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GUIDESTAR

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

GuideStar Webinar

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Purpose

- Explain significance of executive compensation
- Explain rules and regulations regarding executive compensation
- Explain how organizations can protect themselves
- Explain scope of professional assistance available

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Significance 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 significant 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 nonprofits (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 the 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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Tax Consequences of Over Compensation

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Limitations on Executive Compensation

- Exemption issues
  - Private inurement
  - Impermissible private benefit

- Intermediate Sanctions

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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)
- Impermissible Private Benefit

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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 not applicable to organizations exempt under 501(c)(6) or 501(c)(7)

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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?

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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

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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

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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

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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)

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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

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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

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Why Should You Be Concerned NOW?

- We have seen the Service assess intermediate sanctions more in the last 18 months than in the previous 6 years combined
- Executive compensation and intermediate sanctions were included on the IRS TE/GE FY 2011 Workplan
- During a recent conversation with an attorney from the IRS Office of Chief Counsel, we were told that the Service is developing cases for intermediate sanctions and that the Service will pursue these cases aggressively in court
- This was discussed as a significant issue in the Interim Report for the IRS College and University Compliance Project

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Protection Your Organization

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What Can You Do to Avoid Intermediate Sanctions?

- 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

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Assess Your Risks

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

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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

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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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Red Flags

- 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:
  - Lack of sufficient oversight
  - Big numbers
  - Vague or confusing explanations for pay decisions
  - Limited documentation
  - Excessive benefits
  - Management influence
  - Conflicts of interest

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Assessing and Mitigating Risk

A good first step to establishing reasonableness is to establish a clearly defined policy and 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

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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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Professional Resources Available

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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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Questions and Discussion

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