



# Nonprofit Advisor

For the Nonprofit Executive and Board of Directors Member

Winter 2010

## Nonprofit Governance and the IRS

The IRS is interested in how tax-exempt organizations govern themselves. Why? Accountability and tax compliance. The theory is that a well-governed organization is more likely to comply with tax laws, safeguard its assets, and carry out its charitable mission than an organization with lax controls.

### Background

In 2007, the IRS published *Good Governance Practices for 501(c)(3) Organizations*, voluntary guidelines designed to help nonprofits increase accountability, improve transparency, achieve regulatory compliance, and maintain their tax-exempt status. Then, in the lead-up to and launch of the redesigned Form 990 (*Return of Organization Exempt from Income Tax*), the IRS released a flood of resource materials including FAQs, videos, filing tips, and articles on governance and other topics. And recently, the IRS made public the governance training materials that have been created for agents and other IRS personnel who work in the tax-exempt sector. All are available on the IRS website.

### What Is the IRS Looking For?

The training materials provide valuable insight into what might be on an IRS auditor's checklist. Here are the highlights.

**Mission:** A tax-exempt organization's mission should clearly explain what the charity is all about and serve as a constant guide for its activities and actions. The mission should be adopted by the board and reviewed on a regular basis.

**Organizational Documents:** Regardless of how a nonprofit is organized (corporation, trust, unincorporated association, or other), it is required to have organizational documents that provide the framework for governance and management policies.

**Governing Body:** An organization's board should represent the organization's needs and the broad public interest. It should include independent members. Attention should be paid to the size of the board to ensure its effectiveness.

**Governance and Management Policies:** Nonprofits should have written policies regarding executive compensation, conflicts of interest, investments, fundraising, documentation of governance decisions (specifically of board and committee meetings and actions), document retention and destruction, and ethics and whistleblower activities.

**Financial Statements and Form 990:** Directors (or a board-authorized committee) are responsible for handling the organization's financial and other resources and for meeting state and federal audit requirements (if any). Financial resources should be used to further charitable purposes. Although not a requirement, some organizations provide

the board with copies of Form 990 for review and/or approval.

### Transparency and Accountability:

Tax-exempt organizations must make their applications for tax-exempt status (Form 1023) available to the public, as well as Form 990 and Form 990-T.

### Another Side

It's worth noting that the IRS's foray into promoting nonprofit governance has raised some issues. In fact, in a 2008 report, the Advisory Committee on Tax Exempt and Government Entities recommended that the IRS proceed with caution, noting a number of concerns regarding the appropriate role of the IRS with respect to governance matters.

The committee cautioned that the IRS could drive behavior simply by asking about specific governance practices, causing organizations to adopt practices that are not suited to them. The report did, however, acknowledge the IRS's legitimate interest in governance issues as they relate to compliance with the laws under its jurisdiction. ■

### In This Issue

■ Nonprofit Governance and the IRS	1
■ Nonprofits: Beware of IRC Section 4958	2
■ New Identity Theft Rule	3
■ Updates	4

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# Nonprofits: Beware of IRC Section 4958

## *Excess Benefits May Be Subject to Punitive Taxes*

In response to public outrage over seemingly excessive executive compensation, the IRS has announced that it is increasing scrutiny of pay practices at tax-exempt organizations. In addition, revised IRS Form 990, *Return of Organization Exempt from Income Tax*, now requires disclosure of whether the organization's executive compensation is based on a review of comparable market data. If it isn't, the executives involved — as well as the organization's directors — may be subject to significant excise taxes.

### **Who's Affected?**

Internal Revenue Code §4958 (Section 4958) imposes a tax on "excess benefits," such as compensation exceeding the fair market value of the services rendered, provided by an exempt organization to "Disqualified Persons." These are defined as individuals meeting one of the following criteria during the five-year period preceding the transaction providing the benefits:

- (1) Persons in a position to exercise substantial influence over the organization, such as board members, president, chief executive officer, and chief financial officer;
- (2) Family members of persons in a position to exercise substantial influence over the organization; or,
- (3) Entities in which persons listed in (1) or (2) above own more than 35% of the controlling rights.

