

Client Alert

September 10, 2008

IRS Finalizes New Form 990 Instructions – Tax-Exempt Compensation Disclosures Greatly Increased

The Internal Revenue Service completely overhauled Form 990 – the annual return filed by most tax-exempt organizations – earlier this year.* On August 19, 2008, the IRS released instructions for the new Form 990, which significantly expands reporting of the components of, and the processes used to determine, executive compensation. While these instructions are marked “draft” and a final version of the instructions will be issued at year-end, the IRS has indicated there will be no significant changes.

While tax-exempt compensation disclosures continue to be less rigorous than the information required by the SEC from public companies, the new Form 990 creates useful new opportunities (along with obligations) for tax-exempts to explain what was paid to their top executives and why. This is likely to prove increasingly critical, given the growing public scrutiny of tax-exempt compensation practices.

PM&P Observation: We predict that a best practice will emerge in which tax-exempt organizations will strive to provide insights into their pay practices that demonstrate the appropriate use of their resources. Organizations are encouraged to refer to the annual proxy statements of public companies, particularly the Compensation Discussion and Analysis sections, for models of how to report tax-exempt executive compensation programs and processes.

This Client Alert focuses on the portions of the new Form 990 related to disclosure of executive compensation: Part VI of Form 990, which addresses governance issues, and Part VII (along with the related Schedule J), which expands reporting of pay programs.

Part VI – Governance Disclosures

The Governance Disclosure section is divided into three parts:

- i. Governing Body and Management
- ii. Policies
- iii. Disclosure

*See our January 16, 2008 Client Alert, *New Form 990 Signals More Intense IRS Scrutiny of Compensation for Tax-Exempt Organizations*, <http://www.pearlmeier.com/knowledgecenter/alerts/NewForm990.pdf>

Of particular interest in the Policies section are Lines 15(a) and (b), which ask if the organization used a “process” for determining compensation for the CEO and other top managers that included all of the following:

- Review and approval by an independent governing body, such as a compensation committee
- Use of appropriate competitive data
- Documentation and record-keeping of related deliberations and decision-making

If an organization answers “yes” to all three criteria for *either* Line 15(a) or (b), it must then expand on the disclosure of the process in Schedule O and identify the included management team members or positions, as well as the year in which the process was last used for each person.

This section parallels the rules of IRC Section 4958, under which tax-exempt organizations are subject to intermediate sanctions if executive compensation is deemed to be unreasonable. Answering “no” to *both* Lines 15(a) and (b) does not necessarily mean an organization’s compensation is unreasonable, but may indicate it is not following best practices. The instructions to Part VI even suggest that the absence of appropriate policies and procedures may lead to excess benefit transactions, inurement and other activities inconsistent with exempt status.

PM&P Observation: The disclosure of the compensation-setting process creates a new opportunity for tax-exempts to explain why a particular level or type of compensation was provided to executives. Boards should carefully review their current processes and ensure they are comfortable with how they will be reported.

PM&P Observation: Further description of the compensation-setting process is not required in Schedule O if an organization does not check the “yes” box in Lines 15 (a) and/or (b). However, this may not have been the intent of the IRS in drafting these new rules. In fact, executive compensation may be reasonable even if all of the requirements in the instructions to Items 15(a) and (b) are not met. For that reason, even if further explanation is not required, we encourage organizations to describe their compensation-setting process in Schedule O and why they did not answer “yes” to each question.

Part VII – Program Disclosure

Part VII requires that any organization filing a Form 990 disclose compensation-related information for the following individuals:

- The organization’s **officers**, directors and trustees, regardless of amount
- **Key employees** whose **reportable compensation** exceeds \$150,000

- Current five most highly compensated employees (other than officers, directors, trustees, or listed key employees) whose reportable compensation exceeds \$100,000
- Any former officer, key employee or other employee whose reportable compensation exceeds \$100,000 and who would have been among the five most highly compensated employees if the individual had been an employee in the calendar year at issue
- Any former director or trustee whose reportable compensation exceeded \$10,000

For purposes of this instruction:

