

**COMMENTS CONCERNING CURRENT LANGUAGE IN FORM 990 REGARDING
REPORTING OF COMPENSATION ARRANGEMENTS BY EXEMPT
ORGANIZATIONS**

The following Comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation. Those who contributed to these Comments may not necessarily agree in all respects with the conclusions and recommendations expressed.

These Comments were prepared by individual members of the Subcommittee on Forms, Rulings and Other Administrative Developments of the Committee on Exempt Organizations of the Section of Taxation. Principal responsibility was exercised by Robert C. Louthian, III, Victoria B. Bjorklund, Betsy Buchalter Adler, Robert H.M. Ferguson and Thomas E. Chomicz. These Comments were reviewed by Randall Goodman and Bernadette Broccolo for the Subcommittee on Compensation and Benefits of the Committee on Exempt Organizations of the Section of Taxation; by James K. Hasson, for the Section's Committee on Government Submissions; and by Douglas M. Mancino, the Council Director for the Committee on Exempt Organizations.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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EXECUTIVE SUMMARY

On April 23, 2001, the Internal Revenue Service (the "Service") issued Announcement 2001-33, 2001-17 I.R.B. 1137 (Apr. 23, 2001), requesting comments on certain instructions currently contained in Form 990, Return of Organization Exempt from Income Tax ("Form 990"), Form 990-EZ, Short Form of Return of Organization Exempt from Income Tax ("Form 990-EZ") and Form 990-PF, Return of Private Foundations or Section 4947(a)(1) Trusts Treated as Private Foundations ("Form 990-PF"). More specifically, the instructions to Part V of Form 990 and Part IV of Form 990-EZ require reporting organizations to list the names and addresses for contact of officers, directors, trustees, and key employees. Similarly, Line 1 of Part VIII of Form 990-PF, requires private foundations to list the same information for officers, directors, trustees or foundation managers. The forms also require information on compensation packages for individuals listed as officers, directors, trustees or key employees/foundation managers. In 1999, the instructions to the forms were amended to state "If you pay any other person, such as a management services company, for the services provided by any of your officers, directors, trustees or key employees[/foundation managers], report the compensation and other items as if you had paid them directly." In Announcement 2001-33, the Service requested comments on the new instructions contained in the above forms.

These comments address the issues specifically raised in Announcement 2001-33 as well as provide alternative instructions for the forms that would address the concerns expressed by those seeking maximum disclosure on these forms as well as the concerns expressed by those concerned with the burdens imposed on tax-exempt organizations and with the privacy of the individuals involved. In general, we believe that the instructions should limit the information requested to those arrangements that are most likely to have been created for the primary purpose of avoiding disclosure and to exclude from disclosure legitimate arrangements that involve management services organizations.

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GENERAL DISCUSSION

In 1999, the Service changed the instructions to the Form 990, Form 990-EZ and Form 990-PF (sometimes referred to herein collectively as "Revised Form 990") so as to require tax-exempt organizations to report payments for contracted management services as if the organization had directly paid the individuals providing the services. After receiving comments from various individuals and entities, the Internal Revenue Service (the "Service") issued Announcement 2001-33, in which the Service officially requested comments on the nature and extent of certain compensation information that should be reported on a tax-exempt organization's annual information return. Specifically, the Service requested comments on the following:

1. Whether contracting with third parties who provide the reporting organization with allocations for completing the form is consistent with current practices?
2. How can the instructions be revised to simplify reporting, yet protect against abuse by an individual officer, director, trustee, key employee, or private foundation manager who incorporates to avoid reporting?

Prior to 1999, the instructions to the Form 990, Form 990-EZ and Form 990-PF requested that tax-exempt organizations disclose the compensation of their directors, officers, five highest paid employees and five highest paid independent contractors. Tax-exempt organizations were not required to disclose the compensation paid to individuals who were employed by unrelated management service organizations ("MSOs").

