

The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny

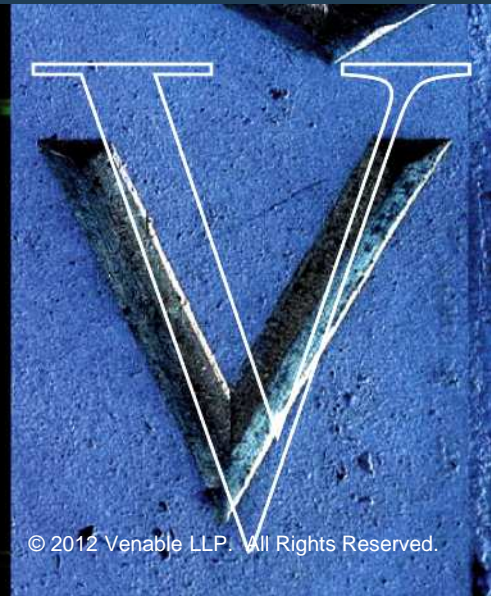
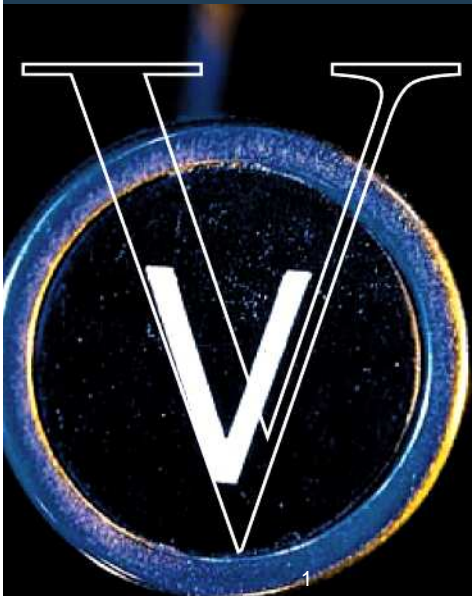
Association of Corporate Counsel
Nonprofit Organizations Committee
Legal Quick Hit

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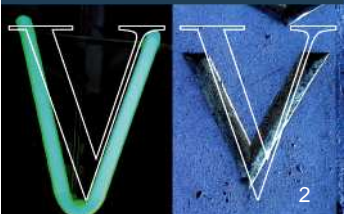
Washington, DC

July 10, 2012, 3 pm ET

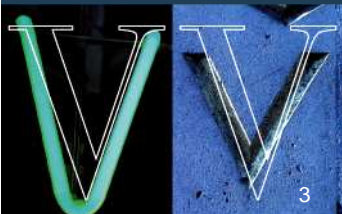


Purpose

- Explain significance of executive compensation
- Explain tax consequences of excessive compensation
- Explain how organizations can protect themselves

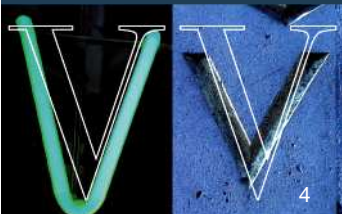


Significance of Executive Compensation



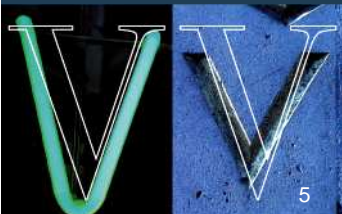
IRS Focus on Executive Compensation

- 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 2010 and 2011 than it did from 2004 through 2010



