

Internal Controls and Exempt Organization Executive Compensation Arrangements

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As nonprofit organizations become more entrepreneurial in carrying out their missions, they are facing many of the same challenges as for-profit organizations in designing compensation and benefit packages that effectively recruit and retain executive talent. While compensation issues at larger nonprofits tend to receive more scrutiny from the public and the IRS,¹ the reality is that compensation policies are becoming more important for nonprofits of all sizes. The increased importance, size, and complexity of the compensation arrangements increase the risk of the organization's providing excess benefits.

Executives (and other individuals) that receive an excess benefit from a tax-exempt organization, and individuals that participate in providing the excess benefit, may be subject to special excise taxes, applied under Code provisions known as "intermediate sanctions."² More important, whenever an excess benefit is paid, the nonprofit risks losing its Sec. 501(c)(3) tax-exempt status because of inurement.³

Both long-standing and recent tax law guidance confirm that robust internal controls are critical for nonprofits and their managers to avoid intermediate sanctions and loss of tax-exempt status. The IRS defines "internal controls" as "the taxpayer's policies and procedures to identify, measure and safeguard business operations and avoid material misstatements of financial information."⁴

1 See, e.g., Carreyrou and Martinez, "Nonprofit Hospitals, Once for the Poor, Strike It Rich; with Tax Breaks, They Outperform For-Profit Rivals," *Wall Street Journal* A1 (April 4, 2008) (includes examples of recent pay packages and perks given to nonprofit hospital executives). See also Stokeld, "IRS Interest in EO Executive Compensation Strong, Official Says," 2008 TNT 226-4 (November 21, 2008) (reporting that the IRS has been studying compensation issues in selected parts of the nonprofit sector—such as hospitals, colleges, and universities—and would "continue to pay close attention to the issue").

2 Sec. 4958.

3 The law reviewed in this article pertains to organizations that are largely exempt from federal income tax under Sec. 501(c)(3), such as educational institutions, hospitals, religious organizations, and other "traditional" charities. These organizations are not only exempt from the federal income tax, they are also eligible, in general, to receive tax deductible contributions under Sec. 170(c)(2)(B). This article does not necessarily cover the rules governing other tax-exempt nonprofits, such as social clubs, business leagues, or other specialized organizations. Furthermore, it covers only the rules that apply to Sec. 501(c)(3) organizations that are *not* classified as private foundations under Sec. 509.

This article provides an overview of the law of inurement and intermediate sanctions. It then reviews recently issued final regulations addressing when the IRS will both impose intermediate sanctions and revoke an organization's tax-exempt status due to inurement. These new regulations highlight the importance of internal controls in maintaining tax-exempt status. Finally, based on the law and general principles of internal controls, the article suggests some policies and procedures that nonprofits should consider adopting.

Inurement

Sec. 501(c)(3) specifically provides that an organization will be exempt from the federal income tax only if "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual." Inurement normally results when compensation in excess of fair market value (FMV) is paid to, or other excessive or targeted benefits are received by, "insiders" at the organization. Insiders generally include organization founders, board members, and their families, as well as anyone else that is "the equivalent of an owner or manager."⁵

Strictly, any instance of inurement, regardless of amount, is cause for the government to revoke the organization's tax exemption.⁶ For a Sec. 501(c)(3) organization, loss of tax exemption because of inurement can be disastrous—and in many cases fatal. The organization will be subject to the federal income tax on its net income.⁷ More important, donors will no longer be able to deduct contributions

to the organization and will lose faith in the organization's ability to manage its resources—thereby stifling, or even killing, fundraising efforts. Finally, the public at large will no longer trust the organization when, because of inurement, it loses the "halo" effect that comes from government-approved Sec. 501(c)(3) status. Accordingly, it is imperative that Sec. 501(c)(3) organizations have controls and procedures in place to help prevent any inurement from occurring.

Church of Scientology Case

Church of Scientology of California,⁸ a case in which the court upheld the IRS's revocation of a church's tax-exempt status, provides an instructive example of how lack of controls can lead to inurement. The court found that the organization's net earnings had inured to the benefit of church founder L. Ron Hubbard and his family in the form of excess royalties and other payments. In addition, the court found that inurement resulted from the church's lack of control over substantial church funds. More than \$3.5 million of church funds was transferred to an offshore corporation and its Swiss bank account. Hubbard and his wife controlled the account and Hubbard himself kept the checkbooks. Furthermore, approximately \$2 million was transferred from the Swiss bank account to a locked file cabinet. The file cabinet was kept aboard the church's cruise ship, which served as the church's headquarters and the Hubbards' residence; Hubbard's wife kept the only set of keys to the file cabinet.

