

Report on Exempt Organizations Executive Compensation Compliance Project--Parts I and II

In 2004, the Internal Revenue Service, through the Exempt Organizations Office of the Tax Exempt and Government Entities Division (EO), implemented the Executive Compensation Compliance Initiative (the Project). The Project encompassed Forms 990 and related returns for tax years beginning in 2002, and was divided into three parts. This report discusses Part I, involving compliance check letters sent to 1,223 organizations, and Part II, a separate project involving examinations of 782 organizations. Approximately 10% of the examinations remain open. Part III, which was initiated based on information gathered in Part II, will be discussed subsequently, as will our continuing work in the executive compensation compliance area.

SUMMARY OF FINDINGS

- Significant reporting issues exist – Over 30% of compliance check recipients amended their Forms 990. Fifteen percent (15%) of the compliance check recipients were selected for examination.
- Examinations completed to date do not evidence widespread concerns other than reporting. However, as this was not a statistical sample, no definitive statement can yet be made concerning the compliance level in this area. Continued work in the area of executive compensation is warranted.
- Where problems were found, significant dollars are being assessed (25 examinations have resulted in proposed excise tax assessments under Chapter 42, aggregating in excess of \$21 million, against 40 disqualified persons or organization managers.)
- Although high compensation amounts were found in many cases, generally they were substantiated based on appropriate comparability data.
- Additional education and guidance, as well as training for agents, are needed in the areas of reporting requirements, and the “rebuttable presumption” procedure that may be relied upon by public charities to establish appropriate compensation.
- Changes in the Form 990 series are necessary to reduce errors in reporting and provide sufficient information to enable the IRS to identify compensation issues
- Part I and Part II utilized new compliance contact techniques, which have since been refined in later projects such as Credit Counseling and Down Payment Assistance.
- Using those refined techniques and concentrating on particular industries, demographics and governance practices in future efforts should allow us to better assess and understand compliance levels and enable us to identify and concentrate our efforts on noncompliant taxpayers.

BACKGROUND

In 1996, Congress enacted IRC section 4958, the intermediate sanction on excess benefit transactions. An excess benefit transaction occurs when a disqualified person¹ receives improper personal gain from the exempt organization. Rather than revoking the charity's tax-exempt status, section 4958 allows the IRS to impose an excise tax against the disqualified person and possibly the organization manager.

In 2002, final section 4958 regulations were promulgated. Shortly thereafter, EO created the Intermediate Sanctions Committee to coordinate all aspects of interpretation and enforcement of section 4958 and the final regulations issued thereunder, including helping identify and develop section 4958 issues.

In 2004, EO formally implemented the Executive Compensation Compliance Initiative, designed to review compensation practices of exempt organizations to identify tax administration concerns and potential areas of abuse in the exempt sector. The Project, which was managed by the Executive Compensation Compliance Initiative Team, included education and outreach components complemented by an examination program focusing on executive compensation paid by a broad range of public charities, as well as private foundations.

Project Objectives:

- Use the Exempt Organizations Compliance Unit (EOCU) and the Data Analysis Unit (DAU), the new offices created as part of the 2004 budget initiative, to impact a broader cross-section of the EO community through correspondence and, where appropriate, traditional examination techniques.
- Increase awareness of compensation as a compliance issue within the charitable sector and establish an IRS enforcement presence in this area.
- Observe the practices and procedures exempt organizations use to determine compensation of their officers, directors, trustees, key employees, and related persons.
- Assess and enhance tax law reporting and compliance with respect to compensation practices of exempt organizations.

¹ A disqualified person is any person who was in a position to exercise substantial influence over the affairs of the tax exempt organization. See IRC §4958(f)(1).

METHODOLOGY

EO contacted 1,826 exempt organizations—1,428 public charities and 398 private foundations—regarding their executives' compensation. Part I of the Project involved compliance check letters sent to 1,223 organizations, and Part II included 782 examinations, 179 of which resulted from responses to the Part I compliance checks.

Part I

The Exempt Organizations Compliance Unit sent compliance check letters to a sample of organizations whose Forms 990 and 990-PF fit within discrete categories of missing information indicating they warranted follow-up.

The letters were sent to 1,023 public charities and 200 private foundations, representing a broad cross-section of the EO community.² The organizations included small, medium and large organizations, with approximately 70% self-classified by NTEE³ codes as health, education, philanthropy, grant making and human services organizations. The Project did not address churches or other organizations that are not required to file Form 990. The recipient organizations fell into five categories:

Category A – Category A involved 50 public charities with assets of \$1 million or more and revenues of \$5 million or more that had reported significant total compensation, but failed to provide complete detailed information regarding the compensation.

Category B – Compliance check letters were sent to 100 public charities of all sizes reporting receivables/loans from officers, directors, trustees, and key employees exceeding \$100,000 or more. The letters requested the organization provide clarification of the loans or a required Form 990 schedule for line 50.

Category C – This category involved 378 public charities that either answered “yes” or failed to respond to the question of whether they had participated in an excess benefit transaction (question 89b).

