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The Next Generation of Nonprofit Executive Compensation: Providing a Competitive Advantage for Your Organization

January 26, 2012

12:00 – 2:00 pm EST

Venable LLP

575 7th Street, NW

Washington, DC 20004

Moderator:

Jeffrey S. Tenenbaum, Esq.

Panelists:

Matthew T. Journy, Esq.

Andrew Lewis

Julie Donnell

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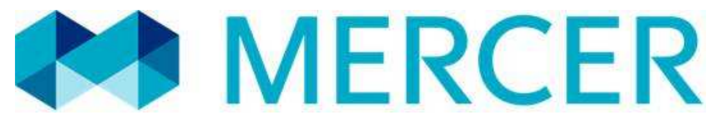

Presentation

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The Next Generation of Nonprofit Executive Compensation: Providing a Competitive Advantage to Your Organization

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Purpose

- The purpose of today's session is to discuss how nonprofits can develop a higher level of sophistication surrounding executive pay and move beyond the basics of compliance to an approach that provides a real competitive advantage
- Topics
  - The current social and regulatory perception of executive compensation, including current IRS initiatives regarding tax-exempt executive compensation and the expanding role of state regulators
  - Using disclosure to help define your remuneration strategy
  - Identifying red flags
  - Assessing and mitigating your risks
  - Identifying goals and developing solutions to link business strategy and executive compensation
  - Using the reasonableness opinion as a way to educate your board and management team
  - Instituting policies and practices to protect your organization
  - Enhancing the role of the compensation committee and clearly delineating responsibilities between the committee, management, and the board

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Current Social and Regulatory Perception of Executive Compensation

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Current Social Regulatory Perception

- Who cares?
- What is the public's perspective?
- Is anyone paying attention?
- What are the risks of excessive compensation?
- What are the risks of inadequate compensation?

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Nonprofit Executive Compensation: Who Cares?

- **IRS** – Protects against tax abuse
- **State Regulators** – Consumer Protection
- **Donors** – Concerned that appropriate portion of contribution is used in accordance with donative intent
- **Members** – Concerned that dues are used in accordance with member intent
- **Media** – Excessive compensation makes great news in current economic environment
- **Competitor Organizations** – The pool of available member and donor funds is smaller than ever, creating competition for those funds
- **Competing Interests** – More than ever, Nonprofit entities are seen as tools of political and social reform, potential adversaries are looking at executive compensation as a means to tarnish public image
- Your **Employees**, **Executives**, and **Target Executives**!

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Nonprofit Executive Compensation: What is the Public's Perspective?

- Regulators
  - Professionally educated with low income
  - Tend to believe that all non-profits (especially charities) should be run by people with altruistic purposes
- Donors/Members
  - Looking for greatest return on investment or donation
- Media
  - Looking for a story, reporting is inconsistent
- Employees
  - Comparing executive salary to their own
- Executives and Target Executives
  - Comparing the salaries with peers and other offers

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Nonprofit Executive Compensation: Is Anyone Paying Attention?

- IRS
  - IRS Area Manager Peter Lorenzetti recently identified executive compensation as “far and away the most common risk area for nonprofits” and an issue that the IRS will “look at on every audit we do”
  - Executive compensation and intermediate sanctions were specifically included on the IRS TE/GE FY 2011 Workplan
  - Executive compensation was discussed as a significant issue in the Interim Report for the IRS College and University Compliance Project
  - We have seen the IRS assess more intermediate sanctions penalties in each of the last two years than in the previous six combined
  - During a recent conversation with an attorney from the IRS Office of Chief Counsel, we were told that the IRS would aggressively pursue these cases in court

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Nonprofit Executive Compensation: Is Anyone Paying Attention?

- Competing Interests and Media
  - Exempt organizations are more frequently being used to obtain very specific goals and even to attack other exempt organizations
  - Playoff PAC v. the Bowl Championship Series
    - Playoff PAC is developing information off of publicly available IRS Forms
    - Executive compensation is a major issue in media reports about problems with BCS
    - Issue has been highlighted on: HBO, ESPN, Sports Illustrated, Nonprofit Times, etc.
  - Fiesta Bowl’s CEO John Junker is the subject of media scrutiny
    - CEO Fired
    - Indicted by federal jury
    - State and federal regulators are investigating
    - IRS has not weighed in on the issue

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Nonprofit Executive Compensation: Is Anyone Paying Attention?

- Competitor Organizations
- Donors and Members
- Employees
- Executives and Target Executives

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Nonprofit Executive Compensation: Risk of Overcompensation?

- IRS
  - Revocation of tax-exempt status for private benefit or private inurement
  - Monetary penalties imposed on individual executives that receive excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Monetary penalties imposed on board members and executives that approve the payment of an excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Loss of goodwill
- Other Federal and State Regulators
  - Potential issues resulting from consumer fraud
  - Loss of goodwill

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Nonprofit Executive Compensation: Risk of Overcompensation?

- Donors/Members/Competitors
  - Competitors that pay executives less compensation will use this information to attract your donors and members
- Media
  - Sensational articles get a lot of focus, and even when misleading, incorrect, or based on incomplete information, retractions are rare and rarely publicized
- Employees
  - Incongruent pay may lead to discontent and turnover
- Organization Executives
  - May be individually liable for IRS penalties
  - The organization may attract the wrong type of executive

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Nonprofit Executive Compensation: Risk of Under-Compensation?

- Under-qualified candidates and executives
- Underpaid, unhappy executives
- High turnover
- Issues relating to executives needing substantial raises or bonuses in last years of employment to “make up for” many years of underpayment

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Using Disclosure to Help Define Your Remuneration Strategy

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Using Disclosure to Help Define Your Remuneration Strategy

- Understand what information can and will be viewed by the public
- Understand what similar organizations are reporting in information that they disclose
- Consult with experts to learn how the information that you disclose will be used by the public, the media, and the IRS
- Learn what policies you can put into place to demonstrate your efforts to pay no more than fair market value

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Using Disclosure to Help Define Your Remuneration Strategy

The executive remuneration strategy has typically been an afterthought for many organizations.

- An effective compensation program must closely align with a company's strategic business objectives, organizational culture, and drivers of value
- This may sound obvious and logical, but all too often the remuneration strategy is developed after-the-fact or has only a coincidental relationship to the business strategy/mission
- The most effective remuneration strategies are born from the business strategy/mission and are seen as a crucial method to help realize that mission
- The IRS Form 990 provides for an opportunity to define your remuneration strategy and comment on the rationale for its structure
- We find that when organizations specifically disclose their remuneration strategy, it presents an eye-opening look into the level of rigor really necessary to arrive at an effective policy
- Gone are the days of simply saying:

"we target the median of the market for base salary and up to the 75th percentile for total cash compensation (performance warranted); benefits and retirement plans will be not be market leading but will be sufficient to be competitive…"

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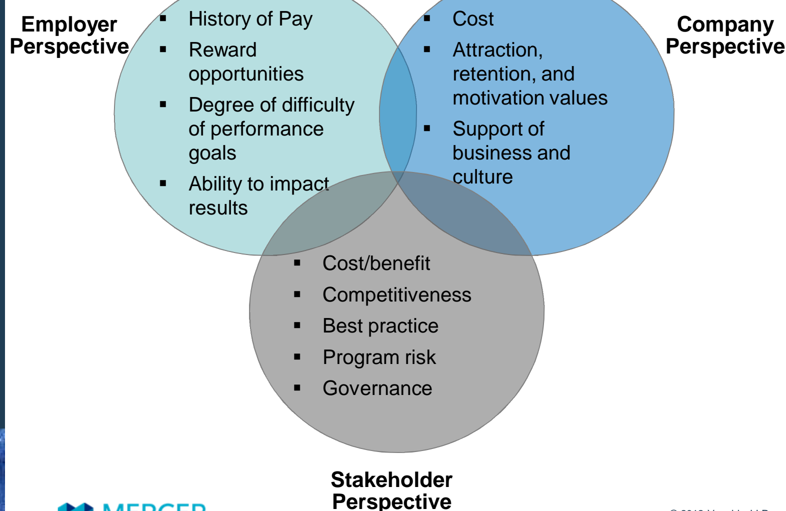
Using Disclosure to Help Define Your Remuneration Strategy

When developing a remuneration strategy consider three important viewpoints:



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Using Disclosure to Help Define Your Remuneration Strategy

Develop and manage a compensation philosophy with an eye to external factors, while considering its implications on pay.

Context/Inputs

Business Requirements

- How will the organization grow and how will it balance growth with profitability?
- What defines success – financial, operating, and strategic?
- What talent requirements are needed?

Competitive Requirements

- Pay opportunity
- Retention and attraction needs

External Requirements

- Regulations and stakeholder perception
- Industry standards and market practice
- Reasonableness of total remuneration

Basic Questions

What do we pay for?