EXECUTIVE SUMMARY

- Executives (and other individuals) that receive an excess benefit from a tax-exempt organization, and individuals that participate in providing the excess benefit, may be subject to special excise taxes known as "intermediate sanctions." The IRS can also revoke an organization's exempt status if the organization engages in excess-benefit transactions.
- An excess benefit results when the organization pays an employee more than reasonable compensation. Reasonable compensation is the fair market value of an employee's services, i.e., the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax exempt) under like circumstances.
- A properly designed and functioning internal control system can greatly mitigate the risk of an organization's becoming subject to intermediate sanctions or revocation of the organization's exempt status due to excess-benefit transactions.

4 Internal Revenue Manual (IRM) Section 4.75.11.4.3 ¶1. IRS examiners are required to evaluate an organization's overall system of internal controls as part of their examination and must then adjust the scope of the examination accordingly (IRM Section 4.75.11.4.3.1 ¶1). Lack of internal controls will not necessarily jeopardize the organization's tax exemption, but it may lead the IRS to adjust the scope of its examination (IRM Section 4.75.11.4.3). See the discussion below, however, on recently issued regulations that make it clear that lack of controls over executive compensation can lead to loss of tax exemption when excess benefits are paid. Furthermore, recent remarks by Steven T. Miller, IRS Tax-Exempt and Government Entities Commissioner, indicate that the IRS is inquiring about, in particular, financial controls at the

start of nonprofit examinations. Stokeld, "IRS to Ask About Internal Controls During EO Exams," 2008 TNT 226-4 (November 21, 2008).

5 *United Cancer Council, Inc.*, 165 F.3d 1173, 1176 (7th Cir. 1999). Whether an individual is an insider is determined by a functional test that "looks to the reality of control rather than to the insider's place in the formal table of organization." *Id.*

6 See *Church of Scientology of Cal.*, 823 F.2d 1310, 1316 (9th Cir. 1987).

7 There may also be state and local ramifications as well, including loss of income, sales and use, and property tax exemptions. The consequences will vary by state and circumstance.

8 *Church of Scientology of Cal.*, 823 F.2d 1310 (9th Cir. 1987).

The church argued that the money in the file cabinet was never used to benefit Hubbard or his family. Even if true, however, the money in the accounts and the file cabinet still created inurement because Hubbard had “unfettered control over millions of dollars in money that originated with the Church.”⁹ Furthermore, the organization failed to produce receipts or other documentation showing how the Swiss bank account funds were raised or disbursed.

The overall lesson is that inurement can result not just from the payment of excess salaries to insiders but also from “[u]naccounted for diversions of a charitable organization’s resources by one who has complete and unfettered control.”¹⁰ If the church had had internal control over the cash in the file cabinets and in the Swiss bank account, perhaps it could have reduced the risk of inurement (and loss of exemption).

Intermediate Sanctions

The IRS has been reluctant to revoke tax exemption for inurement except in egregious situations. This reluctance reflects the reality that revocation is a harsh, all-or-nothing penalty that punishes the organization’s innocent donors, charitable beneficiaries, and employees rather than the insiders who benefited from the inurement and the managers who approved or allowed it. Recognizing this, Congress enacted Sec. 4958, which allows the IRS to impose “intermediate sanctions”—an excise tax regime that is not as draconian as revoking tax exemption—to discourage undesirable transactions, including those that could result in inurement. When inurement occurs, the IRS is free to impose intermediate sanctions and to revoke the organization’s tax-exempt status. In many cases, however, intermediate sanctions

will apply in lieu of revocation of tax-exempt status.

Definitions

Intermediate sanctions apply to excess benefits provided to disqualified persons. In general, a disqualified person is someone in a position to “exercise substantial influence” over the nonprofit.¹¹ Officers and board members would normally be considered disqualified persons.¹² An excess benefit is an economic benefit provided by a nonprofit to a disqualified person that is in excess of the value of the services that person provides.¹³ Thus, intermediate sanctions apply when an influential person at the nonprofit receives compensation in excess of industry or other market norms.

