

Patterson Belknap Webb & Tyler LLP

New York City Bar Association

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Compensation, Inurement, & Intermediate Sanctions

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Compensation: Continued Focus, Continued Importance

- Focus on compensation
 - IRS
 - Congress
 - State regulators
 - Whistleblowers
 - Media
- Fundamental concern: misuse of charitable assets
- Challenges in navigating overlapping regimes

Road Map

- Federal
 - Inurement
 - Intermediate Sanctions
- State
 - New York Not-for-Profit Corporation Law
 - New York Non-Profit Revitalization Act
 - Executive Order 38
- Practical Recommendations

Inurement

- To qualify as an organization described in Section 501(c)(3)
 - No part of the organization's net earnings may inure to the benefit of any private shareholder or individual
- Focus on reasonableness of compensation
- Facts and circumstances determination
- Penalty for violation of inurement prohibition: revocation of exemption

Beyond Inurement: Intermediate Sanctions

- Section 4958 of the Internal Revenue Code of 1986, as amended
 - Enacted in 1996
 - Established “intermediate” means of sanctioning misuse of charitable assets by insiders
- Previously, IRS only had the inurement “atomic bomb”: revocation of exemption
 - Inappropriately severe
 - Rarely sought by IRS
- Intermediate sanctions = less severe weapon
 - Penalties that correspond to degree of misuse
- Inurement is still on the books
 - Can be applied in tandem with intermediate sanctions

Intermediate Sanctions

- Applies to Section 501(c)(3) public charities, Section 501(c)(4) social welfare organizations, and Section 501(c)(29) qualified non-profit health insurers
 - Private foundations have to comply with self-dealing regime
- Imposes excise taxes on “disqualified persons” who engage in “excess benefit transactions”
- Penalizes “organization managers” (officers and directors) who knowingly approve excess benefit transactions

Section 4958 Excise Taxes

- Tax on disqualified person
 - 25% of the excess benefit (first-tier tax)
 - 200% of the excess benefit if not corrected within the taxable period (second-tier tax)
- Tax on organization manager
 - 10% of the excess benefit (up to maximum of \$20K)
 - Organization manager must have participated in transaction knowing it was an excess benefit transaction
 - Exception if organization manager's participation was not willful and was due to reasonable cause

Who is a Disqualified Person?

Organization “insiders” including

- any person exercising substantial influence over the organization’s affairs at any time during five-year period ending on the date of the transaction
- family member of person with substantial influence
- 35-percent controlled entities
 - Entities in which persons with substantial influence or their family members own more than 35 percent of the voting power, profits interest, or beneficial interest

Who is a Disqualified Person? (cont'd.)

Special Rules for Supporting Organizations, DAFs, and DAF Sponsors

- For supporting organizations
 - A disqualified person of a supporting organization is also a disqualified person of the supported organization
- For DAFs
 - Disqualified persons include
 - Donors and donor advisors
 - Family members of donors and donor advisors
 - 35% controlled entities
- For DAF sponsoring organization
 - Disqualified persons include
 - Investment advisors
 - Family members of investment advisors
 - 35% controlled entities

Who has Substantial Influence?

Automatically deemed to have substantial influence

- Board members
- Presidents, CEOs, COOs, or others with similar managerial authority over administration or operations
- Treasurers, CFOs, or others with ultimate responsibility for managing the organization's finances

Automatically excluded

- Employees not described above who make less than \$115,000 and who are not substantial contributors

Substantial Influence: Facts and Circumstances Test

Factors indicating substantial influence

- Organization Founder
- Substantial contributor
- Receives compensation primarily based on revenues derived from activities that the person controls
- Has authority over substantial portion of the organization's capital expenditures, operating budget, or compensation for employees
- Has managerial authority over a segment or activity of the organization representing a substantial portion of the organization's activities, assets, income, or expenses

What is an “Excess Benefit Transaction”?

- A transaction in which the disqualified person receives an **economic benefit** from the organization that **exceeds the value of the services, property or payment** the organization receives **from the disqualified person** in return
 - Classic Examples
 - Payment of unreasonable, excessive compensation to a disqualified person
 - Purchasing property from a disqualified person at a price greater than fair market value

Economic Benefits are Broadly Defined

Include not only cash and non-cash compensation but also

- Bonuses, severance, and deferred compensation
- Fringe benefits
- Use of company automobile
- Housing
- Travel expenses
- Interest-free loans
- Use of organization's credit cards without documentation

Beware of “Automatic Excess Benefit Transactions”

- Failure to treat an economic benefit provided to a disqualified person as compensation = automatic excess benefit transaction
- Penalties assessed without regard to whether the economic benefit provided is reasonable
- To avoid penalties, the organization or the DQP needs to provide “contemporaneous written substantiation” through timely reporting of economic benefits either by
 - Organization on original or amended Form 990, Form W-2, or Form 1099
 - Disqualified person on an original or amended Form 1040
- Ensure reimbursements through accountable plan

Special Automatic Excess Benefit Transaction Rules for DAFs and Supporting Organizations (“SO”)

- A grant, loan, compensation, or other similar payment from
 - DAF to donor, donor advisor, family members, or 35% controlled entities
 - SO to a substantial contributor, members of the substantial contributor’s family, or his or her 35% controlled entities
- A loan by SO to a disqualified person

Are automatic excess benefit transactions

- Regardless of reasonableness of the payment
- Excise tax will apply to all amounts paid, not just excessive amounts

