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# irs provides audit results for executive pay by 501(c)(3)s

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*MSK Client Alert*

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The IRS has just issued a report detailing results of its audits of a sampling of tax-exempt organizations with respect to executive compensation issues, including the excise tax on "excess benefit transactions" under IRC Section 4958. The report is chockfull of interesting nuggets for tax-exempt entities, their executives and advisors including an eye-popping \$21 million in excise taxes assessed against only 40 executives.

## **Background**

In 1996, Congress enacted IRC Section 4958, which imposes excise taxes on "disqualified persons" who engage in "excess benefit transactions." An "excess benefit transaction" is a transaction in which an economic benefit is provided by a tax-exempt entity for the benefit of a "disqualified person," if the value of the benefit provided to the individual exceeds the value of the consideration given, including the performance of services. A "disqualified person" includes any person who during the prior five-year period was "in a position to exercise substantial influence over the affairs of the organization." This means that the excise tax can be imposed on an executive of a Section 501(c)(3) organization if the IRS determines that the executive's compensation is excessive relative to the value of the services the executive provided.

If there is an excess benefit transaction, the disqualified person is subject to a first-level excise tax of 25 percent of the excess benefit. This first-level excise tax cannot be reduced once the excess benefit transaction is determined to have occurred. In addition, there is a second-level 200 percent excise tax payable if the transaction is not corrected before the IRS issues a notice of deficiency or makes an assessment with respect to the first-level excise tax. There is also a ten percent excise tax that may be assessed against an organization manager who participated in the transaction (usually by approving it) if the manager knew that the transaction would be an excess benefit transaction.

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The IRS regulations provide that a compensation arrangement will not generally result in an excess benefit transaction if: (1) the arrangement is approved in advance by the board of directors or similar body composed entirely of individuals that do not have a conflict of interest; (2) the board obtains and relies on data as to compensation paid by comparable organizations; and (3) the board adequately documents the basis for its determination with respect to the compensation arrangement. Frequently, an organization will employ a consultant to prepare a study of compensation paid by comparable organizations to comply with this rule.

In addition, the Internal Revenue Code includes other excise tax provisions specifically applicable to private foundations, including an excise tax on "self-dealing" transactions between a private foundation and its officers and directors, which were also reviewed in the IRS report.

### **The Compliance Initiative**

The IRS decided it wanted to find out to what extent affected taxpayers were incurring liability for these excise taxes so they launched a "Compliance Initiative" that included sending compliance check letters to over 1,200 tax-exempt organizations and conducting examinations of 782 organizations.

Some tax exempt organizations were chosen at random for review. Others were chosen either because they had reported loans on their annual returns to officers, directors or key employees in excess of \$100,000, and yet others were chosen because they either answered affirmatively or failed to answer one or more questions on the annual report that dealt with excess benefit transactions and other transactions with disqualified persons.

Although the IRS concluded that the organizations that were examined "generally were compliant with Section 4958," they still found a basis for assessing \$21 million in excise taxes under Section 4958 and the private foundation excise tax provisions of the Code applicable to amounts received by directors, officers and other key employees. The assessments were based on:

- excessive salary and incentive compensation;
- payments for vacation homes, personal legal fees and personal automobile use;
- payments for personal meals and gifts; and
- payments to an officer's for-profit business in excess of the value of the service provided.

Approximately one half of the organizations examined attempted to satisfy the requirements of Section 4958 by commissioning studies of the compensation paid to executives of comparable organizations. Nearly all of the organizations that obtained these studies set compensation within the range of the obtained comparability data.

With respect to the private foundations examined, five percent paid excessive compensation to officers and directors, approximately half commissioned a survey to establish compensation and nearly all who obtained a study set compensation within the survey range.



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The IRS also found that many organizations had problems completing the Form 990 or 990-PF, which is the annual report form they are required to file. However, after receiving a compliance check letter, approximately half of these organizations provided additional information that did not require changes to the returns or schedules, approximately one-third filed amended returns and most of the balance were selected for examination.

Significant reporting errors and omissions were found when it came to reporting compensation paid to officers and other employees. Most organizations corrected the reporting errors after receiving the compliance check letter. Those that did not were referred for examination.

Loans to officers and other employees were a substantial basis for IRS examination. Over one third of the organizations reporting loans over \$100,000 to officers, directors and other key employees were referred for examination. This issue was considered significant enough to warrant additional compliance checks and examinations with respect to this issue.

### **What does it all mean?**

There are a number of significant conclusions that exempt organizations, their executives and advisors can draw from this survey:

- Many organizations and their advisors are not sufficiently familiar with the excise tax requirements applicable to executive compensation of key employees of tax exempt entities, especially the "excess benefit transactions" excise tax under IRC Section 4958.
- The IRS is taking these requirements very seriously and can be expected to continue to examine tax-exempt organizations with these issues under serious consideration.
- Only a relatively small number of tax-exempt organizations have problems under these provisions, but when problems do arise the tax assessments can be very high.
- Organizations that have not already undertaken compensation surveys to determine if the compensation they are paying is reasonable should seriously consider undertaking such a survey in the very near future.
- Careful attention must be paid to the provisions of the IRS Form 990 and 990-PF that deal with executive compensation issues. Failure to properly complete these provisions can make an organization a target for audit.

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