### **Not To Be Taken Lightly**

Section 4958 taxes, commonly known as "Intermediate Sanctions," are imposed on both the individual receiving the excess benefit and the managers of the organization responsible for approving it. Besides being required to return the excess amount (along with interest) to the organization, the compensated individual is subject to an excise tax of 25% of the excess amount. In addition, the organization's officers and directors can be held personally liable for an excise tax of 10% of the excess amount, assessed jointly and severally among the

managers, with a maximum penalty of \$20,000 per transaction.

If the improper transaction is not corrected within the taxable year in which the transaction occurred, the excise tax can increase to 200% of the excess benefit amount. For egregious violations, the IRS retains the right to revoke the organization's tax-exempt status.

### **What's Reasonable?**

The IRS has defined reasonable compensation as the amount ordinarily paid for like services by like enterprises under like circumstances. The concept of reasonable compensation was further clarified under Treasury Regulation 53.4958-4(b)(ii) to include measurement, not just by comparison with similar nonprofits, but also by comparison with the for-profit sector.

An organization's management can ensure that compensation is reasonable by adhering to the requirements of the IRS's "rebuttable presumption of reasonableness" or "safe harbor" provision. In order to qualify for this "Rebuttable Presumption," the compensation arrangement must meet these three requirements:

- (1) Be approved in advance by a group of independent or disinterested board members (often the compensation committee),
- (2) Rely upon relevant data on comparable positions in other organizations, and,
- (3) Have adequate and contemporaneous documentation of the decision.

The requirement to rely upon relevant data is most effectively met by having a specialist perform an independent compensation study for the board members. (Legal counsel generally recommends an independent study.) The IRS has recognized that a study conducted within two years will be considered sufficiently current.

Documentation of the approved compensation arrangement often takes the form of minutes from the board or compensation committee meeting, whereby the disinterested board members state that an independent market-based compensation study was obtained and relied upon in making the decision. If the Rebuttable Presumption is met, the board members have protection against excise tax penalties.

The Rebuttable Presumption can then be overturned only by contradictory evidence presented by the IRS. An organization's board members can create an additional level of protection by obtaining an opinion from an independent firm that the compensation arrangement is reasonable. In addition to reducing the risk of the IRS-imposed excise tax, the opinion letter will mitigate the fiduciary risks associated with managing the exempt organization.

### **Be Safe, Not Sorry**

Nonprofit organizations and their directors need to be aware of the Section 4958 rules when establishing executive compensation arrangements. And they must comply with the safe harbor provision by meeting the requirements of the Rebuttable Presumption — or their executives and directors will face the consequences.

If you have questions about Section 4958 requirements or would like assistance with a market-based compensation study, please give Reznick Group's advisors a call. We would welcome the opportunity to put our expertise in this area to work for your nonprofit. ■

# New Identity Theft Rule

Over the past several years, Congress has taken legislative action to address the growing problem of identity theft. As a result, penalties are much stiffer for those convicted under federal identity theft laws, and financial institutions and “creditors” — including many nonprofit organizations — will be required to take an active role in combating identity theft.

## The Red Flags Rule

Under a federal regulation known as the “Red Flags Rule,” financial institutions, businesses, and other organizations meeting certain criteria must create and implement a formalized, written Identity Theft Prevention Program (ITPP) designed to detect the warning signs of identity theft. Beyond detection, the Rule also requires that steps be taken for the prevention and mitigation of identity theft.

**“Under this definition, nonprofit health-care organizations, colleges and universities, clubs, and many trade associations are most likely subject to the new rule.”**

## Two Key Definitions

The Rule affects a diverse array of businesses and organizations. To gauge the potential impact on your organization, your first step should be to determine whether your organization is a “creditor.” The regulation broadly defines creditor as an organization that regularly allows customers or clients to defer payment for the goods or services it provides or bills its customers later.

