

Legal Advice

In recent years the IRS has expressed concern about the manner in which nonprofit organizations govern themselves and the effect they have on the revenue of the federal government. In particular, the IRS is concerned with the level of compensation tax-exempt organizations provide their employees and has enacted penalties against organizations which "overly compensate" their employees.

Excessive compensation issues

The IRS is clearly concerned about the payment of excessive compensation by exempt organizations. For purposes of computing compensation, the IRS considers every benefit an individual receives from the organization as part of that individual's total compensation. Therefore, salary is only one component that the IRS will consider when determining if compensation is excessive. Tax-exempt organizations must be aware that payments of any kind and for any reason that direct the resources of the organization toward an individual are also considered in the calculation of an individual's compensation.

Fringe benefits

The IRS has expressed concern over the failure by many exempt organizations to recognize that some fringe benefits constitute taxable income to their officers. Fringe benefits include enrichments such as the private use of a vehicle that is owned or leased by the organization, payment of an individual's automobile insurance premiums, and an organization's payment of an officers personal expenses, including some household expenses, country club dues, maid services and vacations.

As part of the "Taxpayer's Bill of Rights 2," the IRS began imposing intermediate sanctions against individuals involved in certain types of transactions with churches and other tax-exempt organizations. Essentially, these sanctions take the form of excise taxes that may be imposed in lieu of, or in addition to, revocation of the organization's tax-exempt status. Marcus Owen, former director of the IRS Exempt Organizations Division in Washington, D.C., stated at a conference that the sanctions are intended to shock the conscience of individuals in nonprofits who receive excessive salaries, perks and benefits.

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Intermediate sanctions

Essentially, the "Taxpayer's Bill of Rights 2" imposes a series of intermediate sanctions on individuals involved in transactions that result in any disqualified person receiving an excess benefit from a nonprofit organization. For purposes of this new tax law, a disqualified person receives an excess benefit if that person directly or indirectly receives an economic benefit from a tax-exempt organization that exceeds the value of the consideration received by the organization.

For example, if a church pays its pastor \$200,000 per year (the pastor's total compensation package including salary, housing allowance, benefits and fringe benefits) and the value of the pastor's service is determined by the IRS to only be \$100,000, the pastor has received an excess benefit of \$100,000.

One of the problems with this law is the severity of the penalties involved. For each excess benefit transaction, the following series of draconian penalty taxes are involved:

- The disqualified person who receives the excess benefit must repay the benefit to the organization. In addition, those disqualified must pay an excise tax to the IRS equal to 25 percent of the excess benefit.
- The organization managers who were aware and participated in the excess benefit transaction are liable for an excise tax equal to 10 percent of the excess benefit, up to a maximum of \$10,000 for each excess benefit transaction.
- If the disqualified person who received the excess benefit does not repay the organization within the same tax period (defined as the date of the transaction to the date of assessment or notice of deficiency), the IRS imposes a 200 percent excise tax on the excess benefit received by the disqualified person.

If the organization pays or reimburses an employee for the payment of the excess benefit penalty taxes, the payment or reimbursement is itself an excess benefit unless it is included in the employee's taxable compensation the year the payment or reimbursement is made. The employee's total compensation will still be subject to the reasonable compensation requirement.

To better illustrate the potential impact of this law, recall the example above of the pastor whose total compensation is \$200,000, but the reasonable value of his service to the church is only \$100,000. Under this new law, the pastor

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must repay the \$100,000 excess benefit to his church and a \$25,000 excise tax to the IRS. If the pastor does not or cannot repay the excess benefit to his church within the same tax period, then a \$200,000 tax is imposed by the IRS.

If you have specific questions regarding the topic of compensation issues, you should contact a qualified attorney for more extensive legal advice.

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