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CLIENT ALERT

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## NONPROFIT COMPENSATION A FOCUS OF THE IRS

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Following up on announcements earlier in the year, the IRS recently began to poll over 2,000 tax-exempt organizations concerning their compensation arrangements and objectives. The IRS will focus not only on the amounts of compensation but various forms of compensation, such as loans, affiliated service contracts with the organization or other dealings between the organization and its executives.

The IRS indicated that the purpose of the survey project is to “address the compensation of specific individuals and instances of questionable compensation practices, increase the awareness of tax issues as organizations set compensation in the future, and learn more about the practices organizations are following as they set compensation and report it to the IRS and the public...” This effort follows up an announcement in March of 2004 by the IRS that it would commence an initiative designed to monitor nonprofit healthcare entities and improve compliance under Internal Revenue Code section 4958 with regard to excess benefit transactions.

This focus on executive compensation comes at a time when a number of tax-exempt hospitals are feeling increased public scrutiny and suffering under the barrage of a class action lawsuit dealing with practices for billing uninsured patients. Both the IRS initiative and the class action suit are bringing a bright spotlight on compensation levels and practices of nonprofit organizations. This emphasizes again the need for such organizations to be aware of the importance of this issue and the complex rules governing excess benefit transactions.

The excess benefit transaction rules of the Internal Revenue Code are meant to sanction non-fair market value transactions between certain types of tax-exempt organizations and persons in a position to significantly influence the operations of those organizations. One of the most common types of transactions subject to scrutiny under the excess benefit transaction rules are compensation arrangements between an organization and its executives. The excess benefit transaction rules include detailed regulations to provide guidance to organizations in establishing compensation levels for executives. Board members of exempt organizations should be aware of these rules and follow their requirements, not only for the sake of the organization they serve, but also because the excess benefit transaction rules include sanctions that can be assessed personally against board members.

We anticipate that the scrutiny of the compensation arrangements of exempt organizations will only increase in the months ahead. Organizations are well advised to assess their practices for setting compensation, including all elements of a compensation package and address board procedures for reviewing, on a regular basis, the compensation levels and practices of the organization.

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