Bobby: Today we are going to talk about compensation issues. We have Karen Fitch, who is an Exempt Organizations group manager in the Louisville Ky. IRS office. Karen has been with the Internal Revenue Service for 32 years and with Exempt Organizations since 1997. We also have David Fish, who is Manager, TE/GE Division, Rulings and Agreements. He joined that department in December and before that he spent 13 years in Chief Counsel in the Disclosure and Privacy Office. So we are very pleased to have both of them here today.

We sent each of you a confirmation email after you registered for this phone forum – attached to it was a set of powerpoint slides and Publication 4386. If you printed the powerpoint, or if you have them up on your computer, you can follow along as David and Karen deliver their presentations. They'll let you know what slide they're on as they proceed. Karen?

Karen: Today we're going to talk about a variety of issues related to exempt organizations' executive compensation. We're going to start with an update on the IRS's compensation initiative, which involved a set of compliance contacts as well as examinations. After that we'll spend the bulk of our time talking about the critical elements organizations should consider when setting executive compensation.

But first, our compensation compliance initiative. In August of 2004, the IRS issued Information Release 2004-106, announcing a new enforcement effort to identify and halt abuses by public charities and private foundations that pay excessive compensation and benefits to their officers and other insiders. Beginning in late 2004, we contacted a broad spectrum of over 1800 public charities and private foundations seeking information about their compensation practices and procedures. We also just started a new phase of the initiative that we will talk about later, involving an additional 250 contacts. Our goals for the initiative, as shown on Slide #2 were to:

- Learn how exempt organizations determine and manage compensation,
- Gauge existence and effectiveness of exempt organizations' controls over compensation issues,
- Learn how exempt organizations report compensation on Forms 990 and 990PF,
- Address instances of questionable compensation practices, as well as compensation of specific individuals, and
- Increase exempt organizations' awareness of compensation-related tax issues

The initial results of the compensation initiative will be included in a report that we expect to produce in late August or September.

David: As shown on Slide #3, about 1200 of the initial contacts were something we call compliance checks. The other contacts, initially about 600, were what you are probably more familiar with, examinations. We sent out a handy little publication entitled *Compliance Checks* with every compliance check letter, which describes the process and how it differs from an examination. You received a copy of this publication, #4386, in the email along with the powerpoint presentation for this program.

A compliance check (see Slide #4) is a review conducted by the IRS to determine whether an organization is adhering to recordkeeping and information reporting requirements. The check is a tool to help educate organizations about the reporting requirements and to increase voluntary compliance. For example, many of the compliance check letters alerted organizations to errors in their returns, and they resulted in amended returns providing the missing information.

As Pub 4386 explains, a compliance check is not an examination. Unlike an examination, it does not directly relate to determining tax liability for any particular period. So, you should be aware that, even if you receive and respond to a compliance check, we still can return and conduct an examination at a later date. Karen, what types of information on a Form 990 or 990 PF resulted in an organization getting a compliance check letter?

Karen: There were four general areas that triggered a compliance check, as you'll see on Slides 5 and 6.

1. First, we looked at Schedule A, Part 3. That's the schedule that lists the transactions between related individuals or leases of property to officers, directors, or shareholders. If the organization left this blank or answered "yes" without the required explanation, we initiated a compliance check.

2. Second, Form 990, Part 4, Line 50 asks about receivables from trustees, officers, directors and key employees. If you list receivables, you're required to attach a schedule with an explanation. Again, if the organization did not attach an explanation it triggered a compliance check.

3. Third, leaving Column B, of Part V of Form 990 blank generated a compliance check. That column should have an entry for each listed officer, trustee or key employee. If they're not compensated, you should enter a "zero."

4. Last, the big one. We found a lot of organizations don't answer the Question 89 on the Form 990 about whether they entered into an excess benefit transaction. Or if they answered "yes" they didn't attach an explanation.

When responses to the compliance check letters came back, a team of agents reviewed them to determine whether the responses were sufficient or whether the organization should be examined. About 200 of the compliance check letters did in fact result in the organization subsequently being examined.

