



**TAX-EXEMPT ORGANIZATIONS ALERT**  
**NONPROFIT EXECUTIVE COMPENSATION**

**IN SETTING EXECUTIVE COMPENSATION, A TAX-EXEMPT ORGANIZATION SHOULD CONSIDER FOLLOWING THE IRS'S REQUIREMENTS TO ESTABLISH A REBUTTABLE PRESUMPTION THAT THE COMPENSATION IS REASONABLE**

Section 4958 of the Internal Revenue Code (the "Code") imposes a penalty excise tax directly on certain persons who receive excessive compensation from certain tax-exempt, nonprofit organizations. If a nonprofit executive violates section 4958 of the Code, the nonprofit executive is personally liable to pay one or more penalty excise taxes. In some cases, managers of a nonprofit who approve excessive compensation arrangements, such as members of the board of directors, may also have to pay an excise tax. A nonprofit organization can limit the potential exposure of its executives to section 4958 taxes by following a safe-harbor procedure contained in applicable IRS regulations.

**WHOSE COMPENSATION IS POTENTIALLY SUBJECT TO SECTION 4958 EXCISE TAXES?**

Section 4958 of the Code prohibits an "applicable tax-exempt organization" from participating in an "excess benefit transaction" with a "disqualified person." Applicable tax-exempt organizations are nonprofit organizations (other than private foundations) that are exempt from taxation

under section 501(c) (3) or (4) of the Code. An excess benefit transaction occurs when a nonprofit organization provides a benefit to a disqualified person that exceeds the value of the benefit the organization receives from the disqualified person in exchange. For example, if a nonprofit pays its executive director a salary well above what executive directors of similar organizations are paid, the organization would be considered to have engaged in an excess benefit transaction.

A disqualified person is generally defined as any person in a position to exercise substantial influence over the affairs of a nonprofit organization anytime during the five-year period preceding the date of the compensation transaction. IRS regulations say that voting members of a nonprofit's board of directors, presidents, chief executive officers, chief operating officers, treasurers, and chief financial officers are in a position to exercise substantial influence over the organization's affairs, and, as such, deem them to be disqualified persons. Disqualified persons also include family members of other disqualified persons (including spouses, siblings, in-laws,

ancestors, and children, grandchildren, great grandchildren, and their spouses). For example, the spouse of an executive director would be a disqualified person. Special rules, not discussed here, apply to corporations and partnerships in which disqualified persons have an interest, and to donor advised funds and supporting organizations. You should check with your tax advisor to determine who is a disqualified person with respect to your nonprofit.

**HOW DO NONPROFIT EXECUTIVES GET THE BENEFIT OF THE REBUTTABLE PRESUMPTION THAT COMPENSATION PAID BY THE ORGANIZATION IS REASONABLE?**

By following the IRS's three-step safe harbor procedure, a nonprofit organization can significantly minimize the risk that the IRS will later determine that the organization has engaged in an excess benefit transaction. Following this procedure is known as establishing the rebuttable presumption of reasonableness. If the rebuttable presumption of reasonableness is established, payments made under a compensation arrangement will be presumed to be reasonable. Instead of the disqualified person having to show the compensation was reasonable, the burden of proof will shift to the IRS to demonstrate that the compensation paid to the disqualified person was unreasonable. The three steps for establishing the rebuttable presumption of reasonableness involve:

- approval by an authorized body;
- use of appropriate comparability data; and
- documentation.

First, an authorized body of the nonprofit organization must approve the compensation arrangement in advance. A nonprofit's

authorized body may consist of the organization's governing body (i.e., the board of directors or board of trustees), or if permitted by state law, either a committee of the governing body, or other parties authorized by the governing body to act on its behalf.

Members of the authorized body cannot have a conflict of interest with respect to the compensation arrangement. A conflict of interest exists when a member of the authorized body approving the compensation arrangement:

- is a disqualified person participating in or economically benefiting from the compensation arrangement, or is a member of the family of any such disqualified person;
- is in an employment relationship where he or she is subject to the direction or control of any disqualified person who participates in or benefits from the compensation arrangement;
- receives compensation or other payments that must be approved by a disqualified person who participates in or benefits from the compensation arrangement;
- has a material financial interest affected by the compensation arrangement; or
- approves a transaction providing economic benefits to a disqualified person who participates in or benefits from the compensation arrangement, and who in turn has approved, or will approve, a transaction providing economic benefits to the member of the authorized body.

