Atlantic Executive Consulting Group, LLC

Compensation Paid By Non-Profits

Complying with IRS Regulations

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Table of Contents

I. Focus on Executive Compensation.

Executive compensation is one of the most controversial issues in America today. The media is focused on this complex issue. The public, the Internal Revenue Service and the Securities and Exchange Commission are debating the value of executives' services. At non-profit organizations, the employees, donors, and patients are following the debate. Everyone has an opinion, and most people are anxious to express their opinions.

The Internal Revenue Service (IRS) has always watched charities to ensure that their tax-exempt status is not abused. One of the primary factors the IRS now examines is the amounts of compensation and benefits provided by charities, foundations and social welfare organizations to their key employees, contractors, directors and trustees.

The IRS believes that some of these key employees may be taking advantage of their influential positions by setting their own compensation packages at above-market levels.

Years ago, the IRS did little about overpaid executives at charities. They could revoke the tax-exempt status of a charity, but the IRS rarely chose to take such an extreme step. The IRS also had Internal Revenue Code section 4958, which allowed them to impose penalties, in the form of excise taxes, on the excessive portion of compensation paid to an employee. But in 2006, the limit on § 4958(a)(2) excise taxes was increased, and the IRS has significantly increased its efforts to identify overpaid executives.

These excise taxes are referred to as "intermediate sanctions" since they are less severe than having the IRS revoke the charity's tax-exempt status.

These excise taxes are aimed at unreasonable compensation paid to a "disqualified person." A disqualified person is anyone who was "in a position to exercise substantial influence over the affairs" of the tax-exempt organization at any time during the five-year period prior to the transaction, and the family members of any such person. Note that it is not necessary that the person actually exercised substantial influence, only that he or she was in a position to do so.

The Code refers to the unreasonable portion of compensation as an "excess benefit transaction" because the individual is getting a benefit (compensation) in excess of the value of the services he or she provides for that compensation.

Expect the IRS to look closely at compensation amounts paid to:

> Officers who also sit on the charity's Board of Trustees,
>
> Relatives of major donors,
>
> Long-term employees who have cut back their hours (semi-retired),
>
> Employees who receive performance bonuses, and
>
> Anyone who has a hand in setting his or her own compensation level.

Certain industries are of special interest to the IRS. For example, hospitals may be examined because market conditions have pushed their officers' compensation to high levels.

Under Code section 4958(a)(1), the IRS can impose a 25% excise tax on the unreasonable portion of an individual's compensation. (This excise tax is in addition to federal and state income tax, and FICA tax the employee has to pay on that compensation.)

If the unreasonable portion is not repaid promptly, § 4958(b) provides for a 200% excise tax on the unreasonable portion.

Employees are not the only ones subject to the 25% excise tax. Over-paid independent contractors are subject to it also. In rare cases, this could include attorneys and financial advisors (if they meet the definition of disqualified person).

In addition, § 4958(a)(2) allows the IRS to impose an excise tax on an "organization manager" (officer, director or trustee) who participated in permitting the unreasonable compensation, unless such participation was not willful <u>and</u> was due to reasonable cause.

This 10% excise tax applies to the unreasonable portion of the compensation. (It was limited to $10,000 per transaction until a 2006 tax act raised that limit to $20,000.)

Officers and board members who knowingly allow the excessive compensation are jointly and severally liable for this excise tax.

To make their point, the IRS once announced that they had imposed $21 million in § 4958 excise taxes on forty individuals at various charities.

Notice that both the 25% and the 10% excise tax are imposed upon the individuals, not on the charity.

The general public is granted access to a non-profit's financial information. A non-profit is required by law to make available its three most recent Form 990s, upon request. Failure to deliver copies of these forms timely can subject the non-profit to a $25 a day fine per return with a maximum of $10,000 per return. Additionally, the individual failing to deliver the forms can be subject to a $5,000 fine.

In addition to the monetary impact, the publicity resulting from these excise taxes and fines can be disastrous for a charity.

