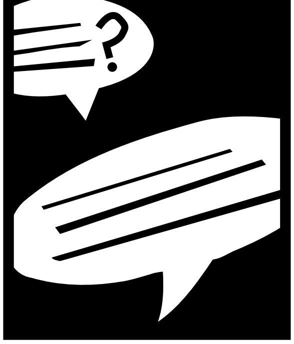

ASK *the experts*

Should Board Members Set Their Own Wages?

What are the rules for compensating board members?

Q: In a recent issue of *Nonprofit World*, (Vol. 15, No. 4), you had an informative response to the question, "Will Reimbursing Board Members Risk Tax-Exempt Status?" The question applied only to reimbursing expenses, but from your response it would appear that board members of a nonprofit 501(c)(3) organization should also avoid voting themselves compensation (that is, wages) for participating in board meetings. Is this correct?

Would the answer be the same regarding compensation for any other services board members perform for the organization?

Any information you can provide on these questions would help boards avoid operating in conflict with regulations for 501(c)(3) organizations. Thanks so much for your help.

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A: First, before taking any action regarding reimbursing or compensating individuals, you should consider your state nonprofit laws and your organization's bylaws and articles of incorporation. This response is subject to that caveat. Unless otherwise indicated, then, the following information concerns only federal statutes.

Let's look at each of your questions in turn.

Question 1: Should board members of a nonprofit 501(c)(3) organization avoid voting themselves compensation for participating in board meetings?

Yes. Whenever possible, it is better procedure to avoid directors voting on their own compensation.

Based on the private benefit and inurement standards of IRS Code 501(c)(3), no part of the net earnings of the organization may inure to the benefit of any private individual. While even a *de minimus* amount of private inurement can risk the organization's tax-exempt status, more realistically substantial intermediate sanctions may be imposed. (See "Don't Wait for Intermediate Sanctions Guidance" in *Nonprofit World*, January-February 1998.) To avoid such penalties, follow these guidelines:

1. Preplan by setting forth a reasonable-compensation policy in the organization's articles of incorporation and bylaws or in an amendment to such documents.
2. Select a committee of non-controlled individuals to adopt a reasonable-compensation policy and document their decision.
3. Rely on comparability data to be sure compensation is reasonable.
4. Check the laws of the state in which your organization was formed. For instance, under the Illinois Not-for-Profit Corporation Act, a not-for-profit corporation *may* pay compensation in a reasonable amount to members, officers, or directors for services rendered.

Question 2: Would the answer be the same regarding compensation for any other services board members perform for the organization?

Yes. The same concerns of private benefit and inurement apply to other compensation arrangements with board members. While the payment of board compensation and expense reimbursement isn't absolutely prohibited, payment of any amounts must be reasonable. Although the IRS won't give an advance ruling on reasonableness, it may issue an advance ruling on whether a compensation plan is inconsistent with exempt status.

While it is well established that reasonable compensation is permitted, "excessive" compensation can result in

It's important that all compensation arrangements pass the "smell test."

revocation of tax-exempt status. In addition, the intermediate-sanctions portion of 1996's Taxpayer Bill of Rights II imposes excise taxes on "disqualified persons" and any "organization manager" with knowledge of an excess-benefit transaction.

Under this law, a "disqualified person" is one who, at any time during the five years before the excess-benefit transaction, was in a position to exercise substantial influence over the organization's affairs. Executive officers, board members, and those in similar positions of responsibility are classed as disqualified persons. An "excess-benefit transaction" is an arrangement in which an economic benefit is provided to any disqualified person if the benefit's value exceeds the value of the consideration received in exchange by the organization. In this context, it's important to recognize that compensation includes not only wages but any fringe benefit such as use of an automobile, interest-free loans, pension and retirement benefits, insurance benefits, and so on.

However, your organization is entitled to rely on a "rebuttable presumption of reasonableness" for compensation transactions as long as the following conditions have been met:

1. The transaction was approved by a board committee composed entirely of individuals unrelated to and not subject to the control of the disqualified persons involved in the transaction.
2. The organization clearly established that this committee was delegated the authority to approve or reject the transaction.
3. The committee obtained and relied upon appropriate data as to comparability.
4. The committee properly documented the basis for its determination.

Since there's a requirement for complete independence in the discussion process, however, some arrangements (such as the board's own compensation) may never qualify for the rebuttable presumption. In such cases, it's wise to rely on 12 factors which the Internal Revenue Manual tells its agents to consider when deciding if compensation is reasonable:

1. nature of employee's duties
2. employee's background and experience
3. employee's knowledge of the business
4. size, profits, and earnings of the business
5. employee's contribution to the profit making
6. time devoted by employee
7. economic conditions in general and locally
8. character and amount of responsibility of employee
9. time of year compensation is determined
10. relationship of parties
11. intent of parties
12. amount paid in similar-sized businesses for similar services.

Finally, it's important that all compensation arrangements pass the "smell test." If it doesn't smell right, it is probably bad.

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As a member of the Society for Nonprofit Organizations, you are invited to send in, every month, one question which you or your organization would like answered. You will receive a written response from one of our panel of experts—professionals located throughout the country. Selected questions and answers will be published in each issue of *Nonprofit World*. If you prefer that your question appear anonymously, please let us know. Send questions to: Ask the Experts, *Nonprofit World*, 6314 Odana Rd., Suite 1, Madison, WI. 53719. Include your name, address, phone number, and Society membership number.