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# How to Be Sure Compensation Is Reasonable

*New regulations give tips on setting compensation and avoiding IRS fines.*

BY HEIDI I. WINZELER

On August 4, 1998, the IRS issued proposed regulations interpreting the intermediate sanctions law. The purpose of intermediate sanctions, as enacted by Congress in 1996, is to punish "disqualified persons," such as top executives and board members of nonprofit organizations, who receive inappropriately generous benefits (called "excess benefits").

Under the intermediate sanctions law, the IRS fines these disqualified persons 25% of the portion of the compensation or other benefits which it determines to be excessive. If the transaction isn't corrected, the individuals involved could face fines up to 200% of the excess benefit. The IRS may target any excess-benefit transaction occurring on or after September 14, 1995.

The new IRS regulations define and clarify some important terms:

## Who Is a Disqualified Person?

A "disqualified person" is anyone in a position to exercise substantial influence over the nonprofit organization. Disqualified persons include voting members of the governing board, president, chief executive officer or chief operating officer, treasurer, and chief financial officer.

The regulations provide two examples of "disqualified persons" which are of particular interest. Radiologists at a hospital are *not* disqualified persons when they make only modest annual contributions to the hospital, don't receive compensation based on revenues from the hospital's activities over which they have control, and have no authority or control over the hospital's budget, capital expenditures, or compensation packages for other employees. In the alternative, cardiologists *could* be disqualified persons if they have managerial authority over the cardiology department and the authority to distribute incentive bonuses to other cardiologists in the department based on revenues earned by the department in accordance with criteria they have established.

Be sure the board documents the procedures it follows.

## Who Are Organization Managers?

Organization managers of a nonprofit organization could face a tax of 10% of the excess benefit, not to exceed $10,000, if they knowingly, willfully, and without reasonable cause participate in the excess-benefit transaction. If more than one individual benefits from the same transaction, all are liable for the resulting tax.

An "organization manager" is defined as an officer, director, trustee, or anyone with similar powers. Independent contractors, acting as attorneys, accountants, and investment managers and advisors, are *not* considered organization managers.

## What Benefits Are Excessive?

An "excess benefit" is the excess of the value of compensation given to a disqualified person over the value of the services provided. Certain benefits provided to disqualified persons are *not* considered excess benefits. These include:

1. paying reasonable expenses for board members to attend meetings (not including expenses for luxury travel or spousal travel)
2. providing disqualified persons with a benefit they receive solely as mem-

bers of or volunteers for the organization if the benefit is provided to members of the public in exchange for a membership fee of $75 or less per year

3. providing a benefit to disqualified persons solely on the basis that they are members of a charitable class the organization intends to benefit.

## How Do You Decide If Compensation Is Reasonable?

The intermediate sanctions law requires that compensation for services be reasonable. Compensation is "reasonable" if it is an amount that would ordinarily be paid for similar services by like enterprises under comparable circumstances. "Compensation" includes everything provided in exchange for services, such as salaries, fees, bonuses, severance payments paid, and deferred compensation that is earned and vested, liability or other insurance coverage premiums, payments to medical and dental plans, and life insurance.

The proposed regulations outline steps an organization must take to avoid intermediate sanctions when setting compensation for employees:

1. Be sure the compensation is approved by a board of directors composed entirely of people who are not related to, or influenced by, the individuals receiving the compensation or benefits.
2. Be sure the board collects compensation data for similar organizations (both nonprofit and for-profit) and uses this information as a benchmark in determining the salaries to be paid to the organization's employees.
3. Be sure the board adequately documents the procedures it follows.

## What's the Next Step?

The new regulations are only proposed and therefore aren't binding. However, they do provide important evidence of the IRS' position, and taxpayers may rely on them until the IRS issues final regulations. All nonprofit organizations, not just those which may have engaged in questionable transactions in the past, should review these new regulations to ensure that their operations comply with the requirements. If you have any questions regarding a nonprofit organization with which you are involved, please feel free to call the author. ■

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These publications are available through the Society for Nonprofit Organizations' *Resource Center Catalog*, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

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