II. How are Compensation Levels Determined?

Setting levels of compensation for key employees is difficult for charitable Boards of Trustees since most board members are not familiar with the complexities of compensation analysis. In fact, determining appropriate cash compensation levels for key employees at a charity may be more challenging than doing so at for-profit companies since charities cannot offer stock options, profit-sharing plans and some of the other incentives used to pay executives at for-profit entities.

Yet pay levels and benefits at charitable organizations must keep up with the market to prevent turnover, since turnover among key employees is costly, interruptive, and damaging to donor relations.

There are three primary approaches to determining an executive’s pay. First is the **“factors”** or **“multi-factor” method** which considers all facts and circumstances.

The factors include:

(1) The executive's qualifications, such as education and experience.

(2) The nature and scope of the executive's duties.

(3) The size and complexity of the organization.

(4) General economic conditions.

(5) The entity's financial condition.

(6) A comparison of the executive’s compensation to the entity’s gross revenue.

(7) A comparison of the executive’s compensation to the entity’s net income.

(8) The organization's compensation policy for other employees.

(11) The amounts of compensation paid to the individual in prior years.

(12) Whether the executive provided additional services, such as personally guaranteeing any of the employer's debts.

(13) Whether the executive was paid according to a long-standing and consistently-applied contingent compensation formula.

Do not forget specialized skills, such as the ability to attract favorable media coverage, relationships with major donors (or potential donors) and other fund-raising abilities, and communications skills (such as public speaking abilities and being multi-lingual).

Another approach to determining appropriate levels of pay involves the use of **comparables**. The IRS and U.S. tax court have put heavy emphasis on comparables. Databases of "comparability data" are available to find historical amounts paid by similar-sized tax-exempt and for-profit organizations in the same industry and in the same geographic area. The salary assessors compiled by Economic Research Institute (ERI) in Redmond, Washington are the most robust databases available and are widely used by compensation consultants and the IRS. ERI uses regression analysis to provide comparability data by position, geographic location, industry, entity size (gross revenue or total assets), time period, and (for some positions) years of experience.

Generally, the IRS and the courts are strict when determining whether data is really comparable. Some compensation databases are not reliable. Be prepared to answer questions about your sources like these: Do you know where they got their data? What quality controls did they have in place? How did they deal with outliers? Did they consider both cash and non-cash compensation?

If used as evidence in court, ERI states that their databases can meet the Daubert challenge.

The third approach to determining pay levels involves looking at the overall financial success of the organization. At for-profit companies, this approach is known as the **hypothetical investor test**. Under this approach, compensation is, in varying degrees, presumed to be reasonable in amount if an independent investor would still be receiving a reasonable return on his/her investment in the company after the compensation at issue had been paid. Although the hypothetical investor test is not normally used at nonprofits, an employee who dramatically improves a nonprofit's financial position may have earned more than his or her peers at comparable organizations.

The reason for multiple methods is that compensation is a complex matter. In the final analysis, determining reasonable amounts of compensation usually requires informed judgment. Every situation is different and there are considerations that do not normally show up in databases. For example, an employee may have been under-compensated in prior years and the employer desires to include catch-up pay in the current year's compensation.

III. Internal Revenue Code section 4958.

Code § 4958(a) applies to excess benefit transactions, such as unreasonable compensation at organizations exempt from tax under § 501(c)(3), (4) or (29). It imposes excise taxes on both the recipient and the persons who allowed the excessive payment to be made:

> **(1) On the disqualified person.**
>
> There is hereby imposed on each excess benefit transaction a tax equal to 25 percent of the excess benefit. The tax imposed by this paragraph shall be paid by any disqualified person…with respect to such transaction.
>
> **(2) On the management.**
>
> …there is hereby imposed on the participation of any organization manager in the excess benefit transaction, knowing that it is such a transaction, a tax equal to 10 percent of the excess benefit, unless such participation is not willful and is due to reasonable cause. The tax…shall be paid by any organization manager who participated in the excess benefit transaction.

