Executive Compensation for Exempt Organizations

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Introduction

Executive compensation for exempt organizations is currently a hot topic on Capitol Hill and with the Internal Revenue Service. Under the leadership of Senator Grassley, the Senate Committee on Finance was committed in recent years to improving the management of nonprofit organizations and preventing fraud. Senator Grassley focused his attention on executive compensation. The IRS has also identified nonprofit executive compensation as one of its priority initiatives. The press has reported on the excesses in some executive compensation packages for current and former executives of prominent charities. Is excessive compensation for nonprofit executives a new problem or is an old problem just getting increased attention?

The excesses in executive compensation in the nonprofit community do not even begin to reach the levels of those reported in the for-profit corporate community in recent years. However, some nonprofit executives are living lifestyles beyond what their organization's donors might expect. The situation with the former president of American University is a prime example of nonprofit executive compensation coming under public scrutiny. The university allegedly paid for private family parties, a personal chef, a limousine and driver for the president's wife, and other personal expenses. When allegations of spending abuse reached the board of trustees, they were torn apart by differing opinions as to the appropriateness of the spending, how to handle the president's compensation and the complaints which arose when it was publicized. The severance package the board negotiated with the president sparked protests and demonstrations by the faculty and students. Senator Grassley inserted himself in the board's discussions. His interest may have helped to bring about positive changes at the university. The board of trustees announced new reforms in their governance and compensation practices as a result of their experiences with the previous president. While this may be an extreme example, Senator Grassley and the IRS are convinced that there are many more cases of excess compensation in the nonprofit community.

Background

In 1996 the tax law was changed to provide an "intermediate sanction" for exempt organizations which engage in excess benefit transactions. Prior to that time, loss of exempt status was the only penalty the IRS could impose on organizations that were not operated exclusively for exempt purposes. The "intermediate sanction" created by Congress was a new tax, intended to be less severe than a revocation of exempt status.

Internal Revenue Code § 4958 imposes a tax on excess benefit transactions for those organizations which are exempt from taxation under Internal Revenue Code § 501(c)(3) or 501(c)(4). An "excess benefit transaction" is a transaction between an individual and an exempt organization where the parties do not benefit equally from the arrangement. Specifically, the individual receives more value than the exempt organization from the transaction. The individual must be a "disqualified person" for a transaction to result in excess benefits. Disqualified persons are those who were "in a position to exercise substantial influence over the affairs of the organization" at any time during the previous five years. It also includes members of their families or any companies where they control more than 35% of the company. Typically officers, directors and senior staff and members of their families are considered disqualified persons.

The excise tax rates vary from 10 to 200%. A tax of 25% of the excess benefit is imposed on disqualified persons who benefit from the transaction. This tax increases to 200% if the excess benefit is not corrected. Any managers or board members who participated in the transaction and knew it was an excess benefit are taxed at 10% of the excess benefit unless their participation was not willful and is due to reasonable cause. Under the Pension Protection Act of 2006, the maximum excise tax is $10,000 per person for each occurrence of an excess benefit.

The IRS recently provided informal guidance for exempt organizations on how to ensure that their compensation arrangements are reasonable. This guidance is based on the early results of compliance checks and examinations the IRS has been conducting on the executive compensation packages of public charities and private foundations.

Compliance Checks and Examinations

There are certain problem areas that will trigger a compliance check or examination by the IRS. The IRS has identified specific questions on Form 990 and Form 990-PF (returns filed by some exempt organizations) that will cause them to take a deeper look at an organization if the questions are left blank or if the organization answers "yes" but then does not provide an explanation. Problem areas to watch out for are:

- Form 990, Part IV, line 50, receivables from officers, directors, trustees and key employees;
- Form 990, Part VI, line 89(b), the existence of any excess benefit transactions; and
- Schedule A, Part III, line 2, transactions between related individuals and other financial arrangements.

What is the difference between a compliance check and an examination? A compliance check is when the IRS contacts an organization and requests more information about a return and the organization's recordkeeping. The IRS does not inspect the organization's books and records nor does it attempt to determine tax liability. Compliance checks are viewed by the IRS as a tool to educate taxpayers. An examination is an inspection of the organization's books and records for the purpose of making a determination as to tax liability. Examinations are more involved and, since potential tax liability is at issue, are usually of greater concern to the organization.

An examination letter seeks much more detailed information than a compliance check letter. In the executive compensation area, examination letters may seek:

- information on the organization's policies and procedures for setting compensation;
- information on the duties and responsibilities of officers, directors and key employees;
- whether the organization intends to establish the rebuttable presumption of reasonableness;
- whether the board approved the compensation arrangements;
- where the board approved compensation, documentation of the board's approval;
- copies of any employment contracts or other agreements with employees;
- whether the compensation reported on the Form 990 or 990-PF matches the compensation reported on Forms W-2 and 1099; and
- whether there was any personal use of the organizations' property.

It is important for organizations to know whether they are facing a compliance check or an examination when they receive a letter from the IRS. If there is an excess benefit transaction, the IRS will impose an excise tax. If the organization failed to report the compensation, it can amend its return to report the income and avoid the tax. But it can only amend its return up until the time the IRS starts an examination. Once the examination has begun, the organization can no longer amend its return. After that time, any compensation that is not reported as such becomes an excess benefit transaction subject to the excise tax.

What problems has the IRS uncovered so far in its executive compensation initiative? Loans to insiders and undocumented loans were so prevalent that the IRS launched an offshoot of the executive compensation initiative in March 2006 focusing on loans. Other problems discovered were:

- paying excessive compensation for part-time work;
- spreading compensation among several related organizations so as to minimize the reporting impact; and
- mistakes in reporting deferred compensation.

