and Universities project, which is scheduled to be posted on our website this afternoon.

We launched this multi-year project in 2008 with the distribution of detailed questionnaires to 400 colleges and universities seeking information about: demographics; reporting of activities that may generate unrelated business income; investment, management, and use of endowment funds; executive compensation practices and amounts; and governance practices. After reviewing the questionnaire responses and Forms 990 and 990-T, we selected 34 institutions for examination, concentrating on reporting of unrelated business income on Form 990-T and of executive compensation on Form 990. In 2010, we released an [Interim Report](#) with our preliminary overview of the questionnaire responses.

The Final Report focuses on the exam results and provides additional analysis of the questionnaire responses. As I talk about the exam results, please keep two things in mind. First, the exams began by looking at tax year 2008 returns and, to the extent necessary, we opened additional years. Second, the schools selected for examination do not represent a statistical sample of all colleges and universities. That means the results are not attributable to all colleges and universities, only to the schools examined.

I mentioned that unrelated business income (UBI) was one of our primary areas of interest when we selected organizations for exam. Let me tell you why. Each year, [IRS Statistics of Income](#) staff analyze Forms 990-T, the form on which exempt organizations report gross UBI of \$1000 or more. They routinely find that exempt organizations offset most of their UBI with deductions, and that only about half of organizations required to file a 990-T report any tax liability. Because unrelated business taxable income (UBTI) is calculated by totaling the income from all unrelated business activities, and then subtracting total allowable deductions, losses from one activity can offset profits from another. For example, if a college earns a lot of unrelated income from one activity, say a parking lot, but takes a big loss on a different unrelated activity, such as a hotel, it can offset the parking lot gains with the hotel losses and end up having no UBTI.

The IRS is curious about why there seems to be so much unrelated business activity, yet so few taxes owed. We decided to look at this issue in the colleges and universities exams.

So what did we find?

Significant underreporting of Unrelated Business Taxable Income:

- UBTI was underreported at 90% of the colleges and universities examined.
- The underreported amounts totaled over \$90 million.
- The underreported amounts resulted from 30 different types of unrelated business activities, but the majority of adjustments resulted from only five.
 - Fitness and recreation centers and sports camps;
 - Advertising;
 - Facility rentals;
 - Arenas; and
 - Golf courses
- In total, the IRS disallowed more than \$170 million in losses and Net Operating Losses (NOLs)¹, which could result in more than \$60 million in tax liability for the impacted organizations.

The underreporting primarily stemmed from four practices:

First, organizations claimed losses from activities that did not qualify as a trade or business. An activity qualifies as a “trade or business” only if, among other things, the taxpayer engages in the activity with the intent to make a profit. Nearly 70 percent of examined colleges and universities reported losses from activities where for many successive years the expenses exceeded income. Continual losses from an activity year in and year out for a protracted period indicates a lack of profit motive. Because the activities involved did not qualify as a trade or business, the claimed losses could no longer be used to offset profits from other unrelated activities in the current year or in future years, which resulted in the disallowance of about \$150 million in losses and NOLs.

Second, on nearly 60% of the Form 990-Ts we examined, we found that colleges and universities had misallocated expenses to offset UBI for specific activities. Organizations may allocate expenses used to carry on both exempt and unrelated business activities, but they must do so on a reasonable basis, and the expenses offsetting UBI must have a proximate and primary relationship to the activities to which they are attributed. In many cases, we found that claimed expenses, which generated losses, did not have the necessary proximate and primary connection to the unrelated business activity.

¹ NOLs are losses reported in one year that are used to offset profits in other years.

Third, just under 40% of the schools examined incorrectly treated certain income producing activities as exempt when the activities were unrelated. Almost all the misclassified activities were producing income, with less than 20% of them generating losses. As a result of the examinations, about \$4 million in income was reclassified as unrelated and subject to taxes.

Finally, more than a third of the schools audited, reported either erroneously calculated or unsubstantiated NOLs on their Forms 990-T, which resulted in the disallowance of nearly \$19 million in NOLs.

Compensation

On the compensation side, the exams focused mainly on compliance with IRC section 4958, which provides that organizations may pay no more than reasonable compensation to their disqualified persons, i.e., their officers, directors, trustees, and key employees, or what we refer to as ODTKEs. Section 4958 applies to private, but not public, colleges and universities, and imposes an excise tax on ODTKEs who received payment of unreasonable compensation and on those persons who approved it.