- Performance measures
- Goals
- Linkage

How much do we pay?

- Comparable organizations
- Target Positioning

How do we pay?

- Differentiation
- Vehicles
- Risk vs. reward
- Time horizon

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Red Flags

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Red Flags

- Application for Tax-Exempt Status – IRS Form 1023 (501(c)(3) organizations), Part V:
  - Line 1: names and compensation of:
    - a) Officers and directors,
    - b) Highest compensated employees earning more than $50,000, and
    - c) Highest paid independent contractors earning more than $50,000
  - Line 3: names, qualifications, and average hours worked for people listed on Line 1
  - Line 4: description of compensation approval process
  - Line 5: conflict of interest policy
  - Lines 7 & 8: other transactions with executives

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Red Flags

- Application for Tax-Exempt Status – IRS Form 1024 (most other exempt organizations), Part II:
  - Line 3: names, titles, and compensation for officers and directors

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- Annual tax/information return – IRS Form 990
  - Part VI, Governance Management
    - Line 12: conflict of interest policy
    - Line 15: process for determining compensation for management

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Red Flags

- Annual tax/information return – IRS Form 990
  - Part VII, Compensation of current and former officers, directors, key employees, highly compensated employees, and independent contractors
    - Section A, Line 1: list name, title, average hours worked, and amount of compensation for:
      - Current officers, directors, and key employees
      - Five highest compensated employees receiving more than $100,000
      - Former officers, key employees, and highest compensated employees receiving more than $100,000
      - Former directors receiving more than $10,000
    - Section B: name, compensation, and description of services provided by five highest compensated independent contractors receiving more than $100,000

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Red Flags

- Annual tax/information return – IRS Form 990
  - Part IX, Statement of Functional Expenses
    - Generally requests information about all expenditures and for 501(c)(3) and (c)(4) organizations; categorizes the expenses as:
      a) Program service expenses
      b) Management and general expenses
      c) Fundraising expenses
    - Line 5: “Compensation of current officers, directors, trustees, and key employees”

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Red Flags

- Annual tax/information return – IRS Form 990
  - Schedule J, Part I, Questions Regarding Compensation
    - Line 1: specific types of benefits
    - Line 2: expense reimbursement
    - Line 3: compensation approval process
      - Compensation committee?
      - Independent expert?
      - Board approval?
  - Schedule J, Part II, Breakdown of Officer, Director and Employee Compensation

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Red Flags

Ongoing regulator and press scrutiny of executive compensation at nonprofit organizations is certain.

- Potential “red flags” include:
  - Passive governance processes
  - Big numbers (i.e., upper quartile compensation, incentives, deferred compensation)
  - Vague or confusing explanations for pay decisions
  - Limited documentation
  - Inappropriate comparison group
  - Excessive benefits or perquisites
  - Misalignment between executive pay and organizational performance (or an inability to define the link)
  - Pay programs that encourage short-term actions
  - Management influence
  - Conflicts of interest

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Assessing and Mitigating Risks

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Professional Resources Available

- When we see this issue raised by clients – *TOO LATE*
- Executive compensation is not an HR issue, it is not an accounting issue, and it is not a pure legal issue
- Do not rely solely on advice of your:
  - Legal counsel;
  - Tax accountant or independent auditor; or
  - HR director

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Professional Resources Available

- When to seek expert advice – before entering into a contract with any officer, director, trustee, key employee, important donor, etc.
- Who to consult:
  - Your legal advisors;
  - A compensation/valuation expert; and
  - Your accountant

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What Can You Do to Avoid Intermediate Sanctions?

- Use caution when entering into transactions with disqualified persons
- Develop, implement, and follow a conflict of interest policy that prevents board members and organization executives from participating in decisions that impact them financially
- Require board approval and documentation of transactions before any payments are made

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What Can You Do to Avoid Intermediate Sanctions?

- Establish the rebuttable presumption of reasonableness
- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value
- To establish the rebuttable presumption:
  1. The transaction must be approved in advance by disinterested members of the organization's governing body;
  2. The governing body must obtain and rely on valid comparability data in approving the transaction; and
  3. The governing body must contemporaneously document its decision and the reason for its decision

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Assessing and Mitigating Risk

A good first step to establishing reasonableness is to document everything related to executive compensation.

- Key items to document include:
  - The organization's compensation philosophy
  - The mix of pay for executives
  - Incentive plans, and especially their performance measurement components
  - Compensation Committee minutes
  - Executive employment agreements
  - Compensation reviews performed by independent advisors
- Documentation can demonstrate that compensation decisions are not arbitrary
- Performing an inventory of such items may reveal any areas of compensation administration where the organization may lack the internal resources with the requisite expertise to help the compensation committee achieve the necessary standards of good governance
- In these instances, it is critical for organizations to seek counsel for independent advisors who can fill these gaps and provide the necessary level of professional counsel

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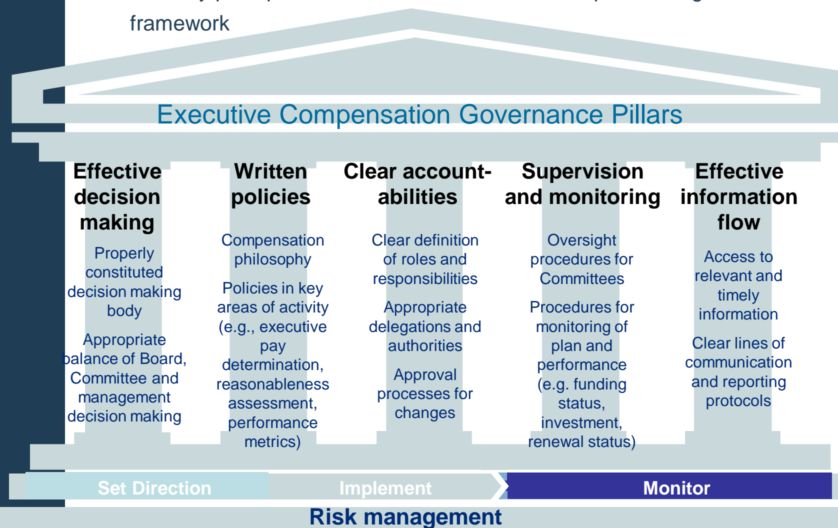
Assessing and Mitigating Risk

Five key principles for an effective executive compensation governance framework



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Assessing and Mitigating Risk

What the compensation committee can do to enforce and/or enhance the governance framework

Effective decision making

Establish a structure and process for decision making so that it is clear who makes decisions on what and when

Written policies

Document compensation philosophy on issues like decision making, compensation strategy, incentive plan design, funding and investment, to provide guidance to the Committee and Board and ensure the desired consistency of approach

Clear accountabiliti-es

Define roles and responsibilities at the Board, Committee and management levels so that it is clear who is responsible to do what and nothing falls through a crack

Supervision and monitoring

Create a process for oversight of sites to help ensure that decisions are reasonable, services meet expectations, and costs are acceptable

Effective information flow

Establish the proper flow of information to help all parties in the structure fulfil their responsibilities efficiently and effectively

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Assessing and Mitigating Risk

The governance framework is a structured, consistent, and continuous process applied to all executive compensation decisions

Management of risk
Avoiding the downside

- Understanding of risks and opportunity to manage these proactively, avoiding losses or loss of value
- Mitigation of risk of loss due to inefficiency / gains from increased efficiencies
- Developing and deploying effective mitigation strategies
- Robust (and timely) decision making that can withstand scrutiny
- Assurance of regulatory compliance / avoidance of fines and other penalties
- Avoidance of surprises

Realization of reward
Capturing the upside

- Support business strategy and talent objectives
- Incorporate market best practices into compensation decisions
- Ability to move quickly to respond to change and take advantage of windows of opportunity
- Improved preparation for risk management
- Potential for streamlining of advisory structure, with associated efficiencies, consistency of advice and potential cost savings

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Linking Business Strategy and Executive Compensation