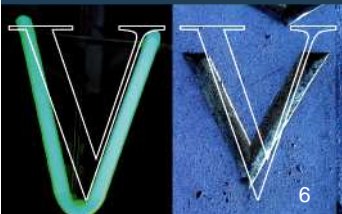
Consequences of Overcompensation

- 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



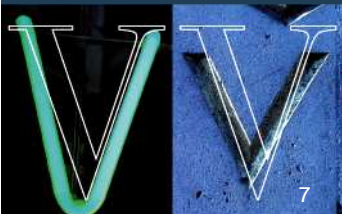
Consequences of Overcompensation

- 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

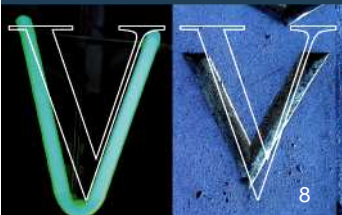


Consequences of Under-Compensation

- 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

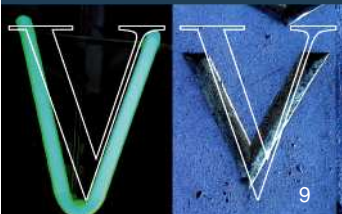


Tax Consequences of Overcompensation



Limitations on Executive Compensation

- Exemption issues – Penalizes organization
 - Private inurement
 - Impermissible private benefit
- Intermediate Sanctions – Penalizes management and individual board members



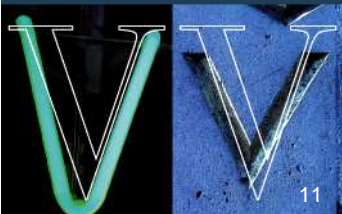
Exemption Issues

- Private Inurement
 - Code generally provides that no part of organization's net earnings can inure to the benefit of any private individual or shareholder
 - Applies to organizations exempt under multiple sections of the Code, including but not limited to: 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
 - Excessive compensation can result in inurement
 - Excessive or unchecked benefits can result in inurement even if total compensation is reasonable



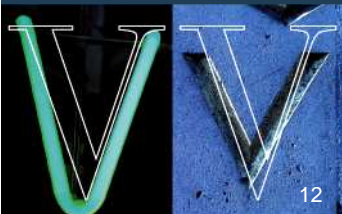
Exemption Issues

- Impermissible Private Benefit
 - Generally, tax-exempt organizations are required to limit their activities that are exclusively in furtherance of their stated mission
 - A non-exempt purpose is generally a purpose that serves a private rather than a public benefit, as such is generally called a “private benefit”
 - Provision of an impermissible private benefit is grounds for revocation
 - The private benefit prohibition is imposed on a more limited group of exempt organizations than private inurement, and is generally not applicable to organizations exempt under 501(c)(6) or 501(c)(7)



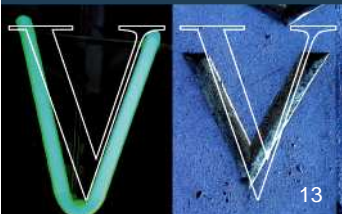
Intermediate Sanctions

- What are intermediate sanctions?
- Who may be subject to intermediate sanctions?
- What transactions give rise to intermediate sanctions?
- Why should you be concerned?
- Why should you be concerned now?
- What can I do to avoid intermediate sanctions?



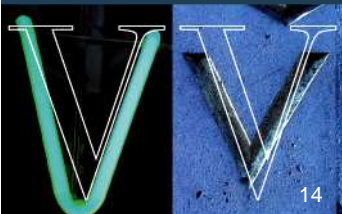
What Are Intermediate Sanctions?

- International Revenue Code (“Code”) section 4958 allows the Internal Revenue Service (“Service”) to impose penalties on “disqualified persons” who participate in or approve “excess benefit transactions”
- These penalties are commonly referred to as the intermediate sanctions
- Similar to “private inurement” concept



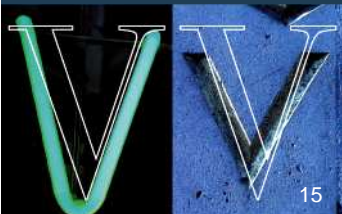
Who May Be Subject to Intermediate Sanctions?

