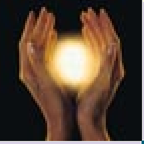
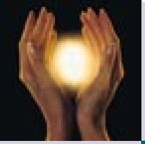


Tax Issues in Compensating the Tax-Exempt Executive

Organizational Consulting Group, L.L.C.

September 28, 2005



Organizational Consulting Group

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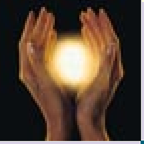
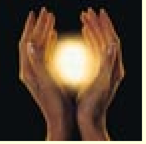
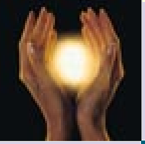


The Gathering Storm

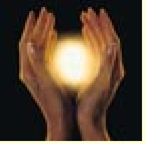


Contemporary Developments

- Federal legislative action
- Regulatory action by state attorneys general
- Public perceptions influenced by media reports



Regulatory Compliance and Compensation of the Tax-Exempt Executive



Current IRS Practice

Targets of Interest

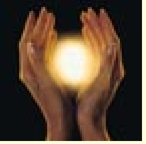
- Public charities
- Private foundations

Regulatory Arsenal

- Private inurement rules – for public charities and private foundations
- Private benefit rules – for public charities and private foundations
- Intermediate sanctions rules and regulations (Internal Revenue Code Section 4958) – for public charities
- Self-dealing rules and regulations (IRC Section 4941) – for private foundations

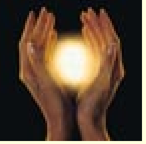
Private Inurement and Private Benefit Doctrines

- Private Inurement Doctrine:
  - "no part of the organization's net earnings may inure in whole or in part to the benefit of any private shareholder or individual."
- Private Benefit Doctrine:
  - "an organization is not considered organized for a proper statutory purpose (e.g., religious, charitable, scientific, etc.) unless it serves a public rather than a private interest."



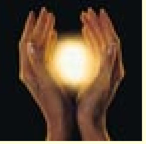
Application to Executive Compensation of Tax-exempt Entities

- Executive employees and other key employees of a tax-exempt organization are generally considered to have a personal and private interest in the activities of the organization, and, therefore, payments to such employees can result in a violation of the doctrines.
- No violation will occur if the organization pays “reasonable compensation” for services actually rendered.
- Internal Revenue Code Section 4958 applies where unreasonable compensation is paid to “disqualified persons.”



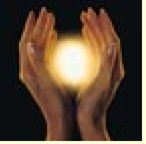
"Reasonable Compensation" - the IRS Perspective

- Factors (all types of entities):
  - Executive's role.
  - Executive's compensation compared to similar employees in similar organizations.
  - Character and condition of organization.
  - Internal consistency of compensation to all employees.
  - [Existence of conflict of interest allowing organization to disguise dividends as compensation.]
- Ask: "Would an inactive, independent investor consider the factor favorably and wish to pay the compensation to retain the executive?"



Courses of IRS Action from Violation

- Pre-1996 (before enactment of IRC Section 4958)
  - No action, or
  - Loss of organization’s tax-exempt status.
- Post-1995 (after enactment of IRC Section 4958)
  - No action, or
  - Excise taxes against *individuals,* and/or
  - Loss of organization’s tax-exempt status.

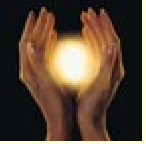


Risks to Organization from Violation of IRC Section 4958

- *Direct* financial effect may be nil.

- *Indirectly*, public disclosure may negatively impact
  - Reputation – this is usually the organization's most important and valuable asset,
  - Fundraising.

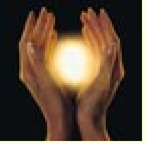
- Vulnerability lasts through 3-year statute of limitations
  - Ends as of 3rd anniversary of last allowed filing date
  - Example: November 15, 2005, for 2001 tax return.



Intermediate Sanctions and Executive Compensation

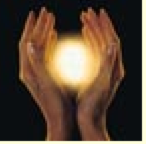
- IRC Section 4958 applies where unreasonable compensation is paid to "disqualified persons."

- "Disqualified persons" include:
  - Voting members of governing body;
  - President, chief executive officer, chief operating officer;
  - Treasurer, chief financial officer;
  - Any person with substantial influence;
  - Any family member of the foregoing;
  - Any entity in which 35% of the interests are owned by any of the foregoing.



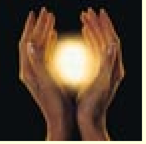
Intermediate Sanctions and Executive Compensation (Cont.)

- **INITIAL TAX:** IRC Section 4958 imposes an initial excise tax on both the disqualified person and any participating "organization manager" (i.e., officer, director, trustee), based upon the portion of the compensation which is deemed "unreasonable."
  - On disqualified person: tax equals 25% of the "unreasonable" portion.
  - On participating "organization managers:" tax equals lesser of 10% or $10,000, with joint and several liability.



Intermediate Sanctions and Executive Compensation (Cont.)

- **ADDITIONAL TAX**: An additional tax in an amount equal to 200% of the "unreasonable" portion is imposed on the disqualified person if such person fails to pay back "unreasonable" portion within the "taxable period."
  - "taxable period" generally means the period beginning with the date of the transaction and ending on the date of assessment.

