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Top Five Reasons for Not-for-Profits to Beware the IRS

For anyone who doubts the seriousness of the Internal Revenue Service's efforts to ensure that not-for-profit entities are following the letter of the law, one need look no further than objective number five in the IRS's 2009-13 strategic plan, which mandates continued oversight of tax-exempt entities (see http://www.irs.gov/pub/irs-pdf/p3744.pdf). This oversight includes scrutiny of total compensation arrangements for officers and directors.

A recently released report from the IRS, the "IRS Nonprofit Hospital Study," illustrates this continued and increasing IRS scrutiny of not-for-profit organizations, including many healthcare entities. The agency compiled results for 500 hospitals based on responses to questionnaires, and a key part of this analysis was an examination of twenty not-for-profit hospitals referencing executive compensation practices. The full report can be found at: http://www.irs.gov/charities/charitable/article/0,,id=203109,00.html.

Executive compensation items on the questionnaire were focused on whether not-for-profit entities were in compliance with the procedures designed to satisfy a rebuttable presumption of reasonableness of compensation under IRC Section 4958 and associated regulations. The questionnaire requested information on salaries and other compensation, including employee benefits and deferred compensation, paid to officers, directors and other key employees. The main concern is, of course, violation of the rules in §4958 with respect to "excess benefit transactions." The issues with respect to excess benefit transactions provide not-for-profit organizations with five very good reasons to beware the IRS.

Reason #1: The IRS is Serious about Intermediate Sanctions

The IRS addresses violations of excess benefit transactions through what are called "intermediate sanctions," that is, penalties on these excess transactions. A business entity has violated the rules when certain individuals associated with a tax-exempt organization receive compensation or benefits that exceed the *value* of services, goods, or donations they have provided the organization. In 2002, the Treasury Department issued temporary regulations relating to intermediate sanctions, and while these have not been finalized, they are rigorously enforced. The total amount of compensation that any not-for-profit entity pays to its executive employees must be "reasonable" as defined by the IRS. If not, then the organization risks penalties and potential loss of tax-exempt status. For more information, see the IRS site: http://www.irs.gov/charities/charitable/article/0,,id=123298,00.html.

While there is no formalized rule defining reasonable compensation, the agency measures reasonableness by reference the amount that would ordinarily be paid for comparable services by comparable enterprises under comparable circumstances. Thus a wide variety of forms of compensation are included in the analysis: salary, bonus, deferrals, non-cash compensation, retirement contributions, benefits, liability insurance, loans and many executive perquisites, including company vehicles or allowances, expense accounts and other allowances. Most mid-sized to large not-for-profit entities offer non-cash benefits in addition to salary in order to compete in thee wider labor market and attract talented and motivated executives.

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Reason #2: Individuals Are Directly Affected By Intermediate Sanctions

Individuals who are subject to intermediate sanctions include a broad group of people "in a position to exercise substantial influence over the affairs of" not-for-profit organizations, including family members. These individuals are defined by law as "disqualified persons" and include:

- The entity's executive director, chief executive officer and/or president, chief operating officer, chief financial officer and treasurer (the list is not limited to these specific titles but is based on function).
- Voting members of a not-for-profit's Board of Directors or other governing body.
- An individual with more than 35% of the organization's combined voting power, profits, or beneficial interests.
- Substantial contributors, as well as a disqualified person's spouse, siblings, ancestors, children, grandchildren, great-grandchildren, and their spouses.

Executives and others are considered to be "disqualified persons" if they were in a position to exercise substantial influence over the affairs of the tax-exempt organization at any time during a period of five years prior to the date of a transaction resulting in unreasonable compensation. Organization managers who "knowingly, willfully, and without reasonable cause" participate in an excess benefit transaction can also be subject to intermediate sanctions.

Reason #3: There Are Significant Penalties for Individuals

If the IRS has determined a particular compensation arrangement is excessive, it may impose an excise tax on the executive and certain interested parties on the amount of the excess compensation. For "disqualified persons," excise taxes imposed for each excess benefit transaction are equal to 25% of the amount above the *true value* of the services or item. Additionally, 200% of the tax can be charged if the excess benefit is not corrected within a specific timeframe. Organization managers, "interested parties," who "knowingly, willfully, and without reasonable cause" participate in these excess benefit transactions can be held liable for 10% of the excess, up to $10,000 per transaction.

For "disqualified persons" in many not-for-profit organizations, the IRS will generally impose an initial excise tax of 25% of excess compensation if they participated in the compensation arrangement, as well as an initial excise tax of 10% of excess compensation for organization managers who participated in the compensation arrangement "unless such participation is not willful and due to reasonable cause." In the case of private foundations, the IRS generally imposes initial excise taxes equal to about half that for other not-for-profit individuals.

