

# Nonprofits: Excess Compensation, Private Benefit, and Unrelated Business Income

Two of the biggest compliance risks for nonprofits are private inurement and unrelated business activity—and this course tackles both. You'll examine what constitutes excessive compensation and sweetheart deals, how the IRS identifies and penalizes these arrangements, and what documentation can protect your clients. The course also covers unrelated business income tax, helping you distinguish taxable activity from exempt purposes. If you work with nonprofits that generate revenue or compensate insiders, this material is essential.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

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### Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

### Course Objectives

- Identify the specifics of IRS monetary penalties.
- Recognize which unrelated business income sources are exempt from UBIT.
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## Chapter 1: EXCESSIVE COMPENSATION, SWEETHEART DEALS, AND OTHER WAYS TO GET IN TROUBLE WITH THE IRS

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### *Chapter Objective*

After completing this chapter, you should be able to:

- Identify the specifics of IRS monetary penalties.

The premise of this chapter might seem ludicrous: that the IRS needs to police nonprofits to prevent them from paying their key employees too much or otherwise enriching insiders. Nevertheless, this has become a hot-button issue for the IRS, largely because of the seemingly endless stream of stories about nonprofit insiders who have unlawfully used nonprofit funds for their own personal purposes. To prevent these kinds of abuses, the IRS has exercised its broad powers and imposed substantial monetary penalties on those who engage in improper financial transactions with nonprofits. In extreme cases, the IRS can revoke the tax exemption of a nonprofit involved in improper financial activities.

Most commonly, the transactions that nonprofits need to watch out for are paying excessive compensation to key employees and giving money or property to insiders without receiving a fair return. Fortunately, the IRS has established procedures that you can follow to avoid running into these problems and the wrath of the IRS.

### *Tip*

**Do you need to worry about this stuff?** You probably don't have to worry about the issues covered in this chapter if you're running a small all-volunteer nonprofit or have only a few employees who are paid at or below market rates. However, even a small nonprofit might run afoul of these rules if directors, officers, or other insiders engage in financial transactions with the nonprofit.

### A NONPROFIT ISN'T A PERSONAL PIGGY BANK

It should go without saying that the money and other assets a nonprofit obtains are to be used only for the organization's nonprofit purposes, not for the private gain or enrichment of insiders. This course uses the term "insider" to refer to those who run the nonprofit, helped found it, work for it, contribute to it, or are related to it in any way. The tax law provides that an organization is entitled to tax-exempt status only if it is "organized and operated exclusively for religious, charitable, scientific," and a few other specified purposes.

Obviously, this requirement is not satisfied where a nonprofit's money is used to benefit insiders instead of furthering its exempt purposes. Lawyers have coined the confusing term "private inurement" to describe when a nonprofit's money or other assets are devoted to private uses by insiders instead of the charitable purposes they were intended for. Here are just a few examples:

- A nonprofit executive used the organization's money to pay his child's college tuition, lease a luxury car for his wife, have his kitchen remodeled, and rent a vacation house at the beach. The nonprofit also permitted him to charge almost \$60,000 in personal expenses to the organization's American Express card.
- The CEO at a tax-exempt hospital used charitable assets to pay for personal items, such as liquor, china, crystal, perfume, an airplane, and theater tickets. The hospital also picked up the tab for the CEO's country club charges and catered lunches to the tune of approximately \$20,000.
- A nonprofit paid \$200,000 for its executive director's wedding reception and tropical island honeymoon. The nonprofit also paid \$90,000 for the down payment on the director's home and had enough left over to pay for his trip to a desert health spa.

Most of the highly publicized cases of private inurement involve larger nonprofits. However, the problem is certainly not limited to large nonprofits. In one case, for example, the founder of a small church, who also served as its president and director, allowed his children to live rent free in a house owned by the church. He also used church credit cards to pay for personal expenses, such as department store purchases, car repairs, food, hotel, and clothing charges—and even had the church hire a private investigator to surveil his daughter-in-law.

When a nonprofit engages in any type of conduct that results in an improper benefit to an insider, one of three things can happen:

- Nothing.
- The IRS can impose monetary sanctions.
- The IRS can revoke the nonprofit's tax exemption.

The most likely IRS response is the imposition of sanctions, so we'll discuss that first.

