



Setting Effective & Ethical Compensation Levels in Nonprofits

### Federal Tax Issues

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Maine Association of Nonprofits, Sept. 29, 2010

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## **AGENDA**

Scope: major federal tax issues unique to compensation paid by tax-exempt entities

- Inurement and Private Benefit
- Excess Benefit Transactions
- Rebuttable Presumption of Reasonableness
- Questions

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## Inurement Prohibition

- 501(c)(3) provides tax exemption for organizations...  
“...no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . .”
- Concept of “insider”.
- See also 501(c)(4), (6), (7), (9), (11), (13), (19) . . . .

## Private Benefit

- 501(c)(3) provides tax exemption for organizations...  
“. . . operated **exclusively** for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . .
- An organization fails to satisfy this requirement if “more than an **insubstantial part** of its activities is not in furtherance of an exempt purpose.”

## Excess Benefit Transactions

Section 4958:

- Added to the Internal Revenue Code in 1996.
- Provides “intermediate sanctions” for cases where inurement and private benefit that do not rise to a level that would justify revocation of exemption.
  - But the sanctions can be imposed in addition to revocation of exemption.

## Excess Benefit Transactions: Excise Taxes

Taxes on the *disqualified person* (defined later):

- initial tax of 25% of the *excess benefit* received from each *excess benefit transaction*, and
- additional tax of 200% of the *excess benefit* if the excess benefit is not *corrected* within the *taxable period*.

## Excess Benefit Transactions: Excise Taxes

Tax on each **organization manager** who knowingly participates in the excess benefit transaction:

- 10% of the excess benefit (unless participation was not willful and was due to reasonable cause).
- Maximum of \$20,000 per excess benefit transaction.

## Excess Benefit Transactions: Excise Taxes

Joint and Several Liability

- If more than one person is liable for excise tax, all are jointly and severally liable for the tax.

## Excess Benefit Transactions: Scope

An “applicable tax-exempt organization” is

- any 501(c)(3) organization *other than a private foundation*,
- any 501(c)(4) organization,
- (certain others).

Private foundations are subject to a different regime, the self-dealing rules, which are generally more stringent.

## Excess Benefit Transactions: Defined

“Excess benefit transaction” means 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 the consideration received** (including the performance of services) in return.

## Excess Benefit Transactions: Defined

**A compensation arrangement can be an excess benefit transaction.**

(509(a)(3) supporting organizations and donor advised funds are subject to special rules as to what constitutes an excess benefit transaction.)

## Excess Benefit Transactions: Defined

“Excess benefit” means:

- The excess in value of the economic benefit provided over the value of the consideration received in return.

## Excess Benefit Transactions: Disqualified Persons

“Disqualified persons” include (among others):

- any person who was ***in a position to exercise substantial influence over the affairs of the organization*** at any time during the 5-year period ending on the date of the transaction, and
- a member of such person’s ***family***.

## Excess Benefit Transactions: Disqualified Persons

The following are disqualified persons *per se*:

- **Directors and Trustees**, i.e., voting members of the governing body
- **Presidents, CEOs, and COOs**, including “any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization.”
- **Treasurers and CFOs**, including “any person who, regardless of title, has ultimate responsibility for managing the finances of the organization.”

## Excess Benefit Transactions: Disqualified Persons

Others may be disqualified persons based on the facts and circumstances.

The following factors “tend to show” the existence of substantial influence:

- the person founded the organization;
- the person is a substantial contributor;
- the person's compensation is primarily based on revenues from activities of the organization (or of a particular department or function) that he or she controls;

...continued...

## Excess Benefit Transactions: Disqualified Persons

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- the person has or shares authority to control a substantial portion of the organization's capital expenditures, operating budget or compensation;
- the person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization;
- the person owns a controlling interest in an entity that is a disqualified person; or
- the person is a non-stock corporation controlled directly or indirectly by one or more disqualified persons.



## Excess Benefit Transactions: Disqualified Persons

Some who would be disqualified persons based on the facts and circumstances are specifically excluded.