Sec. 4958(a) imposes an initial tax on disqualified persons equal to 25% of the excess benefit they have received. If the disqualified person does not “correct” the problem, generally by repaying the excess benefit to the nonprofit, Sec. 4958(b) imposes an additional tax on the disqualified person equal to 200% of the excess benefit. This two-tier tax is designed to force the recipient of the excess benefit to restore such benefit to the organization. No tax is imposed on the organization itself.

Sec. 4958(a) also imposes a tax on organization managers who knowingly participate in providing the disqualified person with an excess benefit.¹⁴ The tax is 10% of the excess benefit. Effective for tax years beginning after August 17, 2006, the maximum tax on managers for any one excess-benefit transaction is \$20,000.¹⁵

Example 1: R Hospital is a Sec. 501(c)(3) organization operating a hospital that has grown significantly in recent years. *P*, the organization’s longtime

president, has been instrumental in the hospital’s growth and success. Up until this year, *P* was paid a \$200,000 annual salary. Recently, *P* demanded that her salary be raised to \$700,000 or she would resign. The board of directors quickly entered into a new multiyear contract with *P* at the new level of compensation.

P is a disqualified person¹⁶ and the board members who approved the new contract would be considered managers.¹⁷ Assume the FMV of *P*’s services to the organization is \$520,000. The amount by which *P*’s salary exceeds FMV, \$180,000 (\$700,000 – \$520,000), is an excess benefit. If the IRS applies intermediate sanctions, *P* will be subject to an initial tax of \$45,000 (25% × \$180,000), and the board will collectively be responsible for a tax of \$18,000 (10% × \$180,000). *P* would need to return the \$180,000 excess benefit to the organization to avoid an additional 200% tax (\$360,000).

The regulations under Sec. 4958¹⁸ are too detailed to review in their entirety here. However, three areas are worthy of mention because they provide helpful rules for organizations in establishing policies and procedures to avoid intermediate sanctions:

- The definition of “reasonable compensation” for purposes of the intermediate sanction rules;
- The rebuttable presumption of reasonableness; and
- The initial contract exception.

Reasonable Compensation

Recall that, per Sec. 4958(c)(1)(A), an excess benefit results when the organization pays more than the FMV of the services it receives from the disqualified person. Accordingly, intermediate sanctions will

9 Id. at 1318.

10 Id. at 1316.

11 Sec. 4958(f)(1).

12 Regs. Sec. 53.4958-3 defines the term “disqualified person” in detail. These detailed rules are beyond the scope of this article, which focuses on executive compensation—and an executive is normally considered a disqualified person. Keep in mind, however, that there may be a threshold question as to whether an individual is a disqualified person and thus potentially subject to intermediate sanctions.

13 Sec. 4958(c)(1).

14 If more than one manager approved the excess benefit, only one tax results, and the managers are jointly and severally liable for that tax (Sec. 4958(d)(1)).

15 Sec. 4958(d)(2). For tax years beginning on or before August 17, 2006, the maximum tax on managers for any one excess-benefit transaction was \$10,000.

16 Regs. Sec. 53.4958-3(c)(2).

17 Regs. Sec. 53.4958-1(d)(2).

18 Regs. Secs. 53.4958-1 through 8.

not apply if the organization compensates a disqualified person at a reasonable level—that is, one set at FMV. Reasonable compensation is defined as “the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances.” This standard is the same one used to judge whether compensation is reasonable for purposes of claiming a deduction under Sec. 162.¹⁹

In determining whether a disqualified person’s compensation is reasonable, the regulations look to the aggregate benefits transferred to the disqualified person rather than the form in which such benefits were paid.²⁰ If the aggregate benefit package is reasonable, there will be no excess benefits.²¹

Example 2: *B* College is a private, accredited institution of higher education that is exempt from tax under Sec. 501(c)(3). *B* recently extended the contract of *K*, its current president, a disqualified person, for several more years. Under the new contract, *K* is entitled to a \$300,000 annual cash salary, housing (valued at \$30,000 per year), a new car every year (valued at \$50,000 per year), and free airfare while on vacation (valued at \$10,000 per year). All these items are documented as being part of *K*’s compensation package, and all taxable amounts are properly reported on *K*’s Form W-2.

