



Electronic Dispatch

Employee Benefits Law Action Memo

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STEPS THAT TAX-EXEMPT ORGANIZATIONS SHOULD TAKE IN LIGHT OF THE IRS'S 2,000 EXECUTIVE COMPENSATION AUDITS AND COMPLIANCE REVIEWS

The Internal Revenue Service ("IRS") announced on March 3, 2005 that it is more than halfway through 2,000 audits and compliance reviews (collectively, "Audits") of the executive compensation practices of tax-exempt organizations, and that it intends to complete all 2,000 of these Audits in 2005. The IRS hopes that these Audits will serve as a warning to all tax-exempt organizations that they should have procedures in place to ensure that the compensation and benefit packages of their executives are reasonable, and that violations of these requirements could result in substantial tax penalties (in egregious cases, it could also result in the loss of an organization's tax-exempt status). Regulations issued by the IRS provide detailed guidance on the "reasonable compensation" requirements that apply to certain types of tax-exempt organizations, and on the steps that such organizations should take to comply with such requirements. Tax-exempt organizations that are subject to these requirements should make sure that:

- the appropriate persons at these organizations are aware of these requirements; and
- procedures are implemented to help ensure that these requirements are satisfied.

What Type of Tax-Exempt Organization Is Being Targeted In the Audits?

The IRS indicated that organizations exempt from tax under Section 501(c)(3) of the Internal Revenue Code ("Tax-Exempt Organizations") are being selected for the Audits. Examples of such organizations include colleges, universities, certain other educational organizations, hospitals, nursing homes, certain other health-related organizations, religious organizations, museums, charitable organizations, and community service organizations that satisfy the requirements for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code ("Code").

What Potential Violations Are Being Reviewed In the Audits?

The IRS has indicated that it is using the Audits to determine whether Tax-Exempt Organizations have engaged in excess benefit transactions. An excess benefit transaction is defined in Section 4958(c)(1)(A) of the Code as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing such benefits." An example would be a Tax-Exempt Organization that provides a compensation and benefits package to its president that exceeds the fair market value of services being provided by the president. These excess benefits requirements also apply to organizations that are exempt from tax under Section 501(c)(4) of the Code.

If an excess benefit transaction occurs, several kinds of taxes arise. A disqualified person who has received an excess benefit from a Tax-Exempt Organization (e.g., the president of the Tax-Exempt Organization described in the preceding paragraph) is liable for a 25 percent tax on the value of the excess benefit (an additional tax of 200 percent of the excess benefit could also apply if the excess benefit transaction is not corrected within a specified period of time). An "organization manager" (i.e., an officer, director, or trustee of a Tax-Exempt Organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of a Tax-Exempt Organization) will be liable for a tax equal to 10 percent of the excess benefit amount (subject to a limit of \$10,000 for all participating organization managers on each transaction) if he or she knowingly participates in an excess benefit transaction, unless such participation was not willful and was due to reasonable cause.



These excess benefit taxes generally will be imposed before the IRS will revoke the tax-exempt status of a Tax-Exempt Organization. However, the IRS has the right, with respect to egregious violations, to consider whether the revocation of the tax-exempt status of a Tax-Exempt Organization might be appropriate.

What Are Some of the More Important Steps That Tax-Exempt Organizations Should Take In Light of the Audits?

Among the more important steps that tax-exempt organizations should take to help protect themselves with respect to the issues raised in the Audits are the following (to the extent they have not already been done):

- officers, directors, and/or trustees of a Tax-Exempt Organization (as well as any other individual having powers or responsibilities similar to such persons) should be informed about the excess benefit transaction requirements in Section 4958 of the Code, and about the potential taxes that could apply if those requirements are not satisfied;
- Tax-Exempt Organizations should identify which persons are likely to be “disqualified persons;” and
- procedures should be established to ensure that any compensation and benefit packages that are provided to disqualified persons are reasonable and satisfy the excess benefit transaction requirements.

Who Are Disqualified Persons?

Section 4958(f)(1) defines a disqualified person, with respect to any transaction, as (1) “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,” (2) certain family members of such a person, and (3) certain 35-percent controlled entities. The IRS has issued detailed regulations regarding this definition that provide, among other things:

- (a) persons who clearly will be disqualified persons include (i) voting members of the governing body, (ii) presidents, chief executive officers, or chief operating officers, (iii) treasurers and chief financial officers, and (iv) persons with a material financial interest in a provider-sponsored organization;
- (b) certain employees who receive benefits that are less than the dollar limit for a “highly compensated” employee in Section 414(q) of the Code (that limit is \$95,000 in 2005, and is subject to cost-of-living adjustments) will not be disqualified persons (this exclusion does not apply, however, to the persons listed in (a) above and to certain other persons); and
- (c) a facts and circumstances analysis could result in certain other persons being classified as disqualified persons (the regulations list several facts and circumstances that tend to show that a person has substantial influence over the affairs of a Tax-Exempt Organization, and included in that list are (i) a person who has or shares authority to control or determine a substantial portion of the Tax-Exempt Organization’s capital expenditures, operating budget, or compensation for employees, and (ii) a person who manages a discrete segment or activity of the Tax-Exempt Organization that represents a substantial portion of the activities, assets, income, or expenses of the Tax-Exempt Organization, as compared to the Tax-Exempt Organization as a whole).

What Guidance Has the IRS Provided About the Kinds of Procedures That Would Be Helpful In Avoiding An Excess Benefit Transaction?

The IRS has issued regulations that provide that a compensation and benefit arrangement will be presumed to be reasonable and will be presumed to be at fair market value if:

- the compensation and benefit arrangement is approved in advance by an authorized body of the applicable Tax-Exempt Organization (or an entity it controls) composed entirely of individuals who do not have a conflict of interest;
- the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and
- the authorized body adequately documented the basis for its determination concurrently with making that determination.

These procedures for establishing a rebuttable presumption of reasonableness are intended to be a "safe harbor," and do not preclude the use of other procedures to establish the reasonableness of a compensation and benefit arrangement for a disqualified person. The IRS has made it clear, however, that it wants Tax-Exempt Organizations to carefully review the reasonableness of compensation and benefit arrangements for disqualified persons (e.g., by reviewing data that shows the compensation and benefit levels paid by similarly situated organizations for functionally comparable positions) before approving such arrangements.

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