## THE IRS INTERMEDIATE SANCTIONS MINEFIELD

The IRS is very serious about preventing excessive compensation, sweetheart deals with insiders, personal use of nonprofit assets, and other such abuses. To this end, Congress has given the IRS the power to impose monetary penalties against insiders it finds to have engaged in this type of prohibited conduct. The IRS calls these penalties intermediate sanctions because they are more than doing nothing, but fall short of revoking a nonprofit's tax-exempt status. These penalties can be

substantial. Moreover, they are levied—not on the nonprofit—but on the individuals who participate in the prohibited transaction.

This may include not only the people who benefited from a transaction, but those within the nonprofit who approved it as well. A nonprofit's managers (directors, officers, or others) who approve a transaction that they know is improper may be subject to a 10% excise tax. And they have to pay these IRS penalties out of their own pockets!

How big can these penalties be? Very big. Consider this simple example: A small rape crisis prevention center pays Sam, its executive director, \$90,000 in total compensation, for 20 hours of work per week. The compensation package is approved by Denise, Dave, and Donald, three of the nonprofit's directors, even though they knew that similar nonprofits in the area paid \$40,000 or less for similar work. The IRS receives a complaint from a former employee of the nonprofit stating that it is paying excessive compensation to Sam. The IRS audits the nonprofit and determines that reasonable compensation for Sam is only \$40,000. Thus, Sam received an excess benefit of \$50,000. Here's what happens:

- Sam must pay the IRS a penalty tax equal to 25% of the excess benefit—in this case, \$12,500.
- Sam must also pay the \$50,000 excess benefit back to the nonprofit; if he doesn't, he will have to pay an additional tax to the IRS equal to 200% of the excess benefit—or \$100,000.
- And, finally, Denise, Dave, and Donald, the directors who knowingly approved Sam's compensation, must jointly pay an excise tax equal to 10% of the amount of the excess benefit, up to a maximum of \$20,000—in this case, \$5,000 total among the three of them.

So, at a minimum, the IRS will receive \$17,500 in penalty taxes—\$12,500 from Sam out of his own pocket and \$5,000 from Denise, Dave, and Donald. The IRS would receive an additional \$100,000 if Sam failed to pay the \$50,000 back to the nonprofit.

Do we have your attention now? Good. Read on, because it is certainly worth it for you to know how to avoid these kinds of potential problems with the IRS. To start, a few basics.

### **Disqualified Person + Excess Benefit = IRS Sanctions**

IRS sanctions are imposed only when insiders—such as board members, officers, or key employees—siphon off a nonprofit's money or assets for their personal enrichment. In IRS parlance, these people are known as “disqualified persons” (“DPs”) and their improper financial dealings are “excess benefit transactions.” The intermediate sanctions rules come into play only when both of these elements—DPs and excess benefits—are combined. For example, you don't have to worry about IRS sanctions when determining the compensation of a low-paid bookkeeper, but you do have to worry when deciding how much to pay your nonprofit's president or executive director. This is because under the IRS's rules, the president is a disqualified person, but the bookkeeper isn't.

Likewise, you don't have to worry about sanctions when your nonprofit pays its president or CEO a reasonable amount because that transaction doesn't result in an excess benefit. The key to avoiding sanctions, then, is never to pay or give an excess benefit to a DP.

**Who is a disqualified person?** A disqualified person is anyone who is in a position to exercise substantial influence over your nonprofit's affairs. This category includes your nonprofit's officers and directors and possibly a few other influential people in the organization. See "Identify Your Nonprofit's Disqualified Persons," later.

**What is an excess benefit transaction?** The fact that a person is a disqualified person doesn't mean that that person can't transact business with your nonprofit and benefit from it financially. Far from it. For example, your nonprofit's CEO or executive director is entitled to be paid, even though they are an automatic DP. Likewise, a DP may sell or lease property to the nonprofit. Sanctions may be imposed by the IRS only when a DP enters into a transaction with the nonprofit and receives benefits greater than they provide in return—for example, a key employee is paid excessive compensation or a DP sells or rents property to the nonprofit for more than its fair market value. The IRS calls such an unequal exchange an "excess benefit transaction." The excess benefit is the difference between the value of what is received by the nonprofit and what the nonprofit gives to the DP.