While some of these items may appear odd (perhaps creating a public relations issue), what matters for tax purposes is the reasonableness of the overall compensation package. If the package’s total value (\$390,000 per year) is the same amount that would be paid to presidents

of similar organizations, there is no excess benefit.

Before a particular benefit to be included in the total compensation package is tested for reasonableness, the organization must clearly indicate that it intends to treat the benefit as compensation for services rendered by the disqualified person.²² To show this intention, the organization must provide “written substantiation that is contemporaneous with the transfer of the economic benefit at issue.”²³

To demonstrate compliance with this contemporaneous substantiation requirement, any taxable amounts must be reported on the disqualified person’s Form W-2 (or Form 1099, if appropriate) and (if required) on Form 990, Return of Organization Exempt from Tax.²⁴ In addition, the organization should maintain documentation to show that “the appropriate decision-making body or an officer authorized to approve compensation approved a transfer as compensation for services in accordance with established procedures.”²⁵ Such documentation can take the form of, for example, a written employment contract entered into before the transfer of the benefit.²⁶

A benefit for which the contemporaneous substantiation requirement is not met is not considered as paid for services rendered²⁷ and thus will likely be classified as an excess benefit. This is true even if the benefit, when added to the other benefits provided to the disqualified person, would not exceed FMV. Organizations must therefore ensure that they contemporaneously document all benefits provided to disqualified persons.

Example 3: *K*, the president of *B* College (from Example 2), has access to discretionary funds for use in connection with college business. *K* uses

\$10,000 of these funds to pay for maid service at his vacation home. Although this disbursement should be construed as compensation, it was paid outside the organization’s payroll function and was therefore not reported on *K*’s Form W-2. Furthermore, *K* did not report the benefit on his Form 1040, and *K*’s employment contract does not include a provision for maid service. In this case, the \$10,000 is not considered as being paid for *K*’s services. As such, it is not added to *K*’s other compensation (\$390,000 per year) and tested for reasonableness. Instead, the \$10,000 will likely be considered an excess benefit and thus subject to intermediate sanctions.

Example 4: The facts are the same as in Example 3, except that the \$10,000 in maid service is included in *K*’s Form W-2 and is specified as compensation in his written employment contract prior to the provision of the benefit. In this case, the \$10,000 is added to *K*’s total compensation and tested for reasonableness. If *K*’s total compensation package of \$400,000 (\$390,000 plus \$10,000 for maid service) is considered reasonable, there will be no excess benefit, and thus intermediate sanctions will not apply.

Rebuttable Presumption of Reasonableness

Regs. Sec. 53.4958-6 provides disqualified persons and organization managers with some protection from intermediate sanctions if certain procedures are followed. If the organization complies with the procedures, compensation provided to a disqualified person is presumed to be reasonable and the burden shifts to the IRS to prove that it is not reasonable.²⁸

19 Regs. Sec. 53.4958-4(b)(1)(ii)(A).

20 Id. Certain benefits are disregarded when determining the reasonableness of the aggregate compensation package. These include many nontaxable fringe benefits under Sec. 132, expense reimbursements under an accountable plan, and certain other miscellaneous benefits. See Regs. Sec. 53.4958-4(a)(4).

21 See Regs. Sec. 53.4958-4(b)(ii)(B).

22 Regs. Sec. 53.4958-4(c)(1).

23 Id. There are exceptions from the contemporaneous substantiation requirement for certain nontaxable benefits (such as health insurance). See Regs. Sec. 53.4958-4(c)(2).

24 Regs. Sec. 53.4958-4(c)(3)(i)(A)(1). Alternatively, this requirement can be satisfied if the disqualified person reports any taxable benefits on Form 1040 before the start of an IRS inquiry (Regs. Sec. 53.4958-4(c)(3)(i)(A)(2)).

25 Regs. Sec. 53.4958-4(c)(3)(ii).

26 Regs. Sec. 53.4958-4(c)(3)(ii)(A). This requirement can also be satisfied by maintaining documentation satisfying the rebuttable presumption of reasonableness (discussed below) (Regs. Sec. 53.4958-4(c)(3)(ii)(B)).

27 Regs. Sec. 53.4958-4(c)(1).

28 Regs. Sec. 53.4958-4(b).

A strong system of internal controls can help prevent loss of tax-exempt status in excess-benefit situations.

An organization should implement procedures and controls to ensure that it can rely on the rebuttable presumption whenever it negotiates compensation arrangements with disqualified persons.

