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GUIDESTAR

Nonprofit Executive Compensation and Incentive Compensation: Keys to Protecting Your Organization and Its Leaders from IRS Sanctions

GuideStar Webinar

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Purpose

- Explain the consequences of excessive executive compensation
- Explain how organizations can protect themselves
  - Rebuttable Presumption of Reasonableness
- Non-Fixed Compensation
  - Revenue Sharing
  - Incentive Compensation

Tax Consequences of Excessive Compensation

Limitations on Executive Compensation

- Exemption issues
  - Private inurement
  - Impermissible private benefit

- Intermediate Sanctions

Exemption Issues

- Private Inurement
  - Code generally provides that no part of organization’s net earnings can inure to the benefit of any private individual or shareholder
  - Applies to organizations exempt under multiple sections of the Code, including but not limited to: 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
  - Penalty for inurement is REVOCATION

Exemption Issues

- Impermissible Private Benefit
  - Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
  - A non-exempt purpose is generally a purpose that serves a private rather than a public benefit, and as such is generally called a "private benefit"
  - Provision of an impermissible private benefit is grounds for revocation
  - The private benefit prohibition is imposed on a more limited group of exempt organizations than private inurement, and may not be applicable to organizations exempt under 501(c)(6) or 501(c)(7)

Intermediate Sanctions

- International Revenue Code ("Code") section 4958 allows the Internal Revenue Service ("Service") to impose penalties on "disqualified persons" who participate in or approve "excess benefit transactions"
- These penalties are commonly referred to as the intermediate sanctions
- Similar to "private inurement" concept

Intermediate Sanctions

- Treas. Reg. Section 53.4958-3(c) lists specific persons who are in a position to exercise substantial influence, including:
  - Voting Members of the organization's governing body
  - President, CEO, COO
  - Treasurer and CFO
  - Organization founders and
  - Some donors

Intermediate Sanctions - Penalties

- Penalty for receipt of an excessive benefit:
  - Return the value of the excessive benefit to the organization and
  - An excise tax of either:
    - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service or
    - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

Intermediate Sanctions - Penalties

- Penalty on organization managers for approval of an excessive benefit transaction:
  - Section 4958(a)(2) imposes a 10% tax on any organization manager who knowingly approves an excess benefit transaction
  - Liability under section 4958(a)(2) is joint and several and capped at $20,000 per transaction

Protecting Your Organization

Avoiding Excessive Compensation

- Use caution when entering into transactions with disqualified persons
- Assess your risk
- Develop, implement, and follow a conflict of interest policy that prevents board members and organization executives from participating in decisions that impact them financially
- Establish reputable presumption of reasonableness

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Rebuttable Presumption of Reasonableness

- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value

- To establish the rebuttable presumption:
    1. The transaction must be approved in advance by disinterested members of an authorized body of the organization's governing body
    2. The governing body must obtain and rely on valid comparability data in approving the transaction and
    3. The governing body must contemporaneously document its decision and the reason for its decision

Rebuttable Presumption – Advanced Approval

- Authorized body:
  - The organization's governing board and
  - A committee of the governing board permitted to act on behalf of the board by state law
- Disinterested individuals: Does not include any person with a conflict of interest, such as:
  - Receiving direct economic benefits from a transaction
  - A family member of a person benefiting from a transaction
  - Employees working under a person benefiting from a transaction or individuals whose compensation will be approved by a person benefiting from the transaction and
  - Individuals who have a material financial interest affected by the transaction
- Approved in advance

Rebuttable Presumption – Comparability Data

- Do you need a third-party compensation or valuation report?
  - Depends on several factors, including size of the organization and amount of compensation
- Do you need to consider comparable data?
  - Yes, the rebuttable presumption of reasonableness cannot be established without consideration of comparable data
- What constitutes “comparable”:
  - Amounts paid by similarly situated organizations: size, receipts, budget, location, activities, and may include both taxable and exempt organizations
  - Availability of similar services in geographic area
  - Compensation surveys prepared by independent firms
  - Actual written offers for employee made by competing organizations and
  - Valuation report prepared by independent expert

Rebuttable Presumption – Comparability Data

- Where you can obtain comparability data?:
  - Forms 990 from similar organizations
  - Published compensation surveys
  - Independent experts

- Special rule for organizations with less than $1 million of gross receipts:
  - These organizations will be deemed to have satisfied this requirement if the organization obtains data from three comparable organizations in similar communities that provide similar services

Rebuttable Presumption – Concurrent Recordkeeping

- Concurrent Documentation:
  - The decision must be documented before the later of the approving body's next meeting or 60 days after the final action of the approving body