Under this definition, nonprofit health-care organizations, colleges and universities, clubs, and many trade associations are most likely subject to the new rule. Simply accepting credit cards for payment does *not* mean an organization is a creditor. However, if an organization regularly sends

out invoices, the Rule may very well apply.

If your organization is a creditor, then the Red Flags Rule applies to any “covered accounts” you may have. In very basic terms, an account is covered if (1) it allows a consumer or member to make multiple transactions or payments or (2) there is a reasonably foreseeable risk of identity theft to the customer or the creditor.

## The Program

Think of the Red Flags Rule as an early warning system. In formulating your ITPP, you’ll need to identify all possible signals (red flags) that someone who is trying to set up a new account or access an existing one may not be the person he or she claims to be.

Some general examples of red flags include address discrepancies, multiple address changes, an alert or notice from a credit reporting agency, forged or altered documents or IDs, and inconsistent personal information. The list of red flags germane to your organization will depend on the type of accounts you have and the various ways clients or members access their accounts. For example, if online access is permitted, then data security and other “cyber” breaches must be included on your list of red flags.

Once the red flags have been identified, the next step is to outline the methods that will be used to detect identity theft and the steps that will be taken to prevent and mitigate the harm done. The program may incorporate and build on your current security measures.

## Administrative Issues

The regulation requires that your ITPP be approved by the board of directors, a committee appointed by the board, or a senior executive and that day-to-day administration is handled by a senior employee (or higher level person). Your ITPP also should outline staff training procedures and be updated regularly.

When it comes to identity theft, third-party service providers are also a concern. It is your organization’s responsibility to ensure that providers have developed an ITPP to comply with the Rule. ■

## Use of Consumer Reports

If your organization uses consumer reports to run background checks on prospective employees or volunteers, the Red Flags Rule requires you to develop policies and procedures to apply when your organization receives notice of an address discrepancy. They should be designed to enable your organization to form a “reasonable belief” that the consumer report relates to the consumer about whom you have requested the report.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

## Updates

### 2010 Retirement Plan Limits

With few exceptions, retirement plan limitations for the 2010 year are unchanged from 2009. The Internal Revenue Code requires that the dollar limits on contributions and benefits related to qualified retirement plans be adjusted for cost-of-living increases every year. There was some concern that limits might *drop* for 2010 because the cost-of-living index for the quarter ending September 30, 2009, was lower than the index from the same quarter in 2008.

However, plan limitations are adjusted according to the procedure for adjusting Social Security benefits, precluding a reduction. As a result, the maximum contribution amount for 401(k), 403(b), and governmental 457 plans remains at \$16,500; the maximum catch-up contribution allowed for participants age 50 or older remains unchanged at \$5,500; and the limitation on the annual

benefit under a defined benefit plan will again be \$195,000.

### IRS Ruling

In a recent private letter ruling, the IRS said that a public charity may: (1) treat a general support grant to another charity as a non-lobbying expenditure so long as the grant is not earmarked for lobbying, (2) make a grant to a public charity restricted for use in a specific program that includes a lobbying component without that grant automatically being considered earmarked for lobbying because of the restriction, and (3) treat a project grant as not earmarked for lobbying if the grant amount, combined with other grants the charity made for that project during the year, do not exceed the non-lobbying portion of the funded project's budget (provided there is no reason to doubt the budget information).

However, if a project grant exceeds the non-lobbying portion of the project budget, the excess amount must be treated as a lobbying expenditure.

Although the ruling was issued to a specific organization, it provides helpful insight into how the IRS might rule in similar situations. ■

### How May We Help You?

**Reznick Group offers a broad range of audit, tax information, return preparation, and executive board advisory services to non-profit organizations. If we can be of service to you, please call.**

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