Category D – Category D involved 497 public charities that either answered “yes” or failed to respond to the question about transactions with disqualified persons (question 2, Form 990, in Schedule A, Part III, Statements About Activities.)

Category E – Category E was the only compliance check letter sent to private foundations. These letters focused on 188 organizations that did not report any officers' compensation on line 13 of Form 990-PF. The private foundations were asked either to check a block indicating no compensation was paid, or to file an amended return providing the required schedule reporting officers' compensation. An additional 12 private foundations were contacted regarding loans to officers.

² Within each category, actual selections were made on the basis of available information and likelihood of issues on the return. At the time of selection, we recognized this as a first step on how to improve EO's selection process for compensation cases. Given the varied results, selection criteria for the groups will be modified in future efforts.

³ National Taxonomy of Exempt Entities, a classification system developed by the Urban Institute and the Foundation Center

Part II

The purpose of Part II of the Project, the Examinations Phase, was to determine whether the compensation of disqualified persons was reasonable in accordance with IRC Chapter 42 and other Code requirements. During the process, agents also considered the private foundation rules against making loans to disqualified persons, the rules prohibiting purchase of charity assets at below market prices, and the rules against sales of disqualified persons' property to charities at inflated prices.

The examination phase involved 782 organizations, made up of the organizations from the following four categories, plus an additional 179 which resulted from unsatisfactory responses to the compliance checks.

Category 1 – The first category of examinations involved 100 small public charities with assets of less than \$1 million and revenues of less than \$5 million; these organizations reported significant amounts of compensation in Part V for one or more of their officers.

Category 2 – The second category of examinations involved 208 larger public charities. These charities had assets of \$1 million or more and revenues of \$5 million or more; they too reported significant amounts of compensation in Part V for one or more officers.

Category 3 – The third category of examination involved 97 public charities chosen through a sample of Form 990s with Part V completed.

Category 4 – The last category of examinations involved 198 private foundations reporting significant officers' compensation on line 13.

FINDINGS

Overall

The Project shows mixed results regarding reporting and compliance by the contacted organizations. The compliance checks uncovered significant reporting errors and omissions in specific areas, particularly excess benefit transactions and transactions with disqualified persons, as well as potential compliance issues related to loans made to officers.

On the other hand, the examinations closed thus far have indicated that those selected for examination generally were compliant with section 4958 and private foundation self-dealing rules. Where breaches of the rules were uncovered, however, the examinations led to proposed excise taxes in excess of \$21 million under section 4958 applicable to public charities and the Chapter 42 provisions applicable to private foundations. Over \$4 million of the proposed excise taxes involved individuals associated with public charities and over \$16 million related to individuals associated with private foundations.

Although the results and demographics of the cases set forth below use specific percentages, the findings are not based on a statistical sampling and cannot be applied to the general population. They merely reflect the organizations selected and are not representative of the entire regulated community. As discussed, more work in this area is indicated.

Part I: Compliance Check Results

Forms 990 and 990-PF Reporting Issues

The compliance checks revealed that many organizations were initially confused when completing the forms or did not understand the instructions. However, after receipt of the compliance check letter, forty- nine percent (49%) of the organizations provided additional clarifying information that did not require changes to their returns or schedules.

Thirty-one percent (31%) filed amended returns or schedules as a result of the compliance check contact. Fifteen percent (15%) of the compliance check recipients were selected for examination based on their responses. The remaining five percent (5%) represents organizations previously selected for examination and organizations contacted in error.

Compensation Issues

Significant reporting errors and omissions were found when it came to compensation paid to officers or other employees. For example, out of 50 public charities reporting compensation over \$250,000, none initially filed schedules detailing the compensation paid to officers or employees. All 50 responded to the compliance check letters; 41 filed acceptable amended returns. Nine were referred for examination.⁴ Similarly, ten percent (10%) of private foundations were referred for examination for failure to correctly report compensation paid to officers and other employees.

Loans to Officers and Employees

Of 100 public charities reporting loans over \$100,000 to officers, directors, trustees, and key employees, 92 involved issues determined to warrant follow-up, and, ultimately, 37 were referred for examination. In addition, seven private foundations provided loans or pledged collateral to or for the benefit of a disqualified person. These issues raised considerable concern and EO initiated Part III of the Project, which includes 200 compliance checks and 50 additional single issue examinations focusing on organizations with loans to executives.

Part II: Examination Results

In General

During this part of the Project, EO conducted 782 examinations, 179 of which arose out of the compliance checks. The status of these exams is as follows:

- 77 examinations remain open
- 705 examinations have been completed
 - 156 surveyed⁵
 - 434 closed without change to status or tax owed
 - 115 closed with a written advisory suggesting modifications of behavior into the future and will be subject to future review by the

⁴ EO also found substantial reporting errors and omissions in public charity responses to questions about excess benefit transactions and transactions with disqualified persons. See “Examination Results – Public Charities.”

⁵ Prior to contact with the taxpayer, the revenue agent and/or manager determined that the case did not merit examination.

