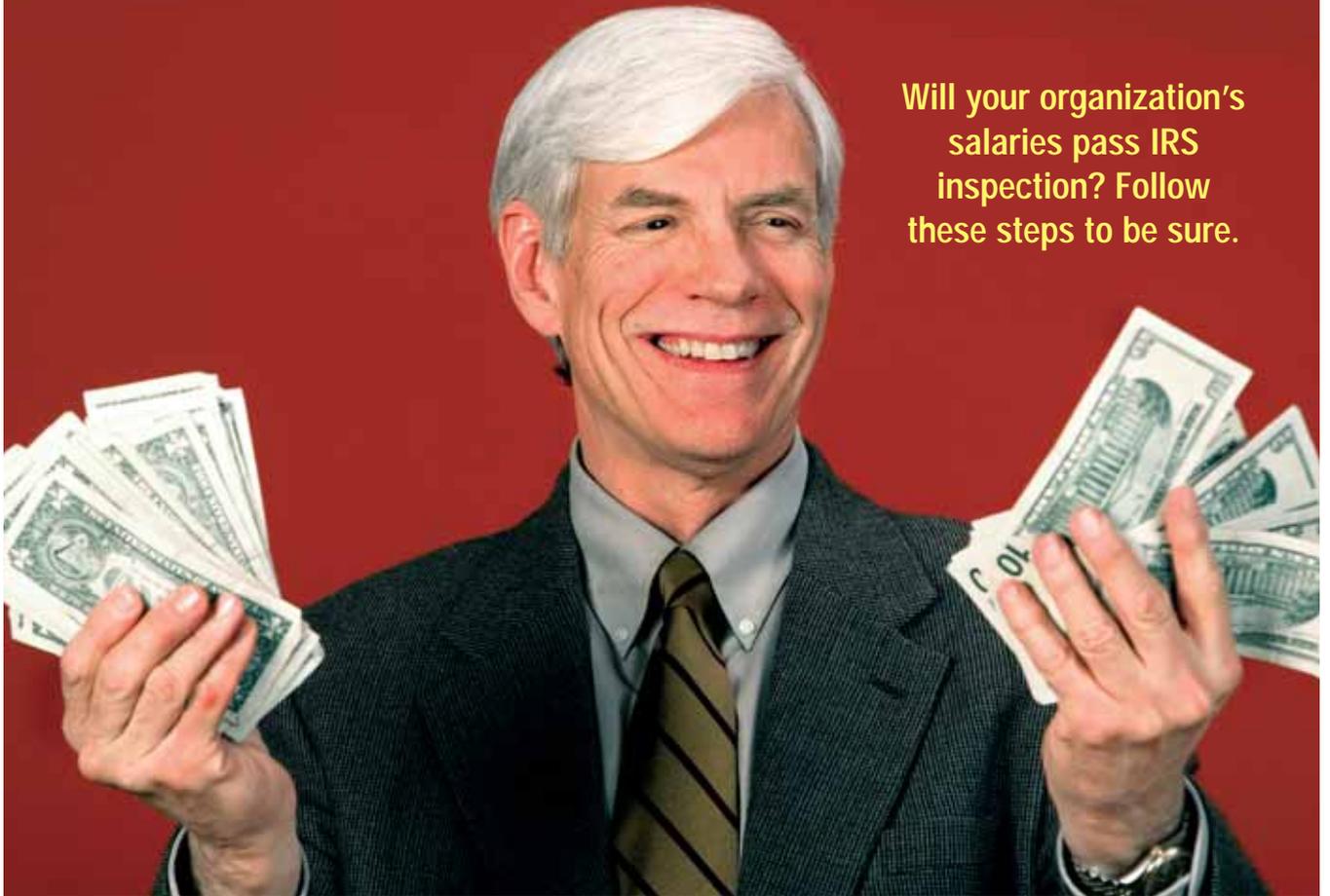




# Compensation Reviews: More Important than You Might Think

Will your organization's salaries pass IRS inspection? Follow these steps to be sure.



By Michael Siebenhaar

**A**t the request of the Senate Finance Committee, the Panel on the Nonprofit Sector recently prepared a report for Congress, suggesting ways nonprofits can improve transparency, governance, and ethical standards. This report's goal is to balance the need for legitimate oversight with nonprofits' need to remain independent and innovative. (For details on this report, see "Government Crackdown on Nonprofits: What You Need to Know," *Nonprofit World*, Vol. 24, No. 2, [www.snpo.org/members](http://www.snpo.org/members).)

