Compensation Arrangements

by Louis E. Michelson

With the recent announcement of a new enforcement effort focusing on nonprofit compensation, the Internal Revenue Service will be asking hundreds of nonprofits for detailed information on compensation practices and procedures. Specifically the IRS will be asking for:

- How nonprofits set and report compensation for specific executives.
- Details concerning the independence of the governing body that approved the compensation.
- Details of the duties and responsibilities of specific executives.
- Information on loans or sales to executives and officers.
- Details involving insider transactions.

Like many of the accountability efforts discussed in this issue, the current IRS focus arises from perceived abuses involving nonprofits. They are an outgrowth of the "intermediate sanction" rules related to compensation: In 1996 Congress imposed new rules on certain nonprofits (namely, public charities and social welfare organizations) so that people in positions of "substantial influence" over the organization do not take advantage of their influence to enrich themselves. Before these new rules, when faced with abuse of position and misuse of charitable assets, the only choice the IRS had was the "atom bomb" of revoking the nonprofit's exempt status. Intermediate sanctions were intended to give the IRS some teeth to punish people with "substantial influence" and those who approved the "excess benefit" transaction.

Example of "Excess Benefit"

The most straightforward example of an excess benefit transaction is for an executive director to arrange for the governing board to approve his or her compensation at an excessive rate– say $450,000, assuming this amount exceeds the prevailing market rate of $250,000 and no preventive steps were taken.

In this scenario, excess benefit is $200,000 (the difference between the amount paid and the fair market value of the services). The executive director could be liable for an excise tax equal to 25 percent of the excess benefit, or $50,000. If the excise tax is imposed on the executive director, the directors on the governing board who participated in approving the transaction could be liable for another excise tax equal to ten percent of the excess benefit. However this tax can not exceed $10,000 with respect to any one transaction.

Rebuttable Presumption Procedure

To help nonprofits avoid engaging in transactions that would be subject to these excise taxes, the IRS proposed regulations that contain a safe-harbor procedure. If a nonprofit follows this procedure, the nonprofit has a "rebuttable presumption of reasonableness" for the amount of compensation paid. The procedure thereby protects the nonprofit against second-guessing by the IRS.

The safe-harbor calls for the nonprofit to take three procedural steps before compensation is paid. First, the body deciding on compensation (typically the board of directors) needs to have a meeting to discuss the proposed compensation. The board members who participate must not have a personal interest in the compensation.

Second, the board must consider comparability data. This data may be based on industry surveys, documented compensation of persons holding similar positions in similar organizations, or expert compensation studies. The IRS does not require any particular number of comparables or the number of comparable sources. The board must approve the compensation. As one might expect, the person whose compensation is being approved may not vote on this decision.

Third, the board must prepare minutes that document the procedure. Generally these minutes must be prepared before the next board meeting.

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Compliance and Audit Alerts

Since enactment of the intermediate sanction rules, Form 990 contains new questions that ask about excess benefit transactions in which a nonprofit may have participated. If it has participated in such transactions, the nonprofit should report and provide details on the transaction – even if it occurred in an earlier tax year. But according to the IRS, many charities simply are not completing the question relating to excess benefit transactions. Even when nonprofits do follow the procedure required to obtain the rebuttable presumption, the IRS has criticized these efforts as inadequate.

The IRS has informally announced that it is questioning compensation surveys performed by the nonprofit's regular CPA firm instead of by an independent firm. The IRS requires that contracts with compensation consultants be entered into by the members of the board of directors on behalf of the nonprofit, and that the executive whose compensation is being evaluated have no role in selecting or contracting with the consultant. The IRS also questions the adequacy of compensation surveys that do not adequately document the names of the comparable nonprofits that were included in the survey or the names of comparable executive directors. Little weight is likely to be given by the IRS to such reports.

Advance Preparation and IRS Enforcement Initiative

The IRS informally indicated that, in deciding which organizations to select for this project, it will consider a number of "risk factors" including:

- Compensation that seems "out of whack."
- Employees earning more than $1 million (although employees earning less than $1 million are "not off the audit screen").
- Loan activity involving the nonprofit organization.
- Other insider transactions.
- How the exempt organization answers question 89b on Form 990. Failure to answer this question is likely to result in an inquiry.

Testifying before the Senate Finance Committee on June 22, 2004, IRS Commissioner Mark W. Everson stated that this enforcement program will include both traditional examinations and correspondence compliance checks. He stated that the purpose of the project is to enhance compliance by learning what practices organizations use to set compensation and learning how organizations report compensation to the IRS and the public. Mr. Everson also stated that one purpose of the project is create "positive tension" for organizations as they decide compensation arrangements. Nonprofits need to know that their decisions will be reviewed by the IRS.

Prevention

Two preventive steps logically flow from the foregoing. First, nonprofits should take advantage of the rebuttable presumption when establishing compensation for persons who exert influence over the organization: An ounce of prevention is worth a pound of cure. Second, directors should closely review reporting on Form 990 since sufficient reporting that addresses the IRS concerns could prevent further unnecessary inquiry.

Finally, become familiar with the new intermediate sanction regulations. Two plain-English articles on these new rules have been posted to the IRS website at www.irs.ustreas.gov/charities/index.html: "Easier Compliance is Goal of New Intermediate Sanction Regulations" and "Rebuttable Presumption is Key to Easy Intermediate Sanctions Compliance." Like all the proposed regulations outlined in this issue of the *CAN Alert*, it is critical for nonprofit leaders to be aware of the laws governing them. ■

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