## Excess Benefit Transactions: Disqualified Persons

“Family” means:

- Spouse;
- Brothers or sisters (by whole or half blood);
- Spouses of brothers or sisters (by whole or half blood);
- Ancestors;
- Children;
- Grandchildren;
- Great grandchildren; and
- Spouses of children, grandchildren, and great grandchildren.

## Excess Benefit Transactions: Organization Managers

“Organization manager” includes any officer, director, or trustee (or any individual having similar powers or responsibilities).

- An “officer” is one who
  - is designated as such in the certificate of incorporation, bylaws, or other formation document; or
  - regularly exercises general authority to make administrative or policy decisions on behalf of the organization.

## Excess Benefit Transactions: Organization Managers

“Organization manager” also includes a member of a board committee who is not an officer, director, or trustee if the organization is attempting to invoke the rebuttable presumption of reasonableness based on the committee's actions.

## Excess Benefit Transactions: Organization Managers

“Participation” by an organization manager includes

- affirmative action by the manager (e.g., a “yea”) and
- silence or inaction where the manager is under a duty to speak or act.

## Excess Benefit Transactions: Economic Benefit

Compensation for purposes of determining reasonableness under section 4958 includes all economic benefits provided in exchange for the performance of services, including

- All forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation;
- All other compensatory benefits, **whether or not included in gross income for income tax purposes**, including payments to welfare benefit plans, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits (other than certain fringe benefits), including expense allowances or reimbursements (other than expense reimbursements pursuant to an accountable plan), and the economic benefit of a below-market loan.

## Excess Benefit Transactions: “Automatic”

An economic benefit will not be treated as consideration for the performance of services unless the organization clearly indicates its intent to so treat the benefit

- Without such clear intent, conveyance of the economic benefit constitutes an “automatic excess benefit transaction,” and **the full value is an excess benefit, even if the organization received fair value in return.**

## Rebuttable Presumption of Reasonableness

Payments under a compensation arrangement are **presumed to be reasonable** if the following conditions are satisfied--

- The arrangement is approved in advance by an **authorized body** composed entirely of individuals who do not have a **conflict of interest** with respect to the arrangement;
- 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.

## Rebuttable Presumption of Reasonableness

“Authorized body” includes (among others):

- The organization’s governing body (e.g., board of directors or trustees); and
- A committee of the governing body, to the extent that the committee is permitted by State law to act on behalf of the governing body.

**Recusal:** 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.

## Rebuttable Presumption of Reasonableness

A person has a **conflict of interest** with respect to a compensation arrangement unless he or she--

- Is not a disqualified person participating in or economically benefitting from the arrangement and is not a member of the family of any such disqualified person;
- Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefitting from the arrangement;

... continued ...

## Rebuttable Presumption of Reasonableness

... continued ...

- Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefitting from the arrangement;
- Has no material financial interest affected by the arrangement; and
- Does not approve a transaction providing economic benefits to any disqualified person participating in the arrangement, who in turn has approved or will approve a transaction providing economic benefits to the member.

## Rebuttable Presumption of Reasonableness

- 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 the compensation arrangement in its entirety is reasonable.

## Rebuttable Presumption of Reasonableness

For this purpose, 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 relevant geographic area;
- current compensation surveys compiled by independent firms; and
- actual written offers from similar institutions competing for the services of the disqualified person.

## Rebuttable Presumption of Reasonableness

For a decision to be “documented” adequately, the written or electronic records of the authorized body must note--

- The terms of the transaction that was approved and the date it was approved;
- The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;
- The comparability data obtained and relied upon by the authorized body and how the data was obtained; and
- 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.

## Rebuttable Presumption of Reasonableness

Deviation from comparables:

- 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.

## Rebuttable Presumption of Reasonableness

Documentation “concurrent” with compensation approval:

- 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.



## Rebuttable Presumption of Reasonableness

For non-fixed payments not subject to a reasonable cap, the rebuttable presumption 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 have been subsequently satisfied.

## Questions?

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