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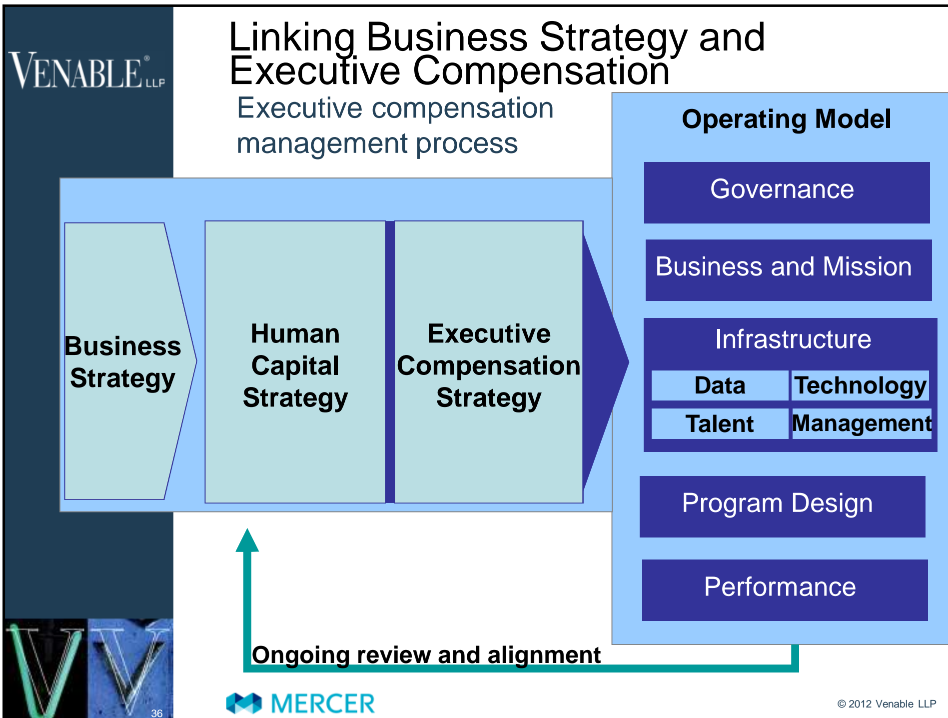
Linking Business Strategy and Executive Compensation



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Using Reasonableness Opinion as a Way to Educate Your Board and Management Team

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Using Reasonableness Opinion as a Way to Educate Your Board and Management Team

- A detailed and documented process is not only critical for good governance but is also a strong component of demonstrating reasonableness in order to obtain the "rebuttable presumption" associated with Intermediate Sanctions
- The Compensation Committee should provide education, report issues and progress of executive compensation program decisions to the full Board
- A increasingly critical vehicle for communicating these decisions is the reasonableness opinion
- The simple one-page opinion of the past has been replaced with a comprehensive document that clearly communicates the Committee's intent for making executive pay decisions
  - Summary of findings
  - Organizational background
  - Compensation program details
  - Rationale for decisions (i.e., comparator organizations, data sources, financial performance)
  - Market analysis and methodology
  - Reasonableness Opinion

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Five Key Considerations When Administering Executive Compensation in a Nonprofit Organization

- Use the governance of executive pay to clearly delineate the authority of the Board and Compensation Committee vis-a-vis the CEO
- Appropriately document compensation decision-making deliberations – not just conclusions or outcomes
- Clearly articulate the mix of pay and how that mix of pay should be structured to reinforce the business strategy and mission of the nonprofit organization
- Define the market from which you will recruit or lose talent and also understand what other stakeholders perceive your market to be (i.e., be aware of the actions of other local nonprofit organizations)
- Ensure the reasonableness opinion fully defines and explains the nuances of the facts and circumstances in nonprofit organizations – business strategy and mission, market for talent, comparator organizations competitive landscape – surrounding the complexity of executive pay decisions

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Instituting Policies and Practices to Protect Your Organization

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Instituting Policies and Practices to Protect Your Organization

- IRS focus on identifying inadequate policies and practices:
  - IRS Form 1023
  - IRS Form 990
  - College and University Compliance Project Interim Report
  - IRS Examinations
- Recommended policies:
  - Executive Compensation Policy
  - Conflict of interest Policy
- Timing
- Benefits of Policies

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Enhancing the Role of the Compensation Committee and Clearly Delineating Responsibilities Between the Committee, Management, and the Board

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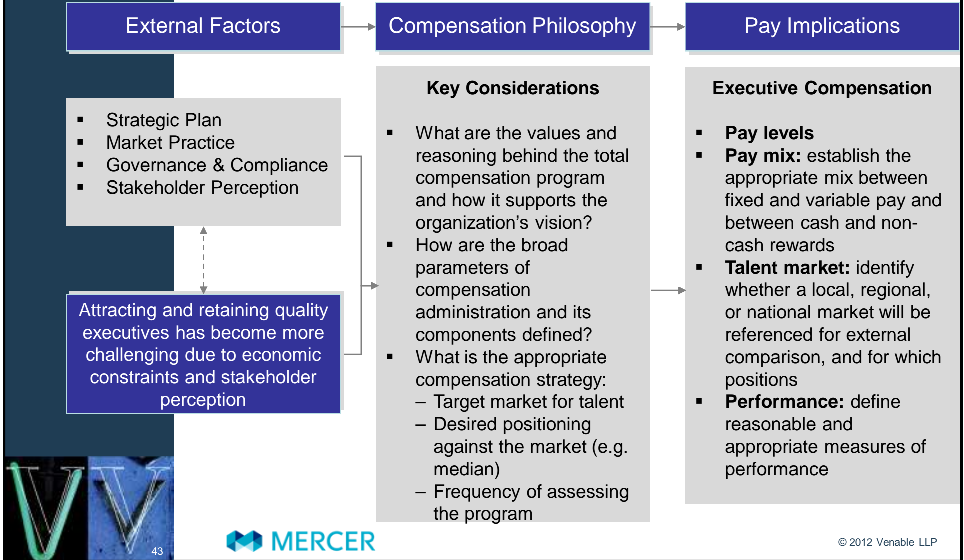
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Enhancing the Role of the Compensation Committee and Clearly Delineating Responsibilities Between the Committee, Management, and the Board
External Factors
Compensation Philosophy
Pay Implications
Strategic Plan
Market Practice
Governance & Compliance
Stakeholder Perception
Attracting and retaining quality executives has become more challenging due to economic constraints and stakeholder perception
Key Considerations
What are the values and reasoning behind the total compensation program and how it supports the organization's vision?
How are the broad parameters of compensation administration and its components defined?
What is the appropriate compensation strategy:
– Target market for talent
– Desired positioning against the market (e.g. median)
– Frequency of assessing the program
Executive Compensation
Pay levels
Pay mix: establish the appropriate mix between fixed and variable pay and between cash and non-cash rewards
Talent market: identify whether a local, regional, or national market will be referenced for external comparison, and for which positions
Performance: define reasonable and appropriate measures of performance
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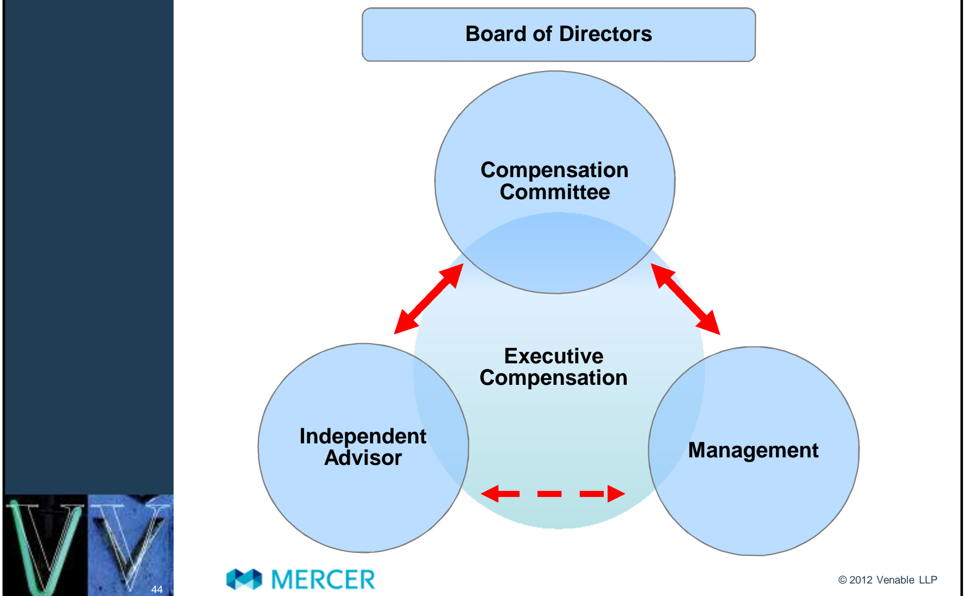
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An Independent Advisor Typically Works for the Committee and with Management
Board of Directors
Compensation Committee
Executive Compensation
Independent Advisor
Management
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Questions and Discussion

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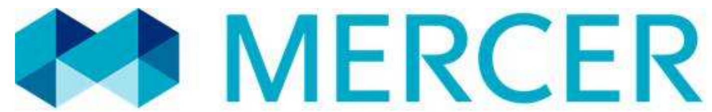

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Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished author, lecturer and commentator on nonprofit legal matters. Based in the firm's Washington, D.C. office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting trade and professional associations, charities, foundations, think tanks, credit and housing counseling agencies, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, the inaugural (2004) recipient of the *Washington Business Journal*'s Top Washington Lawyers Award, the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. He also was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. He started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill.