In cases where excessive compensation arrangements are not corrected by the earlier of the receipt of notice of tax deficiency from the IRS or the actual assessment of the excise tax, an additional excise tax of 200% of excess compensation is imposed on disqualified persons. In addition, additional excise tax of 50% of excess compensation is imposed on each participating organization manager. While in the past the IRS has not frequently been imposing these penalties, there are indications it intends to do so in future years.

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Finally, the IRS may use employ the equivalent of the "death star" in cases of excessive compensation arrangements by revoking the not-for-profit's Section 501(c)(3/4) tax-exempt status on the basis that the payment of excessive compensation violates the prohibition against the use of not-for-profit assets to benefit private individuals. Does the IRS ever deploy this weapon? Absolutely! In 2009 alone, 37 firms have lost their tax exempt status. While many of these did not lose their status due to "excessive compensation", certainly some were impacted.

Reason #4: Rebuttable Presumption Criteria are Definitive

Independent board members must be informed, as well as systematically evaluate, research and approve all executive compensation arrangements. A primary source of problems with regards to executive compensation is the inadequacy of efforts by not-for-profit boards of directors to implement and maintain legally required compensation oversight processes. According to Steve Miller, the Commissioner of the Exempt Organizations Division of the IRS, if a nonprofit organization (other than a private foundation) implements the following procedures, it will create a rebuttable presumption that the compensation is reasonable:

1. The transaction was approved in advance by an authorized body of the not-for-profit organization composed of individuals who do not have a conflict of interest, meaning that each member must not have any personal interest in the compensation arrangement and must not be related to or under the control of anyone involved in the arrangement. Any person who has a conflict of interest, including but not limited to the person whose compensation is being approved, cannot participate in the discussion or vote.
2. The authorized body obtained and relied upon current market compensation data appropriate to the position, such as published compensation survey data or custom surveys of industry data, before making its decision. This data should include compensation of persons holding similar positions in similar organizations.
3. The authorized body adequately documented the basis for its determination at the time it made its decision.

The documentation, e.g., board or trustee minutes, must contain the terms and dates of approved compensation arrangements, the names of the members of the decision-making body who were present and the names of those voting, a description of data relied on by the decision-making body and how the data was obtained, an explanation of the thought process of the decision-making body regarding why it considered the compensation to be reasonable; and explanations of actions taken by members of the decision-making body having a conflict of interest.

If these criteria are met, it becomes the IRS's responsibility to prove that an excess benefit transaction was made. Once these procedures are in place for executive compensation determination, they should be monitored annually. In addition, many not-for-profit organizations are governed by state non-profit corporation and charitable trust acts, thus compensation arrangements should also be evaluated in light of these applicable state laws.

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Reason #5: Audits are the IRS' Preferred Method

While the IRS is reluctant to publicize rules that deal directly with executive compensation levels, it will certainly evaluate how executive compensation is determined using a formal audit process and a facts-and-circumstances approach. When auditing a not-for-profit entity, the IRS will request detailed information and supporting documentation regarding:

- The organization's compensation practices and process, specifically how it determines and reports executive compensation.
- The independence of the governing body (e.g., board of directors or trustees) that approves executive compensation arrangements.
- The responsibilities and accountability of the organization's executives.
- Other transactions between the entity and its executives, such as sales or loans.
- Compliance with compensation disclosure information as requested on Form 990 or Form 990-PF.

Appropriate and adequate documentation is the key to any successful IRS audit defense. Every year or so, the organization should take the time to re-examine its executive compensation process to ensure that well documented guidelines for developing and periodically reviewing compensation are in place. Not-for-profit organizations should adopt their own internal "audit process" to ensure they are in compliance:

1) Determine whether the organization is an applicable tax-exempt organization required to be in non-compliance with intermediate sanctions (IRC §4958).
2) Assess the specific application of §4958 to compensation transactions and identification of "disqualified persons."
3) Determine whether the organization has established a formal "Conflicts of Interest" policy and whether the policy complies with the provisions of §4958. If the policy does not exist or is inadequate, draft a new policy for board approval.
4) Determine whether the organization has established a formal policies and procedures addressing all compensation (cash and non-cash) paid for services in compliance with §4958. If policies do not exist or process is inadequate, implement corrective action.
5) Evaluate whether any of applicable compensation transactions may be considered an excess benefit transaction, and determine the level of non-compliance.
6) Develop a corrective action plan for those transactions, if any, determined to be in violation of §4958.

***Note**: This document is provided for informational purposes only and is not intended to serve as legal or tax advice. For specific information about intermediate sanctions and excise taxes on excess benefit transactions, consult your attorney or tax adviser.*