For example, the son of a nonprofit's executive director cannot serve on the authorized body approving the executive director's compensation, because the son has a conflict of interest with respect to the

executive director's compensation arrangement.

Second, prior to making its decision, the authorized body must retain and rely upon appropriate data as to how the compensation to be paid compares to compensation paid by similar organizations for similar services. Comparability data is appropriate if it provides the authorized body with sufficient information to determine if the compensation arrangement in its entirety is reasonable.

Examples of relevant information include:

- compensation paid by similarly situated for-profit and nonprofit organizations for comparable positions;
- whether or not there is a ready supply of people to perform similar services in the geographic area where the nonprofit is located;
- current compensation surveys compiled by independent firms; and
- actual written offers from similar institutions competing for the services of the disqualified person.

For a nonprofit with annual gross receipts of less than \$1 million during the three prior taxable years, the IRS will consider the organization to have appropriate comparability data if it obtains data on compensation paid by at least three comparable organizations in the same or similar communities for similar services.

Third, when making its determination that compensation to be paid to a nonprofit executive is reasonable, the authorized body must adequately document the basis for its determination. The documentation may be written or electronic, such as written minutes or an email summary of the meeting. The documentation must note:

- the terms of the transaction and the date it was approved;
- the members of the authorized body who were present when the transaction was debated;
- the comparability data obtained and relied on by the authorized body and how the data was obtained; and
- any actions taken by a regular member of the authorized body who had a conflict of interest with respect to the transaction (e.g., recusal).

Adequate documentation also means timely documentation. The organization must prepare records before the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken, whichever ever occurs last. Also, the authorized body must, within a reasonable period of time, review and find that the records are reasonable, accurate, and complete.

The nonprofit must comply with all three steps to establish the rebuttable presumption of reasonableness. The nonprofit will not enjoy the protections the safe harbor affords if the organization fails to meet any one of its three requirements. Following the three-step procedure for establishing the rebuttable presumption of reasonableness is voluntary. The IRS will not automatically assume a violation by an organization that chooses not to follow the safe harbor. However, establishing the rebuttable presumption of reasonableness is the most reliable way to guard against potential exposure to penalty taxes resulting from a nonprofit executive's receipt of excessive compensation. Establishing the rebuttable presumption of reasonableness is also considered to be a "best practice" in terms of nonprofit governance.

## **WHAT HAPPENS IF A VIOLATION OF SECTION 4958 OF THE CODE OCCURS?**

Section 4958 of the Code imposes penalty taxes directly on individuals who receive an excess benefit from a nonprofit and on organization managers who knowingly approve a transaction that gives rise to an excess benefit.

A disqualified person who receives unreasonable compensation is liable for an initial tax and may be liable for an additional tax. The initial tax on the disqualified person equals 25% of the amount by which the value of the compensation received exceeds the value of the services provided to the organization by the disqualified person in return. If the initial tax is imposed and the disqualified person does not repay the amount of the excessive compensation (with interest) to the nonprofit organization, an additional tax is imposed on the disqualified person equal to 200% of the amount of the excessive compensation received. If a disqualified person makes a payment less than the full amount of excessive compensation (plus interest), the 200% tax is only imposed on the unpaid portion of the correction amount.

A tax equal to 10% of the amount of the excessive compensation received by a disqualified person is imposed on any "organization manager" who knowingly approves excessive compensation. An organization manager includes any officer, director, or trustee of a nonprofit organization, or any individual who has powers and responsibilities similar to officers, directors, or trustees of the organization. A manager knowingly approves excessive compensation if he or she actually knows of facts that indicate that the transaction would result in unreasonable compensation. Furthermore, if more than

one organization manager is liable for a section 4958 tax, all such organization managers are jointly and severally liable for this tax.

An organizational manager's exposure to the tax may be limited by several factors. If an organization manager relies on the reasoned written opinion of legal counsel, certified public accountants, accounting firms, or independent valuation experts, and the opinion reflects elements of the transaction within the professional's expertise, the organization manager is protected from the tax even if that opinion is ultimately found to be incorrect.

The tax is not imposed if the manager's participation was not willful and was due to reasonable cause. An organization manager is not considered to have participated in an excess benefit transaction if he opposed the transaction in a manner consistent with the fulfillment of the organization manager's responsibilities to the organization. Furthermore, the total tax imposed on all organization managers is limited to \$20,000 for each excess benefit transaction.

Before you develop a compensation package for your executive employees, you should check with your tax advisor to determine whether your nonprofit should take advantage of the IRS safe harbor.

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