

**TESTIMONY OF
LOIS G. LERNER, DIRECTOR OF THE EXEMPT ORGANIZATIONS DIVISION
OF THE INTERNAL REVENUE SERVICE
BEFORE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT
ON THE OVERSIGHT OF TAX-EXEMPT ORGANIZATIONS
MAY 8, 2013**

Good morning Chairman Boustany, Ranking Member Lewis, and Members of the Oversight Subcommittee. Thank you for the opportunity to appear this afternoon. My name is Lois G. Lerner and I am the Director of the Exempt Organizations Division, which is part of the Tax Exempt and Government Entities division of the Internal Revenue Service (IRS).

Exempt Organizations (EO) administers the tax law governing 29 categories of organizations described under section 501(c) of the Internal Revenue Code¹, plus others that also are not required to pay federal income tax, such as section 527 political organizations and section 529 qualified tuition programs. Under one of these categories, section 501(c)(3), organizations range in size from very small organizations to extremely large and complex organizations such as hospitals and universities. One way we manage the challenge of regulating such a diverse group of organizations is by undertaking projects focused on how specific segments are complying with the tax law. The project that I am here to discuss today focused on colleges and universities, which is one of the largest segments of the charitable sector in terms of assets and income.

IRS launched the Colleges and Universities Compliance Project in 2008 with the distribution of questionnaires to 400 colleges and universities randomly selected from the total population of 2,402 tax-exempt colleges and universities that grant bachelor's, master's, and more advanced degrees² and are exempt from federal income tax under section 501(c)(3) or whose income is excluded from federal income tax under section 115. The questionnaire covered organizational and demographic information, as well as exempt and unrelated business activities, endowment funds, executive compensation, and governance practices. In general, the Questionnaire asked for information about the 2006 tax year.

More than 90 percent of colleges and universities that received the Questionnaire responded. Questionnaires allow the IRS to efficiently gather information about exempt organizations overall and to allow for more selective use of exam resources. In 2010, IRS released an [interim](#) overview of the questionnaire responses, and in April 2013, IRS released our Final Report.

¹ Unless otherwise indicated, all "Code" and "section" references are to the Internal Revenue Code of 1986, as amended ("IRC").

² Entities that granted associates degrees (such as community or junior colleges), technical schools, and certificate programs were excluded from the study.

In addition to analysis of the questionnaire responses, the [Final Report](#) includes the results of our examinations of colleges and universities. Pursuant to the Subcommittee's request, the results of these examinations will be the focus of my presentation today. In selecting colleges and universities for examination, the IRS first reviewed Questionnaire responses to identify those respondents having the greatest potential for compliance issues with respect to unrelated business income or executive compensation. The IRS then evaluated Form 990 reporting to further inform its selection process. The IRS chose 34 colleges and universities for examination, generally equally divided between private and public institutions. About two-thirds of those selected were large organizations, with 15,000 or more students.

With more than 90 percent of examinations completed, IRS released our Final Report to share what we have learned. It is important to understand that the colleges and universities that we examined are not representative of colleges and universities overall. While the questionnaire was sent to a random sample of colleges and universities, schools were selected for examination according to risk-based criteria. Thus, no conclusions should be drawn about other colleges and universities or the sector as whole based on our examination results. It is also important to note that section 6103 of the Code generally prohibits disclosure of taxpayer information. Thus, our report and my comments today are not taxpayer specific.

UNRELATED BUSINESS INCOME

As tax-exempt organizations, colleges and universities are not taxed on income from activities that are substantially related to their exempt purpose even if the activity is a trade or business. To be substantially related, activities must contribute importantly to the accomplishment of an organization's exempt purposes.

A college or university is subject to tax on income from an unrelated trade or business.³ A trade or business is unrelated if it is not substantially related to the accomplishment of an organization's exempt purposes, even if funds from the business are used to support those purposes.⁴

Not all unrelated business income (UBI) is subject to tax. The law provides various exceptions and modifications to the calculation of unrelated business income tax. Section 512 of the Code sets forth the rules for determining whether UBI is taxed, excluding income from certain types of activities⁵ and also permitting all deductions directly connected with the unrelated trade or business. Unrelated Business Taxable

³ The unrelated business income tax applies to organizations that are exempt from income tax under section 501(a), which includes private colleges and universities. Section 511(a)(2)(B) provides that the tax applies to any state college or university or any corporation wholly owned by a state college or university.

⁴ I.R.C. §513(a).

⁵ I.R.C. §512(b). For example, dividends, interest, certain investment income, royalties, certain rental income, certain income from research activities, and gains or losses from the disposition of property are excluded when computing unrelated business taxable income (UBTI).

Income (UBTI) is the amount of UBI that is taxable after deducting expenses directly connected to the trade or business.

In the examinations of colleges and universities, the IRS focused on how organizations report their business activities, including the characterization of activities as exempt or unrelated, the methodology for allocating expenses among activities, the significance of recurring losses on specific activities, the calculation of net operating losses (NOLs), and the application of exceptions and modifications in the calculation of UBTI. The IRS looked at these issues, and others, as they applied to a wide variety of activities conducted by colleges and universities, including advertising and exclusive-provider arrangements, sports-management agreements, facility rentals, arenas, food service, golf courses, hotels, recreation centers and programs, parking lots, commercial research, and bookstores.