To fall under the rebuttable presumption rules, the compensation package must first be approved in advance by an authorized body of the organization (e.g., the board of directors or a committee thereof) composed solely of individuals with no conflicts of interest with respect to the compensation.²⁹

Second, the authorized body must obtain and rely on relevant comparability data prior to approving the compensation package.³⁰ Such data must be sufficient to allow the body to determine whether the proposed compensation is reasonable. Relevant data include

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 organization]; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person.³¹

Small organizations (those with annual gross receipts of less than \$1 million) are eligible for a special safe harbor. Such organizations need rely only on data on compensation paid by three comparable organizations.³²

Finally, the authorized body must adequately and concurrently document the basis for its approval.³³ To meet this

requirement, the written or electronic records of the authorized body must include:

- The compensation arrangement's terms;
- The date it was approved;
- Which members of the authorized body were present during the debate over the compensation and who voted on it;
- The comparability data relied on and how they were obtained; and
- Any action taken with respect to the compensation package by authorized body members who did not vote because of a conflict of interest.³⁴

The authorized body must record the basis for its decision, and the required records must be prepared before the later of the body's next meeting or 60 days after the final approval of the compensation package. Within a reasonable time period, the required records must be reviewed and approved by the authorized body as being accurate and reasonable.³⁵

Initial Contract Exception

Regs. Sec. 53.4958-4(a)(3) provides that intermediate sanctions do not apply to certain benefits provided under an initial contract.³⁶ An initial contract is one the organization enters into with someone who was not a disqualified person immediately before that contract was entered into. Accordingly, the exception applies when the organization is hiring a new executive who had no significant prior influence over the organization. The initial contract exception applies only to fixed payments made under the contract. Fixed payments include future payments determined under a fixed formula or future payments (such as bonuses) that are contingent on certain events or

objective measures (such as the generation of a certain level of revenues). The initial contract exception does not cover discretionary payments.³⁷ Nor does it cover renewals of the initial contract, which occur after the executive has become a disqualified person.³⁸

Example 5: *H* University is a private, accredited institution of higher education that is exempt from tax under Sec. 501(c)(3). *H* hires a new president, *Z*. *Z* previously had no involvement with *H* and thus is not a disqualified person prior to taking office at *H*. Once *Z* takes office, she is considered a disqualified person with respect to *H*.³⁹ The initial contract provides that *Z* will receive an annual fixed salary of \$300,000 for the next five years. In addition, *Z* is entitled to an annual \$20,000 bonus for the next five years if *H*'s donations during the year increase by at least 20% over the previous year.

Both the \$300,000 fixed salary and the \$20,000 bonus—based on a fixed formula with objective criteria—are covered by the initial contract exception. Therefore, it is unnecessary to analyze whether *Z*'s pay package constitutes an excess-benefit transaction. Once the contract's five-year term is up, any payments made under subsequent compensation contracts will be subject to scrutiny for excess benefits.

Example 6: The facts are the same as in Example 5, except that the \$20,000 bonus is not triggered by fundraising targets. Instead, per the contract, *H*'s board of trustees decides each year, based on its evaluation of *Z*'s overall performance during the year, whether the \$20,000 bonus will be paid.

Z's \$300,000 fixed salary is still subject to the initial contract exception, but any

29 Regs. Sec. 53.4958-6(a)(1). The definition of an authorized body appears in Regs. Sec. 53.4958-6(c)(1)(i).

30 Regs. Sec. 53.4958-6(a)(2).

31 Regs. Sec. 53.4958-6(c)(2)(i).

32 Regs. Sec. 53.4958-6(c)(2)(ii).

33 Regs. Sec. 53.4958-6(a)(3).

34 Regs. Sec. 53.4958-6(c)(3)(i).

35 Regs. Sec. 53.4958-6(c)(3)(ii).

36 The initial contract exception will not apply to payments made under the initial contract during any year in which the person hired "fails to perform substantially the person's obligations under the initial contract during that year" (Regs. Sec. 53.4958-4(a)(3)(iv)).

37 Regs. Sec. 53.4958-4(a)(3).

38 See also Regs. Sec. 53.4958-4(a)(3)(v) regarding initial contracts that are subsequently modified or subject to cancellation.

