

Compensation & Benefits – Complying With IRS Rules

One of the key objectives of the Internal Revenue Service (IRS)'s strategic plan for 2005-2009 is to deter abuse within tax-exempt and governmental entities, and misuse of these entities by third parties for tax avoidance or other unintended purposes. In line with its strategy, IRS has already authorized a 30 percent increase in enforcement personnel for exempt organizations by September 2005, and has implemented or is in the process of implementing a number of corrective activities.

On Aug. 10, 2004, the IRS announced the *Tax Exempt Compensation Enforcement Project* to identify and halt compensation abuses among tax-exempt entities. As part of this project, the IRS will contact more than 2,000 charities and foundations to seek more information about compensation practices and procedures. Since one of the objectives of the project is to gather information on organization's practices to set compensation, IRS does not necessarily contact organizations it thinks are acting improperly. However, it is possible that some of these contacts may lead to audits.

What is the IRS looking for in their compensation investigations? The IRS first checks to see whether the executive compensation is reasonable. The IRS has indicated that reasonable compensation is measured with reference to the amount that would ordinarily be paid for comparable services by comparable enterprises under comparable circumstances.

If the IRS decides to audit a tax-exempt organization, it will request detailed information and supporting documentation regarding the organization's compensation practices and procedures, the independence of the governing body that approved the compensation, duties and responsibilities of the charity's executives, and compliance with compensation disclosure information requested on Form 990 or Form 990-PF.

In analyzing whether executive compensation is reasonable, every form of compensation is taken into account including: salary, bonus, deferred and

non-cash compensation, retirement funds, medical and liability insurance, loans and fringe benefits.

Fringe benefits include providing employees with electronic and telecommunication equipment, such as vehicles, cell phones, computers and Internet service allowances. These items are considered "listed property." Strict substantiation requirements are in place for these items due to the nature of the properties lending themselves to personal use.

Business use of a "listed property" is excludable from the wages of the employee as a working condition fringe benefit, while the personal use is included in the wages of the employee. However, if organizations do not meet the substantiation requirements, all use is included in the wages of the employee. Substantiation requirements dictate employees to keep records of business and personal uses of any "listed property" in order to determine whether the value of any of the use should be included in the employee's wages.

For nonprofit organizations (other than private foundations), the IRS generally imposes an initial excise tax equal to 25% of the excess portion of the benefit on any "disqualified person" who participated in the compensation arrangement and an initial excise tax equal to 10% of the excess portion of the compensation on any "organization manager" who participated in the compensation arrangement if such participation is willful and not due to reasonable cause. The term "disqualified person" generally refers to any person who is capable of exercising substantial influence over the affairs of the organization. If "excessive" compensation is not corrected by the organization by the earlier of the receipt of notice of tax deficiency from the IRS or the actual assessment of the excise tax, an additional excise tax equal to 200% of the excess portion of the compensation would be imposed on the relevant disqualified person. These penalties are in addition to the disqualified person repaying all excess compensation to the organization.

What can Organizations do to avoid penalties?

Nonprofit organizations and their governing bodies should ensure that they have well documented guidelines for developing and periodically reviewing compensation targets for their executives.

Organizations should also adopt policies regarding “fringe benefits”, fully document all expense reports, and require employees to reimburse any personal expenses. If the expenses are not reimbursed, they should be included as compensation on Form W2 or Form 1099-misc.

Questions?

For information regarding these topics or general questions, please call Wegner LLP, CPAs and Consultants at (608) 274-4020.