HONORS

Listed in *The Best Lawyers in America 2012* for Non-Profit/Charities Law, Washington, DC (Woodward/White, Inc.)

Washington DC's Legal Elite, *SmartCEO Magazine*, 2011

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

AV® Peer-Review Rated by *Martindale-Hubbell*

Listed in *Who's Who in American Law* and *Who's Who in America*, 2005-present editions

AREAS OF PRACTICE

Tax and Wealth Planning

Antitrust

Political Law

Business Transactions Tax

Tax Controversies

Tax Policy

Tax-Exempt Organizations

Wealth Planning

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

Financial Services

Consumer Financial Protection Bureau Task Force

GOVERNMENT EXPERIENCE

Legislative Assistant, United States House of Representatives

BAR ADMISSIONS

District of Columbia

EDUCATION

J.D., Catholic University of America, Columbus School of Law, 1996

B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS

American Society of Association Executives

California Society of Association Executives

New York Society of Association Executives

ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, published by the American Society of Association Executives, and is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. He also is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. In addition, he is a frequent author for ASAE and many of the other principal nonprofit industry organizations and publications, having written more than 400 articles on nonprofit legal topics.

SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer for ASAE and many of the major nonprofit industry organizations, conducting over 40 speaking presentations each year, including many with top Internal Revenue Service, Federal Trade Commission, U.S. Department of Justice, Federal Communications Commission, and other federal and government officials. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *The New York Times*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine, The Chronicle of Philanthropy, The NonProfit Times* and other periodicals. He also has been interviewed on nonprofit legal issues on Voice of America Business Radio and Nonprofit Spark Radio.

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Matt Journy is an associate in Venable's Washington, D.C. office, where he practices in the Nonprofit Organizations and Associations practice group. In his practice, Mr. Journy counsels trade and professional associations, public charities, private foundations, and other nonprofits on a variety of tax, governance, and general corporate matters, including tax exemption applications, audits, tax planning, joint ventures, unrelated business income tax issues, lobbying, and charitable solicitation, among other issues.

Having worked both as a regulator and tax consultant in the nonprofit community, Mr. Journy draws upon his prior experience to provide clients with reliable and thorough advice on the wide array of legal issues faced by nonprofits. Before joining Venable, Mr. Journy worked at Ernst & Young, LLP in the National Tax Practice, where he provided nonprofit clients with tax advice relating to corporate reorganizations, expenditure responsibility for international grants, fundraising activities, commercial co-ventures, unrelated business income, and post-issuance compliance for private activity bonds. In addition to providing tax advice, Mr. Journy provided tax compliance services, including the technical review of various federal and state tax and information returns. Prior to joining Ernst & Young, Mr. Journy worked in the Tax-Exempt/Government Entities Division of the IRS Office of Chief Counsel, where he prepared legal and technical advice for field agents and composed legal memoranda on a variety of issues affecting tax-exempt organizations.

AREAS OF PRACTICE

Tax-Exempt Organizations

Tax and Wealth Planning

Political Law

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

GOVERNMENT EXPERIENCE

Attorney, Internal Revenue Service

BAR ADMISSIONS

Massachusetts

District of Columbia

EDUCATION

LL.M., Georgetown University Law Center, 2006

J.D., Northeastern University School of Law, 2003

B.A., Marquette University, 1999

PUBLICATIONS

- October 24, 2011, Unrelated Business Income Tax for Nonprofits: The Basics
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, Nonprofit Salary Trends and Executive Compensation Issues
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, IRS Nonprofit College & University Compliance Project: Findings, Examinations and Mock Audits
- May 13, 2011, IRS Denies 501(c)(3) Status to Bankruptcy Counseling Agency
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance
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- June 2008, Requirements for Tax-Exempt Status under IRC § 501(c)(7): A Primer for Social Clubs
- June 2008, Advertising Considerations for Tax-Exempt Social Clubs

SPEAKING ENGAGEMENTS

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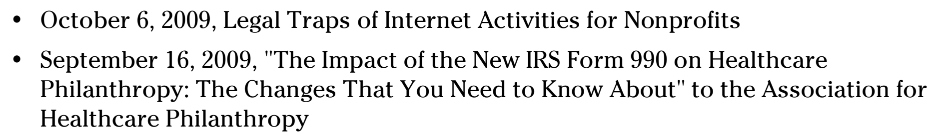
- November 3, 2011, National Business Officers Association / National Association of College and University Business Officers Tax Forum on School, College and University Nonprofit Tax Challenges
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, "Nonprofit Executive Compensation" for Association TRENDS
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, "Internal Revenue Service (IRS) Compliance Project: Findings and Examinations; 990 Discussions," 9th Annual Higher Education Compliance Conference
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance
- April 10, 2011, "Top Tax Issues Relating to Income Generated by State and Municipal Organizations Exempt under Sections 115, 501(c)(3) and 501(c)(4)" at the 2011 IMLA Mid-Year Seminar
- March 8, 2011, Legal Quick Hit: "Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- October 18, 2010, "Confusing Stuff You Need to Know to Keep You and Your Chamber Out of Trouble" for the Western Association of Chamber Executives (WACE)
- June 8, 2010, Legal Quick Hit: "Lessons in Tax Compliance: The Broad Impact of the IRS' Interim Report on the Colleges and Universities Compliance Project" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 9, 2010, "Legal Traps of Internet Activities for Nonprofits" a Lorman Teleconference
- March 16, 2010, The Form 990: Dealing with the Fall Out (Audioconference)
- March 9, 2010, Legal Quick Hit: "Intermediate Sanctions: Why You Should Be Concerned about Excess Benefit Transactions and How You Can Avoid Them" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- February 12, 2010, "Avoiding IRS Audit Risks: Protecting Your Club's Tax Exemption Status from IRS Scrutiny" at the Club Managers Association of America (CMAA) World Conference on Club Management
- January 12, 2010, Legal Quick Hit: "FIN 48: What Every Nonprofit Needs to Know" for the Association of Corporate Counsel



- October 6, 2009, Legal Traps of Internet Activities for Nonprofits
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BIOGRAPHY
Andrew Lewis

Andrew Lewis is a Principal in the Human Capital business of Mercer, specializing in assisting tax exempt organizations design and deliver innovative executive and broad-based employee reward systems.

Andy has worked with a wide variety of tax exempt organizations assisting them in addressing complex issues. Several of his projects have included:

- Developing an innovative annual incentive program for a large regional health system
- Partnering with the Compensation Committee of various research and development organization on all facets of executive remuneration
- Providing annual executive compensation consulting assistance to the Compensation Committees of numerous tax exempt organizations to help ensure compliance with IRS regulations governing executive compensation
- Creating a broad-based employee pay program for a large national tax exempt organization
- Designing an executive retention program for major long-term care facility
- Conducting various custom surveys to help hospitals and health systems fine-tune their compensation programs for high-demand positions
- Conducting training sessions for Board members of tax exempt organizations seeking to better understand their role in determining executive compensation

Before joining Mercer, Andy was a Senior Consultant at another global human resource consulting firm, where he specialized in providing compensation consulting services to clients in the healthcare and broader tax exempt markets.

Andy has a bachelor's degree in economics from the State University of New York at Geneseo and a master's degree from Cornell University in Industrial and Labor Relations.

BIOGRAPHY

Julie Donnell

Julie Donnell is an Associate in the Human Capital business of Mercer.

She has worked on numerous compensation and talent management projects for tax-exempt, private and public organizations within the healthcare, manufacturing, financial services, consumer products and technology industries. Julie is located in Chicago.

Recent projects include:

- Audit of compensation programs, identifying opportunities to better align compensation with internal needs and market practices
- Review of executive compensation levels and policies in not-for-profit organizations to ensure compliance with the Intermediate Sanctions Legislation
- Design of salary and wage structures for executives and employees
- Develop a broadband structure covering 16,000 employees for a US-based health system through the use of position evaluations
- Design of compensation programs for organizations transitioning through bankruptcy, as well as designing short- and long-term incentive plans for organizations emerging from bankruptcy

Julie is on Mercer's healthcare industry consulting practice steering committee, providing project management expertise.

Julie has a Bachelor's degree in organizational behavior from Olin Business School at Washington University in St. Louis.

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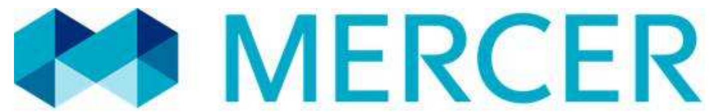

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June 3, 2010

A Lesson in Compliance: IRS Releases Interim Report on Nonprofit Colleges and Universities Compliance Project (Short Version)

Related Topic Area(s): Tax and Employee Benefits

On May 7, 2010, the Internal Revenue Service (the "IRS") released the Interim Report on its Nonprofit Colleges and Universities Compliance Project (the "Interim Report"), summarizing the status of the Compliance Project and the information that it received in response to the compliance check questionnaires sent out to more than 400 nonprofit, tax-exempt colleges and universities in October 2008.