39 Regs. Sec. 53.4958-3(c)(2).

bonuses paid—because they are discretionary—will not be subject to the initial contract exception. Hence, each bonus that is paid will be subject to scrutiny for excess benefits. In determining whether the bonus is an excess benefit, the overall reasonableness of all payments made to Z (including the base salary and the bonus) will be considered.⁴⁰

Practice tip: When an organization is recruiting a new executive, the organization should structure the compensation arrangement to qualify for the initial contract exception.

Reporting Executive Compensation

Nonprofit executive compensation (and thus excess benefit and inurement issues) will soon become more high profile, thanks to a redesigned Form 990.⁴¹ The new form is effective beginning in 2009 (for the 2008 tax year). It requires an explanation of how the organization determines its executive pay and certain disclosures about the specific benefits provided to executives earning over \$150,000 per year.⁴² Presumably, such detail will enable the IRS to more readily identify excess benefits and inurement.⁴³ However, because Forms 990 are publicly disclosed, it will be easier for organizations to gather at least some compensation data on similar organizations—which could aid them in ensuring that they are paying reasonable compensation.⁴⁴

The Interaction of Intermediate Sanctions and Revocation of Exempt Status Due to Inurement

On March 28, 2008, Treasury issued final regulations detailing when a tax-exempt organization that engages in

excess-benefit transactions will lose its tax-exempt status.⁴⁵ These regulations illustrate situations in which the IRS will both impose intermediate sanctions and revoke the organization's tax-exempt status.⁴⁶ The regulations make it clear that a strong system of internal controls can help prevent loss of tax-exempt status in excess-benefit situations. When determining whether an organization's tax-exempt status should be revoked for inurement in excess-benefit situations, the IRS should consider all the relevant facts and circumstances, including:

organization's ongoing activities that further its exempt purpose.

- Whether the organization has given excess benefits on multiple occasions to one or more individuals.
- Whether the organization has put in place safeguards reasonably designed to prevent excess benefits from being paid.
- Whether the excess benefits that did occur have been "corrected" (recovered from the disqualified person) or the organization has made good-faith efforts to obtain reimbursement from those who received the excess benefits.⁴⁷



The IRS will weigh the last two factors more heavily in favor of allowing the organization to keep its exemption in situations in which the organization discovers the excess benefits and takes action to correct them before the IRS discovers them. In no event, however, will correction of the excess benefit, after IRS discovery, be sufficient on its own to support continued recognition of exemption.⁴⁸

What these regulations make clear, above all else, is the importance of having controls in place to prevent and detect excess-benefit transactions. Having such safeguards will be a favorable factor in keeping exempt status should the IRS impose intermedi-

- The size and scope, both before and after the excess-benefit transactions, of the organization's ongoing activities that further its exempt purpose.
- The size and scope of the excess-benefit transactions (in total) in relation to the

ate sanctions. In addition, the safeguards themselves will allow the organization to detect and correct any excess-benefit problems prior to the IRS getting involved.

The regulations illustrate the application of the rules in six examples.⁴⁹ Two of these

40 See Regs. Sec. 53.4958-4(a)(3)(vii), Example (2).

41 The form and instructions are available at www.irs.gov.

42 See 2008 Form 990, Part VII, and Schedule J. Organizations that have a tax year other than the calendar year should be aware of a new rule regarding the period to be used for disclosing executive compensation. According to temporary regulations effective September 9, 2008 (and applying to tax years beginning on or after January 1, 2008), an organization must disclose executive compensation on Form 990 for the calendar year ending with or within the organization's annual accounting period (unless the IRS requires disclosure for a different period in the instructions to Form 990) (Temp. Regs. Sec. 1.6033-2T(a)(2)(ii)(h)). Prior law allowed the organization to disclose compensation on a tax- or calendar-year basis (Regs. Sec. 1.6033-2(a)(2)(ii)(h)).

43 Self-reported excess benefits are shown on the 2008 Form 990, Schedule L.

44 The public may request Forms 990 from the IRS or from the organization.

The organization is required to follow certain procedures to ensure that its Forms 990 are available for public inspection. See the instructions to Form 990 for the detailed rules. Regardless of the formalities required, the public can access most Forms 990 via the GuideStar online service at www.guidestar.org. See also "Suggested Internal Controls" below for information on compensation data that can be purchased from GuideStar.

45 T.D. 9390 amending Regs. Sec. 1.501(c)(3)-1(f). The regulations are effective for excess-benefit transactions occurring after March 28, 2008 (Regs. Sec. 1.501(c)(3)-1(f)(3)).

