



Nonprofit Alert

A West Rhode & Roberts Publication

Compensating Compliance - How To Stay §4958 Compliant

This year the Internal Revenue Service is going to increase enforcement on non-profit organizations that claim their exempt status under IRS codes §501(c)(3) and §501(c)(4) and provide excess benefit transactions to disqualified persons. Some organizational leaders are probably thinking that the benefits they receive are reasonable and fair and there is no need to be concerned about the issue. However the penalties for excess benefit transactions are costly to the beneficiaries and the decision-makers of the transaction. Therefore it is in an organizations best interest to understand the issue and know how to be compliant.

An excess benefit transaction provides a benefit to a disqualified person in excess of reasonable compensation for that person's services to the organization. Let's break this down. First, a benefit is anything of economic value, which includes cash and non-cash compensation, deferred compensation, liability insurance premiums, reimbursed expenses not under an accountable plan or for personal use and other compensatory benefits. Excluded benefits include non-taxable fringe benefits, expense reimbursements paid under an accountable plan, benefits provided to a volunteer and benefit provided to a disqualified person solely as a member of a charitable class. Second, a disqualified person is anyone who, in a five-year period beginning 1995 and ending on the date of the transaction, was in position to exercise substantial influence over the exempt organization. A disqualified person may also be a family member of the disqualified person, a voting member of the governing body and even an organization with more than 35% controlling interest in the organization in question. Some circumstances may also determine whether someone is disqualified, such as if the person is the founder or a substantial contributor to the organization. Finally an excess benefit is when a person receives an economic benefit with a value greater than the value of the

services given to the organization. The next thing to cover is the law itself and the actions an organization needs to take to be compliant with the law.

The law concerning excess benefit transactions was placed in the Internal Revenue Code section §4958 in 1996 and was followed up by the department of Treasury regulations §53.4958. Before the law was placed in the Internal Revenue Code, if a non-profit was convicted of private inurement through excess benefit transactions, the exempt status would be revoked. Now the penalty has been transferred from the organization to the individual beneficiary and the individuals who approved the transaction, leaving the non-profit with a survival mechanism to carry out their exempt mission. If an individual is getting excess benefit, the IRS will penalize the person 25% of the excess benefit and require that the money be returned within the taxable period. If the person fails to do so, any subsequent penalty is 200% of the excess benefit. Any manager involved in the excess compensation scheme is penalized 10% of the excess compensation and not to exceed \$10,000. This is not just a slap on the wrist and should be reason enough to be in compliance with §4958.

In order to prevent being in non-compliance with excess benefits, the individual should report all compensation on their personal tax return 1040, and the organization should report their compensation to the individual on the form W-2, 1099 or the 990. In addition to that the organization should prove that the compensation is not excessive by the rebuttal presumption. In order to comply with the rebuttal presumption three things must be met and documented thoroughly. First the organization giving the compensation should assign an independent board of directors to arrange and decide on the compensation arrangement. This decision-making body should be independent in their decision.

"Client Alert" is a publication of WEST RHODE & ROBERTS CPAs. It is intended to provide general information only. For more detailed information or professional assistance, please contact us at 2550 5TH AVE., FIRST FL, SUITE 103, SAN DIEGO, CALIFORNIA 92103, TEL. (619) 615-5380, FAX (619) 615-5389.



Nonprofit Alert

A  West Rhode & Roberts Publication

Second, there must be documentation that comparative data was used to decide on the proper amount of compensation. If the organization has under \$1 million dollars in revenue only 3 comparative sources from similar communities is sufficient to make a decision. Otherwise, the research should be extensive and show that the compensation is reasonable. Experts may be used to value the compensation and of course there is no discussion allowed between the decision-making body and the disqualified individual. Finally the decision must be made and fully documented before the later of the next decision-making body meeting or 60 days after

the final actions of the body. Additionally there must not be a large lapse of time between the preparation and approval of the documentation.

If a non-profit organization understands these issues and follows the rebuttal presumption before compensating an individual, it may save itself from the IRS penalties. Also remember that the more documentation the better and when in doubt contact the IRS, an attorney or tax professional.