Excess benefit transactions can take a variety of forms, but by far the most common is paying excessive compensation to DPs such as presidents, CEOs, CFOs, or other highly compensated employees (defined as employees earning \$150,000 or more). Other common excess benefit transactions include:

- Excessive expense accounts—for example, payments for excessive travel and food expenses or misuse of the nonprofit's credit card
- Personal use of nonprofit property by a DP, such as a car or dwelling
- Paying personal expenses for members of a DP's family
- Leasing property from a DP in return for excessive rent
- Purchase of goods or services from DPs at above fair market value
- Sale of goods or services to DPs at below fair market value, and
- Loans to DPs with below market interest rates (or no interest at all).

*Tip*

**Get a professional opinion.** If you think that a proposed transaction with someone might be an excess benefit transaction, consider getting a written professional opinion from an attorney, a certified public accountant or accounting firm, or an independent qualified valuation expert. If the directors or other managers of your nonprofit obtain and follow an opinion, the IRS can't impose sanctions on them if it later determines that the transaction was an excess benefit transaction. To be relied upon, the opinion must explain why the transaction isn't an excess benefit transaction.

**Automatic Excess Benefits**

In some cases, the IRS imposes intermediate sanctions automatically, without even having to determine if a DP was paid too much or some other transaction was unreasonable. This occurs in two situations. First, any payment or other economic benefit to a DP that is not clearly identified by the nonprofit as compensation for the person's services is treated as an excess benefit, even if the amount is reasonable. For example, if a nonprofit pays for a benefit, such as life insurance coverage for a DP, and doesn't document in writing that the payment is compensation for the DP's services, the payment will automatically be treated as an excess benefit. (See "Document All Taxable Compensation Paid to DPs," later.)

Second, an automatic excess benefit also occurs whenever a nonprofit reimburses a DP for work-related expenses without following the recordkeeping rules for accountable reimbursement plans. For example, if a nonprofit reimburses its director for a \$5,000 trip without requiring him to document his expenses, the entire amount will be treated as an excess benefit, and the director will have to return the money to the nonprofit and pay IRS sanctions as well. This result can easily be avoided by following the accountable plan rules discussed below. (See "Reimburse Employee DP Expenses Under an Accountable Plan," later.)

**Loans With Insiders**

It is generally not a good idea for a nonprofit to lend money to a DP. About 20 states ban loans from nonprofits to their directors or officers, while another seven place limits on them. You should check your state's nonprofit laws before even thinking about making a loan to a DP. If your nonprofit does make a loan to a DP, its terms should be fully set forth in a written promissory note and formally approved by the board using the procedure described in "Follow IRS-Approved Procedures," below.

**The Poster Child for IRS Sanctions**

A used car salesman established a nonprofit to help the homeless. All of its revenues were obtained by selling used cars donated by the public. The car salesman served as the nonprofit's

president and executive director. The board of directors consisted of the salesman, his wife, father-in-law, and an unrelated CPA. An IRS examination found that the nonprofit sold \$200,000 worth of donated cars each year, but donated only \$5,000 a year to homeless shelters. Among other things, the nonprofit:

- Paid the president a salary of \$120,000 per year, without obtaining approval from the board
- Leased a vehicle for the president's use, without requiring him to account for how he used the car
- Hired a towing company owned by the president's son to which it paid much more than the going rate for such services
- Made payments to the president for an alleged loan he made to the nonprofit, although there was no promissory note or other evidence that the loan was ever made, and
- Permitted the president and his relatives to make personal use of the nonprofit's business premises.

The IRS found that the president and his relatives were DPs and that all of these transactions were excess benefit transactions, upon which it imposed sanctions. (IRS Technical Advice Memo 200243057 (2002).)

The promissory note should list the original amount borrowed, balance due, maturity date, repayment terms, interest rate, security provided, and purpose of the loan. The loan should be treated as such on the nonprofit's books. Also, the existence and terms of the loan must be fully disclosed to the IRS and public on the Form 990 or Form 990-EZ most nonprofits file with the IRS each year.

The DP must actually repay the loan under the terms of the agreement, and the nonprofit must demand repayment if the DP doesn't do so. If the interest rate is below market, or there is no interest, the value of the forgone interest must be added to the DP's total compensation. The interest rate is below market rate if the amount loaned exceeds the present value of all the payments due under the loan. (Present value is the total amount that a series of future payments is worth now—several present-value calculators can be found on the internet.)

It isn't uncommon for DPs who receive money that they can't otherwise account for to claim that the payments were loans from the nonprofit, or repayments of loans the DP previously made to the nonprofit. These claims won't be accepted by the IRS unless the loan is fully documented and treated like a real loan.