Legal Counsel

Executive Compensation Is Under Scrutiny

Recent government talk about compensation sounds a warning for nonprofits.

By Tom English

Recent economic woes have resulted in many changes by the federal government. One such area is executive compensation. Senator Grassley has proposed changes to requirements for nonprofit compensation.[1] While his proposal wasn't adopted, it highlights the current thinking in Washington. This article outlines current nonprofit requirements and changes suggested by Senator Grassley. The discussion will show the need for action to prevent compensation problems.

The Current Compensation Problem

Sec. 501(c) (3) provides for tax-exempt status to organizations that accomplish a charitable purpose. If an "insider" (an executive, board member, or someone else with major influence in the organization) receives compensation that's unreasonable, the organization is avoiding paying taxes on activity outside the charitable purpose.

The IRS recently conducted studies of public charities and exempt hospitals and, in general, found very high salaries.[2] The IRS found it hard to challenge the compensation levels in many cases because the organization had complied with the "rebuttable presumption" (discussed later).

When an organization establishes a rebuttable presumption, the burden of proof shifts to the IRS. This effectively changes the situation from "guilty until proven innocent" to "innocent until proven guilty." The Senate Finance Committee staff uncovered abuse of the rebuttable presumption in its studies of not-for-profits. The committee report states: "Many of these organizations were able to use the rebuttable presumption procedures to justify paying compensation comparable to executives in for-profit organizations, including comparables from for-profit entities that had nothing in common with the tax-exempt organization."[3]

> Senator Grassley has proposed changes to requirements for nonprofit compensation.

Since many in the government believe compensation is excessive, they're considering removing the rebuttable presumption. Senator Grassley's proposal was a step in this direction. This evidence, combined with the current mood in Washington, suggests that changes to compensation rules may be on the horizon.

What Is Excess Compensation?

Excess compensation is any benefit paid to a disqualified person in excess of fair market value (FMV).[4] A disqualified person is one who is able to exercise substantial influence over the organization. The logic is that those with such influence can cause themselves to receive excessively high compensation.

The IRS may revoke the organization's tax exemption for excess compensation. A more likely result is for the IRS to impose intermediate sanctions.

What Are Intermediate Sanctions?

Intermediate sanctions are excise taxes applied to any amount of excess compensation.[5] The tax is applied to the disqualified person and to managers who knowingly participated in providing the excess benefit. The disqualified person is taxed at 25% of the excessive compensation.

The disqualified person is also required to correct the problem, likely by repaying the excess compensation. If not corrected, there is an additional tax of 200% of the undue compensation.

Managers who knowingly participated in providing the excess benefit are taxed 10% of the excessive compensation to a maximum of $20,000. You can see from the magnitude of the penalties that you should take steps to avoid compensating executives at a rate above market.

What Is a Rebuttable Presumption?

Tax regulations provide a safe haven against the problem of too-high compensation and resultant penalties. If you follow certain procedures, the compensation you provide is deemed to be reasonable and

Nonprofit World • Volume 28, Number 5 September/October 2010.
Published by the Society for Nonprofit Organizations
P.O. Box 510354, Livonia, Michigan 48151
734-451-3582 • www.snpo.org

the burden of proof shifts to the IRS. This rebuttable presumption of reasonableness is what Senator Grassley's proposal addressed. Based on the committee reports that nonprofits were abusing the safe haven and being protected by the rebuttable presumption, the Senator attempted to limit the protection. While this attempt failed, it's reasonable to assume that further attempts will be made.

The regulation requires a compensation package to be approved by a committee of people independent of the compensation arrangement. This committee must arrive at the level of compensation by using data on comparable executives at comparable organizations. Finally, all proceedings and related data must be properly documented. Current law dictates that following these procedures will provide protection against the problem of excess compensation.

A further protection is granted to initial contracts since a new hire should be employed at market rates. A new employee, or someone promoted to a position of significant influence, is deemed to be receiving FMV compensation as long as the compensation is fixed.

What Steps Can You Take to Avoid Penalties?

• **Form a compensation committee.** This committee shouldn't include any individual who is a disqualified person. Larger organizations could consider hiring internal auditors to serve on this committee. Smaller organizations could use board members who have no operational function. Independent public accountants or attorneys might also be good members of this committee. The committee's function is to establish non-biased compensation for all disqualified persons in the organization.

• **Prepare proper documentation.** Be sure all activities of the compensation committee are documented on a timely basis, generally within 60 days of the meetings. Proper minutes should fulfill this need. Remember that this documentation will be the major item used by the IRS for its determinations.

• **Collect comparability data.** This data should show that your executive compensation is similar to that of organizations like yours. You can gather this data from the tax filings of comparable organizations. The IRS has determined that three comparables are sufficient for organizations with receipts under one million dollars.

• **Monitor activities.** The committee should keep an eye on all compensation activities related to disqualified persons. All contract changes should originate with the committee or, at a minimum. be approved by the committee.

• **Document fringe benefits.** For example, if a disqualified person receives a club membership paid by the organization, be sure to include it in the documented compensation. If you don't document such benefits, and the IRS determines them to be compensation, they will automatically be considered excessive.

• **Be on the lookout for IRS changes to compensation requirements.** Be proactive in complying with them. ■

Tom English (tenglish@boisestate.edu) is professor of accounting at Boise State University.

If you follow the rebuttable presumption, you shift from "guilty until proven innocent" to "innocent until proven guilty."

Footnotes

[1]For a current discussion, see a Columbia Law School debate at http://www.prnewswire.com/news-releases/ken-feinberg-richard-epstein-and-mark-w-smith-to-debate-the-governments-regulation-of-executive-compensation-at-columbia-law-school-90894424.html.

[2]The Grassley Amendment (#F-8, Reform Intermediate Sanctions Rules for Tax-Exempt Organizations) can be found at http://services.taxanalysts.com/taxbase.

[3]Sec 4958 (c) (1) (A).

[4]Sec 4958 (f) (1).

[5]Sec 53.4958-6.

Managers can be penalized with a tax up to $20,000.

A Short Glossary

Excess compensation: salary and benefits paid to organizational insiders above the amount paid by comparable organizations.

• **Disqualified person:** an insider or a family member of an insider (see "Insider").

• **Fair market value (FMV):** the amount of compensation that similar organizations are paying their executives.

• **Insider:** any person in a position to exercise significant influence over organizational operations.

• **Intermediate sanctions:** taxes imposed by the IRS in cases of excess compensation. These are called intermediate sanctions because they are not as severe as the ultimate sanction of revoking the organization's tax-exempt status (which was once the only option the IRS had for punishing excess compensation).

• **Rebuttable presumption:** a protection from penalties if you follow certain steps, which include forming a committee to oversee compensation matters, using comparable data to determine salary and benefits, and documenting all compensation decisions.

Don't Get Caught in the Compensation Trap

See these resources at www.snpo.org/members:

• **New IRS Employment Tax Initiative: What Does It Mean for Nonprofits?** (Vol. 28, No. 2)

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

• **Expectations for Board Members Are Changing** (Vol. 19, No. 3)

• **Avoiding the Snares of Intermediate Sanctions** (Vol. 14, No. 6)