



# CLIENT ADVISORY

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The Internal Revenue Service recently published the findings of their Executive Compensation Compliance Initiative (the "Project"). This project was divided into 3 parts. Part I involved compliance check letters sent to 1,223 organizations, Part II involved examinations of 782 organizations (approximately 10% of the examinations remain open) and Part III is a result of the information gathered in Part II of the Project and will be discussed subsequently, as well as the continuing work in the executive compensation area.

The objectives of the Project were:

1. Use of the Exempt Organizations Compliance Unit and the Data Analysis Unit, to impact a broader cross section of the Exempt Organization departments through correspondence and traditional examination techniques.
2. Increase awareness of compensation as a compliance issue within the charitable sector and establish an IRS enforcement presence in this area.
3. Observe the practices and procedures exempt organizations use to determine compensation of their officers, directors, trustees, key employees, and related persons.
4. Assess and enhance tax law reporting and compliance with respect to compensation practices of exempt organizations.

Initially, the IRS contacted 1,826 exempt organizations regarding their executives' compensation. In Part I of the Project, the IRS followed up by sending compliance check letters to 1,223 exempt organizations whose Forms 990 and 990-PF fit within discrete categories of missing information which required the IRS to follow up. These organizations were divided into five (5) categories:

**Category A:** 50 public charities with assets of \$1 million or more and revenue of \$5 million or more that had reported significant total compensation, but did not provide detailed information regarding the compensation.

**Category B:** 100 public charities of all sizes reporting receivables/loans from officers, directors, trustees, and key employees exceeding \$100,000 or more. Requested clarification of the loans.

**Category C:** 378 public charities that either answered yes or failed to respond to the question of whether they had participated in an excess benefit transaction.

**Category D:** 497 public charities that either answered yes or failed to respond to the question about transaction with disqualified persons.

**Category E:** 188 private foundations that did not report any officers' compensation.

In Part II the IRS conducted 782 examinations, 179 were the result of responses to the compliance checks in Part I. The purpose was to determine whether the compensation of disqualified persons was reasonable in accordance with the Internal Revenue Code. These exempt organizations were divided into the following four (4) categories:

**Category 1:** 100 small public charities with assets of less than \$1 million and revenues of less than \$5 million (these organizations reported significant amounts of compensation for one or more of their officers)

**Category 2:** 208 larger public charities with assets of \$1 million or more and revenues of \$5 million or more (these organizations reported significant amounts of compensation for one or more officers).

**Category 3:** 97 public charities chosen through a sample of Form 990s with Part V (Current Officers, Directors, Trustees, and Key Employees) completed.

**Category 4:** 198 private foundations reporting significant officers' compensation.

The results of the Project are as follows:

1. Significant reporting errors and omissions in specific areas, particularly excess benefit transactions and transactions with disqualified persons as well as potential compliance issues related to loans made to officers. Forty-nine percent of the compliance check recipients provided additional information that did not require changes to their returns or schedules. Over 30% of compliance check recipients amended their Forms 990 while 15% of the compliance check recipients were selected for examination.
2. The examinations that have been conducted did not find widespread concerns other than reporting. The IRS believes that continue work in the executive compensation area is still needed since a number of the organizations improperly reported compensation on at least one form.

3. Significant penalties are being assessed where problems are found. The issues allowing for the penalties were: excessive salary and incentive compensation; payments for vacation homes, personal legal fees, or personal automobiles that were not reported as compensation; payments for personal meals and gifts to others on behalf of disqualified persons that were not reported as compensation; and payments to an officer's for profit corporation in excess of the value of services provided by the corporation. The EO needs to readdress the issue of when penalties should be assessed for filing an incomplete Form 990.
4. The compensation amounts were substantiated with comparable data.
5. Additional training is necessary in areas of reporting requirements (providing clearer instructions regarding what needs to be reported), as well as the "rebuttable presumption" procedure that may be relied upon by public charities to establish appropriate compensation.
6. Form 990 needs to be revised to reduce errors in reporting and provide sufficient information to enable the IRS to identify compensation issues.
7. The use of new compliance contact techniques helps the IRS to concentrate on particular industries, demographics and governance practices to better assess compliance levels.

Finally, the issues involving loans to officers have raised considerable concern with the IRS. The IRS has begun Part III of the Project which includes 200 compliance checks and 50 additional single issue examinations focusing on organizations with loans to executives.