David: The compliance check letters should not be confused with correspondence examinations or with examinations generally. The differences are explained in the publication we sent with the letter. We also want to note that currently Publication 4386 is being revised, to make it clear that we can do a compliance check to ensure that an organization's activities are consistent with their stated tax-exempt purpose.

Part of the compensation initiative also involved single issue examinations—these are the 600 examinations we referred to earlier, plus the approximately 200 examinations that resulted from the compliance check letters. In a single issue examination, at least in the beginning, we're examining only the compensation of disqualified persons to determine if their compensation is reasonable and is in accord with other compensation rules--such as the private foundation rules that apply to loans to disqualified persons, purchase of charity assets at below market prices or sales by disqualified persons to charities at an inflated price.

As a side note here, disqualified persons generally are organization insiders who are liable for the private foundation excise taxes on self dealing, as well as insiders who are liable for the intermediate sanctions under section 4958—of course, 4958 only applies to public charities under 501(c)(3) and 501(c)(4)s. To address one of our listener's questions, and here we are only going to deal with 4958, disqualified persons are statutorily defined as any person who is a position to exercise substantial influence over the affairs of an applicable tax exempt organization. These are generally high level officers, like the CEO and CFO, but could also include, under the right facts and circumstances, substantial contributors and people like heads of departments of a hospital. To save time we'll refer you to Treasury Reg. 53.4958-3 and IRM 7.27.30.3.

Single issue examinations don't necessarily mean simple examinations. Under appropriate circumstances, we can expand an examination to address multiple issues.

Karen: The examination letter clearly states upfront that it is an examination and asks for much more detailed information than is required in a compliance check. These are the types of things we're asking for in single issue examinations – take a look at Slide #7.

- How do you establish compensation – what are your policies and procedures?

- What are the duties and responsibilities of the persons listed in Part 5?

- Do you intend to establish the rebuttable presumption?
- Did the board approve the compensation? If so, provide copies of the approval and any employment contracts and agreements?
- Does the compensation reported agree with the W-2s and 1099s issued?
- Did individuals use the organization's property for any purpose other than to further the organization's exempt purpose? If so, was this reported as compensation on the W-2s and 1099s?

The difference between a compliance check and an examination is important. One of the reasons it's important, and we'll go into a little bit of detail now, is to avoid so-called automatic excess benefit transactions.

Under the statute and regulations, an organization must clearly indicate its intent to treat an economic benefit as compensation for services or the economic benefit will automatically be an excess benefit transaction under section 4958. That is how the term "automatic excess benefit transaction" came about. Under the regulations, an organization indicates its intent to treat a benefit as compensation by reporting the benefit on Form 990, on Form W-2 or 1099, or by the executive reporting the benefit on his or her Form 1040. We have seen numerous organizations that have failed to report fringe benefit perks, like personal use of an automobile or reimbursement of personal expenses. These will be so-called automatic excess benefit transactions, with an automatic 25% tax on the amount of the benefit. The organization has up until the time the IRS starts an examination to amend its returns to report this income and avoid an automatic excess benefit transaction. Once an examination starts, it's too late. That's one reason why it's critical to know whether a contact is a compliance check or an examination.

Finally, we should note that we recently sent out a compliance questionnaire to several hundred hospitals. In addition to asking questions about the hospitals' compliance with the community benefit standard, the questionnaire also asked detailed questions about how the hospitals set compensation.

David: Although it's too early to reach any specific conclusions from the initiative, Karen and I have some observations we would like to share. Take a look at Slides #8 and #9.

The mere act of sending out the letters has heightened everyone's sensitivity about how compensation is set and how it is reported on the Form 990. This is a good thing. Expect to see more of this approach in the future.

Remember, we mentioned that one of the areas that triggered a compliance check was missing or inadequate information on the Form 990 question involving receivables from officers, directors and trustees. Information frequently omitted included interest rates, amount of the original loan, loan repayments, and collateral. In addition, some of the loans made up a very large amount of the organization's total assets. We found a good number of very substantial loans to insiders and lots of undocumented loans. In fact, based on what we were seeing regarding loans, we started a new phase of the compensation initiative at the end of March, dedicated solely to loans. This new phase involves 200 compliance check letters and 50 examinations.