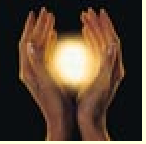


Intermediate Sanctions and Executive Compensation (Cont.)

Potential Individual Exposure of a Disqualified Person:

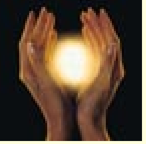
- Repayment of original excess benefit, with interest, *plus*
- 25% initial tax, *plus*
- 200% additional tax, *plus*
- 10% tax (to $10,000) if also participated as an Organization Manager

And, the organization may not reimburse the disqualified person for any portion of these penalties.



Intermediate Sanctions and Executive Compensation (Cont.)

- Determination of Reasonable Compensation under IRC Section 4958; apply general Section 162 standards (facts and circumstances test).
  - All forms of cash and non-cash compensation taken into account (*e.g.,* salary, fees, bonuses, severance payments, deferred compensation).
  - Compensation and payments from entities controlled by the organization (ownership greater than 50%) also taken into account.
  - Non-taxable employee benefits under Section 132 excluded.

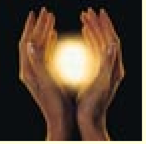


Intermediate Sanctions and Executive Compensation (Cont.)

- **REGULATORY EXEMPTIONS:**

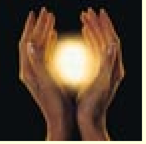
  – **Initial Contract (or First Contact):** Intermediate sanctions do not apply to fixed payments under the first contractual relationship between the organization and a new disqualified person. Extension, renewal, or material change to initial contract results in loss of exemption.

  – **Lower Paid Employees:** Intermediate sanctions generally do not apply to payments to employees making less than $85,000.



Intermediate Sanctions and Executive Compensation (Cont.)

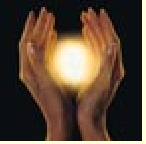
- **REGULATORY SAFE HARBOR:**
  - **Rebuttable Presumption of Reasonableness:** Compensatory payments to disqualified persons are presumed reasonable if:
    - Payments are approved by disinterested governing body.
    - Governing body relied upon appropriate comparability data.
    - Basis for determination adequately documented at time of approval.
  - **Reliance on Professional Advice**: Organization manager not generally liable under Section 4958 if such manager relied upon written opinion of professional.



What Does All This Mean to My Organization?

- **The Positives**:
  - ***Safe harbor enables organization to safely set executive compensation at commercially competitive levels***.
  - Increased retention of key executives.
  - Increased ability to attract qualified executive employees.

- **The Negatives**:
  - IRS likely to be more aggressive in scrutinizing compensation payments.
  - Compensation payments must be more closely monitored and examined to ensure compliance with Intermediate Sanctions.
  - Failure to “protect” compensation decisions may constitute breach of fiduciary duty.

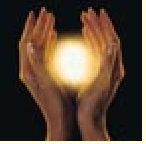


What Do I Need to Do to Protect My Organization and its Managers?

- Prudent steps:
  - Maintain compensation committee of the board that does not include executive employees (including CEO).
  - Maintain records of reasonable compensation.
  - Use formal, structured, consistently applied program.
  - Document required performance.
  - Use independent consultant to:
    - Assess competitive opportunities
    - Design compensation program
    - Establish performance/pay relationships
  - Obtain and retain written professional opinions.

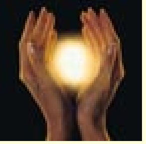
Case Study

Intermediate Sanctions



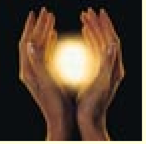
ABC Foundation

- Scientific research foundation
- Not-for-profit organization
- Several different entities
- Cutting-edge medical research



ABC Foundation

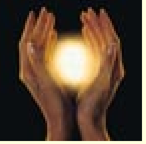
- Unique board of trustees members have responsibilities that include:
  - Trustee involvement
  - Day-to-day management of the organization and its entities
    - Operations managers
    - Chief executives
    - Patent attorneys
    - Chief legal counsel
- Concern: intermediate sanctions rules may impose penalties if compensation is found to be unreasonable



ABC Foundation

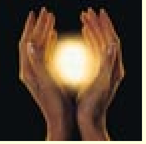
- Overall requirements:
  - Perform compensation research and analysis
  - If compensation is found to be reasonable, support with professional opinion
  - Primary client contact with foundation's legal counsel (to protect privilege)

- Methodology:
  - Compile survey data
    - Not-for-profit examples
    - For-profit examples
  - Develop peer group of organizations in the for-profit sector by
    - Industry
    - Primary business
    - Organization size



ABC Foundation

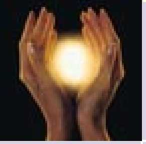
- Methodology (continued)
  - Analyze data
    - Position responsibilities
    - Hybrid approach when comparing positions
    - Proxy analysis of publicly-traded for-profit organizations
  - Consult with legal counsel on findings
  - Provide written opinion, with supporting data



ABC Foundation

- Responsibilities of board or appropriate committee
  - Approves compensation
  - Obtains and rely upon *“appropriate comparability data”*
  - Adequately document its basis for its decision

- Appropriate comparability data
  - Compensation levels paid by similarly situated organizations, *tax-exempt* and *for-profit,* for comparable positions
  - Availability of similar services in the area
  - Current compensation surveys by independent firms
  - Written offers by competitors



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