**Board members have more at stake than their personal reputations.**

Among the areas addressed is executive compensation. The report recommends that Congress impose greater penalties for board members and other managers who receive or approve excessive compensation unless they took steps to determine the "reasonableness" of the compensation.

## How to Assure Compensation Is Reasonable

The IRS (in IRC Section 4958) outlines a three-stage process to reduce exposure to unreasonable compensation penalties. Here are the steps to follow:

### **1. Gain independent approval.**

Be sure your board — or a board committee — approves all compensation arrangements. This committee must be composed *entirely* of people who don't have a conflict of interest with respect to

the compensation arrangements. If the committee's decision is subject to approval by the entire board, then no one on the board may have a conflict of interest.

If you're on the board or committee making compensation decisions, follow these rules to assure that you won't have a conflict of interest:

- You can't be a "disqualified person" (a person whose compensation is being decided).
- You can't be related to a disqualified person.
- You can't be in an employment relationship subject to a disqualified person's control.
- You can't receive compensation or other payments subject to approval by a disqualified person.
- You can't have a substantial financial interest affected by the compensation arrangement.
- You can't approve a compensation arrangement for someone who, in turn, will approve a transaction for you.

### 2. Make comparable comparisons.

If you're on the board or committee making compensation decisions, don't approve any compensation arrangements until you have obtained comparability data. Use this information to make your decisions. Examples of comparability data include:

- compensation levels paid by organizations similar to yours (both taxable and tax-exempt) for functionally comparable positions
- availability of similar services in your organization's geographic region
- current compensation surveys compiled by independent firms
- actual written offers from organizations similar to yours for the services of the person whose compensation you are deciding.<sup>1</sup>

### 3. Document your decisions.

If you're on the board or committee making compensation decisions, you must document the basis for your decisions. To satisfy this requirement, you need to maintain written or electronic records describing:

- the terms of the compensation

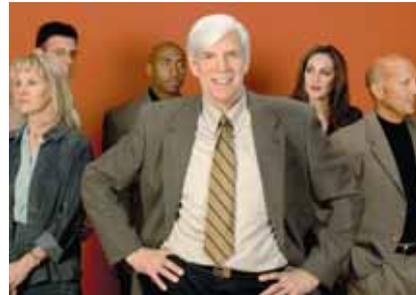
arrangement

- the date the arrangement was approved
- the names of those who were present during the discussion and who voted on it
- the data you relied upon in making the decisions.

You must prepare these records before the committee's next meeting or 60 days after the decision is made (whichever comes later). You must then review these records within a reasonable time.

### Penalties Can Be Harsh

Board members have more at stake than their reputations. A 10% excise tax is imposed on any "organization manager" who participates in an excess benefit transaction.<sup>2</sup> An organization manager is defined as any officer,



Every two or three years, review your compensation arrangements.

director, or trustee of the organization, including anyone who regularly exercises authority to make administrative or policy decisions for the organization.

One way to avoid penalties is to base your compensation decisions on benchmarking performed by an independent consultant. Be sure this consultant has experience with nonprofit organizations.

In addition, be sure you keep good records to document all compensation decisions. Every two or three years, review your compensation arrangements to be sure they're based on current, relevant data.

By performing these reviews, you're protecting your organization and your board members. And

### Keep the IRS from Your Door

To be sure you're following IRS rules and making the best possible compensation decisions for your organization, see these *Nonprofit World* articles (available free at [www.snpo.org/members](http://www.snpo.org/members)):

**Executive Compensation: Rewarding Excellence and Ensuring Governance** (Vol. 23, No. 5)

**Government Crackdown on Nonprofits: What You Need to Know** (Vol. 24, No. 2)

**How to Be Sure Compensation Is Reasonable** (Vol. 17, No. 1)

**Nonprofit Pay Hits New High, Survey Finds** (Vol. 24, No. 4)

there's another compelling argument for frequent compensation reviews: They can help ensure that your compensation is competitive enough to attract and retain the best people. ■

### Footnotes

<sup>1</sup>Smaller charities (with annual gross receipts of less than \$1,000,000) are required to obtain less data than larger charities, but it's still a good idea to compile as much data as you can.

<sup>2</sup>You can avoid this tax if you correct the excess benefit promptly and establish to the IRS's satisfaction that the excess benefit was due to reasonable cause and not willful neglect.

*Michael Siebenhaar, JD, CPA, MBA (michael.siebenhaar@buckconsultants.com), is a director in Buck Consultants' Executive Compensation practice. The information in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser.*