Code **§** 4958(b) imposes an additional tax on the disqualified person:

> In any case in which an initial tax is imposed by subsection (a)(1) on an excess benefit transaction and the excess benefit involved in such transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the excess benefit involved. The tax imposed by this subsection shall be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction. [Subsection (f)(1) defines a disqualified person – see below.]

Regulation 53-4958-1(d)(3) states that:

> …participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager.

Code **§** 4958(f)(1) defines a disqualified person to include:

> (A) any person who was, at any time during the 5-year period ending on the date of such transaction in a position to exercise substantial influence over the affairs of the organization.
>
> (B) a member of the family of an individual described in subparagraph (A).

See Code **§** 4958(f)(1)(C) through (F) for others that may be considered to be disqualified persons.

IV. Avoiding the Excise Taxes.

Many charitable boards need guidance on pay due to the subjective nature of determining reasonable compensation, complex facts and the desire to avoid IRS scrutiny.

The last thing any volunteer board member wants is to be personally exposed to an excise tax. An independent consultant can give officers and board members comfort that pay levels are in line, help reduce turnover and help avoid the excise taxes.

The regulations under § 4958 provide <u>two</u> ways that an organization's managers can protect themselves from the 10% excise tax even if some compensation is determined to be unreasonable. One way involves reliance on professional advice (Reg. 53-4958-1(d)(4)(iii)) and the other way is the rebuttable presumption of reasonableness (Reg. 53-4958-6). Both relate to whether the manager was a "knowing" participant.

A. Professional Advice (Opinion Letter)

An organization's manager is not considered to be a "knowing" participant (and therefore not subject to the 10% excise tax) when appropriate professional advice was obtained and relied upon. Regulation 53-4958-1(d)(4)(iii) states (emphasis added):

> Reliance on professional advice. An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. For purposes of section 4958(a)(2) and this paragraph (d), a written opinion is reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. However, a written opinion is not reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction shall not, by itself, however, give rise to any inference that an organization manager participated in the transaction knowingly. For purposes of this paragraph, appropriate professionals on whose written opinion an organization manager may rely, are limited to -
>
> (A) Legal counsel, including in-house counsel;
>
> (B) Certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and
>
> (C) Independent valuation experts who -
>
> (1) Hold themselves out to the public as appraisers or compensation consultants;
>
> (2) Perform the relevant valuations on a regular basis;

(3) Are qualified to make valuations of the type of property or services involved; <u>and</u>

(4) Include in the written opinion a certification that the requirements of paragraphs (d)(4)(iii)(C)(1) through (3) of this section are met.

In preparing opinion letters, the compensation professional should consider all relevant facts and circumstances including, but not limited to:

Compensation levels paid by similar organizations, both taxable and tax-exempt, for comparable positions;

The availability of similar employees in the geographic area;

Current compensation surveys compiled by independent firms;

Any written offers from similar employers competing for the services of the disqualified person; and

Other relevant factors usually include the size of the organization, the geographic area it serves, and the qualifications and duties of the employee.

Under U.S. Treasury Department Circular 230, an opinion letter must state that the author believes that if the compensation amount is challenged by the IRS, it would "more likely than not" be upheld in court. Circular 230 requires that certain additional disclosures be included in the opinion letter. Under section 10.35(e)(3), the disclosure usually includes a statement saying that the letter contains a "limited scope opinion" as defined by Circular 230 (Title 31 Code of Federal Regulations, Subtitle A, Part 10, revised as of September 26, 2007). The letter also includes a statement that the opinions expressed in the letter are limited to the one or more federal tax issues addressed in the letter, and that additional issues may exist that could affect the federal tax treatment of the transaction or matter that is the subject of the opinions and the opinions do not consider or provide a conclusion with respect to any additional issues; and, with respect to any significant federal tax issues ***outside*** the limited scope of the opinion, the opinion was not written and cannot be used for the purpose of avoiding penalties.

Circular 230 states that the author of an opinion letter should be knowledgeable in all tax aspects of the opinion. An opinion letter should also include a statement of independence from the compensation professional.