- The Code section 4958 penalties may only be imposed on disqualified persons
- Section 4958(f) generally defines the term “disqualified person” to include:
 - Any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization;
 - Family members of individuals who are in a position to exercise substantial influence;
 - A 35-percent controlled entity;
 - Any person who is described above with respect to a supporting organization of the applicable tax-exempt organization; and
 - Certain donors and donor advisors with respect to donor-advised funds



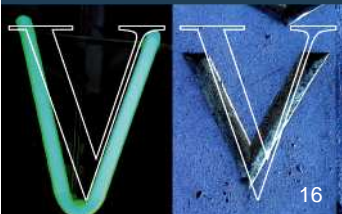
Who May Be Subject to Intermediate Sanctions?

- Treas. Reg. Section 53.4958-3(c) lists specific persons who are in a position to exercise substantial influence, including:
 - Voting Members of the organization's governing body;
 - President, CEO, COO;
 - Treasurer and CFO;
 - Organization founders; and
 - Some donors



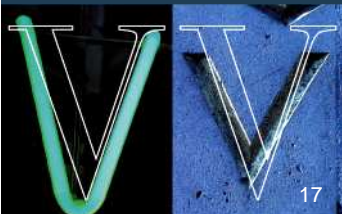
What Type of Transactions Give Rise to Intermediate Sanctions?

- Common situations that may result in “excess benefit transactions” include:
 - Compensation;
 - Payments for services provided to the organization (e.g., back-office service providers);
 - Purchase of property by the organization or the sale of property to a disqualified person; and
 - Provision of certain fringe benefits (which may be “automatic” excess benefits)



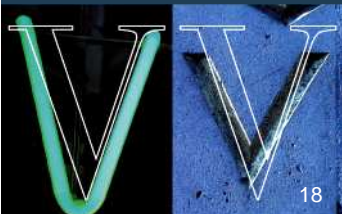
Why Should You Be Concerned?

- Penalty for receipt of an excessive benefit:
 - Return the value of the excessive benefits to the organization; and
 - An excise tax of either:
 - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service, or
 - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

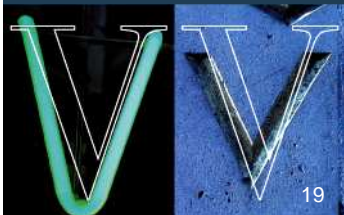


Why Should You Be Concerned?

- Penalty on organization managers for approval of an excessive benefit transaction:
 - Section 4958(a)(2) imposes a 10% tax on any organization manager that knowingly approves an excess benefit transaction



Protect Your Organization



What Can You Do to Avoid Excessive Compensation?

- Use caution when entering into transactions with disqualified persons
- Assess your risk
- Establish a clearly defined compensation policy to accomplish the organization's goals
- 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
- Establish reputable presumption of reasonableness



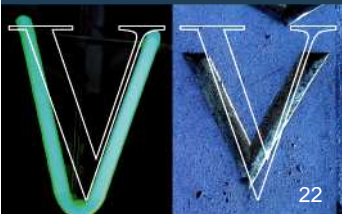
Assess Your Risks

- IRS is focused on identifying inadequate policies and practices
 - IRS Forms 1023 and 1024
 - IRS Form 990
 - IRS Examinations
- Identify Red Flags



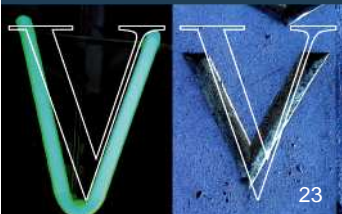
Red Flags

- 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



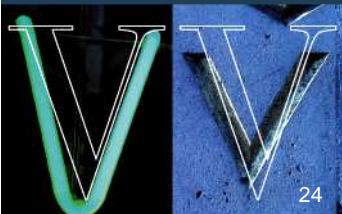
Red Flags

- Annual tax/information return – IRS Form 990, Part IV
 - Line 23a: Did the organization engage in an excess benefit transaction with a disqualified person?
 - If the answer to Line 23 is “Yes,” then complete Schedule L, in which you will need to describe the transaction to the IRS.
 - Schedule L, Part I:
 - Name the disqualified person
 - Describe the transaction