- Appropriate documentation:
  - The terms of the transaction approved
  - The date of approval
  - The members of the authorized body who present during the discussion of the transaction and who voted on the transaction
  - A description of the comparability data that was used by the authorized body and how the data was obtained
  - Actions taken by members of the authorized body who had a conflict of interest and
  - If the amount of compensation exceeds the fair market value range of the comparability data, then the authorized body must record the basis for its determination

Rebuttable Presumption of Reasonableness

Effect of establishing the "rebuttable presumption":

1. As the title suggests, the presumption can be rebutted; however, to our knowledge, we have never seen the IRS attempt to rebut the presumption
2. Provides board members with near-absolute protection from excise tax on participation
3. The very nature of the process, independent members using objective data, significantly mitigates the risk of overcompensation
4. Provides organization with a clear and easy explanation about compensation decisions and
5. Allows the organization to affirmatively answer all Form 990 questions relating to the policies and procedures that the IRS deems to be most desirable

Rebuttable Presumption of Reasonableness (cont.)

- Section 53.4958-6(e) of the regulations provides that an organization’s failure to establish the rebuttable presumption does not create any inference that a transaction is an excess benefit transaction. However, our experience representing organizations has taught us this is clearly not the case

- The effect of failing to establish the rebuttable presumption:
  - In recent litigation and examinations, the IRS based its entire position on the fact that an organization failed to establish the rebuttable presumption of reasonableness
  - The IRS will prepare its own valuation, often using non-comparable organizations

Rebuttable Presumption of Reasonableness (cont.)

- Failing to establish the rebuttable presumption—litigation experience:
  - IRS issued a notice of deficiency for excise taxes for about $2 million
  - IRS based its position on a transaction for which it obtained no information relating to the valuation of the transaction
  - IRS said that the value of the transaction was $0 for the organization, even though the report of an internal expert provided that the value of the benefit received by the organization exceeded the benefit provided to the disqualified person
  - The IRS refused to acknowledge the relevance of two valuation reports prepared by independent experts subsequent to the transaction and
  - After almost two years of litigation, the IRS conceded the entire issue about a month before the trial

Rebuttable Presumption of Reasonableness (cont.)

- Failing to establish the rebuttable presumption—based on our experience where an organization fails to establish the rebuttable presumption—the IRS will prepare its own analysis often using non-comparable data
- Actual examples of non-comparable organizations include:
  - The amount of compensation provided by an organization located in LA was compared to that provided by organizations located in: Kokomo, IN; Bethany, OK; Tulsa, OK; Sioux City, IA; and South Portland, ME
  - The compensation of a full-time CEO was compared to the compensation of CEOs working as "interim director," executive director, "VP/Secretary," and one individual with no listed title
  - In determining the average amount of compensation, in one IRS valuation, the IRS included an organization that did not provide any compensation information for its president, and the report treated this as $0 in compensation for purposes of determining the average compensation for a position

Forms of Compensation

Forms of Compensation

- Non-fixed compensation
  - Revenue Sharing
  - Incentive Compensation

- Benefits
  - Paying only for the benefits actually received by the organization
  - Incentivizes performance

- Risks
  - IRS scrutiny

Forms of Compensation – Revenue Sharing

- The IRS is always skeptical of revenue sharing arrangements

- At least one court has held that even if a revenue sharing arrangement is reasonable, the total amount paid under the arrangement may be excessive for purposes of inurement

- The IRS has taken the position that even if a revenue sharing arrangement is reasonable, the total amount of compensation paid under the arrangement may constitute an excess benefit transaction

Forms of Compensation – Revenue Sharing (cont.)

- It is difficult to establish the rebuttable presumption for revenue sharing arrangements because the total amount of compensation is not known

- If you enter a revenue sharing arrangement, we recommend that you set a firm cap for the total amount of compensation to be paid under the agreement
  - Allows the organization to establish the rebuttable presumption by approving the total potential amount of the transaction
  - Protects the organization from inurement
  - Is generally viewed more favorably by the IRS

Forms of Compensation – Incentive Compensation

- Bonuses and other performance-based incentives are preferable to revenue sharing
  - Not viewed as negatively by the IRS
  - Easier to establish the rebuttable presumption of reasonableness for at least a portion of the compensation

Forms of Compensation – Incentive Compensation (cont.)

- When providing incentive compensation:
  1. Establish the rebuttable presumption by capping the total amount of compensation
  2. The governing body should explain the reason for its decision to use incentive compensation in the written documentation of its decision
  3. In approving officer compensation, the governing body must establish clear, quantitative standards that the executive must satisfy to receive incentive benefits
  4. Prior to payment of the incentive compensation, the governing body must approve payment after determining the previously established standards have been satisfied

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Questions and Discussion

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