In 1999, the Service revised the instructions to the various Forms 990 so as to require tax-exempt organizations which pay MSOs for services provided by the tax-exempt organization's officers, directors, trustees, or key employees, to report such individuals' compensation as if the tax-exempt organization had paid them directly. According to Announcement 2001-33, the Service revised the instructions to prevent a specific, perceived abuse, i.e., certain tax exempt organizations had transferred their key employees/foundation managers to a separate for-profit corporation so as to avoid reporting the key employees'/foundation managers' salaries on the applicable Form 990.¹ While Service officials had hinted that a change in the various Forms 990

¹ We note that the related party prohibition in Rev. Proc. 97-13 already provides a significant barrier for organizations that have bond-financed property and would attempt to avoid disclosure by forming a separate, but related, management organization. Accordingly, the potential for significant abuse in this area does not appear likely.

instructions was to be expected, the change in instructions was not presented for advance public comment but, instead, simply appeared in the Revised Form 990.

In general, Section 6033(b) of the Internal Revenue Code of 1986 (the "Code") contains a list of highly-specific items of information that certain tax-exempt organizations must disclose on their annual information returns. In relevant part, Sections 6033(b)(6) and 6033(b)(7) require certain tax-exempt organizations to disclose "the compensation and other payments made during the year to foundation managers (within the meaning of section 4946(b)(1)) and highly compensated employees." The term "foundation manager" is defined in Section 4946(b)(1) as an officer, director or trustee of a private foundation or an individual having powers or responsibilities similar to those of officers, directors or trustees. Accordingly, these Code sections do not specifically require a tax-exempt organization to provide the information requested by the Service in the instructions to the Revised Form 990.

Presumably, the Service's authority for the revised instructions is derived from the general authority given to the Secretary of Treasury in Section 6033(b)(14) of the Code to obtain "such other information for purposes of carrying out the internal revenue laws." While the discretion granted to the Service to request information from certain tax-exempt organizations is broad, it is not unfettered.² Accordingly, attempts to use such authority to increase compliance with the internal revenue laws should be weighed against whether the additional burdens imposed on tax-exempt organizations are justified, whether the privacy of individuals is unduly sacrificed and whether the information obtained truly advances disclosure principles.

1. Whether contracting with third parties who provide the reporting organization with allocations for completing the form is consistent with current practices?

While we are not expert in matters such as the day-to-day operations of MSOs, or the manner in which they provide allocation information to their tax-exempt clients, we note that association management trade associations have presented compelling arguments that the information sought by the Revised Form 990 instructions is not generally provided in a manner that is responsive to the Revised Form 990 instructions and, in addition, that even if it could be provided in such a manner the information would not accomplish the purposes sought by the Service for a variety of reasons. See generally, comments submitted by International Association of Association Management Companies, dated May 7, 2001. Despite our limited experience, however, we also believe that the information currently being requested by the Service is not provided to tax-exempt organizations by MSOs in a manner that is responsive to the Revised Form 990 instructions.

² In 1977, the Service internally debated whether it had the discretionary authority under Section 6033(a)(2)(B) to raise the gross receipts level from \$5,000 to \$10,000 for organizations excepted from filing annual information returns under Section 6033(a)(2)(A)(ii) of the Code. See generally, Gen. Couns. Mem. 37,034 (March 8, 1977). While the Acting Chief Counsel ultimately concluded that the Commissioner did have the discretionary authority to raise the gross receipts threshold, after previously concluding that the Commissioner did not have the discretionary authority to do so, the Acting Chief Counsel noted that the Commissioner must have a reasonable basis for doing so. While not directly analogous, we believe that Commissioner's discretionary authority in Section 6033(b)(14) should likewise be invoked only after careful consideration.

2. How can the instructions be revised to simplify reporting, yet protect against abuse by an individual officer, director, trustee, key employee, or private foundation manager who incorporates to avoid reporting?

We believe a less intrusive alternative exists that would allow the Service to obtain disclosure of perceived abuses without placing undue burden on tax-exempt organizations or causing excessive intrusion into private matters. Specifically, we recommend a two-part change to the instructions that includes: (i) a slight modification to the existing instructions with respect to reporting of compensation by related organizations and (ii) a modification to the new instructions that uses an approach similar to Section 414(m)(5) of the Code with respect to affiliated service groups.

First, under the current Form 990 instructions, a reporting organization must report on an attachment to its return the compensation paid by a related organization to the officer, director, trustee, or key employee if (i) any officer, director, trustee, or key employee received total compensation of more than \$100,000 from the reporting organization and all related organizations and (ii) more than \$10,000 of this compensation was provided by the related organization. Accordingly, a reporting organization can avoid disclosure if the reporting organization does not pay more than \$100,000 to its officers, directors, trustees or key employees. In order to correct this loophole, we recommend that the second condition in the above discussed instructions be removed so that a reporting organization is required to report compensation paid by a related organization without reference to a specific dollar threshold.