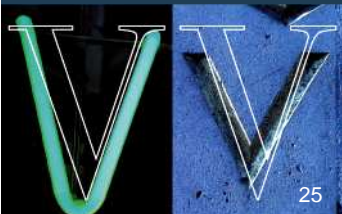
Red Flags

- Annual tax/information return – IRS Form 990, Part VI, Governance Management: Section B Policies : “This Section B requests information about policies not required by the Internal Revenue Code”
 - Line 12: conflict of interest policy
 - Does the organization have a policy?
 - Who is subject to the policy?
 - Is compliance with the policy continuously monitored?
 - Line 15: Did the process for determining executive compensation include: (1) **a review and approval by independent persons**, (2) **the use of comparability data**, and (3) **contemporaneous substantiation of the deliberation and decision**?
 - Line 15b: Describe the compensation approval process in Schedule O



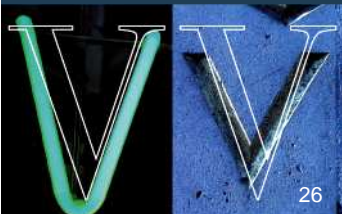
Red Flags

- 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



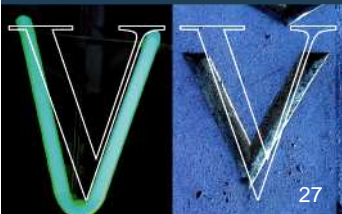
Red Flags

- 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”



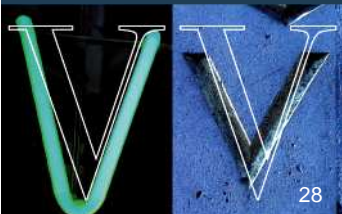
Red Flags

- 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?
 - Line 9: Did the organization follow the rebuttable presumption procedure
 - Schedule J, Part II, Breakdown of Officer, Director, and Employee Compensation



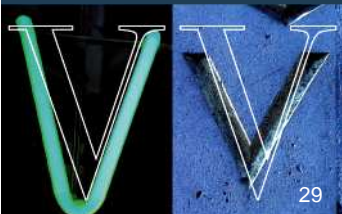
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- IRS Enforcement
 - IRS Area Manager Peter Lorenzetti recently identified executive compensation as “far and away the most common risk area for nonprofits” and an issue that the IRS will “look at on every audit we do”
 - Executive compensation and 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
 - IRS is currently litigating an excise tax assessed under Code section 4958



Red Flags

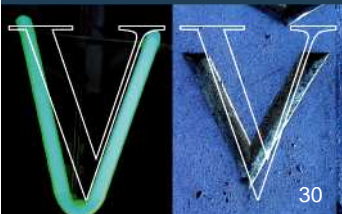
- Ongoing regulator and press scrutiny of executive compensation at nonprofit organizations is certain
- Potential “red flags” include:
 - Lack of sufficient oversight
 - Big numbers
 - Vague or confusing explanations for pay decisions
 - Limited documentation
 - Excessive benefits
 - Management influence
 - Conflicts of interest



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



Rebuttable Presumption of Reasonableness

Benefits of establishing the “rebuttable presumption”:

1. We have never seen the IRS attempt to rebut the presumption;
2. Provides board members with near absolute protection from excise tax on participation;
3. The very nature of the process, independent members using objective data, significantly mitigates the risk of overcompensation;
4. Provides organization with a clear and easy explanation about compensation decisions; and
5. Allows the organization to affirmatively answer all Form 990 questions relating to the policies and procedures that the IRS deems to be most desirable



Questions and Discussion

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