

Client Alert

A report
for clients
and friends
of the firm August 2004

Exempt Organization Compensation Practices Under IRS Scrutiny

The Internal Revenue Service (the "Service") is expanding its efforts to identify and halt abuse by charities and foundations that pay excessive compensation to their officers and other insiders. The Service announced on August 10, 2004 a new enforcement effort, The Tax Exempt Compensation Enforcement Project, that will focus on compensation of officers, favorable insider transactions such as loans, sales or leasing of property to insiders, and Form 990 reporting of possible excess benefit transactions and compensation.¹ In addition to addressing questionable compensation practices, the announced goals of the Project also include learning more about existing compensation practices of tax-exempt organizations and increasing awareness in the tax-exempt world of the tax issues inherent in setting compensation arrangements.

The Internal Revenue Code permits an exempt organization to pay fair market value compensation to its executives and other insiders for their services to the organization. A payment of excessive compensation will cause the executive or insider, and the board members who approve the compensation, to be subject to potentially onerous financial penalties or "Intermediate Sanctions," based on the amount that the compensation paid exceeds fair market value. Organizations which are classified as private foundations and their officers and board members are also subject to substantial monetary penalties for transactions involving excessive compensation to executives. In very egregious cases, the Service has the power to revoke the organization's exemption in addition to imposing the financial penalties on the executive or insider and the approving board members.

The Service intends to contact approximately 2,000 charities and foundations as part of the Project and has already sent letters of inquiry to 200 organizations. It is anticipated that more than 500 organizations will be subject to an examination rather than merely having to respond to written questions. These examinations are likely to focus on the extent of the organization's efforts to determine market value for the services, including reviewing the organization's search for comparables and its advice from independent valuation experts. Contact by the Service does not necessarily imply improper activity since the Project's objectives include collecting information about existing compensation practices. The Project commenced at the end of July 2004 and is expected to continue into 2005.

The Service routinely shares information about charities developed in audits with the states' attorneys general having jurisdiction over the charity. Accordingly, it should be expected that the New York Attorney General and other states' attorneys general also will examine any charities the Service determines have participated in excessive compensation arrangements.

Any organization receiving an inquiry letter or a telephone call from the Service should take the inquiry very seriously and promptly address it by contacting its legal advisor to coordinate all communication with the Service, collect the required information, and prepare the response. In addition, organizations should review their existing compensation arrangements with senior executives to ensure that there is adequate independent support showing the market nature of the transaction.

We will be happy to assist any organization in preparing for and responding to an inquiry from the Service. We have many years of experience advising organizations on structuring compensation arrangements to comply with the applicable rules, including Intermediate Sanctions, and have represented numerous organizations in connection with their IRS examinations.

¹ IR-2004-106 (Aug. 10, 2004).

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Tax Department

Proskauer's Tax Department includes over 25 attorneys with significant and diverse tax, executive compensation and employee benefits law experience. The following individuals serve as contact persons and would welcome any questions you might have:

Jacob I. Friedman

212.969.3805 — jfriedman@proskauer.com

Stuart L. Rosow

212.969.3150 — srosow@proskauer.com

Michael S. Sirkin

212.969.3840 — msirkin@proskauer.com

Tammy D. Fried

212.969.3984 — tfried@proskauer.com

Health Care Department

Edward S. Kornreich

212.969.3395 — ekornreich@proskauer.com

You may also contact any other member of Proskauer's Tax Department in:

New York	212.969.3000
Los Angeles	310.557.2900

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