Karen: We're seeing the practice of spreading compensation of officers and other insiders among several affiliated organizations, for-profits or management companies with only a small amount reported on any one return. Question 75 on Form 990 is the Service's attempt to collect information on compensation paid by related organizations. This year, we expanded considerably Form 990 question 75 so we could try to find out what was going on.

Reasonable compensation for part-time work. For example, $100,000 might be reasonable comp for an individual working 40 hours a week. One hundred thousand dollars is not necessarily reasonable compensation if an individual works only ten hours a week. There are no special rules for determining comparability for part time work. You would look to see if there part time comparables—if not, it is a matter of business judgment, which would include annualizing their salary on a full time basis and eyeballing it to see if it is out of line.

We saw a lot of confusion as to how, when and how much deferred compensation to report. The instructions explain that deferred compensation is to be reported as accrued. You don't need to report accruals reported in prior years. The instructions also explain that deferred compensation should be reported again when paid. There is an element of double counting there, so in a footnote, or schedules or notes to the 990, you should indicate if amounts paid in a particular year have already been reported as accrued. Also, amounts need to be reported even if not vested or if subject to a substantial risk of forfeiture.

We found fringe benefits that were not considered and reported as part of compensation, such as personal free use of a car, apartment, cell phone, etc.

We saw general errors in completing the form—either due to unclear forms and instructions, or sloppiness on the part of the preparer. For example, many "yes" answers to question 89b (about excess benefit transactions) became "no" answers once the organization was questioned. As you're probably aware, the IRS is in the middle of a groundbreaking effort to redesign the whole Form 990 to make it simpler and easier for organizations that file it; and the IRS, the public, and state charity regulators that use it.

Karen: David and I just talked about the progress of our compensation initiative and what we have learned so far. I will talk about compensation more generally and specifically about what boards of exempt organizations should do to meet their responsibilities with respect to executive compensation.

I will not say anything groundbreaking today but I'll tell you what the IRS is thinking about in regards to compensation issues. You will probably find that it reflects your own thinking on how compensation should be set, what constitutes reasonable compensation and what exempt organization boards should do to make sure that their organizations are paying reasonable compensation.

Exempt organizations should focus their attention on the four key governance areas listed on Slide #10.

Legal protection. Every board should consider meeting the requirements of the rebuttable presumption of reasonableness. I will not repeat what's in the regulations, but to summarize, in order for the rebuttable presumption to be met, compensation must be set in advance by disinterested board members on the basis of appropriate comparability data and the decision must be appropriately and timely documented. Meeting the rebuttable presumption of reasonableness is not a prerequisite for having reasonable compensation but it will minimize the likelihood of future IRS scrutiny of the organization's compensation arrangements.

The procedures for the rebuttable presumption are a good template for boards to use in order to determine what compensation might be reasonable for their organization.

The next key area is reporting and disclosure. That means all economic benefits to officers, directors and key employees should be reported timely on Form 990. As David mentioned, we recognize the Form 990 is a complex document and difficult to fill out but every exempt organization should do its best to make sure that the form is completed properly.

As we mentioned earlier, we're currently in the process of redesigning Form 990 to capture better information and try to make it easier for exempt organizations to comply. We're going to talk a little bit later about some of the compensation related changes that were made to the Form in 2005—admittedly, these changes don't make the form simpler or easier to use.

The next key area is avoiding automatic excess benefit transactions. That means that every form of compensation needs to be reported timely as compensation.

The fourth key area is transparency. Many boards delegate the responsibility of determining executive compensation to compensation committees. That is perfectly appropriate but the board still has the responsibility, the ultimate responsibility, over compensation. To the extent appropriate, executive compensation matters must be disclosed to the full board.

Regardless of whether an organization intends to meet the rebuttable presumption of reasonableness, it is a good practice for every tax-exempt organization to make sure that their compensation is set by disinterested persons.

David, we just mentioned that compensation should be set by disinterested board members. In this area, the regulations talk about the absence of a conflict of interest. What constitutes a conflict of interest?