Review of Operations (ROO) office

Twenty-five (25) of the organization examinations resulted in proposed or assessed excise taxes aggregating in excess of \$21 million against 40 disqualified persons or organization managers. Issues giving rise to these assessments included:

- excessive salary and incentive compensation;
- payments for vacation homes, personal legal fees, or personal automobiles that were not reported as compensation;
- payments for personal meals and gifts to others on behalf of disqualified persons that were not reported as compensation; and
- payments to an officer's for profit corporation in excess of the value of services provided by the corporation.

Self Reporting of Disqualified Persons

Eleven percent (11%) of the disqualified persons involved in private foundation self-dealing reported the transactions; none did so in the public charity excess benefit transactions. Thirteen percent (13%) of the private foundation self dealing transactions and 11% of the public charity excess benefit transactions were corrected before contact by EO examinations.

Forms 4720 Issues

The excess benefit transaction issues identified in the Project included excessive compensation, loan transactions, and personal use of the public charity's assets for the benefit of a disqualified person. Fifteen percent (15%) of the public charities examined provided loans and/or pledged assets for the benefit of a disqualified person, with 53% of those loans made with terms more favorable than commercial loans and 31% that were not repaid in accord with the stated terms.

Compensation/Employment Tax Reporting

Of the public charity examination cases:

- 85% properly reported compensation on Form 990,
- 87% properly reported compensation on Form 941, and
- 85% properly reported compensation on Form W-2.

Of the private foundation examination cases:

- 94% properly reported compensation on Form 990 PF,
- 86% properly reported compensation on Forms 941, and
- 81% properly reported compensation on Forms W-2.

Despite the relatively high reporting compliance figures for the examined cases, a number of the organizations improperly reported compensation on at least one form.

Public Charities

Excess Benefit Transactions

Public charities experienced difficulties accurately responding to certain excess benefit transaction and disqualified person questions on Form 990. We contacted 378 organizations regarding question 89b on the Form 990. Seventy-eight organizations reported that they had engaged in an excess benefit transaction; most of these were due to incorrect responses to the question. The other 300 organizations failed to report if they had engaged in an excess benefit transaction. The Review of Operations (ROO) will look at subsequent filings of some or all of these organizations to see if issues continue.

Section 4958 Rebuttable Presumption Procedure

Section 4958 regulations provide a three-pronged rebuttable presumption process (independent governing body, reliance on comparable data, and adequate documentation) that public charities may use when establishing what appropriate compensation is for a disqualified person. Treas. Reg. 53.4958-6. The examinations resulted in the following observations:

- 51% of organizations attempted to satisfy all three-prongs to establish the rebuttable presumption;
- 54% of organizations commissioned comparability studies, with 97% of the studies looking both to similar type and sized organizations;
- 97% of organizations commissioning comparability studies set compensation within the range of the obtained comparability data; and
- 95% of disqualified persons recused themselves from discussion and approval of their compensation.

Private Foundations

Compliance

Twenty-seven (27) of the 200 private foundations selected for compliance checks were converted to examinations. The examinations revealed the following about the organizations involved:

- 5% paid excessive compensation to officers and directors,
- 86% required recusals of officers and directors from discussion and approval of their compensation,
- 59% had written conflicts of interest policies,
- 49% commissioned a survey to establish compensation, and
- 92% set compensation within the survey range.

Forms 4720

Of the Chapter 42 cases, two Forms 4720 were self-reported by the involved persons regarding self-dealing excise taxes and an additional 11 Forms 4720 were secured during examinations.

LESSONS LEARNED AND RECOMMENDATIONS

1. The size of the Project and the diverse universe created logistical difficulties. Future initiatives involving a similarly large number of organizations should consider breaking the project into components such as separating public charities and private foundations.
2. Using correspondence as the exclusive method of conducting single issue examinations for factually sensitive and complicated issues, such as self- dealing and excess benefit transactions, should be reconsidered. Although it is appropriate to use broad contacts to identify cases to be examined, an upfront field visit or other contact with the examined organization might substantially reduce the volume of records needed to be reviewed and the time spent on the examination.
3. Compliance check questions must be clear and focused in order to produce responses that can be readily analyzed and can enable the Service to select appropriate cases for examination.
4. Form 990 compensation reporting needs to be revised to facilitate accurate and complete reporting. The Form 990 redesign project should focus on reducing the number of places the same information is reported on the form, providing clearer instructions regarding what needs to be reported, and requesting specific information to identify potential non- compliance areas such as loans to officers and directors.
5. EO needs to revisit the issue of when penalties should be assessed for filing an incomplete Form 990 or 990-PF.
6. EO should communicate to the public the most common return preparation errors identified during the compliance checks and examinations.
7. EO should further educate the public charity sector about the section 4958 rebuttable presumption and how to satisfy the requirements of the presumption.
8. Future initiatives should focus on the correlation between satisfaction of the rebuttable presumption by an organization and the reasonableness of compensation paid to its disqualified persons by such an organization.
9. EO should change its process for monitoring excise taxes collected for excessive compensation to better distinguish between the different types of excise taxes collected from public charities and private foundations.
10. The relatively small percentage of corrections made by disqualified persons before contact by EO illustrates the need for a continued enforcement presence in this area. EO should continue to review compensation issues in more focused projects and should pursue base- lining general compliance with the compensation rules.