- An “**officer**” is a person who manages the organization’s daily operations, such as a president, vice-president, secretary or treasurer. This definition includes the “top financial official” (the person with ultimate responsibility for the firm’s finances) and the “top management official” (the person with ultimate responsibility for carrying out decisions and overseeing the organization), regardless of their titles.
- A “**key employee**” is defined as an employee other than an officer, director or trustee who meets all three of the following tests:
 - Has reportable compensation in excess of \$150,000 for the year at issue (the “\$150,000 Test”);
 - Has or shares control or influence over the organization as a whole (similar to that of officers, directors or trustees), or generally manages or had authority or control over at least 10% of the organization’s activities (the “Responsibility Test”); and
 - Was among the organization’s top 20 highest paid employees for the year (the “Top 20 Test”)
- “**Reportable compensation**” generally includes the amount reported for the individual on Form W-2 (for employees) or Form 1099 (for directors and trustees).

The instructions provide descriptions and examples of the required disclosures, with a table showing how more than 50 common types of payments should be reported on Part VII and Schedule J, such as:

- Base salary/wages/fees paid
- Base salary/wages/fees deferred (taxable and nontaxable)
- Severance or change-of-control payments made
- Tax gross-ups paid
- Health benefit plan premiums (taxable and nontaxable)
- Travel (taxable)
- Social club dues (taxable)

PM&P Observation: Extending Form 990 disclosure to include all key employees earning over \$150,000 has been controversial. Some organizations not currently subject to this expanded disclosure, including one professional football league, have publicly opposed this requirement as an invasion of employee privacy, maintaining that their employees' names and compensation are readily available to association members.

Schedule J

Schedule J is generally required if compensation paid to any person reported in Part VII exceeds \$150,000, or if former officers, directors, trustees or key employees are listed in Part VII. It consists of three parts:

Description of the organization's compensation practices: This section consists of a checklist of the compensation actually paid and the processes used for individuals listed in Part VII. The instructions provide useful narratives and examples that explain items in the checklist, such as:

- Providing a definition of “travel for companions,” “social club dues” and “personal services” provided by a chef, masseuse, or maid
- Providing a definition of a “compensation consultant” and under what circumstances the consultant is considered independent
- Delineating certain types of pay such as severance or change-of-control, supplemental retirement, equity-based compensation, and compensation contingent on revenues or net earnings

Detailed breakdown of total compensation: Reportable income must be disclosed for each person listed in Part VII who earns over \$150,000 and for former officers, directors, trustees, or key employees listed in Part VII. Explanations are required for:

- Bonus and incentive compensation
- Deferred compensation
- Nontaxable benefits

Supplemental Information: This section provides space for the organization to further address questions from the first section, or to provide additional information relevant to the information provided elsewhere in Schedule J.

PM&P Observation: The supplemental information section of Schedule J offers another opportunity for a tax-exempt organization to provide a narrative that explains what and why certain compensation was provided.

Conclusion

The new Form 990 will likely require more work on the part of a tax-exempt organization's management team and Board of Directors/Trustees, particularly during the first year of implementation. The additional and more detailed reporting on amounts and processes will require each organization to think through its data sources and procedures to ensure timely reporting.

In addition, each organization will want to ensure its processes will stand up under public disclosure and scrutiny. This issue is of special importance given the ever-increasing scrutiny of executive pay by outside constituencies such as the media, Congress and the general public. We encourage organizations to begin the process now, as the new Form 990s will report on actions taken during 2008.

Full 2008 instructions for the new disclosure and the 2008 Form 990 are available at: <http://www.irs.gov/charities/article/0,,id=185561,00.html>

Important Notice: Pearl Meyer & Partners has provided this analysis based solely on its knowledge and experience as compensation consultants. In providing this advice, Pearl Meyer & Partners is not acting as your lawyer and makes no representations or warranties respecting the legal, tax or accounting implications or effectiveness of this advice. You should consult with your legal counsel and tax advisor to determine the effectiveness and/or potential legal impact of this advice. In addition, this Client Alert is not intended or written to be used, and cannot be used by you or any other person, for the purpose of (1) avoiding any penalties that may be imposed by the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or other matter addressed herein, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.



www.pearlmeyer.com

NEW YORK

445 Park Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON

Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES

550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