Although an opinion letter is not a guarantee, having such an opinion letter on file could protect the officers and board members from personal exposure to the 10% tax and protect the organization from unfavorable publicity.

B. Rebuttable Presumption

Regulation 53-4958-1(d)(4)(iv) says:

> Satisfaction of rebuttable presumption of reasonableness. An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, if the appropriate authorized body has met the requirements of §53.4958-6(a) with respect to the transaction.

To create a rebuttable presumption, these requirements must be met:

> The compensation must be approved in advance by an independent board or board committee without the disqualified person participating except to answer questions,
>
> Appropriate comparability data that documents the arms' length nature of the transaction, such as compensation surveys, must be obtained and relied upon prior to making the compensation decisions, and
>
> The basis for approval must be documented in writing, such as through Board minutes, concurrently with making the decisions.

Regulation 53.4958-6 explains in detail how to create a rebuttable presumption that a transaction is not an excess benefit transaction (emphasis added):

(a) In general. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied -

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization within the meaning of §53.4958-4(a)(2)(ii)(B)) composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;

(2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, as described in paragraph (c)(2) of this section; and

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

(b) Rebutting the presumption. If the three requirements of paragraph (a) of this section are satisfied, then the Internal Revenue Service may rebut the presumption that arises under paragraph (a) of this section only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. With respect to any fixed payment (within the meaning of §53.4958-4(a)(3)(ii)), rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date the parties enter into the contract pursuant to which the payment is made (except in the event of substantial nonperformance). With respect to all other payments (including non-fixed payments subject to a cap, as described in paragraph (d)(2) of this section), rebuttal evidence may include facts and circumstances up to and including the date of payment. See §53.4958-4(b)(2)(i).

(c) Requirements for invoking rebuttable presumption.

(1) Approval by an authorized body.

(i) In general. An authorized body means -

(A) The governing body (i.e., the board of directors, board of trustees, or equivalent controlling body) of the organization;

(B) A committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or

(C) To the extent permitted under State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.

(ii) Individuals not included on authorized body. For purposes of determining whether the requirements of paragraph (a) of this section have been met with respect to a specific compensation arrangement or property transfer, an individual is not included on the authorized body when it is reviewing a transaction if that individual meets with other members only to answer questions, and otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement or property transfer.

(iii) Absence of conflict of interest. A member of the authorized body does not have a conflict of interest with respect to a compensation arrangement or property transfer only if the member-

(A) Is not a disqualified person participating in or economically benefitting from the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person, as described in section 4958(f)(4) or §53.4958-3(b)(1);

(B) Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(C) Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(D) Has no material financial interest affected by the compensation arrangement or property transfer; and

(E) Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member.

(2) Appropriate data as to comparability.

(i) In general. An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards set forth in §53.4958-4(b), the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value. In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred; and offers received as part of an open and competitive bidding process.

(ii) Special rule for compensation paid by small organizations. For organizations with annual gross receipts (including contributions) of less than $1 million reviewing compensation arrangements, the authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. No inference is intended with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.

(iii) Application of special rule for small organizations. For purposes of determining whether the special rule for small organizations described in paragraph (c)(2)(ii) of this section applies, an organization may calculate its annual gross receipts based on an average of its gross receipts during the three prior taxable years. If any applicable tax-exempt organization is controlled by or controls another entity (as defined in §53.4958-4(a)(2)(ii)(B)), the annual gross receipts of such organizations must be aggregated to determine applicability of the special rule stated in paragraph (c)(2)(ii) of this section.

(iv) Examples. The following examples illustrate the rules for appropriate data as to comparability for purposes of invoking the rebuttable presumption of reasonableness described in this section. In all examples, compensation refers to the aggregate value of all benefits provided in exchange for services. The examples are as follows:

Example (1). Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q's compensation for its president at $600x per annum, the executive committee of the Board of Trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of $100x to $700x; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee's decision with respect to Q's compensation was <u>not</u> based upon appropriate data as to comparability.