An organization can shift the burden of proving unreasonable compensation to the IRS by following the three steps of the rebuttable presumption process:

- Using an independent body to review and determine the amount of compensation;
- Relying on appropriate comparability data to set the compensation amount; and
- Contemporaneously documenting the compensation-setting process

EO has done a lot of work in the compensation area over the last several years, and has found that most exempt organizations try to follow the rebuttable presumption. Because we had not previously looked behind the comparability data used by the organizations to see whether it was truly comparable to the position being considered, we decided to look at that issue in the Colleges and Universities exams, and enlisted the aid of IRS valuation experts to evaluate the comparability data relied upon by the private colleges and universities we examined.

The experts found that, in about 20% of the examined schools, the comparability data used to set compensation was not appropriate data, which means the schools failed to meet the requirements of rebuttable presumption of reasonableness. Problems with compensation data included:

- Using information from supposedly comparable schools that were not similarly situated to the school relying on the data.
- Compensation studies that neither specified the selection criteria for the supposed comparable schools nor explained how those schools were like the school relying on the study.
- Compensation surveys that did not specify whether amounts reported included only salary or included total other types of compensation, as required by section 4958.

Because of the wide use by the sector of the rebuttable presumption, I want to stress the need for organizations to review and question the data provided by consultants or others before relying on it to determine compensation amounts. Otherwise, an organization may find itself outside of the rebuttable presumption, and be required to prove to the IRS that the compensation in question is reasonable.

So what did the compensation amounts look like? Although we only looked at comparability data for private schools, we looked at compensation paid by both. For the top management official in both public and private colleges, the average total compensation was a little over \$600,000 and the median total compensation was about \$500,000

We also looked at compensation levels for the six most highly compensated non-ODTKEs. Sports Coaches and Investment Managers received the highest average compensation, close to \$900,000.

Employment Tax and Retirement Plans

In addition to looking at Forms 990 and Form 990-T, we reviewed employment tax and employee plan returns for some of the 34 schools examined.

We examined employment tax returns at about a third of the colleges and universities we examined and found issues at all of them, resulting in about \$36 million in increased wages and over \$7 million in taxes and penalties.

On the retirement plan front, we looked at reporting at about a quarter of the colleges and universities we examined, and found problems at about half. Examinations resulted in increases in wages of more than \$1 million and the assessment of more than \$200,000 in taxes and penalties.

Interactive 1023

In the time remaining, I want to tell you about an exciting development that resulted from a recommendation in last year's [Advisory Committee \(ACT\) report](#). The focus of the report was the Form 1023 application for charitable status. The ACT made several recommendations, including making the form available on-line so it could be filled out, filed and, once approved, viewed electronically. Recognizing that those changes would be costly and probably take some time, the ACT suggested that, in the interim, EO make available on-line the educational materials previously developed for Cyber Assistant, an earlier attempt at an on-line Form 1023, which unfortunately did not work as planned, and would have been costly to fix.

As you all know, the IT world moves very quickly and some things that were impossible or very costly four years ago are suddenly very doable today. We looked into what is now possible, and for a much, lower cost, we have been able to incorporate materials developed for Cyber Assistant into a draft Interactive Form 1023 that provides education and assistance to applicants while they fill out the form. Although the final form won't be filed electronically, it will provide helpful pop-up definitions of unfamiliar terms and clickable links to related pages on IRS.gov and StayExempt.irs.gov.

For example, when the form requests the organization's EIN and the novice looks at "EIN" and doesn't know what that means, the user can click on EIN and get information about its meaning, and a web link to the site where she can request an EIN. Earlier today, Judy Kindell talked about the [rules](#) charities have to follow in the wake of a tragedy – namely they must have a broad charitable class and conduct a needs assessment if they are going to provide assistance beyond the immediate aftermath of the event. Based on inquiries my office has been getting, we believe there is a lot of confusion in this area. So, on the Part IV narrative section, the draft Interactive 1023 has a pop-up that provides users with links to EO website pages that will help them better understand the rules before they file their applications.

Our ACT members have already reviewed the draft form and made comments, and they tell us they are very pleased with it. So, our next step will be to post a non-printable version of the draft form on our website and ask for input from the public. Although most folks at this conference don't need the assistance the form provides, I encourage all of you to look at the form when we post it and get back to us your comments. We will announce the release of the draft Interactive 1023 on our [website](#) and through the EO Update, our free e-newsletter.

Ultimately, We hope the Interactive 1023 will provide us with more complete applications and better information, which will enable us to process more applications without requiring time-consuming development — an especially important goal during

this time of budget constraints and limited staffing resources. So, be on the look-out for the draft Interactive Form 1023, and send us your comments.

Thank you again for the opportunity to speak with you.