David: Click over to Slide #11. The regulations provide a good definition. They provide five examples of a board member who is considered to have a conflict of interest.

1. The member is a disqualified person covered by the compensation arrangement being reviewed,

2. The member is an employee subject to the direction and control by the disqualified person covered by the compensation arrangement being reviewed,

3. The member receives payments subject to approval by the disqualified person covered by the compensation arrangement being reviewed,

4. The member has a material financial interest affected by the compensation arrangement, or

5. The member approves the compensation arrangement for the disqualified person who in turn has approved or will approve an economic benefit for that member.

The part of the definition that most frequently generates questions is the fourth one – whether there is a conflict of interest if the member has a material financial interest affected by the compensation arrangement. This is a functional definition so I cannot tell you that a particular relationship will always result in a conflict of interest or another one won't--it depends on whether there is a financial interest, whether it is material, and whether it is affected by the compensation arrangement.

So not every relationship will always result in a conflict of interest. A relationship that generates a conflict of interest for one purpose may not generate a conflict of interest for another purpose. For example, if a member of a board is a partner in a law firm, he would have a conflict of interest for purposes of negotiating a retainer between the exempt organization and that law firm. On the other hand, he will not or likely will not have a conflict of interest for purposes of discussing a contract with a construction company unless he has shares in that construction company or has a similar financial interest in it.

What do you do if a conflict of interest exists? Well, there are a number of steps that can be taken. A board member with a conflict of interest can recuse himself from decision-making. Such board member can step down from the board or compensation committee. Or, the organization can end the business relationship with the business in which the member has a financial interest. Or, the organization can re-evaluate the terms of its business relationship with that business. To do that, the organization may use an RFP process to generate disinterested bids or hire a consultant to examine the terms of the relationship to make sure that they are fair and reasonable.

Karen: Whether the organization intends to satisfy the rebuttable presumption of reasonableness or not, it needs to make sure that the compensation it sets is objective and reasonable. The definition, found in section 4958, is that reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax-exempt, under like circumstances.

Obviously determining reasonable compensation is not an exact science. This is the same definition, by the way, that is used in section 162. The authority under section 162 also applies and is helpful here.

From this definition it is obvious that meeting the definition of reasonable compensation requires the three types of comparisons shown on Slide #12:

1. First, the jobs must be compared to determine whether they constitute like services,

2. Second, the enterprises must be compared to determine whether they constitute like enterprises, and

3. Third, the surrounding circumstances must be compared to determine whether they constitute like circumstances.

How do we compare services? Compensation must be commensurate with the duties and responsibilities of the person being compensated. Obviously, when you compare somebody’s compensation to another person’s compensation you need to make sure that the comparison is based on substantially similar duties and responsibilities. The following questions are relevant to determining duties and responsibilities. (See Slides #13 and #14.)

• What does the person actually do?

• Is the person's involvement hands-on or policy-oriented?

• Is the job national or local in scope?

• What is the number of employees managed by the person, if any?

• What is the size of the budget or assets managed by the person, if any?

• Does the person manage multiple functions, departments, facilities or entities?

For example, an executive who is primarily involved in major policy decisions and strategy is not necessarily comparable to an executive who is really hands-on and implements the strategies designed by others, even if their titles are the same.

The key is comparing duties and responsibilities, not the title. It's a functional comparison.

Compensation must be commensurate with the number of hours per week, or some other unit of time, devoted to the job, and so comparisons must be based on the same number of hours. Obviously a full-time person should not be compared to a part-time person.

Where a person provides services to two or more related organizations, care should be taken to determine the number of hours devoted to each organization and the specific positions within those organizations. Frequently, a single payer entity may be paying compensation for work performed for different entities; it may be difficult to attribute the proper amount of compensation to the duties performed.

Also, when a person manages multiple functions, departments or entities, the comparison with a person who manages only a single function, department or entity may be inappropriate because the extent, scope or nature of the job may be different. That's important to keep in mind.

David: Compensation covering the whole year is generally not comparable to compensation for only part of the year unless it has been pro-rated.