The information revealed from the questionnaires and the discussion of the issues by the IRS in the Interim Report are insightful and enlightening for all tax-exempt organizations.

Findings of the Colleges and Universities Compliance Project

This Compliance Project began when the IRS mailed compliance check questionnaires to 400 colleges and universities in October 2008. After reviewing information received from the compliance questionnaires, the IRS initiated examinations. Based on the Interim Report, to date, the Compliance Project has resulted in 30 examinations, approximately 8% of the colleges and universities that received questionnaires. The focus of these examinations has been principally in the areas of unrelated business income and executive compensation.

With respect to unrelated business income, the Interim Report noted that:

- Nearly half of the small colleges that completed the questionnaire reported never filing a Form 990-T, the annual reporting form on which they would identify taxable unrelated business income.
- A higher number of organizations reported that they engaged in unrelated activities on the questionnaire than those that reported such activities on their Forms 990-T.
- There seems to be substantial confusion and non-reporting of unrelated business income resulting from transactions with related or controlled entities.
- Approximately 65% of the colleges and universities that responded to the questionnaire reported that they have neither sought nor relied on the advice of legal or tax counsel when determining whether an activity was unrelated.

With respect to executive compensation, the Interim Report noted that:

- Less than 40% of the organizations that responded to the questionnaire indicated that they had a formal compensation policy and less than 30% hired independent consultants to assist the organizations by providing or analyzing comparability data.
- With respect to loans to officers, directors, trustees, and key employees (the "ODTKEs"), only about 50% of the small and medium-sized colleges and universities that reported providing loans to ODTKEs reported that the terms of the loans were in writing.

The Interim Report also indentified troubling statistics in the areas of identifying related entities and reporting income from controlled entities. Finally, the Interim Report noted low overall use of outside advisors and a general lack of written governance policies.

Lessons for Colleges and Universities Not Yet under Examination

The information in the Interim Report is particularly helpful to colleges and universities that are not currently under examination, as it provides a blueprint for what the IRS considers to be optimal compliance. Colleges and universities not yet under examination should take the following steps with respect to the issues in highlighted in the Interim Report:

- Unrelated Business Income – Colleges and universities should compare the data presented in the Interim Report to their own activities to determine whether they engage in any of the activities that the IRS characterized as potentially unrelated. If so, organizations should either report such income on the annual Form 990 and/or 990-T, or should take steps to document why such activities are related to the organization's exempt purposes. Structuring or restructuring activities to make them related or eligible for one of the exemptions from unrelated business income may be in order. Obtaining guidance from legal or tax counsel can be helpful.
- Compensation – With the potential penalties of revocation of exempt status or imposition of intermediate sanctions in mind, colleges and universities should use the Interim Report as a guide to ascertain whether their compensation

policies are compliant with IRS expectations. They also should determine if the amount of compensation provided is safely within the range of compensation provided by comparable organizations and should seek the assistance of independent compensation consultants when making such determinations.
- Governance – Organizations should develop and implement appropriate policies and procedures as discussed in the Interim Report. Implementation of such policies will both reduce the likelihood of a future examination based on deficiencies reported on the Form 990 and also can help the organization avoid some of the problems that could jeopardize the organization's tax-exempt status, result in unrelated business income, or in the imposition of intermediate sanctions.

While the recommended steps require time and resources, it is significantly less expensive and easier to address potential tax issues prior to an examination than it is to do so during an examination.

Lessons for All Tax-Exempt Organizations

The benefits of the information contained in the Interim Report are not limited to colleges and universities; rather, they are beneficial to all tax-exempt organizations by providing lessons for future compliance projects and current tax compliance.

Future Compliance Project Lessons
- If you receive a compliance check questionnaire, complete it. The IRS opened an examination on each of the 13 organizations that received, but did not complete, a questionnaire.
- Avoid lack of uniformity within your industry. The Interim Report noted a significant lack of uniformity on certain issues, such as the way in which unrelated income is defined and reported. This lack of uniformity likely increased the number of individual examinations. Members of industry trade associations should request more education about industry practices and common issues where required.
- Smaller organizations should catch up on compliance. The Interim Report revealed that small colleges and universities were less likely to have implemented certain governance policies, engaged independent consultants for advice on compensation, and prepared certain annual tax filings, such as the Form 990-T. These institutions would benefit from membership in a trade association of similar entities to pool their resources and, collectively, hire the appropriate experts to provide general information and develop guidelines for governance, compensation and annual tax reporting.

Lessons Relevant for Current Tax Compliance
- Unrelated business activities and executive compensation will continue to be issues of significant focus. During this Compliance Project, the IRS has gone to great lengths to educate its revenue agents about these issues, and they will continue to be at the forefront of an agent's focus during future examinations, including those outside of the Compliance Project.
- Future IRS focus will be on related entities and organizational governance among other areas. In the Interim Report, the IRS noted that it was going to use the Compliance Project to develop and review information regarding transactions with related entities and organizational governance. Combined with the addition of new sections to the Form 990 on these issues, this puts the entire tax-exempt community on notice that future examinations will include reviews of related entities and corporate governance.

Conclusion

The Interim Report provides a wealth of information that can be used by colleges and universities, as well as other members of the tax-exempt community, to ensure compliance with applicable provisions of the federal tax code. As industries and organizations engage in various activities and assess their risk, they should analyze the Interim Report and conduct their activities accordingly, ideally prior to becoming the subject of an IRS examination.

* * * * * *

For a more extensive version of this article, please **click here**.

To review our May 2010 article on the IRS tax-exempt organization audit process, please **click here**.

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This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

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The IRS Tax-Exempt Examination Process

Related Topic Area(s): Tax and Employee Benefits

The most aggressive tax-exempt organization enforcement initiative to date has provided lessons to the entire EO community.

In 2003, the Service began a compliance project focused on the entire sector of credit counseling organizations tax-exempt under Section 501(c)(3). The credit counseling compliance project was a huge undertaking which, by some estimates, involved IRS examinations of more than 80% of the industry as measured by revenue. The unprecedented scope of this project—essentially the examination of nearly every organization within a single industry—was matched only by the Service's aggressive posture during the examinations. Unlike previous compliance projects, the Service set out a clear goal for the credit counseling compliance project—to "attack," as the Service put it, the tax-exempt credit counseling industry. On 11/30/03, IRS Commissioner Mark W. Everson testified before the U.S. House of Representatives Committee on Ways and Means. In response to a question on the portion of the industry the Service had "under audit," Commissioner Everson said, "we are actually attacking 40 percent of it."

Over the last six years, as announced on 6/23/09 by Commissioner Sarah Hall Ingram, the Service "examined virtually every credit counseling organization in the country, and revoked the tax-exemption of over 40 percent of the industry, as measured by revenues."

While the credit counseling compliance project was unique with regard to its scope and the Service's extremely aggressive position, the lessons learned from this process can be used to help tax-exempt organizations—particularly those exempt under Section 501(c)(3)—better understand the focus of the Service's future examinations. These lessons contain guidance on how to prepare for future examinations, what an organization should do when it is informed of an impending examination, what to do during an examination, and what to do if an examination results in an adverse determination.

Background

Tax-exempt status is highly valued, and not just because it allows an organization to receive related income without being subject to taxation. There are other, substantial benefits, including exemption from certain statutory requirements, that go along with exempt status (particularly for organizations exempt under Section 501(c)(3), which also can receive tax-deductible contributions). In exchange for these benefits, exempt organizations have a number of organizational and operational obligations they must meet.

As a result of these additional benefits and responsibilities, the scope and consequences of exempt organization examinations are drastically different from examinations of taxable corporations. As such, an exempt organization executive needs to understand that the consequences of an adverse determination include not merely additional tax and penalties; there is also revocation, a result that can be the death of the organization. Both because the credit counseling audits involved Section 501(c)(3) organizations and because the requirements and the costs of revocation are highest under that section, this article focuses on organizations that are tax-exempt under that section.

Section 501(c)(3) requirements

As mentioned above, unlike their taxable counterparts, tax-exempt organizations are subject to multiple organizational and operational requirements. As such, examinations of tax-exempt organizations are not merely financial audits; they are comprehensive reviews of the organizations' governance, operation, management, activities, and methodologies to ensure compliance with each of the substantial requirements for qualification. Therefore, any review of examinations of exempt organizations must begin with a description of the requirements for exemption.