Example (2). The facts are the same as Example 1, except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of $200x to $300x. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q's many years of service as a tenured professor and high-ranking university official at Z in setting Q's compensation at $275x annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

Example (3). X is a tax-exempt hospital that is an applicable tax-exempt organization for purposes of section 4958. Before renewing the contracts of X's chief executive officer and chief financial officer, X's governing board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. The survey, as prepared and presented to X's board, constitutes appropriate data as to comparability.

Example (4). The facts are the same as Example 3, except that one year later, X is negotiating a new contract with its chief executive officer. The governing board of X obtains information indicating that the relevant market conditions have not changed materially, and possesses no other information indicating that the results of the prior year's survey are no longer valid. Therefore, X may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.

Example (5). W is a local repertory theater and an applicable tax-exempt organization for purposes of section 4958. W has had annual gross receipts ranging from $400,000 to $800,000 over its past three taxable years. In determining the next year's compensation for W's artistic director, the board of directors of W relies on data compiled from a telephone survey of three other unrelated performing arts organizations of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability.

(3) Documentation.

(i) For a decision to be <u>documented adequately</u>, the written or electronic records of the authorized body must note -

(A) The <u>terms</u> of the transaction that was approved and the <u>date</u> it was approved;

(B) The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;

(C) The comparability data obtained and relied upon by the authorized body and how the data was obtained; and

(D) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

(ii) If the authorized body determines that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination. For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time period thereafter.

(d) No presumption with respect to non-fixed payments until amounts are determined.

(1) In general. Except as provided in paragraph (d)(2) of this section, in the case of a payment that is not a fixed payment (within the meaning of §53.4958-4(a)(3)(ii)), the rebuttable presumption of this section arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption under paragraph (a) of this section subsequently are satisfied. See §53.4958-4(b)(2)(i).

(2) Special rule for certain non-fixed payments subject to a cap. If the authorized body approves an employment contract with a disqualified person that includes a non-fixed payment (such as a discretionary bonus) subject to a specified cap, the authorized body may establish a rebuttable presumption with respect to the non-fixed payment at the time the employment contract is entered into if -

(i) Prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation;

(ii) The maximum amount payable under the contract (taking into account both fixed and non-fixed payments) does not exceed the amount referred to in paragraph (d)(2)(i) of this section; <u>and</u>

(iii) The other requirements for the rebuttable presumption of reasonableness under paragraph (a) of this section are satisfied.

(e) No inference from absence of presumption. The fact that a transaction between an applicable tax-exempt organization and a disqualified person is not subject to the presumption described in this section neither creates any inference that the transaction is an excess benefit transaction, nor exempts or relieves any person from compliance with any Federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.

(f) Period of reliance on rebuttable presumption. Except as provided in paragraph (d) of this section with respect to non-fixed payments, the rebuttable presumption applies to all payments made or transactions completed in accordance with a contract, provided that the provisions of paragraph (a) of this section were met at the time the parties entered into the contract.

To summarize, if compensation is covered by a rebuttable presumption, the § 4958(a)(2) excise tax can then be imposed on the organization's managers only if the IRS develops sufficient contrary evidence to rebut the charity's evidence. In other words, the burden shifts to the IRS to prove that the compensation was unreasonable.

V. Expanded IRS Reporting Requirements

The Internal Revenue Service expanded Form 990 to require extensive disclosure of details about management compensation that were not previously reported to the IRS. The form also asks for an explanation of the process by which compensation amounts were determined. These disclosure requirements are intended to help the IRS quickly identify organizations which may have the most potential for abuse.

Each non-profit filing Form 990 must complete the Part VI, which asks specific questions about the organization's governance, management policies, and disclosure practices. Although no particular structure or policies are required, the IRS believes that the absence of appropriate structure or policies may lead to "excess benefit transactions," such as the payment of unreasonable compensation to top employees. Therefore, the questions ask about the independence of directors, documentation of meetings and actions, conflicts of interest, whistleblower policies, and compensation practices. The questions concerning compensation include the following:

> "Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?
> a. The organization's CEO, Executive Director, or top management official?
> b. Other officers or key employees of the organization?
> Describe the process in Schedule O (see instructions)."

