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Certified Public Accountants & Business Consultants

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## NOT-FOR-PROFIT SERVICES GROUP

### Client Information Bulletin

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#### INSIDER ACTIVITIES AND THE NOT-FOR-PROFIT ORGANIZATION

Most not-for-profit organizations conduct activities with individuals and companies which are considered “insiders” to the Organization. These include compensation and benefits provided to key executives, business transactions conducted with Board members or other related parties, etc. While there have always been prohibitions against inappropriate transactions of this nature, in July 1996 a new set of laws were passed by Congress and signed by the President which impose a tax on these transactions.

The legislation imposing this tax is clearly labeled as a revenue-raiser and many now expect that the IRS will be closely reviewing “insider” transactions and making use of this enforcement “tool” whenever possible. (As an example of how important some people view this new legislation, the Massachusetts Bar Foundation conducted an all-day seminar devoted entirely to this subject shortly after the legislation was signed into law.) Thus, although you believe that all of the transactions entered into by your Organization in the past that meet the definition of “insider” transactions are appropriate, it may be worthwhile to take some additional steps in the future to further document the appropriateness of the subject transactions.

Here is an excerpt from a news article just after the IRS released final regulations on this subject:

The advent of intermediate sanctions excise taxes is leading to a "revolution" in tax litigation for exempt organizations, Leonard J. Henzke Jr., an attorney-adviser in the IRS Exempt Organizations Division (Tax Exempt and Government Entities) said March 14, 2002.

"I want to impress upon you that this is a tremendous revolution in the area of exempt organizations," Henzke said at the annual Washington Non-Profit Legal and Tax Conference. "The ballgame going forward" for section 501(c)(3) and (c)(4) organizations, which are subject to section 4958, will involve imposing intermediate sanctions on disqualified persons, often instead of challenging the exempt status of an organization, he said.

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The Legislative Committee Reports relating to this legislation provide an important “safe harbor.” When an Organization meets the “safe harbor” requirements the Organization establishes a *presumption* that the amount of compensation paid to an insider, or the amount involved in a purchase or sale transaction, is reasonable. The safe harbor is met if:

1. The transaction is approved by the Board or a Committee of the Board.
2. The Board or Committee obtains independent, comparable data or valuations.
3. The Board or Committee (adequately) documents its determination.

We recommend that our clients consider the following actions to assure that they will fall within the “safe harbor” in regard to these transactions:

1. Include a policy statement in the by-laws which clearly identifies the conflict of interest policy in place at the Organization.
2. Formalize the process of identifying “insider” transactions and potential conflicts-of-interest. This might entail requiring all employees who initiate purchase orders to read the conflict-of-interest policy and complete the *Related Party Transactions Disclosure Form* on an annual basis.
3. The by-laws might also require all Board members to complete the *Related Party Transactions Disclosure Form* on an annual basis.
4. The by-laws should identify what actions will take place when a situation arises in which a conflict-of-interest exists. This action should include obtaining comparable data. Such conflicts might either be resolved by the Board itself, or the Board may delegate this to a Committee, with the Board being made aware of the resolution with the opportunity to indicate their approval.
5. Since compensation of key executives is one of the “insider” transactions covered by the legislation, additional documentation is warranted in this area. Regardless of the formalized executive evaluation and compensation-setting process that may be in place at your Organization, we recommend that the Board be formally apprised of all compensation, including fringe benefits for the all key executives of the Organization, especially those who are direct reports to the Executive Director or CEO.

Note that this list of recommendations is not all inclusive. It is an inexact science determining what set of procedures will constitute coverage by the “safe harbor” presumption. We recommend that all of the above be considered and that changes in policy and procedures be adopted according to the specific facts and circumstances of the affected transactions.

## ABOUT OUR FIRM

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