Second, in order to distinguish the abusive situations sought to be disclosed by the Service from the legitimate arrangements with MSOs, we recommend that the Service adopt an approach similar to the one in Section 414(m)(5) of the Code regarding the aggregation of employees. Under Section 414(m)(5) of the Code, employees of separate corporations are treated as if employed by a single employer for certain benefits and discrimination testing. The provision was enacted by Congress to prevent a particular abuse whereby highly compensated employees were being transferred by various organizations to separate corporations, which separate corporations employed such individuals and then leased them back on a full or substantially full-time basis to their former employer-organization. By transferring the highly paid employees to a separate corporation in this manner, the separate corporation was able to maintain a much more lucrative pension plan for the highly compensated individuals. Section 414(m)(5) prevents this type of arrangement by allowing the Service to disregard the separate corporation for certain benefits-testing purposes and treat the employees of both corporations as if employed by a single corporation for certain benefits-testing purposes.

Section 414(m)(5), however, does not sweep within its net all arrangements in which employees are leased on a full or substantially full-time basis to another organization. Instead, Congress limited the applicability of Section 414(m)(5) to those arrangements where an organization contracted with an unrelated organization for the primary purpose of circumventing the benefit testing provisions with respect to a group of highly compensated employees.

Under Section 414(m)(5), the employees of two otherwise-unrelated organizations are treated as if employed by a single entity if the principal business of the management service organization is performing management functions on a regular and continuing basis for one

organization or for one organization and other organizations related to that one organization. Stated differently, if the principal purpose of an MSO is to provide management function services to a single entity (or a single entity and its related organizations), the employees of both the MSO and the entity receiving its services are treated as if employed by a single employer for benefits-testing purposes. Accordingly, if an MSO is providing management function services to several unrelated entities, the management service organization's employees are not aggregated with the employees of the organization receiving the MSO's services.

The parallels between the abusive arrangements sought to be curtailed by Section 414(m)(5) of the Code and the purported abusive situations sought to be disclosed by the Revised Form 990 instructions are virtually identical. In each case, key employees are transferred to a separate organization and then provided back to the tax-exempt employer on a full or substantially full-time basis. Adopting an approach similar to the one taken by Section 414(m)(5) of the Code would require a tax-exempt organization to disclose individual compensation information for key employees furnished by an MSO where the principal purpose of such furnishing was the avoidance of disclosure, but would protect from disclosure legitimate arrangements where MSOs provide management service functions to at least two unrelated organizations.

Proposed Language for Revised Instructions

We believe the instructions could be revised as follows. The bolded sections below are alternatives for you to consider:

"If you pay any other person, such as a management services company, for the services provided by any of your officers, directors, trustees, or key employees [or foundation managers for private foundations], and **[the principal purpose] or [at least one of the purposes]** of such other person is to provide management services solely to you (or entities related to you), you must report the compensation and other items as if you had paid the officers, directors, trustees, or key employees [or foundation managers for private foundations] directly. If, on the other hand, the person providing such management services provides substantial management services to other entities not related to you, the person will not be considered to have the principal purpose of providing services to you, and you do not have to report the amounts paid for the services so provided."

[The basis for the two alternatives set forth above was as follows. The "principal purpose" language alternative is the most consistent with the terminology used in Section 414(m) of the Code, which section was the model for our comments. The "one purpose" language alternative is more inclusive of the type of information in which the Service appears to be interested.]

Conclusion

Attempts by tax-exempt organizations to circumvent the salary-information reporting requirement on Forms 990 should not go unchecked and are arguably within the Service's broad discretion to collect information from certain tax-exempt organizations. However, it is equally clear that legitimate business arrangements that are otherwise not disclosable under Section 6033(b) should not be swept up within the Service's general authority under Section 6033(b)(14) without compelling circumstances. Especially where the perceived abuse is so narrow, we believe that a less intrusive and less burdensome method exists that would achieve the Service's stated purpose for the instruction change. To that end, we suggest the above alternative that relies upon the principles of Section 414(m)(5) as a model.

We welcome the opportunity to meet with appropriate representatives to discuss these suggestions in person and the possibility of testifying at appropriate public hearings if desired by the Service.