According to IRS instructions, in order to answer yes to questions a. and b. above, the process for determining compensation should include each of the following elements:

- Review and approval by a governing body or compensation committee, provided that persons with a conflict of interest with respect to the compensation arrangement at issue were not involved. For purposes of this question, use the definition of “conflict of interest” set forth in Regulations section 53.4958-6(c)(1)(iii).

- Use of data as to comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations.

- Contemporaneous documentation and recordkeeping with respect to the deliberations and decisions regarding the compensation arrangement.

Schedule O of the expanded Form 990 asks for a narrative description of the compensation-setting process. This includes identifying the specific offices or positions for which the process was used to establish compensation. Also, the form asks you to state the year in which this process was last undertaken for each such person.

All organizations filing Form 990 are also required to complete the Part VII – Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors. Questions here ask for the names of these individuals and the number of hours each one worked. They also ask for compensation amounts paid by the organization (and by related organizations) to each current and former officer, director, trustee, key employee and highest compensated employee. Names and amounts of compensation paid to the five highest paid independent contractors must also be listed.

When entering this information, please remember that an officer of the organization must sign the completed Form 990 under the penalties of perjury.

Since copies of the completed Form 990 must be made available for public inspection, all compensation details disclosed on the form will be available to the organization's employees, donors, state regulators, and the media.

VI. Conclusion

We are now in an environment where emphasis on corporate governance is at an all-time high. And this includes charitable organizations. As part of that governance, each charity's advisors and board members should closely monitor compensation and benefits provided to employees and contractors.

Although the IRS does not require tax-exempt organizations to follow any prescribed format in setting pay levels**,** the charity's board must meet strict conditions to create a rebuttable presumption that compensation is reasonable and to avoid eyebrow-raising answers to questions on Form 990.

VII. Disclaimer and Circular 230 Disclosure

This memorandum is provided for general information only and should not be used as a substitute for professional advice. IRS regulations and disclosure requirements are subject to change. As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code. This memorandum does not cover regulations or disclosure requirements of federal or state agencies other than the Internal Revenue Service.

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Index

Curriculum Vitae of Stephen D. Kirkland

A native of Charleston, South Carolina, Stephen earned a Bachelor's degree in Accounting at Emory University in 1981. He earned a Master of Tax Accounting at the University of Alabama in 1982. He then spent ten years with PricewaterhouseCoopers before co-founding a regional firm. In 2006, he became a member of Atlantic Executive Consulting Group, LLC.

Specialty

Compensation consulting and opinion letters
Financial and tax planning for executives and business owners

Certifications

- Certified Public Accountant
- Certified Management Consultant
- Certified Forensic Consultant
- Certified in Financial Forensics

Active memberships

- Institute of Management Consultants
- WorldatWork (formerly American Compensation Association)
- American Institute of Certified Public Accountants, Forensic and Valuation Section
- South Carolina Association of Certified Public Accountants
- University of South Carolina Retirement and Benefits Management Seminar,

Moderator and member of Planning Committee (1988 to Present)

Activities

Stephen has provided expert testimony in U.S Tax Court cases involving the reasonableness of executive compensation.

He has written articles on compensation issues and has been quoted in *Barron's*, *Bloomberg News*, *Kiplinger's Personal Finance, Worth* and *The Wall Street Journal*. He speaks at conventions and continuing professional education seminars for CPAs, financial planners and attorneys. At the University of South Carolina's Moore School of Business, he has been a member of the adjunct faculty where he taught a graduate level course.

Stephen and his wife, Pam, are members of First Baptist Church of Columbia where he is a Deacon. He is a member of the National Eagle Scout Association and serves on the Board of Directors of charitable organizations.

Information about Atlantic Executive Consulting Group, LLC is available at AECG.biz.