



Nonprofit *Alert*[®]

Alerting nonprofit leaders to key legal developments and responsive risk management steps

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IRS Reports on Executive Compensation Compliance Project

In 2004, the IRS implemented an initiative designed to review compensation practices of exempt organizations and identify potential areas of abuse. The project was two-tiered, encompassing (1) a compliance check phase, and (2) an examination phase. Based on review of Forms 990, the IRS sent compliance check letters to 1,223 exempt organizations of various shapes and sizes whose Forms 990 indicated that compensation information may be missing. The examinations phase followed, and was aimed at determining whether the compensation of disqualified persons was reasonable. This phase involved 782 organizations, with broad revenue and asset ranges among both public charities and private foundations. Nearly 25% of those selected for examination stemmed from unsatisfactory responses to the compliance check phase.

The IRS recently issued a report of its findings in both the compliance check and examinations phases. In sum, the IRS found that while many organizations reported incomplete or inaccurate information regarding compensation on their Forms 990, incidences of payment of excessive compensation were not frequent. The compliance check phase revealed that:

- significant issues exist regarding complete and accurate reporting of compensation, as 31% of compliance check recipients amended their Forms 990 after receiving the compliance check letters;
- many organizations were confused by the Form 990 and instructions;
- loans to officers and employees raised considerable compliance concerns. 100 public charities reported loans to officers, directors, and key employees of over \$100,000. After follow-up with 92 of these organizations, 37 were referred to examination. (Based on these findings, the IRS has initiated a third phase to the project that is focused on organizations providing loans

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Compensation Compliance...continued

to executives. This phase will include 200 compliance checks and 50 additional examinations.)

For the examinations phase, the IRS has reported that 705 out of 782 examinations are complete, and the vast majority resulted in no change to status, and no tax was owed. 115 were closed with a written advisory and will be subject to future review. Only 25 of the examinations resulted in proposed excise taxes. However, these assessments are large, totaling \$21 million in proposed excise taxes against 40 disqualified persons and organization leaders. Of the proposed \$21 million in excise taxes, over \$4 million involved public charities and over \$16 million involved private foundations. Issues which gave rise to these assessments included:

- excessive salary and incentive compensation;
- payments for vacation homes, personal legal fees, and 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 a disqualified person's for profit corporation in excess of the value of services provided by the corporation.

Overall, the IRS noted the following lessons learned from the compensation project:

- (1) the one issue of widespread concern that surfaced was the extent of incomplete and inaccurate compensation reporting;
- (2) additional guidance for exempt organizations and IRS agents is needed regarding

reporting requirements and the “rebuttable presumption” relied upon by public charities to establish appropriate compensation levels;

(3) changes in Forms 990 are necessary to reduce reporting errors and to more readily identify compensation issues;

(4) high compensation levels were typically adequately substantiated based on comparability data (54% of organizations examined commissioned comparability studies, and of these 97% set compensation within the range of the comparability data obtained);

(5) using compliance contact techniques focusing on specific industries and demographics will enable the IRS to more efficiently identify noncompliant organizations in the future.

⇒ Executive compensation will likely continue to be a hot issue for the IRS, and several state attorneys general offices also routinely review charity compensation. To assist your organization in establishing reasonable compensation and avoiding the government's scrutiny, order **Nonprofit Alert® Memos, Compensation Policies & Legal Guidelines for Nonprofit Leaders** and **Intermediate Sanctions Law**.

Tax Court Scrutinizes Cell Phone Use Deductions

In October 2006 the United States Tax Court ruled in favor of the IRS in upholding rather strict substantiation requirements for claiming business deductions for cell phone use. In *Harrell v. Commissioner*, T.C. Summ. Op. 2006-165, a United Parcel Service (“UPS”) employee claimed a \$2,850 deduction for cell phone usage as an unreimbursed business ex-

Cell Phone....continued

pense. The deduction was denied by the IRS for failing to provide sufficient evidence to meet the strict substantiation requirements of Internal Revenue Code Section 274.

In *Harrell*, the only substantiation the petitioner submitted with his return was a letter from UPS stating that he used his cellular telephone to communicate and conduct business with the company, and that he was not reimbursed for those charges. The Tax Court cited settled law when stating “deductions are a matter of legislative grace, and the taxpayer must prove that he/she is entitled to the claimed deductions.”