Compensation for the final year of service is not comparable automatically to compensation for other years of service because final years frequently involve additional payments such as severance.

It's important to know whether compensation that is used as a comparable includes an element of compensation for prior services. If that type of compensation is used as a comparable in setting compensation for current services, various payments for prior services, severance and that sort of thing, need to be deducted.

Also keep in mind that if a person is compensated for work in multiple capacities for the same organization or for a group of related organizations, all economic benefits received by such person from these organizations have to be aggregated. It doesn't automatically follow that if the person's compensation as a director is within the reasonable range, and that person's compensation as an officer is within the reasonable range, that added together they will also be reasonable. They may be or they may not be. If the person is performing the job of two people, you can't just automatically double the compensation. It doesn't work that way.

Next, (go to Slide #15), how do we compare enterprises? Well, comparisons need to be based on entities of similar size. Indicators of size include budget, revenues (gross revenue or net revenue), number of employees, number of persons served by the organization during a specific period of time and whether the organization is stand alone or part of a group.

The comparables used by the organization should come from the same industry to best match the individual's duties and responsibilities. For example, a preschool is not comparable to a university even though both involve credentialed teachers because the duties and responsibilities involved in working for a preschool are not necessarily comparable to the duties and responsibilities involved in working for a university. The same is true when you're comparing nursing homes and hospitals. They both may have a director of nursing but it's not necessarily the same job.

Under the current section 4958 regulations, it is relevant that other enterprises compete for the services of the executive in setting compensation. Competing job offers for the same individual is one way to justify compensation.

A question we receive all the time is can we use for-profit comparables. Compensation comparables, as the regulations expressly provide, can come from nonprofit or for-profit entities or both. You can use only for-profit comparables but you may not be able to use the rebuttable presumption of reasonableness. The regulations reference compensation levels at both taxable and tax-exempt entities, and the use of the word both suggests that for-profits alone aren't going to qualify.

Also, if you rely on just for-profit data, you will likely draw increased scrutiny from the IRS. But, it's not impermissible per se, and the organization may be able to use for-profit only comparables if it shows that there are no appropriate nonprofit comparables in its market or it may show that both tax-exempt and for-profit entities compete for the same pool of specialized talent.

Karen: Let's move on to what constitutes like circumstances, which appears on Slide #16. Many exempt organizations, like other enterprises, now pay sophisticated compensation packages consisting of many items in addition to base salary. When you compare compensation you have to make sure that the compensation packages being compared consist of a similar mix of compensation items. For example, a compensation package that consists of just base salary is obviously not comparable to a compensation package that also includes various perks and benefits.

In determining the composition of a compensation package, it's very important to make sure that all forms of compensation are properly aggregated and accounted. I simply cannot overemphasize how important it is for all items of compensation to be counted. The regulations are very specific about what items can be excluded. Other than that, everything has to go in the mix, whether it's treated as income for income tax purposes or not, it all has to be counted in compensation for purposes of the determination of reasonableness.

As we mentioned, the compensation initiative has taught us that there are specific problem areas and specific items which frequently fall through the cracks.
We mentioned some of them before. I will briefly restate them:

- personal components of business travel,
- personal use of employer-owned property,
- gifts and gift certificates,
- tax gross-ups,
- expense reimbursements outside corporate policies,
- spouse travel expenses,
- non-accountable expense allowances,
- club membership and the like.

For example, many exempt organizations don't include the value of housing they provide to their employees--why is that compensation, they ask? Again, unless there's a specific exclusion you can point to, you have to include everything in the total compensation. To avoid unexpected problems down the road each exempt organization should design and follow procedures for expense reimbursements and business use documentation. It's a good idea to use the accountable plan procedures of the [regs.]. In addition to including all items on the organization's Form 990, the organization should also make sure that all benefits intended as compensation are in fact documented as compensation. If not, as we mentioned, they may be treated as automatic excess benefit transactions, even if the total compensation is reasonable.

Many exempt organizations, particularly smaller ones without in-house benefits departments, underreport compensation unintentionally. Even so, it is still a big problem, and still an automatic excess benefit transaction.