Correcting Excess Benefit Transactions

- If corrected during taxable period, second-tier 200% tax will not apply
 - Taxable period = Transaction date through earliest of mailing date of notice of deficiency or date on which first-tier tax assessed
- “Correction” = undoing the excess benefit and taking additional measures to restore organization’s financial position
 - E.g., Repayment of excess funds plus interest
- Prompt correction is key

Preventing Excess Benefit Transactions

- Identify the organization's disqualified persons
- Ensure organization is paying disqualified persons reasonable compensation determined according to a fair and disinterested process
- Follow steps needed to establish the “rebuttable presumption of reasonableness” under the regulations

The Rebuttable Presumption of Reasonableness

- Following these procedures shifts the burden of proving unreasonableness of transaction to the IRS
- Rebuttable presumption obtained if transactions involving disqualified persons are approved by a Board or committee that
 - Is composed of individuals unrelated to and not subject to the control of the disqualified persons
 - Obtains and relies upon appropriate data as to comparability or value
 - Adequately and contemporaneously documents the basis for its determination

Requirement #1: Compensation Fixed by an Authorized Independent Body

- An authorized body means
 - The Board
 - A committee of the Board
 - To the extent permitted under State law, other parties authorized by the Board to act on its behalf following procedures specified by the Board
- Must be composed entirely of people who have no conflict of interest with respect to the compensation arrangement
 - This means that no person on the body receives compensation determined by the individual whose compensation is being reviewed by the body or committee

Requirement #2: Reliance on Comparability Data

- Appropriate data includes
 - Data from similarly-situated organizations (can be non-profit or for-profit)
 - Salaries for functionally comparable positions under like circumstances
 - Availability of similar services in geographic area
 - Current independent compensation surveys
 - Actual written offers competing for services of disqualified person
- Special rule for small organizations
 - “Appropriate data” = compensation paid by 3 comparable organizations in the same or similar communities for similar services

Requirement #3: Adequately and Contemporaneously Document Basis for Compensation

- Authorized body must take minutes documenting decision, including
 - Terms of transaction approved
 - Date of approval
 - Members of authorized body present during debate and vote
 - Comparability data obtained and source of data
 - Any actions or recusal by members of the body with a conflict of interest
 - If going higher or lower than comparability data, the basis for such determination
- Prepare minutes before later of next meeting or 60 days
 - Review for accuracy and completeness

New York Law: Fiduciary Duties and N-PCL

- Case Law
- Section 717 of N-PCL
 - Duty of care
 - Exercise the care that an ordinarily prudent person would exercise in a like position and under similar circumstances
 - Duty of loyalty
 - Act in good faith and in the best interests of the organization
 - Put organization's interests first and refrain from conduct detrimental to the best interests of the organization
- Section 515 of N-PCL
 - Organization may pay reasonable compensation to members, directors, or officers for services rendered

New York Law: Non-Profit Revitalization Act

- New N-PCL Section 515 Requirement
 - No person who may benefit from compensation arrangement may be present at or otherwise participate in any Board or committee deliberation or vote concerning the person's compensation
 - EXCEPT that the Board or committee may request that the person present information as background or answer questions at a Board or committee meeting prior to the commencement of deliberations or voting

New York Law: Executive Order 38

- Issued on January 18, 2012
- Governs payment of executive compensation and administrative expenses by entities that receive funding from New York state to provide services
- Directed commissioners of 13 state agencies to promulgate regulations that
 - Cap administrative expenses at 25% (decreasing to 15% over time) of State funds or State-authorized payments
 - Limit executive compensation paid by organizations receiving State funds or State-authorized payments to \$199,000
- Agency regulations took effect on July 1, 2013

New York Law: Executive Order 38

- Applies to “Covered Provider”
 - Entity or Individual
 - That received annual amount of greater than \$500,000 in State funds or State-authorized payments to render services for the benefit of members of the public pursuant to an agreement with one or more agencies

AND

- At least 30% of whose annual New York State revenues were from State funds or State-authorized payments

New York Law: Executive Order 38

- Executive Compensation Limits
 - Covered provider may not use State funds or State-authorized payments for annual compensation of covered executive in excess of \$199,000 (unless waiver is obtained)
 - Covered provider receiving State funds or State-authorized payments may not pay covered executive annual compensation in excess of \$199,000 with ANY FUNDS unless
 - Waiver obtained
- OR
 - Compensation is not greater than the 75th percentile of compensation provided to comparable execs at comparable providers AND compensation was reviewed and approved by Board (including at least two independent directors)
- Annual reports required
- Failure to comply: loss of payments, termination of contracts, “other lawful actions or penalties”
- Regulations provide multiple opportunities for correction

New York Law: Executive Order 38

- Guidance issued June 2013
 - Breakdown of definitions
 - Covered provider
 - Program services
 - Reporting period
 - Covered executive
 - State funds and State-authorized payments
 - Worksheets to determine applicability of regulations

Practical Guidance

- Identify applicable law
 - Public charity? Inurement, intermediate sanctions
 - Private foundation? Inurement, self-dealing
 - New York not-for-profit? New York fiduciary law, N-PCL (as amended by NPRA)
 - Provider of services to New York agencies/recipient of New York State funds/authorized payments? Executive Order 38
- Within each regime, develop methodology for determining
 - Whose compensation is covered
 - Who reviews compensation of covered individuals
 - What procedures are required

Practical Guidance

- Review methodology from time to time
- Ensure that Board or applicable committee understands rules
 - Routine training
 - Counsel, if necessary
 - New member orientation
 - Reminder of requirements at beginning of comp review
- Helpful to have calendar of key dates
 - Form 990 filing
 - Executive Order 38 report
 - Executive Order 38 waiver
 - Compensation review timeline (organization-specific)

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