



MEMORANDUM

Note: This memo contains general information and is not intended to constitute legal advice. For advice about your particular situation, speak to a qualified tax attorney or accountant.

To: Community Action Agency Financial Network e-Forum Members
From: Community Action Program Legal Services, Inc. (CAPLAW)
Re: IRS and OMB Rules on Employee Bonuses
Date: December 4, 2006

If your private nonprofit Community Action Agency (CAA) is considering implementing a bonus plan for its employees, you should familiarize yourself with IRS guidance on the issue of incentive compensation arrangements provided by 501(c)(3) organizations. You should also discuss your plans with a qualified tax attorney or accountant before implementing them.

Below is a list of factors the IRS has identified as indicating that an incentive compensation arrangement is consistent with a charity's 501(c)(3) status, as well as a summary of a bonus arrangement the IRS recently ruled passes muster under section 501(c)(3). Although the IRS guidance discussed in this memo can't be cited as precedent, it gives us an idea of issues the IRS considers important when it looks at incentive compensation plans of 501(c)(3) organizations. We have also included a brief description of what OMB Circular A-122 requires.

IRS Rulings

Based on IRS rulings, following are factors your agency should incorporate into its proposed bonus program:

- The agency must have a "real and discernable business purpose" for implementing the bonus plan that demonstrates that the plan furthers the organization's charitable purposes (for example: motivating and reinforcing efficiency and quality of service and encouraging cost containment). The plan must not be simply a device to distribute profits to principals of the organization or transform the organization's principal activity into a joint venture.
- The bonus plan must be established and implemented by an independent board of directors or an independent committee of the board, such as a personnel or compensation

committee. (For board members to be “independent” neither they, nor individuals or businesses with which they are affiliated, may receive compensation from or transact business with the CAA.) This demonstrates an arm’s length relationship between the organization and the employees benefiting from the plan. (In addition, we assume that the agency has adopted and implemented a conflict of interest policy that prohibits board members receiving compensation from or transacting business with the organization from discussing and voting on matters relating to that compensation and those transactions; if it has not, it should do so now.)

- The plan should include safeguards to prevent a reduction in the charitable services the agency would otherwise provide and to prevent abuse of the plan (for example, taking steps to ensure that the agency is on track to provide all the program services it has committed to in its annual program budgets and plans before paying out bonuses and to ensure that program managers do not set aside funds for the bonus pool that should be used to provide program services).
- Total compensation – including amounts paid under the plan, plus all other forms of compensation – provided to each employee must be reasonable (i.e., equal to the compensation that would ordinarily be paid for similar services by a similar enterprise – exempt or non-exempt – under similar circumstances).

Note that, in setting total compensation for employees of a CAA who are considered “disqualified persons” under the IRS’s “intermediate sanctions” rules (including the executive director, the CFO and certain other top managers), the board (or board committee) should take steps to comply with a procedure known as the intermediate sanctions “rebuttable presumption.” For more information on the rebuttable presumption, see the publication “Rebuttable Presumption Procedure Is Key to Easy Intermediate Sanctions Compliance,” available on the IRS’s website at www.irs.gov/pub/irs-tege/m4958a2.pdf.

- The bonus plan should include a cap on the size of a bonus that employees may earn (e.g., a certain percentage of their regular salaries). This will help the CAA determine in advance whether the employee’s total compensation is reasonable and will help in budgeting for payments under the plan.
- The bonus plan should set objective standards for judging employee performance that are linked to the agency’s accomplishment of its exempt purposes. It should also reward an employee for his or her actual accomplishments, rather than for the overall performance of parts of the organization in which the employee does not do significant work or on which the employee’s own work performance is not likely to have an impact.
- The plan should specify that the board (or, if applicable, the board committee overseeing the plan) may, in its sole discretion, cancel the bonus plan at any time if doing so is in agency’s best interests and that the board (or board committee) may cancel or reduce potential bonus awards at the time they are scheduled to be paid if payment of the awards would be in violation of any law or regulation, would jeopardize the agency’s ability to meet its obligations to funders, would jeopardize the agency’s ability to carry out its tax-

exempt purposes or would otherwise not be in its best interest. (The agency should discuss with its employment attorney how to structure and operate the plan so that cancellation of the plan or cancellation or reduction of potential bonus award will not run afoul of any state law concerning the payment of wages.)

See IRS Information Letter 2002-0021 (Jan. 9, 2002); Private Letter Ruling 200601030 (Jan. 6, 2006); and General Counsel Memorandum 39674 (June 17, 1987). If your CAA is considering linking the amount of compensation any employees earn to the net revenues of the organization or a part of the organization, you should be sure to consult a tax lawyer or accountant, as these types of arrangements require additional planning.

As to the process to be used for approving and awarding bonuses, we recommend you read IRS Private Letter Ruling 200601030 (available on the IRS website www.irs.gov). It contains a description of a bonus arrangement the IRS recently determined was consistent with a 501(c)(3)'s tax-exempt status. Note that the bonus plan discussed in that ruling covers only the organization's senior managers and that the compensation committee establishes individual performance objectives for each participant (except the executive director, whose performance objectives are set by the full board). It is possible that where a bonus plan extends to an organization's rank-and-file employees, the compensation committee would not need to set individual performance objectives for each employee as long as it does so for senior managers and executive officers and as long as it sets general standards for the award of bonuses to rank-and-file employees and ensures that senior staff follow those standards in awarding bonuses to their subordinates. Let your tax advisor know if you are considering such a plan so that s/he can research whether there are any other IRS rulings that address the issue of whether the independent body overseeing the plan must set performance objectives for each participant where the plan covers more than just senior managers.

OMB Circular A-122

Any incentive compensation arrangement must also be structured to comply with the requirements of OMB Circular A-122, "Cost Principles for Non-Profit Organizations." Under Circular A-122, incentive compensation is an allowable cost under a federal grant to the extent that: (1) overall compensation is determined to be reasonable (this requirement is consistent with the IRS requirement that an employee's total compensation be reasonable) and (2) the incentive compensation is paid or accrued either: (a) under an agreement entered into in good faith between the organization and the employees receiving the incentive compensation before the employees performed the services on which the incentive compensation was based or (b) pursuant to an established plan followed by the organization so consistently as to imply an agreement to make an incentive compensation payment. See OMB Circular A-122, Att. B, ¶ 8.j (available online at http://www.whitehouse.gov/omb/circulars/a122/a122_2004.html).

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any matters addressed herein.