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# Tax-Exempt Organizations Alert: What Nonprofits Should Know About Executive Compensation

## Introduction

Section 4958 of the Internal Revenue Code (the "Code") imposes a penalty excise tax directly on certain persons who receive excessive benefits from Section 501(c)(3) organizations, including excessive executive compensation. If a nonprofit executive violates section 4958 of the Code, the executive is personally liable to return the excess benefit and 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 spelled out in the IRS regulations when setting executive compensation.

## Whose Compensation May be Subject to Section 4958 Excise Taxes?

Section 4958 of the Code prohibits certain tax-exempt nonprofits from participating in an "excess benefit transaction" with a "disqualified person." This applies to nonprofit organizations 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 in return.

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 are thus deemed 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 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 Should Nonprofits Set Executive Compensation?

Because the penalties for paying excess compensation can be so severe, the Internal Revenue Code contains a "safe-harbor" for determining executive compensation. By following this 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 the 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:

1. Approval by an authorized body;
2. Use of appropriate comparability data; and
3. Documentation.

In addition to these three steps, the nonprofit has to properly report the compensation to the IRS.

First, an authorized body of the nonprofit organization must approve the compensation arrangement in advance. A nonprofit's authorized body may consist of the board of directors or board of trustees, or if permitted by state law, a committee of the board. 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 family member of any such disqualified person;[1]
- Is in an employment relationship where he or she is subject to the direction or control of any disqualified person who

[1] For example, under the conflict of interest rules, 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.

benefits from the compensation arrangement;
- Receives compensation or other payments that must be approved by a disqualified person who benefits from the compensation arrangement;[2]
- Has a material financial interest affected by the compensation arrangement; or
- Approves a transaction providing compensation to a disqualified person when the disqualified person has, in turn, approved or will approve a transaction providing economic benefits to the member of the authorized body. [3]

Second, prior to making its decision, the authorized body must obtain and rely upon appropriate data that compares the compensation to be paid with 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 for the prior three 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. Larger nonprofits must obtain information from more organizations.

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— such as a board

[2] For example, if an executive director approves payments for an independent contractor doing work for the nonprofit, the independent contractor, or his or her family members, should not be part of the body charged with approving the executive director's compensation.

[3] The goal is to prevent any quid pro quo transaction, whereby Disqualified Person A approves a compensation package for Disqualified Person B with the expectation that Person B will approve a compensation package for Person A.

member—who had a conflict of interest with respect to the transaction (e.g., the director recused himself or herself from the meeting).

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

Following the three-step procedure for establishing the rebuttable presumption of reasonableness is voluntary, and the IRS will not automatically assume a violation by an organization that chooses not to follow the "safe harbor" guidelines. 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. It is also considered to be a "best practice" in terms of nonprofit governance. The nonprofit must comply with all three steps to establish the rebuttable presumption of reasonableness.

- For additional information about excess benefit transactions generally, *see also* D.C. Bar Pro Bono Center, Tax-Exempt Organizations Alert: Avoiding Excess Benefit Transactions, *available at* http://www.lawhelp.org/dc/resource/how-to-avoid-excess-benefit-transactions-when/download/C2359DC6-464B-4B2F-8B1B-8A9CA9EAF064.pdf

**What Happens if a Violation of Section 4958 Occurs?**

Section 4958 of the Code imposes penalty taxes directly on individuals who receive an excess benefit from a nonprofit. The Code also imposes a penalty tax 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 equal to 25% of the amount by which the value of the compensation received exceeds the value of the services provided to the organization in return. In addition, the disqualified person must return the excess benefit to the organization.

For example, if an organization pays its CEO $50,000 in excess benefits, the CEO will owe a penalty tax equal to $12,500 and he or she must return the $50,000, with interest, to the organization.

If the initial tax is imposed and the disqualified person does not repay the amount of the excessive compensation to the 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 organization 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, 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 or she voted against the transaction. 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" guidelines.

**Additional Resources**

- D.C. Bar Pro Bono Center, Tax-Exempt Organizations Alert: Avoiding Excess Benefit Transactions, *available at* http://www.lawhelp.org/dc/resource/how-to-avoid-excess-benefit-transactions-when/download/C2359DC6-464B-4B2F-8B1B-8A9CA9EAF064.pdf

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