Rebuttable Presumption

How can organizations ensure that reasonable compensation is paid? The IRS recommends that boards consider meeting the rebuttable presumption of reasonableness for compensation. To do that, compensation must be approved in advance by disinterested board members using appropriate data on comparable positions in other organizations and there must be contemporaneous documentation of the decision. While a compensation arrangement can be reasonable without meeting the presumption of reasonableness, meeting the presumption will minimize the likelihood the IRS will question the compensation arrangement. Even if an organization is not going to take advantage of the rebuttable presumption, it is a good idea to have executive compensation reviewed and approved by disinterested board members. All forms of compensation including any economic benefits received by the officers and directors should be reported on Form 990.

Comparables

Reasonable compensation is defined as the amount ordinarily paid for similar services by similar organizations under similar circumstances. The IRS is concerned that organizations are not always comparing apples to apples when comparing executive compensation. Similar job titles do not necessarily mean similar compensation should be paid. Factors to consider in evaluating comparables are:

- similarities of the duties and responsibilities;
- experience levels;
- same or similar industry;
- national or local organization;
- number of people supervised;
- number of departments, facilities or entities managed;
- number of hours worked;

- whether the compensation includes severance or other payments for prior service;
- whether the individuals are handling single or multiple functions;
- whether the individuals are paid by more than one entity; and
- whether the employers are for-profit or nonprofit.

Special care should be used when relying solely on for-profit comparables as this may result in increased scrutiny by the IRS and loss of the rebuttable presumption. Use of for-profit comparables may be acceptable when there are no appropriate nonprofit comparables in the geographic area or if the organization can demonstrate that nonprofit organizations compete with for-profit companies for the same pool of specialized talent.

Hiring a compensation consultant to provide the information on comparables is an excellent way to establish the reasonableness of any comparable salary and benefits information used in setting executive compensation. Normally a compensation consultant will meet with the compensation committee or the full board and review the executive's current compensation package as well as make recommendations for enhancements. The consultant provides information on the comparables used to benchmark the executive's compensation, thus bringing a level of objectivity to what is often a subjective process.

Documentation

Documentation of the board's approval of the compensation arrangements is very important and often overlooked. The documentation should include the terms of the compensation, the date it was approved, the members of the board or committee present during the debate and vote on the compensation, the information on comparable compensation that was used in the decision-making, the actions of any members of the board or committee who had a conflict of interest, and the basis for the determination that the compensation was reasonable under the circumstances. In order to avail itself of the presumption of reasonableness, the documentation should be contemporaneous with the action approving the compensation.

Compensation Elements

What is counted as compensation varies between organizations due to misunderstandings about how the law applies. Everything that is not excluded by the regulations (*de minimis* fringe benefits) should be included in determining the amount of compensation. In addition to salary, fees, bonuses, and severance payments, compensation includes such things as deferred compensation, vacation and other leave, retirement benefits, health and life insurance, housing, personal expenses related to business travel (such as dry cleaning, health club use and movie rentals), personal use of employer-owned property (such as cars, cell phones and computers), non-cash awards, tuition reimbursements, wardrobe allowance, spouse travel expenses and club memberships. Employment agreements should contain all terms and conditions of the compensation package, not just the salary and any bonus offered.

Expense accounts and other allowances to be used at the discretion of the executive should be included in compensation. The organization should determine a reasonable level for an expense account, set limits and establish and implement an approval and auditing process to review the expenditures. Expense accounts and other allowances are reported with other elements of compensation on the Form 990 in Part V-A.

Some organizations have sought to hide the full compensation paid to their executives by spreading it among several related organizations. This strategy will no longer work as the revised Form 990 asks for information on compensation paid by all related organizations, whether taxable or tax-exempt, that have common supervision or control.

Compensation Committees

To address concerns about confidentiality of compensation arrangements, some boards delegate the responsibility for establishing compensation to a compensation committee. If there is no specific compensation committee, often the executive committee will fill that role. In rare cases the entire board handles the review and approval of executive compensation as a committee of the whole. Usually a committee assumes the responsibility for reviewing executive compensation arrangements and determining whether they are reasonable given the duties and responsibilities of the compensated individual. If a committee is used to review compensation, the committee should disclose the executive compensation arrangements it approves to the full board since the board has the ultimate responsibility for the compensation that is paid. Executive compensation should be reviewed on an annual basis even if there is no change in the compensation to be paid.

Conflicts of Interest

Every organization should have a conflict of interest policy in place before it is needed. The organization should regularly review the terms of all relationships with officers, directors and employees to ensure they are fair and reasonable. Board members with conflicts should recuse themselves from any votes involving their conflict. This is particularly true with executive compensation. It is not uncommon for the senior staff member of an organization to be a member of the board of directors. Compensated individuals and those related to them should not be approving their compensation and they should not be on the compensation committee. Staff members who serve on the board should not take part in any discussion or vote on their compensation other than the normal employee's role in compensation negotiation.

Conclusion

The stakes have been raised and public scrutiny has increased. Boards need to take their responsibilities seriously when setting executive compensation. They should consider all elements of the compensation package. They should also take advantage of the rebuttable presumption that a compensation package is reasonable by: 1) setting all compensation in advance by disinterested persons; 2) using comparables to justify the reasonableness of the compensation; and 3) documenting all decisions about compensation. Boards should not shy away from paying competitive compensation to retain outstanding executives but they should protect themselves and their organization by making sure the compensation they pay is reasonable.