General Section 501(c)(3) issues. In general, for an organization to qualify as exempt under Section 501(c)(3), it must pass both the "organizational" and "operational" tests set forth in the Code and accompanying regulations. As such, the organization must demonstrate that it is both "organized" for a qualifying purpose or purposes and that it is "operated" for the furtherance of such purpose or purposes.

In determining whether the “organizational” test is met for a particular organization, the Service generally looks to governing documents. If an organization's articles of incorporation and bylaws are consistent with the requirements and identify one or more qualifying exempt purposes, the organizational test usually is deemed to have been met. Qualifying exempt purposes for Section 501(c)(3) are those that are scientific, educational, charitable, religious, testing for public safety, and literary. [1]

The “operational” test is more involved and more subjective than the “organizational” test. In general, the Service will consider the full scope of an organization's activities to ascertain whether, in practice, the organization is fulfilling its stated mission and whether any substantial part of the organization's activities is for a non-exempt purpose. A non-exempt purpose is generally one that serves a private interest rather than a public interest. Therefore, this is often described as a “private benefit.” The presence of a private benefit, if substantial in nature, will destroy an organization's exemption, regardless of an organization's other charitable purpose or activities. A private benefit can disqualify an organization if the benefit flows to individuals or entities closely related to the organization as well as disinterested third parties.

In *Better Business Bureau of Washington D.C., Inc*., 34 AFTR 5, 326 US 279, 90 L Ed 67, 1945 CB 375 (1945), the U.S. Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an “underlying commercial motive” that distinguished its educational program from that carried out by a university.

Similarly, in *American Institute for Economic Research*, 9 AFTR 2d 1426, 157 Ct Cl 548, 302 F2d 934, 62-1 USTC ¶9466 (Ct. Cl., 1962), the Court of Claims considered the status of an organization that provided analyses of securities and industries and of the economic climate in general. The organization sold subscriptions to various periodicals and services providing advice for purchases of individual securities. Although the court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose, it held that the organization had a significant non-exempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt.

In light of these requirements, one of the first things the Service will look to in an examination is not a statement of revenues and expenses, but an organization's actual operations. During the course of tax-exempt organizations' examinations, it is not unusual for agents to review the minutes from meetings of an organization's governing body, review employee training manuals or handbooks, and even attend organization programs. As such, it is imperative that every exempt organization documents how each of its activities, from training employees to holding fundraisers, furthers the organization's exempt mission, and ensures that all of its materials—both public and internal—are consistent with its mission.

Private inurement. Another limitation for Section 501(c)(3) organizations is that such organizations are prohibited from entering into transactions that result in “private inurement.” Generally, a transaction between a tax-exempt organization and an “insider” (i.e., someone able to exert substantial influence over the tax-exempt organization or someone with a close relationship to such an individual) will result in private inurement if it results in greater than fair market value or unreasonable return benefit being paid to the “insider.” If the Service determines that a tax-exempt organization's assets inured to the benefit of an insider, the Service has the authority to revoke the organization's exempt status.

Note that private inurement is generally considered to be separate from the larger concept of “private benefit,” discussed above. While private benefit may exist when the activities of an organization confer a more than insubstantial benefit on either insiders or disinterested third parties, private inurement is specifically tied to those closely related to the organization and usually involves pecuniary benefits.

In analyzing the private inurement issue, the Service will frequently review whether the organization has a conflict of interest policy and whether the organization entered into any transactions with entities controlled by the organization's insiders. Further, the Service likely will do a substantive analysis of the agreements between the organization and its insiders, including employment agreements, to determine reasonableness. Once again, this issue goes much deeper than the mere reconciliation of income and expenses that characterizes most examinations of taxable organizations.

Intermediate sanctions. In addition to the private inurement proscription, the Code allows the Service to levy excise taxes (referred to commonly as “intermediate sanctions”) against certain individuals and private entities that receive better-than-fair-market-value in transactions with Section 501(c)(3) and 501(c)(4) organizations. [2] In practice, the Code's proscription of private inurement and its intermediate sanctions provisions are focused on the same type of activity—transactions that provide excessive benefit to an individual or an entity that has the ability to exert substantial influence over the tax-exempt organization, or to those that are closely connected to such an individual or entity.

An important distinction between the two doctrines concerns the type of sanctions allowed. Under the private inurement provisions, only the tax-exempt organization may be penalized and the sole penalty available is revocation of exempt status. By contrast, the Service may use the intermediate sanctions provisions to impose excise taxes on the individual or entity that benefited from the better-than-fair-market-value transaction, as well as on the individual exempt organization managers who knowingly approved the transactions. [3]

Certain individuals (referred to in the intermediate sanctions provisions as “disqualified persons”) who benefit from excess benefit transactions must repay to the tax-exempt organization the full amount of the excess benefit.

Additionally, the disqualified person may be subject to an initial excise tax equal to 25% of the amount of the excess benefit. Also, the Service may impose an excise tax of 10% of the excess benefit on the organization's managers who approved the transaction, including members of the board of directors. If a disqualified person fails to repay the amount of the excess benefit before a tax is assessed or a notice of deficiency is issued, the Service may impose an additional excise tax of up to 200% of the excess benefit on the disqualified person.

For purposes of Section 4958, a “disqualified person” is any person who is (or has been within the previous five years) in a position to exercise substantial influence over the tax-exempt organization. Among the facts and circumstances that the Service will consider as tending to reflect that a person or entity has substantial influence over the affairs of an organization are (1) the person holds a position of authority within the organization (e.g., a director or officer), (2) the person or entity's compensation is based on revenues derived from activities of the organization, and (3) the person or entity manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization as a whole. [4]

For a transaction to result in excess benefit, it must be one for which the tax-exempt organization paid more than fair market value. Treasury regulations implementing the intermediate sanctions set out a three-step process for an exempt organization to use in establishing a “rebuttable presumption” that a particular transaction was reasonable (i.e., not excessive). That process is: (1) have the transaction considered in advance by a body of disinterested decision-makers (at a time when the disqualified person is not part of the decision-making); (2) have the decision-making body rely on appropriate, reliable comparability data (such as independent surveys) when deciding whether a contemplated transaction is at fair market value; and (3) have the fact of the decision, the identity of the decision-makers, and the basis for the decision contemporaneously documented. While this process is not mandatory, it shifts the burden of proof to the Service to demonstrate that the transaction involves an excess benefit, provides credible and contemporaneous evidence that the organization sought to ensure the transaction was appropriate, and generally helps ensure that the transaction is fair to the organization regardless of whether the IRS ever reviews it.

In making determinations with respect to whether a benefit resulted in an excessive benefit, the Service will consider each transaction with one or more disqualified persons, including the procedure that the organization used to approve it. The authors have most often seen this issue come up with respect to the payment of excessive compensation, but it is not uncommon to see it when the organization buys property from a disqualified person or enters into a service contract with an entity owned or controlled by a disqualified person.

Unrelated business income tax. An exempt organization is not taxed on its income from an activity that is substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business. However, if an exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, the organization is generally subject to tax on its income from that unrelated trade or business.

Unrelated business income is income (1) from a trade or business (2) that is regularly carried on by an exempt organization and (3) is not substantially related to the performance by the organization of its exempt purpose or function. While beyond the scope of this article, there is a rich body of guidance on the meaning of each of these criteria, as well as numerous exceptions.

In general, if the Service finds that an exempt organization is subject to UBIT, the consequence is not a denial or revocation of the organization's exempt status. Rather, the organization will be subject to tax only on the unrelated business income. However, depending on the circumstances and the scope of how the Service defines the criteria as applied to an exempt organization, the tax owed on the unrelated business income could be significant.

Liability for UBIT will not automatically jeopardize an organization's tax-exempt status. However, to the extent that a substantial portion of an organization's activities are unrelated to its tax-exempt purpose, the organization may be jeopardizing its tax-exempt status regardless of whether it pays tax on the unrelated income.

Focus and trends in IRS examinations

As mentioned above, unlike examinations of taxable entities, the primary focus of examinations of tax-exempt organizations is on the organizations' operations. As such, during an examination, the Service will review an organization's activities, relationships, and governance to ensure that all such activities further an exempt mission and that none of the organization's programs further a substantial non-exempt purpose or provide an impermissible benefit.

Traditionally, examinations of tax-exempt organizations have focused primarily on organization activities, and the Service has developed cases for revocation for engaging in activities that do not further an exempt purpose or for providing private benefit or private inurement. In developing these cases in the past, the Service has largely ignored the intermediate sanctions provisions that, as discussed above, allow the Service to impose substantial pecuniary penalties on individuals who are able to influence the activities of the organization to receive excessive benefits and on individuals who approve such benefits.

