

# KROKIDAS & BLUESTEIN

## ATTORNEYS

### CLIENT ALERT

#### IRS ISSUES FINAL REPORT ON EXEMPT ORGANIZATIONS COMPLIANCE PROJECT

The Internal Revenue Service (“IRS”) recently reported the results of its Colleges and Universities Compliance Project. As detailed in its final report, the IRS found significant instances of noncompliance in two key areas - unrelated business income and executive compensation. As a result, the IRS has said that going forward it will focus on enforcing compliance in these areas. Although the Compliance Project focused on colleges and universities, all exempt organizations should be aware of the problems identified by the IRS and take appropriate action to ensure that their practices comply with law.

#### Unrelated Business Income

**Compliance Issues Related to UBTI:** Tax exempt organizations are subject to tax on unrelated business taxable income (“UBTI”), or income derived from a trade or business that is not substantially related to the accomplishment of an exempt purpose. In its report, the IRS noted the following noncompliant practices related to the calculation of UBTI:

##### Failure to Report Activities Generating UBTI on IRS Form 990-T

- The IRS examination found that 40% of colleges and universities surveyed had misclassified trade or business activities which should have been classified as unrelated and reported on IRS Form 990-T.

##### Improperly Offsetting NOLs Against UBTI

- After examining the exempt colleges and universities, the IRS concluded that a significant portion of the Net Operating Losses (NOLs) and losses claimed to offset UBTI were associated with trade or business activities which showed continual losses over a period of years, and therefore lacked the required profit motive. As a result, the IRS disallowed NOLs and losses claimed by 70% of the institutions examined.

### Improperly Offsetting Expenses Against UBTI

- As a result of its examination, the IRS disallowed expense deductions taken against UBTI at 60% of the colleges and universities surveyed because the deductions were based on misallocation between exempt and unrelated trade or business activities.

**Next Steps:** Administrators of tax-exempt organizations should consult their attorneys and adjust their reporting and tax preparation practices to avoid the problems noted by the IRS in the final report.

### Executive Compensation

**Compliance Issues Related to Comparability Data:** The U.S. Treasury Regulations mandate the use of appropriate comparability data by tax exempt organizations to obtain a rebuttable presumption that the compensation paid to a person in a position to exert influence over the organization does not confer an excess benefit to the individual. Through its work on the Compliance Project, the IRS found several weaknesses related to the comparability data used by exempt colleges and universities to set compensation for key employees:

#### Failure to Use Data from Similarly Situated Organizations

- The IRS concluded that about 20% of the colleges and universities examined used data from institutions that were not similarly situated.

#### Failure to Document the Criteria Used to Select Comparable Institutions

- The IRS noted that colleges and universities failed to document the criteria used to select institutions for comparability data and to explain why certain institutions were deemed comparable.

#### Failure to Use Surveys That Specified Whether Benefits Were Included

- The IRS also found that compensation surveys relied upon by the colleges and universities failed to specify whether the amounts reported included salary only or also included other types of compensation or benefits.

**Next Steps:** Administrators of exempt organizations should examine their compensation practices to ensure that the compensation offered to persons in positions of influence is reasonable in light of applicable laws and regulations, and to ensure that the compliance issues discussed in the final report are avoided.

## **Further Information**

For more information about the conclusions and implications of the Colleges and Universities Compliance Project, or about any issues relating to tax exemption compliance, please contact attorney Elka Sachs ([esachs@kb-law.com](mailto:esachs@kb-law.com)) or attorney Sheryl Howard ([showard@kb-law.com](mailto:showard@kb-law.com)) at Krokidas & Bluestein LLP.

A copy of the IRS's final report may be accessed at [http://www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_042513.pdf](http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf).