

# Profitable **Solutions** *for* **Nonprofits**

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Excessive compensation

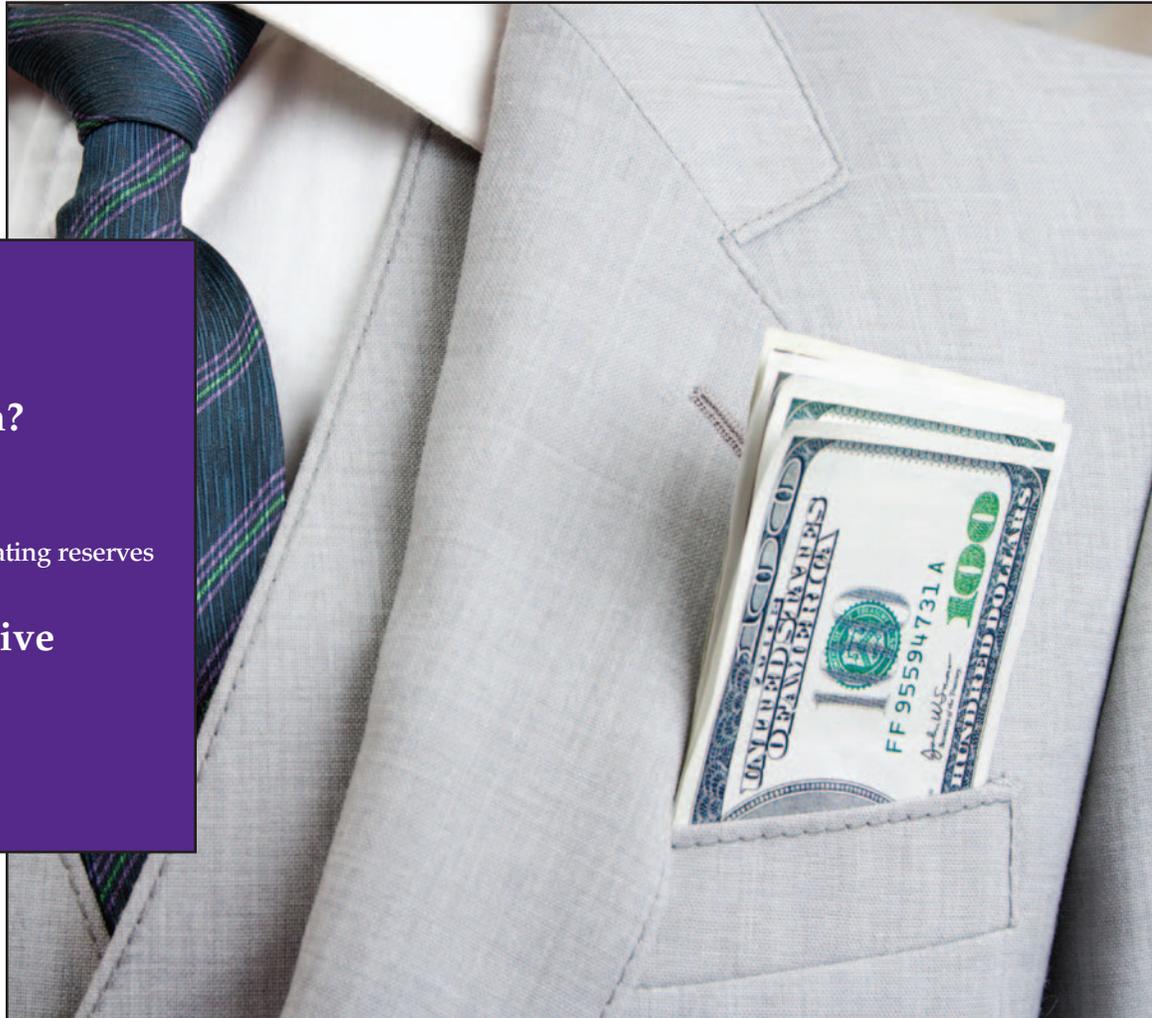
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## Excessive compensation

# Can you satisfy the rebuttable presumption?

**A**n August *New York Times* article put the spotlight on the generous compensation enjoyed by two executives at the nonprofit Young Adult Institute — totaling nearly \$2 million a year. Their behavior lit a firestorm, prompting the state government to seek compensation data at other New York-based nonprofits.

Exempt organizations across the country should be sensitive to the issue. When a nonprofit executive receives excessive compensation, the IRS can impose excise taxes on the executive, and the organization will suffer reputational damage. Fortunately, you can limit the potential liability of your not-for-profit's members by taking advantage of a three-step procedure known as the rebuttable presumption.

### THE LAW ON COMPENSATION

Internal Revenue Code Section 4958 prohibits 501(c)(3) and 501(c)(4) organizations from engaging in an “excess benefit transaction” with a “disqualified person.” Disqualified persons generally include anyone in a position to exercise substantial influence over the organization's affairs at any time in the five-year period preceding the transaction, such as officers and directors.

An excess benefit transaction takes place when a disqualified person receives a benefit that exceeds the value of the benefit the organization receives in exchange — for example, when an executive director is paid a salary that far exceeds the salary

of executive directors at similar organizations. Violations of Sec. 4958 can lead the IRS to impose excise taxes (intermediate sanctions) on the disqualified person who benefited from the transaction as well as the nonprofit's managers (for instance, board members) who approved it.

### THE REBUTTABLE PRESUMPTION

Federal tax regulations provide a rebuttable presumption of reasonableness for compensation arrangements that satisfy three requirements. If all of the following are met, it's up to the IRS to show that compensation was nonetheless unreasonable.

**1. The compensation arrangement was approved in advance by an authorized body of the organization.** Compensation generally must be set by the board of directors or a subcommittee composed of board members. It's critical that none of the



## DEFINING A CONFLICT OF INTEREST

A member of the authorized body (see main article) charged with approving a compensation arrangement has a conflict of interest with respect to the arrangement if he or she:

- \* Is a disqualified person participating in or economically benefiting from the compensation arrangement or is a family member of any such disqualified person,
- \* Is in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement,
- \* Receives compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement,
- \* Has a material financial interest affected by the compensation arrangement, or
- \* Approves a transaction providing economic benefits to any disqualified person participating in the compensation arrangement, who in turn has approved — or will approve — a transaction providing economic benefits to the member.

participants have a conflict of interest regarding the arrangement. For example, neither the executive nor a subordinate of the executive can participate in the compensation decision.

**2. The authorized body relied upon appropriate comparability data prior to making its determination.** That entity can rely on data derived from industry surveys, documented compensation of individuals in similar positions in similar organizations, expert compensation studies or other comparable data about reasonable compensation for the position. If your organization's gross annual receipts are less than \$1 million, you only need compensation data for three similar positions in similar communities. The regulations don't specify the requisite number of comparables for larger organizations.

Remember that similar job titles don't necessarily mean similar jobs. When evaluating comparability data, the positions must have comparable *duties*, not just titles.

**3. The authorized body adequately documented the basis for its determination while making that determination.** This requirement is often overlooked. Documentation must include terms of the arrangement and the date it was approved, members of the

body who were present during debate on the arrangement and those who voted on it, comparability data that was relied on and how it was obtained, and any actions by a member with a conflict of interest.

*When a nonprofit executive receives excessive compensation, the IRS can impose excise taxes on the executive, and the organization will suffer reputational damage.*

You must prepare the documentation before the later of the next meeting of the authorized body or 60 days after the body's final actions. The body also must approve the documentation within a reasonable time after preparation.

### A BEST PRACTICE

If you're not already abiding by the rebuttable presumption requirements when setting compensation for disqualified persons, start now. Otherwise, you risk incurring costly excise taxes and long-lasting reputational damage. \*

# Safety net essentials

*Now more than ever, you need operating reserves*

**T**oo few nonprofits keep healthy operating reserves. A study of charities in the Washington, D.C., area, for instance, found that 57% of the organizations had insufficient operating reserves to cover three months of expenses — the minimum level many experts consider necessary to maintain financial stability.

Forgoing reserves leaves your nonprofit vulnerable to rapid or unexpected drops in revenue or jumps in expenses. You may regard such funds as optional or a luxury, but that's just not the case these days.

## WHAT ARE OPERATING RESERVES?

The Nonprofit Operating Reserves Initiative Workgroup defines “operating reserves” as the portion of unrestricted net assets that nonprofits designate to sustain financial operations. The assets would be tapped in the event of significant unbudgeted increases in operating expenses or losses in operating revenues. Reserves also should be liquid, or easily converted to cash.

*Robust reserves allow organizations to seize unexpected opportunities and set aside funds for long-term goals and plans.*

Note that operating reserves and cash on hand are *not* the same. Cash is often restricted for specific purposes, such as future projects or programs, and is therefore unavailable for other uses, unlike reserves.

Operating reserves also are distinct from endowments. Endowments are restricted, as well, and the organization can typically spend only the interest generated by



the principal funds, making that money unavailable for daily operations.

## WHY DO WE NEED RESERVES?

The times are turbulent, and even when the economy gets solidly back on its feet, it won't stay that way indefinitely. Operating reserves can help nonprofits bridge the gap when revenue streams or donations fall off because of a wobbly economy.

Robust reserves also allow organizations to seize unexpected opportunities, set aside funds for long-term goals and plans, and cover increased expenses after a natural disaster or other emergency hits.

You also can tap reserves to ramp up your staff and deliver services under federal contracts that don't provide payment for 30 to 60 days. Reserves will come in handy, too, if grants fail to come through, or major fundraising events are delayed or canceled.

## HOW MUCH DO WE NEED?

There's no universal operating reserves benchmark that applies to every organization, and the question of an appropriate operating reserves amount can raise some

thorny issues among stakeholders. Some may argue, for example, that the nonprofit has an ethical obligation to devote as much of its available resources as possible to carrying out its mission. Others might worry about the appearance or difficulty of soliciting additional donations while sitting on significant reserves.

Reserves, however, aren't about accumulating wealth. They're about securing the financial stability necessary to function effectively for the long run.

According to the Workgroup, you need to consider several questions when setting the goal amount, including:

- \* Are your revenue sources subject to large unexpected negative fluctuations?
- \* Are your resources subject to sudden increases in demand?

- \* Are your income and expenses subject to significant day-to-day fluctuations?
- \* Have your planning and budgeting processes been historically accurate in forecasting financial results?
- \* Are adequate backup resources likely to be available?
- \* Is the governing body trying to expand the organization?

The Workgroup recommends a *minimum* reserves level of 25% or three months of your nonprofit's annual expense budget. The adequacy of reserves beyond that amount will depend on specific circumstances.

#### YOU CAN'T AFFORD NOT TO

Organizations without sufficient operating reserves can run into trouble meeting payrolls, paying bills, providing services and retaining qualified staff. Your CPA can help you determine the amount of reserves you need to minimize such risks. \*

## When contributors receive something in return

**D**oes your charity understand how to treat quid pro quo arrangements? "Quid pro quo" describes an arrangement in which a contributor gives money in exchange for something else. Whether it's a supporter buying a ticket for your charity ball or an attendee at your charity auction successfully bidding on a hotel stay, such situations create an obligation for your nonprofit.

#### UNDERSTANDING THE REQUIREMENTS

According to IRS rules, you may ignore contributions of less than \$75, but if your not-for-profit receives more than \$75 *and* provides a benefit to the donor, you

must advise the donor that it's a quid pro quo contribution. With such contributions, donors can deduct only the amount they pay *in excess* of the value of the goods or services.

Additionally, the charity must put in writing the amount donated, the goods or services provided in return, and a good-faith estimate of their value. You must also provide written acknowledgment when the donation is solicited or when it's received.

If you're holding a musical performance for which tickets are sold, for example, each ticket should

disclose the tax-deductible portion of the ticket price (in this case, the market value of a similar event in your area). You must make the disclosure in a readily visible format. You can find examples in IRS Publication 1771, *Charitable Contributions — Substantiation and Disclosure Requirements*.

Your organization could be penalized for failing to furnish the proper acknowledgment and disclosure. Fines are \$10 per contribution, up to \$5,000 for the fundraising event. If the contribution is \$250 or more, failure to provide and describe a good-faith value of the benefit may cost the donor their contribution deduction.



## VALUING THE GOODS AND SERVICES

A key task for the charity is to value the goods or services. An example: Your organization takes a group of supporters to a sporting event and pays for their tickets. The supporters then make large donations. Determining quid pro quo is fairly simple in such cases: The amount your organization paid for the tickets would be considered the fair market value, and only the amount of the contributions *in excess of this value* would be a tax-deductible contribution for the donor.