The Tax Court concluded that insufficient substantiation was introduced as to: (1) specific telephone calls made using the cellular telephone; (2) the portion of the use that might be related to Mr. Harrell’s work (rather than to personal calls); or (3) any other matter that would support a claim that the cellular telephone was property used in Mr. Harrell’s trade or business of performing services as an employee. As a result, the Tax Court sustained the IRS’ disallowance of the claimed unreimbursed employee expense deduction for Mr. Harrell’s cell phone use.

⇒ Proper treatment of expense reimbursements is especially important for officers and directors of exempt organizations given that excess benefit transactions may arise if taxable reimbursements are made to “disqualified persons.” For more information on employee reimbursements, order **Nonprofit Alert® Memo Expense Reimbursement for Volunteers and Employees.**

Volunteer Immunity Upheld in Alabama for Board Chair

The Supreme Court of Alabama recently upheld volunteer immunity for the Chair of the Board of a private school. Parents brought suit against the Chair for a number of claims including breach of their enrollment contract after students were expelled for allegedly circulating lewd photographs around the school. The Board Chair had met with the parents as part of the investigation of the students, but was not ultimately responsible for the students’ dismissals.

Under Alabama’s Volunteer Service Act, a volunteer acting in good faith and within the scope of his or her official functions is immune from civil liability for such actions. The Court found that the Board Chair’s participation in the meetings and obtaining information was part of his official duties, and the ultimate decision was made by the headmaster, as required by the Board’s delegation of disciplinary authority. Thus, the Chair’s involvement was within the scope of his duties and cloaked under the immunity provided by the statute. This decision affirms efforts of state legislatures to encourage volunteerism by protecting volunteers against personal liability for offering their services to a nonprofit organization.

⇒ Note that most state statutes limiting the liability of volunteers serving nonprofits apply to actions done in good faith. Thus, given that lawsuits may be brought against volunteer directors alleging conduct outside the scope of immunity, it is important that nonprofits evaluate their D&O insurance needs.

IRS Revokes Exempt Status of Homeless Shelter

The IRS has revoked the 501(c)(3) tax-exempt status of an organization providing shelter for homeless veterans. The IRS determined that the shelter (1) did not properly report expenditures related to a qualifying tax-exempt purpose, (2) served private interests of related parties, and (3) engaged in several transactions which were not based on fair market value. In its review of the organization, the IRS also highlighted that it did not maintain minutes of meetings and did not hold elections.

The only source of revenue for the shelter was through bingo games. Bingo revenue was deposited in a bingo trust account, and then transferred to the organization's general account by check. However, on various occasions, the president would only transfer a portion of the bingo trust account, withdrawing the remainder as cash. The president was unable to substantiate that all amounts withdrawn as cash were used for the exempt purposes of the shelter. The IRS found the president did not maintain adequate records to determine the amount paid, date paid, purpose, payee, or any other evidence or receipts of disbursements.

As to the private interests served, the IRS found that the president, who owned the buildings used to house homeless individuals, had sole and full access to all funds related to operating the housing. There was no lease agreement between the president and the organization. There were no contracts addressing payments made to the president as compensation and thus unexplained disbursements were deemed to have been for the benefit of the president. Based on this record, the IRS determined that the organization was operated

for a private purpose and thus did not qualify for exemption under IRC section 501(c)(3).

Exempt Organizations Eligible for Telephone Excise Tax Refund

Similar to individuals and business entities, tax exempt organizations are eligible to request a telephone excise tax refund. To request a refund, organizations must file a Form 990-T (which is filed to report unrelated business income) and attach Form 8913. The Form 990-T must be filed with the Form 8913 even if the organization has no unrelated business income. The amount of the refund requested may be calculated either by (1) adding the actual amount of refundable long-distance telephone excise taxes paid for the 41 months in the refund period (March 2003 through July 2006), or (2) using a formula the IRS has developed to estimate taxpayers' refunds. The formula compares excise taxes paid for two specified months in 2006, and is explained in the instructions to Form 8913. For more information, visit www.irs.gov.

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