Examinations resulted in increases to UBTI reported on Form 990-T for a significant number of the colleges and universities examined.

The primary reasons for increases to UBTI were:

- Disallowance of losses and NOLs (i.e., losses reported in one year that are used to offset profits in other years) associated with activities misclassified as a trade or business;
- Disallowing expenses that were not connected to unrelated trade or business activities;
- Errors in computation or substantiation; and
- Reclassifying exempt activities as unrelated.

Examinations resulted in more than 180 changes to UBTI reported for more than 30 specific activities by colleges and universities. The majority of these adjustments came from the following activities:

- Fitness, recreation centers, and sports camps;
- Advertising;
- Facility rentals;
- Arenas; and
- Golf courses.

COMPENSATION

Several EO projects have focused on executive compensation. In 2007, the IRS released a report on the [Executive Compensation Compliance Initiative](#), and in 2009, the IRS released a report on the [Hospital Compliance Project](#), which included examinations of 20 hospitals focusing on executive compensation. The IRS considered the amount of reported compensation when selecting colleges and universities for examination. Therefore, compensation amounts reported in the study do not reflect compensation levels at colleges and universities generally.

Compensation amounts

In examinations, IRS looked at the compensation amounts paid by public and private colleges and universities to those highly paid employees who serve as Officers, Directors, Trustees, and Key Employees (“ODTKEs”) and to highly paid employees who are not ODTKEs.

For nearly all the colleges and universities examined, the highest-paid ODTKE was identified as the “top management official,” most of whom had the title of “President.” IRS also looked at compensation levels for the most highly compensated non-ODTKEs. They fall primarily into one of five categories: Sports Coaches, Investment Managers, Head of Departments, Faculty, and Administrative/Managerial.

For the private colleges and universities examined, the IRS looked not only at the amount of compensation paid, but also at whether they were setting compensation in compliance with section 4958 of the Code. Section 4958 applies to organizations that are exempt from tax under section 501(a) and described under sections 501(c)(3) or 501(c)(4). This includes private colleges and universities, but generally does not include public colleges and universities.⁶

Section 4958 imposes an excise tax on compensation that constitutes an excess benefit transaction. An excess benefit transaction occurs when a disqualified person⁷ receives more than reasonable compensation for services rendered to the organization. Reasonable compensation is understood to be the amount that would ordinarily be paid for like services by a like enterprise under like circumstances. In determining the reasonableness of compensation, all items of compensation are taken into account.⁸

The regulations under section 4958 set forth a three-step process by which organizations can establish a rebuttable presumption that compensation paid is reasonable: (1) using an independent body to review and determine the amount of compensation in advance of actual payment; (2) relying on appropriate comparability

⁶ The income of public colleges and universities is generally exempt under section 115. Some of these organizations seek IRS recognition that they are also exempt under section 501(c)(3). However, they are exempt from section 4958 because of their status as a governmental unit or affiliate. Treas. Reg. § 53.4958-2(a)(2)(ii).

⁷ Section 4958(f)(1) defines disqualified person, in part, as any person who was in a position to exercise substantial influence over the affairs of a tax-exempt organization. Any of the following persons is in a position to exercise substantial influence over the affairs of a tax-exempt organization: (1) Voting members of the governing body; (2) the president, chief executive officer, or chief operating officer; and (3) the treasurer or chief financial officer.

⁸ Treas. Reg. § 53.4958-4. These include: all forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments, and deferred and non-cash compensation; the payment of liability insurance premiums, or the payment or reimbursement by the organization of taxes or certain expenses under section 4958, unless excludable from income as a de minimis fringe benefit; all other compensatory benefits, whether or not included in gross income for income tax purposes; taxable and nontaxable fringe benefits, except fringe benefits described in section 132; and foregone interest on loans.

data to set the compensation amount; and (3) contemporaneously documenting the compensation-setting process. Compensation set according to a process that satisfies these requirements is presumed to be reasonable in amount, and the IRS has the burden of proving that the compensation is excessive under section 4958. If the requirements are not met, the organization has the burden of proving reasonableness.

To a large extent, the private colleges and universities that we examined followed practices in setting compensation that were consistent with establishing meeting the rebuttable presumption of reasonableness. A detailed discussion of those practices is included in the report. In a few examinations, it appeared that the school had attempted to establish the rebuttable presumption of reasonableness, but failed to do so – generally because appropriate comparability data was not used.

Employment Tax and Retirement Plans

In addition to examining Forms 990 and 990-T focusing on UBI and compensation, the IRS also reviewed employment tax and employee plan returns. These reviews covered employment tax and employee plan issues for all employees, not just for ODTKEs and the highest-paid non-ODTKEs.

The IRS looked at employment tax returns at about a third of the colleges and universities that we examined. The completed exams resulted in adjustments in wages and led to the assessment of tax and, in some cases, penalties.

The IRS looked at retirement plan reporting at approximately a quarter of the colleges and universities examined. In many cases, these examinations have resulted in increases in wages and the assessment of taxes and penalties.

NEXT STEPS

The examinations of college and universities identified some issues with respect to UBI. As a result, the IRS plans to look at UBI reporting more broadly. In addition, IRS plans to ensure that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation.

Thank you again for the opportunity to be here this afternoon. I will be happy to answer your questions.