Some exempt organizations now pay equity-based or revenue-based compensation. This is permissible as long as the total compensation is reasonable and the equity or revenue-based compensation reflects the executive's contribution and not some external factors. However, if you use equity or revenue-based compensation, it makes it more likely that the IRS will take a closer look. It's a good practice to use caps on equity and revenue-based compensation. That answers one of the questions we received from the audience—while there is no prohibition on revenue based compensation, such an arrangement will likely receive more scrutiny. It is also much more difficult to establish the rebuttable presumption with a revenue sharing arrangement unless there is a cap. Also, while 4958 might not apply to a revenue sharing arrangement with non disqualified persons, you still may have a private benefit issue, depending on how many employees are involved and how extensive the sharing.

David: Next, let's look at similar geographic area. It's important for the organization to use comparables from the same geographic area. The current regulations specifically state that the availability of similar services in the geographic area of the organization is relevant to determining the appropriate level of compensation. If there are no comparables in your geographic area, it's okay to go outside of that area but you have to make appropriate cost-of-living adjustments.

The number of comparables. As Slide #17 notes, the regulations do not specify how many comparables you need to consider. However, if you are a small organization trying to meet the requirements of the rebuttable presumption of reasonableness you have to use at least three. If you're making notes on your powerpoint presentation, one astute listener noted that the requirement of three comparables is the special rule for small organizations—there is no specific number of comparables required for larger organizations to obtain the rebuttable presumption—of course the implication would be you probably need more than three.

Once the range of comparables is established, the next question is: where should the organization's compensation fall within that range of comparables?

(See Slide #18) That's also a question from one of our listeners. There are no hard and fast rules to determine the appropriate percentile. Obviously, if the compensation is at or below the 50th percentile for the relevant market, the IRS is less likely to scrutinize such compensation arrangement. The higher you go above the 50th percentile, the better evidence you need to present to be able to show that the compensation is reasonable. You may be able to exceed the range, but, again, you have to be able to justify your decision.

Potential factors to consider when justifying above-average compensation include:

- Ratio of the organization's revenues to the proposed compensation,
- Ratio of the organization's expenses to the proposed compensation,
- Executive's track record both outside and within the organization,
- Difficulty of replacing the executive,
- Written offers from unrelated enterprises competing for the services of the executive,
- Competitive market pressures,
- Special circumstances requiring the executive's special qualifications such as undoing damage from bad publicity, recovering from mismanagement, and growth in different areas.

We had a question involving a small organization that wants to bring in a top notch person to grow its activities, and to recruit such a person initially requires that the organization compensate this person out of the range of what would be comparable for organizations of similar size. Of course, the organization aspires to be bigger—that's why it is bringing in this individual. There's nothing inherently wrong with this, but the organization needs to document its decisions and reasoning.

The organization should ask itself: Is this the best use of my limited dollars? Again, if you feel that you need to offer a high compensation package, you have to be able to justify it. Somebody like Placido Domingo may deserve a premium for leading an arts organization, because of his star visibility and special talents. But star visibility also has limits. Somebody like Placido Domingo might be great for the Washington National Opera, but he wouldn't deserve a premium for being a CEO of a hospital.

Different types of evidence can be used, alone or in combination, to satisfy the comparability requirements. The regulations under section 4958 provide that comparability data may include, but are not limited to, compensation levels paid by similarly-situated organizations, both taxable and tax exempt, for functionally comparable positions, the availability of similar services in a geographic area of the applicable tax-exempt organization, current compensation surveys compiled by qualified independent firms, and actual written offers from similar institutions competing for the services of the qualified person. This is a non-exhaustive list.

I want to add a word of caution on compensation surveys. Having a survey is not necessarily a magic bullet for compliance with the requirements for the rebuttable presumption. A compensation survey does not absolve the organization from showing that the entities in the survey constitute like-enterprises and provide like-services.

For example, in Eberl's Claim Service v. Commissioner, 249 F.3d 994 (10th Cir. 2001), the taxpayer was the founder, president, and sole shareholder of a small catastrophic claims adjustment company. He attempted to rely on a survey published in Forbes magazine to justify his compensation. The Forbes survey summarized compensation of the15 highest paid insurance company CEOs in the country. The Tenth Circuit rejected the comparison between the companies listed in the Forbes survey, the largest companies in the country, and the taxpayer's relatively small nonpublic company.