46 Regs. Sec. 1.501(c)(3)-1(f)(2)(ii).

47 Id.

48 Regs. Sec. 1.501(c)(3)-1(f)(2)(iii).

49 Regs. Sec. 1.501(c)(3)-1(f)(2)(iv).

are particularly instructive because they specifically demonstrate the importance of using controls to prevent excess-benefit transactions. In one example,⁵⁰ an organization sold a building to a company controlled by the organization's chief executive officer at a price that was below FMV. The building's sale constituted an excess-benefit transaction with a disqualified person. Accordingly, intermediate sanctions applied. The organization identified the excess-benefit transaction before the IRS began an examination of the organization. The organization promptly terminated the CEO's employment and hired legal counsel to recover (i.e., correct) the excess benefit from the former CEO. Furthermore, the organization promptly implemented new contract review procedures and a conflict of interest policy. Such measures were designed to prevent similar excess-benefit transactions from occurring in the future.

The example concludes that although intermediate sanctions applied, the organization's tax-exempt status would not be revoked. Because the organization identified the excess-benefit transaction before an IRS examination, sought to recover the excess benefit from the former CEO, and "implemented safeguards that are reasonably calculated to prevent future violations" in the form of contract review procedures and a conflict of interest policy, the organization was allowed to keep its tax exemption.

In another example,⁵¹ an organization's board of directors implemented written procedures for setting executive compensation. Such procedures were based on compliance with the rebuttable presumption rules, discussed above, of Regs. Sec. 53.4958-6. The policy complied with those rules, except the board failed to use appropriate comparability data in setting executive salaries. Specifically, the board used data from organizations that were larger in size and served a larger geographic region with a more diverse population. As

such, the organization could not rely on the rebuttable presumption of reasonableness, and the IRS subsequently determined that certain payments made to the organization's executives were excess-benefit transactions. Accordingly, intermediate sanctions applied.

The organization, concerned about its contractual obligations with its executives, did not seek to recover the excess-benefit transactions and did not remove any of its executives from office. However, it did add new members to its compensation committee who had expertise in compensation matters and amended its compensation policy to require more appropriate comparability data to be used in setting executive compensation.

The example concludes that although intermediate sanctions applied, the organization's tax-exempt status would not be revoked because of inurement. The organization had implemented written procedures reasonably calculated to prevent the occurrence of excess benefits. Even though the board failed to use the appropriate data in making its determinations, the fact that written procedures were in place to prevent excess benefits was a significant factor in favor of allowing the organization to retain its tax-exempt status. Furthermore, by correcting its procedures to capture better data in setting compensation going forward, the organization was well positioned to avoid future excess-benefit transactions.

Suggested Internal Controls

Based on the law summarized above and general principles of internal controls, tax-exempt organizations should consider implementing the following controls to avoid intermediate sanctions and loss of tax exemption for inurement. Some of these suggestions come from the tax law itself, while others are derived from general practices concerning internal controls and procedures.⁵² Accordingly, while

the controls discussed here should help tax-exempt organizations avoid inurement and excess benefits, they should not be considered authoritative guidance.

The internal control system in place should conform to the general principles of internal control and at a minimum result, as discussed in detail above, in a rebuttable presumption of reasonableness under Regs. Sec. 53.4958-6. Organizations should consider implementing controls in the following areas:

- Compensation committee;
- Documented procedures;
- Minutes of meetings;
- Support for compensation;
- Monitored activities;
- Contract changes; and
- General controls over the accounting function.

Compensation Committee

A compensation committee of the board of directors should be in charge of setting compensation for all disqualified individuals. This committee should consist of members with no conflicts of interest in the decision being made. Any committee members that have a conflict of interest (for example, a member would benefit from a committee decision) should recuse themselves from the vote.⁵³

Documented Procedures

A well-documented procedures manual should detail the process to be followed regarding compensation of disqualified individuals.