It's not as easy when some of the items given away have been donated to your organization. Let's say, for instance, that your charity put on a one-day chocolate lovers' event with live chamber music. The hosting hotel charged you a reduced amount for the candy and desserts as its contribution, and the chamber quartet performed at no cost. To establish the value to be reported to the donor, you must determine what it

would cost someone to attend a similar event. In this case, you might be able to find a comparable activity in a nearby community.

## PLACING VALUE ON AUCTIONED ITEMS

All items auctioned at a charity auction (silent or regular) must have a value placed on them. The charity should ask the donor to put a value on the item unless it's readily apparent, such as with a \$50 gift certificate. The value should be the amount that a willing buyer would pay for the item in an "arm's length" transaction — that is, in the marketplace.

The charity can then publish the item's value on bid cards or in a catalog of auction items. This serves as the acknowledgment, and the buyers will be entitled to a deduction for the amount paid *in excess of* that value.

## UNDERSTANDING EXCEPTIONS TO THE RULE

There are a few instances when quid pro quo reporting isn't necessary:

**Membership exception.** This exception happens when membership benefits (free admission or free parking, for example) are provided, but the annual membership fee is \$75 or less.

**Token exception.** This exception takes place when a contribution is for \$49.50 or more and the goods cost less than \$9.90, *or* the value of the benefit to the donor doesn't exceed 2% of the donation or \$99, whichever is less.

**Intangible religious exception.** This exception pertains to religious benefits, such as religious services or classes that are provided by an organization operated exclusively for religious purposes (excluding travel, education and consumer goods).

In other situations, it's safer to report quid pro quo than not.

## SUBJECTIVE DECISIONS

Making decisions on the value of items you give to contributors in exchange for contributions often involves a degree of subjectivity — value is sometimes in the eye of the owner. If you have any disclosure or reporting questions concerning contributions to your nonprofit and quid pro quo arrangements, contact your CPA. \*

# Newsbits

## SALVATION ARMY GOES DIGITAL

The Salvation Army last holiday season began shifting to digital donations at their famous red kettles. The charity was testing the use of Square, a mobile payments tool that allows anyone to accept credit card payments via mobile devices. In an effort to keep up with tech-savvy donors and changing technology, the organization deployed Square at 10 red kettle locations each in Chicago, Dallas, New York and San Francisco.



Bell ringers in the test cities carried Android™ smartphones donated by Sprint Nextel that were equipped with Square's postage-stamp-size card reader and two apps, one from Square and one from the Salvation Army. (Square also works on iPhone® and iPad® devices.) Donors swiped their credit cards and signed on the phone itself, just as they would at any credit card processing terminal, and the money was deposited directly into the Salvation Army's account.

The *New York Times* reported that other nonprofits and individual fundraisers also have begun to use the Square technology. A Girl Scout troop in Silicon Valley, for example, used it last year to sell about 400 boxes of cookies at the workplace of one troop member's father. \*

## A NONPROFIT THAT ENDORSES PRO-NONPROFIT CANDIDATES

A new 501(c)(4) called CForward was recently formed to champion the economic role of nonprofits and to educate and support candidates for political office. The organization will endorse and work to elect candidates who demonstrate a clear understanding of the economic role nonprofits play in their geographic area.

In particular, CForward plans to educate candidates about the:

- \* Number of nonprofits that operate in their district, city, state or the country,
- \* Jobs the organizations create, the wages they pay, and the payroll taxes they generate,
- \* Amount of outside investment nonprofits bring into the community, and
- \* Ancillary financial impact their work has on the economy.

Initially, CForward will focus on local elections — especially mayoral and gubernatorial — prioritizing its support for candidates who commit to appointing a point person, team or cabinet-level officer to work directly with nonprofit constituents. \*

## WHICH CELEBRITIES HAVE FOUNDATIONS?

The Foundation Center has issued its latest edition of the *Celebrity Foundation Directory*, featuring detailed descriptions of more than 1,700 foundations started by VIPs in the fields of business, entertainment, politics and sports. The directory, a digital publication useful for prospect research, can be purchased online for \$59.95 or accessed for free at the Foundation Center's libraries, as well as at affiliated libraries, community foundations and other nonprofit resource centers nationwide. \*