Recently, however, the Service has become more aggressive in pursuing revocations of exempt status. In addition to the activist statements referenced at the beginning of this article regarding the credit counseling industry, the authors have participated in a number of informal conversations with revenue agents and others in the Service. These conversations reinforce the perception that the Service has taken a sharp move away from seeking to achieve mutually

agreeable results in exempt organization examinations.

Further, recent activities by the Service suggest that it has begun to use the intermediate sanctions far more frequently than ever before. It is not an exaggeration to say that in the last year, the authors have seen the Service assess intermediate sanctions in more examinations than in the previous five years combined. The manner in which the Service has assessed the penalties is also unique. Previously, the Service seemed to focus its efforts on developing cases with obviously excessive benefits and proposed intermediate sanctions in lieu of revocation. In the last year, however, the authors have seen the Service impose intermediate sanctions with more aggression, proposing assessment in situations where the amount of the excessive benefit is minimal and even imposing intermediate sanctions in addition to revocation. Not only is this new approach being used to develop cases during examinations, it is also supported by the Office of Chief Counsel of the IRS. During a recent conversation with an attorney at Counsel's office, the authors were told that the Service is developing cases for intermediate sanctions and that it will pursue these cases aggressively in court.

With this new IRS posture, organizations need to be aware of the potential risks and act accordingly, particularly with regard to potential private inurement and intermediate sanctions matters. Additionally, organizations still need to be aware of the more traditional issues, such as engaging in substantial nonexempt activities or providing impermissible private benefit. Especially in this more aggressive enforcement environment, organizations cannot wait until the Service appears to clean up any existing exemption or intermediate sanctions issues.

Types of examinations

The Service conducts several types of examinations. Two of the types of examinations the authors have seen most frequently in the world of tax-exempt organizations are correspondence examinations and field examinations.

Correspondence examinations

Correspondence examinations are what the name implies—examinations in which an organization responds to requests made by the Service through letter, fax, or email. [5] Correspondence examinations generally are used for smaller organizations and are limited to a review of a particular issue. In some situations, a correspondence examination will be converted to a field examination.

Correspondence examinations serve many purposes. First, correspondence examinations allow the Service to review the activities of many organizations quickly, limiting the the burden on the Service's resources. Also, because of their limited focus, correspondence examinations allow the Service to conduct a widespread review of a particular issue in an entire industry, or statistically valid sample of organizations in a given industry, all at once.

An organization subject to a correspondence examination will be alerted by a letter from the IRS informing it of the examination and requesting information pertaining to the issue being examined. Based on the information provided, the Service will make a determination regarding the issue under review, request additional information, or convert the examination to a more intrusive field examination.

When an organization receives notification of its correspondence examination, it is important that the organization respond quickly and completely. First, a complete failure to respond frequently will draw even sharper attention from the Service. Second, sending the Service disorganized, incomplete, or inadequate information may increase the likelihood of the Service determining that it needs to convert the examination to a field examination.

Field examinations

Field examinations are what people usually think about when they think of IRS examinations. They begin with a notification from the IRS that it is going to conduct an examination of the organization's activities during a particular period. The notice will include a proposed date for an office visit by the agent conducting the examination. In addition to the office visit, the Service will provide an initial Information Document Request (IDR) setting forth the initial documents and other information the Service is seeking from the organization. Unlike correspondence examinations, field examinations are often burdensome, intrusive, and slow moving.

During a field examination, an IRS revenue agent will be on site reviewing the information provided and interviewing individuals who have knowledge about the organization's operations. Further, the substantial amount of information requested in the initial IDR is itself a burden. While every examination is unique, the initial IDRs sent during examinations of credit counseling agencies would frequently request information and explanations of more than 50 items, including such items as all minutes for meetings of the governing board for three tax years, copies of all third-party service agreements, and copies of all bank statements during the periods under examination. In one examination that the authors worked on, the information requested by the initial IDR filled more than 40 boxes. In addition to the work and effort required to assemble and copy all of this information, most agents would like to review the information on site, sometimes requiring multiple weeks at an organization's offices. Also, as the agents review the information, they likely will have questions and need to interview various employees about the information provided in response to the IDR. Finally, the initial IDR is rarely, if ever, the Service's last request for information and the agent's initial visit to the organization's offices is rarely his or her last.

While the nature of the examination causes field examinations to be burdensome, the breadth of the information reviewed causes them to be long and slow moving. During the examination that began with the 40-box response to the initial IDR, the Service issued more than a dozen additional requests for information during the course of its

examination. While that is an extreme example, it is no wonder that IRS examinations can take in excess of two years to reach a proposed resolution when one considers the amount of time required by organizations to gather, organize, and copy all of the information requested; the amount of time required by the agent to review all of this information, interview the organization's employees about the information, and prepare additional requests for information; and then the time required to repeat the process several times. If the proposed resolution is anything other than a no-change letter (described below), further discussions between the organization and the Service likely will consume even more time.

Potential outcomes

There are four potential outcomes of an IRS examination of a tax-exempt organization—a no-change letter, a no-change letter with written advisories, a closing agreement, and a revocation.

No-change letter

A no-change letter is the best result of an examination of a tax-exempt entity. Essentially, a no-change letter informs the organization that the Service found no issues during its examination and has determined that the organization properly completed its annual Forms 990. As such, the Service recommends no changes to the examined Form 990.

No-change letter with written advisories

A no-change letter with written advisories is the second best result. Such a letter informs the organization that, while it is generally acting in accordance with the requirements of Section 501(c)(3), the examination uncovered one or more minor issues that, while worth mentioning, are not substantial enough to result in a revocation.

The no-change portion of the letter indicates that the organization will continue to be recognized as a tax-exempt organization without need for revision to the examined Form 990. The advisories portion of the letter provides the organization with a description of the issues (such as the failure to maintain adequate records) that the Service found and informs the organization of the consequences of failing to comply with such requirements in the future. In the event of a subsequent examination of an organization that received a no-change letter with written advisory, it is almost certain that the Service would look closely at those areas identified in the advisory portion to determine whether the organization made changes to its operations. Still, the advisory technically carries with it no formal enforcement mechanism (although the authors have been told that the Service has a process in place to monitor compliance with advisories).

Closing agreement

A closing agreement is an agreement with the Service under which it agrees to continue recognizing the tax-exempt status of an organization and the organization agrees to (1) act in accordance with specific guidelines required by the IRS and (2) possibly pay a stated penalty amount (generally considered a payment in lieu of tax). A closing agreement is not the most favorable resolution to an examination because it frequently requires payment of a pecuniary penalty. It does, however, allow an organization to retain its tax-exempt status.

Closing agreements generally are appropriate when an organization was engaged in noncompliant activities but, prior to the close of the examination, ceased such activities. In these situations, the Service will frequently agree to continue to recognize the organization's tax-exempt status if the organization agrees to sign an agreement stating that it will no longer engage in specified activities and will pay tax on the revenue derived from such activities. Such documents have often also included an agreement by the organization to implement certain procedures to prevent future problems. In practice, the Service has moved away from offering closing agreements, primarily due to the significant procedural hurdles that it must overcome to get them approved internally.

Revocation

A revocation letter is the worst possible outcome. Upon receiving a final revocation, the organization is no longer recognized as a tax-exempt organization as of the date specified in the letter. Based on the information provided in the letter, an organization may have to go back and re-file tax returns for prior years as a taxable entity (and pay any accompanying tax liabilities, plus interest and penalties). As detailed below, however, the Service will first issue a proposed revocation letter and allow the organization a chance to respond before finalizing the revocation.

Dealing with the IRS

Dealing with an IRS examination is an extended process. It requires a commitment to meeting the requirements for tax-exempt status prior to the examination and working with the Service during the examination to show why the organization should remain exempt.

Prior to an examination

In almost every examination on which the authors have worked, all of the issues raised by the Service could have been easily addressed prior to the examination by developing adequate governance and policies, avoiding certain activities, and doing a better job at making sure annual filings were timely and accurate. The examinations in which the IRS raised few, if any, issues were examinations of organizations that generally had taken the appropriate precautions years before.

Governance and policies. Many of the common problems discovered during examinations could or should have been addressed by better governance. For instance, many issues relating to excessive compensation could have been

addressed through the implementation of an appropriate compensation approval policy (one that, at a minimum, incorporated the rebuttable presumption process provided in the intermediate sanctions regulations, at least with respect to disqualified persons). In an examination of an exempt organization, the Service invariably will request the compensation approval policy, as well as an explanation of the organization's compensation approval process. Not only will the implementation of such a policy help the organization avoid potential issues relating to the amount of compensation that it provides, but providing the Service with a copy of the policy sets a positive tone for the Service's compensation review. In general, the Service is far less likely to challenge a compensation level for an executive if a solid policy was followed by the organization in arriving at that level than it would if there were no such policy or procedures in place.