Minutes of Meetings

All proceedings of the compensation committee should be consistent with the procedures in the manual, and timely, detailed minutes of the committee's actions should be maintained. These minutes should, at a minimum:

- Identify all disqualified individuals;
- Identify the comparables to be used;

50 Regs. Sec. 1.501(c)(3)-1(f)(2)(iv), Example (4).

51 Regs. Sec. 1.501(c)(3)-1(f)(2)(iv), Example (6).

52 For information about internal controls for nonprofit organizations, see, for example, "The AICPA Audit Committee Toolkit: Not-for-Profit Organizations," www.aicpa.org/audcommctr/toolkitsnpo/homepage.htm, or Cuomo, "Internal Controls and Financial Accountability for Not-for-Profit Boards," www.oag.state.ny.us/bureaus/charities/pdfs/internal_controls.pdf (a guide for

New York nonprofits but containing helpful information for all nonprofits).

53 Aside from the formal controls, note that it is best practice to have the compensation committee develop an overall compensation strategy based on the trends in the nonprofit's particular industry. A hospital, for example, may need to follow a different compensation strategy from, say, a private school or social service organization. Adopting an overall compensation strategy can help the committee make more informed, consistent decisions.

- Document the basis for approval; and
- List the committee members' votes.

Support for Compensation

The compensation committee should use current comparables to aid in the compensation decision. These comparable data are available from consulting firms and other data sources. For example, GuideStar, a tax-exempt organization that gathers and analyzes data on nonprofits, provides fee-based services that allow nonprofits to obtain comparability data (see "Compensation Research" at <https://commerce.guidestar.org/guidestar/default.aspx>). Since the IRS has determined that nonprofits with annual receipts of less than \$1 million need only three comparables, larger organizations should obviously consider the need for more than three.

Monitored Activities

The organization should use its internal audit department, or a unit with similar independent oversight function, to monitor the establishment and operation of the compensation function.

Contract Changes

All contract changes for disqualified persons should be approved and documented by the committee because the benefits of the initial contract exception may be lost and/or the new arrangement may be excessive.

General Controls over the Accounting Function

While the procedures noted above deal specifically with the compensation function, it is critical that the organization have a robust system of internal controls in other functional areas as well. Disqualified persons will often use vehicles outside the compensation arena (inadvertently or deliberately) for their personal benefit. As noted earlier, if such benefits are not documented as compensation, they may be considered excess benefits. Expense reimbursements, for example, are often

Strictly, any instance of inurement, regardless of amount, is cause for the government to revoke the organization's tax exemption.

a common cause of excess benefits.⁵⁴ Accordingly, strong controls over expense reimbursements are particularly important in preventing excess benefits. Specifically, the organization should require periodic reviews, by either the compensation committee or the internal audit department, of expense reimbursements made to all disqualified persons.

Likewise, as shown in the *Church of Scientology* case, the organization should have strong controls over its liquid assets. Executives are often given access to some discretionary funds to carry out their duties. Misuse of these funds could result in excess benefits.⁵⁵ Accordingly, the compensation committee or the internal audit department should periodically review activity involving the use of cash and cash equivalents by disqualified persons. Such reviews can mitigate the risk of the "unfettered control" problem identified in *Church of Scientology*.

Reviews of general and expense reimbursement or cash equivalents could be problematic for smaller organizations that have few individuals in the management function. These smaller organizations usually have an external audit requirement and should consider using the external auditors to review these areas. Alternatively, the board of directors, if independent of organization management, could serve in this capacity.

Finally, the purchasing/procurement function is another area of risk for excess benefits. The concern here is that benefits will be inadvertently provided to disqualified persons when they (or an individual or entity related to them) provide goods or services to the

organization and are paid an amount in excess of FMV. To reduce the risk in this area, all purchases of goods or services from disqualified persons should be approved by the compensation committee. Such transactions can be identified by establishing a computer match of vendor invoices to the name, address, or phone number of disqualified persons.

Conclusion

A solid system of internal controls is important for any organization. As illustrated here, however, internal controls can be particularly important for nonprofits hoping to avoid intermediate sanctions and maintain their tax-exempt status. Quality internal controls over executive compensation can help prevent excess-benefit transactions from occurring. Furthermore, should an excess-benefit transaction occur, the presence or absence of internal controls over executive compensation may well determine whether an organization avoids the embarrassment and harsh financial consequences of losing its tax-exempt status.

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EditorNotes

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⁵⁴ Most frauds in the nonprofit sector involve improper disbursements. See Greenlee et al., "An Investigation of Fraud in Nonprofit Organizations: Occurrences

and Deterrents," *36 Nonprofit and Voluntary Sector Q.* 676 (2007).
⁵⁵ See Example 3 above for an illustration of this problem.