So, when relying on surveys, your organization needs to make sure that it has the supporting data that shows that both the enterprises listed in the surveys are indeed comparable and the jobs listed in the survey are comparable. That information need not be included within the four corners of the survey. The organization has to be prepared to present evidence that it possessed that information at the time it made the compensation decision.

By the way, there is no requirement for exempt organizations to hire a compensation consultant. It may be a good decision, especially if the organization intends to rely on for-profit data, but in some cases it may be an unnecessary expenditure. Compensation of tax-exempt employees is supposed to be, at least for the most highly compensated ones, a matter of public record and so by utilizing the Internet, phone calls, trade association data and the like, the exempt organization may be able to gather appropriate comparability data itself. This combination of multiple forms of inquiries will help obviate the issue that organizations sometimes do not report on the 990 all the various perks and benefits, making it hard to rely on these organizations' 990 data alone as comparable. We are aware of the issue and are trying to educate organizations about these reporting obligations so overall everyone can base their decisions on better data.

We have a question whether a measure like five times the average salary for comparable organizations would constitute reasonable compensation. We wouldn't rule out making comparisons that way—we've heard references to measures like that, but we're not that familiar with it since we're not engineers or economists.

Karen: Board members should always remember that their fiduciary duties are generally non-transferable. If a board utilizes a compensation committee to set compensation, the full board should be in regular communication with compensation committees. The level of oversight will vary depending on the type and size of the organization, but there has to be a system in place so the board can be aware of the most important compensation matters within the organization.

So to sum up, good compensation practices have two components, which we show on Slide #19: procedural and substantive. Exempt organizations are not likely to get in trouble with the IRS if they develop and follow procedures for setting compensation and if they make an honest, responsible effort, commensurate with their size and revenues, to determine what the appropriate level of compensation is for their size, revenues, organizational structure, and mission.

Now lets move on to the compensation-related changes we made to the Form 990 for tax year 2005, which appear on Slides #20 and #21. The changes we're going to talk about generally rose out of or are related to the compensation initiative.

There's still, obviously, time for exempt organizations on a calendar year to file for 2005. We'd like to encourage everyone to file electronically.

The first change we'd like to talk about for this year — Question 75a. Enter the total number of voting officers, directors and trustees. Many problems arise related to boards that are too small. We have also heard that many problems arise out of boards that are too large.

The next two things, we've expanded parts b and c of Question 75 to collect information about entities related to the EO and compensation paid by entities related to the EO. This will help ferret out excess compensation and other non-arm's-length dealing. Unfortunately, we discovered that the new question 75b and c and the accompanying new instructions needed some clarification. We published a Q and A on IRS.gov to clarify the information we wanted that you may have seen recently—it was noted in the most recent EO Update. We also received a question from the audience on that point. Question 75b asks about family and business relationships, and the listener wanted to know what that meant. EOs should use the definitions of family and business relationship contained in the instructions to question 51 for purposes of answering question 75.

David: We added a table, Part V-B, to record compensation paid to former officers, directors and trustees. Former officers, directors, trustees and key employees that receive compensation or that got severance pay weren't necessarily recorded on the Form 990. That was a big loophole.

Finally, you might recall there is a space on the 990 to identify the five highest compensated independent contractors for professional services. We didn't see any reason for differentiating between professional services, and non-professional services, in terms of compensation practices. So this year, we added a new table to identify compensation of the five highest paid independent contractors for non-professional services.

Now let's move onto our final topic. Back in September we published long-awaited regulations, in proposed form, that explain when the IRS can impose the sanction of revocation when section 4958 also applies. These regulations make sense in terms of the compensation initiative and are important in our efforts to establish an enforcement presence.

The proposed regulations consist of three parts, which we summarize on Slide #22. The first part sets forth examples that demonstrate that the private benefit doctrine is alive and well. It did not go away when Congress enacted section 4958 and remains a separate basis for revocation.