Additional policies that can benefit the organization during an examination include a conflict of interest policy, a document retention policy, a public disclosure policy, and a whistle-blower protection policy. Moreover, the organization should have an independent board of directors that monitors and documents its compliance with each of these policies. The Service has published a list of its preferred policies in the tax-exempt organization portion of its Web site. [6] By developing and implementing policies that conform to the Service's preferences, organizations can demonstrate that, to the extent their activities comply with these policies, their activities are in compliance with the requirements of Section 501(c)(3).

Activities. On Form 1023, "Application for Recognition of Tax Exempt Status Under Section 501(c)(3)," every tax-exempt organization provides the Service with a description of its activities and its tax-exempt purpose(s). The surest way for an organization to avoid issues regarding its activities is to comport its activities in accordance with the information disclosed on its Form 1023. Also, when the organization undertakes new activities, it is important to document how those activities further the organization's tax-exempt mission, as well as to report such new activities on the organization's annual Form 990.

Annual reporting. The most important annual IRS reporting requirement is Form 990. Through Form 990, organizations must report information about their activities, governing body, executive compensation, revenue sources, a breakdown of the types of expenses they incur, a description of how their major activities accomplish the exempt mission, and a description of transactions with related parties. Also, the Form 990 is subject to public disclosure, meaning that this substantial amount of information is available to the Service, the media, and the general public (through resources such as the Guidestar Web site). As such, it is imperative for organizations to complete Form 990 as completely and as accurately as possible. Misinformation, incomplete information, or information presented in a manner that does not favorably portray the organization's activities can attract the Service's attention, as well as adverse media or public scrutiny.

During an examination

While many of the issues pertaining to IRS examinations can and should be addressed prior to the examination, the most import part of the process is obviously the examination itself. The actual examination can be as short as a few months or as long as five or more years.

Notification and response to initial IDR. As discussed above, the examination will begin with the notification and the initial IDR. The notification will likely include a proposed date for the initial visit, and the initial IDR will include a due date. Organizations must understand that these are proposed dates. It is far more important for an organization to be prepared than to be quick. If the proposed date of the initial visit is two weeks from the receipt of the initial IDR and the organization cannot be prepared in time, it should call the agent and reschedule the initial visit. In the authors' experience, agents do not like to significantly delay initial visits or the due dates for IDR responses, but most understand that they are requesting a significant amount of information and that organizations need time to assemble it.

Also, the authors have found that a thorough, well-organized response to the initial IDR is the best way to set a positive tone for an examination. In most examinations, the response to the initial IDR is incomplete and disorganized. Not only does this fail to accomplish the goal of demonstrating the organization's compliance, it also creates more work for the agent and sets an adversarial tone from the outset. If the initial response to the examination is thorough and well organized, however, the agents will recognize that the organization is making an effort and will be willing to work with it as issues arise during the course of the examination. This relationship with the agent is an important, though often overlooked, aspect of the examination.

While an examination is very much focused on facts and documents, a substantial basis for the outcome of the examination is statements, explanations, and interpretations. If an organization has a good relationship with the agent, its statements and explanation are more likely to be given weight by the agent and the agent's interpretations of facts likely will be more favorable to the organization. This is just one of the many reasons that the authors recommend providing a complete and well-organized response to every IDR. It also is another reason for requesting additional time to respond to information requests early. Many organizations believe that the more quickly they respond to requests from the agent, the more quickly the examination will be completed. It is true that if the organization does not substantially delay its responses to the Service, its portion of the examination will be quicker. Still, the Service frequently moves at its own pace, and the speed with which the organization provides information to the Service has very little impact on the overall pace of the examination. Additionally, a rushed response to an IDR frequently has errors or omissions that can result in additional requests for information and additional delays.

Finally, when responding to the initial IDR, it is important to respond to each request. The authors find it is most helpful to mimic the organization of the IDR in an organization's responses. For instance, if questions are ordered by numbers, responses should be as well. Also, the organization should include a well-crafted narrative explanation of the information provided in response to each request. This makes it possible to explain how each document provided to the Service demonstrates compliance with the requirements of Section 501(c)(3). For instance, do not simply give the Service a copy of a 200-page employee manual and hope that the agent focuses on the best parts of the employee training program. Rather, give the Service the employee training manual with an explanation about how the training program discussed on thus-and-such pages focuses on developing the specific skills needed to serve the community in accordance with the organization's exempt mission.

By providing a thorough and organized response to the initial IDR request, the organization can set the appropriate tone for the rest of the examination. For this reason, it is also generally advisable to involve outside experts at the outset. One common source of trouble in examinations is delegating the preparation of IDR responses to employees with no particular knowledge of the exempt organization requirements, particularly if that employee must continue to cope with his or her other duties. This can result in a late, incomplete, disorganized response, and sometimes an actually harmful one (e.g., one that discloses problematic activity with no explanation or corrective plan).

Interviews. The agent probably will need to interview certain employees and organization executives during the course of the examination. One of the most important things to understand about interviews is that they provide a context and further explanation of information already provided to the Service. The focus of the interviews will likely be tied to specific information that the Service wants to know, such as why a particular process is used or how it furthers the organization's exempt mission. With this in mind, the interviewee should limit the information discussed during the interview to only the information asked for by the agent. Also, it is acceptable to ask to see the information referred to in the question. Finally, people should only answer questions to which they know the answer. Answers such as, “no,” “I don't know,” and “I need to look into that” are frequently the best answers. If at all possible, organizations should arrange for legal counsel and/or other tax advisors with exempt organizations expertise to both prepare interviewees and to be present for interviews.

Requests to extend the statute of limitations. As mentioned above, examinations can take years. As such, during the course of an examination, many organizations will receive a Form 872, "Consent to Extend the Time to Assess Tax." An organization is not required to sign the Form 872, but if it does not, the Internal Revenue Manual—the Service's internal procedure manual—requires agents to issue a 90-day letter revoking the organization's tax-exempt status, cutting short an organization's procedural rights within the Service and forcing it either to accept the revocation or pursue a challenge (post-revocation) in federal court. Therefore, it is often advisable to sign an extension form.

After an examination

Upon completion of the examination, assuming no closing agreement has been reached, the Service will issue one of three letters—a no-change letter, a no-change letter with advisories, or a proposed revocation letter. If the organization receives a no-change letter, the examination is complete and the organization will continue to be recognized as exempt. In such situations, the organization need only keep up the good work.

If the organization receives a no-change letter with advisories, the examination is complete and the organization will continue to be recognized as exempt prospectively. However, the Service's recognition of the organization's tax-exempt status will be based on the condition that it agrees to the follow the advisories issued by the Service. In such situations, the organization needs to keep up the good work and follow the advisories (and document that they have been followed).

The worst result at this stage in the audit is the proposed revocation. A proposed revocation is not a final determination, however, and has no immediate impact on an organization's tax-exempt status. [7] A proposed revocation is merely the Service's position based on the information it reviewed during the course of the examination. At this point, the organization will have 30 days (or longer if an extension is negotiated) to “protest” the proposed ruling and avail itself of the IRS appeals process, a process that itself could take several more years. During the pendency of the appeal, the organization would remain tax-exempt.

It is important for organizations to understand that a proposed revocation is not a final ruling. The authors represent several clients that each received a proposed revocation, only to have the Appeals Division of the IRS overturn the proposed revocation and recognize the organization as exempt. Additionally, the authors have represented many organizations that received their proposed revocation letters more than five years ago without ever receiving final adverse determinations.

Conclusion

IRS examinations can be intimidating, especially for tax-exempt organizations that are subject to extremely invasive procedures. However, proper preparation prior to the examination coupled with an organized presentation of information during the examination can produce a successful result and a relatively painless experience.

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[1] See Section 501(c)(3) generally; note that other potentially qualifying purposes not relevant to this review also exist.
[2] See generally Section 4958.
[3] Representatives of the Service, speaking informally, have stated that the Service may consider not only compensation paid directly to an individual from the exempt organization, but also compensation received indirectly through related organizations for purposes of evaluating whether such individual received total compensation in excess of fair market value. The Service generally will take such an approach only when the indirect compensation is paid by an entity that is supported solely by revenue paid by the exempt organization.
[4] There is an "initial contract" exception to the facts-and-circumstances test. Specifically, Reg. 53.4958-4(a)(3) provides that intermediate sanctions generally will not apply to payments made pursuant to a binding written contract between an applicable tax-exempt organization and a person who was *not* a disqualified person immediately prior to entering into the contract.
[5] Reg. 601.105(b)(2).
[6] See **www.irs.gov/pub/irs-tege/governance_practices.pdf**.
[7] While a proposed revocation has no immediate impact on an organization's tax-exempt status, it may result in nontax reporting issues including financial statements, bond disclosures, or state reporting requirements.

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