These proposed regulations, by the way, apply only to section 501(c)(3) organizations. Of course, intermediate sanctions are also available for section 501(c)(4) organizations--but these proposed regulations do not apply to (c)(4)s.

Before we address the second part of the regulations, the revocation factors, we'll briefly summarize the third part of the proposed regulations. The third part of the proposed regulations contains a set of examples that shows that the IRS has the authority to deny an organization's application for exemption if the IRS determines that the organization is likely to engage in excess benefit transactions in the future. All these examples, as well as the examples in part one of these proposed regulations, reflect current law.

The middle part of these proposed regulations is the revocation standards themselves. The factors that are reflected in these proposed regulations largely reflect the current facts and circumstances approach to making revocation decisions.

In the preambles to the proposed, temporary, and final regulations under section 4958, we set forth certain factors that we may consider in making revocation decisions. The preamble to the final regulations states that, until guidance is published, we will consider all relevant facts and circumstances in the administration of section 4958.

The revocation factors in these proposed regulations are basically the relevant facts and circumstances that we referred to in the preamble. The list is not exhaustive. Karen, what are the factors?

Karen: Take a look at Slide #23.

1. The first factor examines an exempt organization's exempt activities both before and after an excess benefit transaction.

2. The second factor compares the relative size and scope of the organization's exempt activities to the relative size and scope of the excess benefit transactions.

3. The third factor is whether there were repeated excess benefit transactions.

4. The fourth factor is whether the organization has taken or plans to take any remedial actions such as implementing safeguards to prevent the recurrence of benefit transactions.

5. And the fifth factor looks at whether the organization has attempted to seek correction from the disqualified persons involved.

Click to Slide #24. All factors are to be considered in combination with each other. No single factor is accorded any specific weight, except that the fourth and the fifth factors give extra credit, kind of like a thumb on a scale, to organizations that do voluntary compliance before the IRS gets involved. Depending on the circumstances, an organization can get credit for trying to obtain correction even though the disqualified person never actually corrects the excess benefit transaction.

But it's important to know that correction by itself — in the absence of any other factors favoring continued exemption -- will not be enough to forestall revocation. The message that these proposed regulations send to the exempt organizations community is: come forward if you are concerned about past noncompliance. Come forward; engage in remedial measures before the audit. Generally, the revocation factors in the proposed regulations would only apply to situations where revocation is based on inurement. These factors do not need to be applied if the revocation is for other reasons--So if revocation is based on private benefit, political activities, or substantial non-exempt purpose, the factors in the regulations do not need to be applied.

To date, the outside comments we have received on these proposed regulations have been favorable. After receiving some very helpful and comprehensive public comments, we are currently working on finalizing the regulations.

It looks like we have some time to answer some of audience questions that did not fit neatly into our presentation.

First, a long term pastor has been living in a church parsonage and the church now wants to transfer ownership of the property to the pastor. The pastor has made major improvements to the property over the years. How can the property be transferred to the pastor? Can the property be "gifted" to him?

The answer—it is very hard to establish a gift in the employment context. The value of the house over the value of the improvements would be considered compensation, and the question would be whether the total of the compensation he received would be reasonable—remember that a payment may be considered compensation for past services, so it is entirely possible that the transfer of the house could be considered reasonable comp. The income and employment taxes on a transfer that large could be substantial.

We also received a question about reporting payments made to management service organizations. Under Announcement 2001-33, exempt organizations do not have to provide the names, addresses or compensation of officers, directors, trustees, key employees or foundation managers if they pay a management services company for those services. Instead, the organization may state the name of the MSO, the address of the MSO and the amount paid to the MSO. While this announcement governs 990 reporting, it would not affect the potential imposition of section 4958 excise taxes.

Slide #25 provides some links to our webpage and related topics. We hope you've found this presentation useful.

Bobby: Thanks for joining us today. We'll be emailing you a confirmation of your attendance within the next day or two. We'll also be asking for your feedback on this session – we use your comments to improve and tailor our education and outreach. So please return the survey with your comments as soon as you can. Have a good [morning] [afternoon]!