

# Smart Business and Board Governance Strategies to Successfully Prepare for and Defend a Tax-Exempt Nonprofit Executive Compensation Audit

By:

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The stakes are higher today than they have ever been before regarding executive compensation and the scrutiny imposed by the federal and state governments and the national news media. Negative media reaction and public outcry in cases of executive compensation packages viewed as excessive, regardless as to whether or not they really are, has set the stage for government regulators, the Internal Revenue Service and State Attorney General Offices to investigate, audit and suppress abuses. As a result of their findings, more federal and state statutes and regulations concerning not-for-profit executive compensation are being enacted.

Actions taken by State Legislatures and Attorney General Offices in New Jersey and New York to limit executive compensation and reported investigations of not-for-profit organizations to rein in suspected abusive executive compensation practices are acting as a stimulus for even more government regulation. As a result, this is causing many not-for-profit boards across the country to examine their board governance strategies and practices concerning executive compensation and how they will pay their top people in the future.

## **So who oversees and regulates who?**

**Many tax-exempt nonprofit organizations such as 501(c)(3) charitable organizations which may include certain foundations, 501(c)(4) Quasi-governmental organizations, 501(c)(14) State Chartered Credit Unions and 501(c)(6) Business and Trade Associations, are:**

- Required to file an annual tax information return – Form 990 or 990EZ depending on the size of the organization
- Subject to Section 4958 of the Internal Revenue Code regarding Intermediate Sanctions - except for 501(c)(6) Business and Trade Associations and Private Foundations.
- Subject to Private Inurement requirements
- Subject to impermissible private benefit transaction rules
- Under IRS scrutiny for 457 Deferred Compensation Plans
- Under IRS scrutiny for excessive and unreasonable executive compensation practices

**When reviewing not-for-profit executive compensation, what positions are potentially under scrutiny?** Depending on who is scrutinizing whom, the compensation of officers, directors, trustees, key employees, and the highest compensated employees and independent contractors rise to the top of the list.

Officers typically would include Chief Executive Officers, Presidents, Executive Directors, Chief Operating Officers, Chief Financial Officers and Vice Presidents and/or Key Employees who have responsibilities similar to an officer when managing a significant segment or activity for the organization.

Directors and former directors paid for their serves on the Board. Based on Internal Revenue Service guidelines, compensation paid in excess of \$10,000 per year could put a board director or trustee under the microscope.

Highly compensated employees can also be on the list when their total compensation exceeds \$150,000 as a Key Employee or when one of the top five highest compensated employees other than officers earning more than \$100,000.

Over the last few years, the Internal Revenue Service has added additional staff to increase its efforts to audit and investigate tax exempt not-for-profit organizations as it looks for excessive and abusive executive compensation practices and programs. And as stated earlier, state legislators, regulators and Attorney Generals have been very active imposing rules and regulations on the compensation of executives, directors, trustees and the highly compensated.

If you are on the Board for a tax-exempt nonprofit organization, you have to be concerned about personal liability for participating in approving compensation actions deemed excess by IRS. Under section 4958 of the Internal Revenue code, the code imposes “Intermediate Sanctions” in the form of excise taxes on “disqualified persons” which include officers, senior executives, highly compensated, etc. whose organization engages in impermissible and excessive benefit transactions on behalf of them. Section 4958 also penalizes board directors and trustees who knowingly approve excess compensation and/or impermissible benefit transactions. However, please note that (501(c)(6) Business and Trade Associations and Private Foundations are not subject at this time to Section 4958 of the IRS code. As a result, board directors and trustees of business and trade associations are not personally penalized for knowingly approving excessive compensation and /or impermissible benefit transactions but beware that the (501(c)(6) Business and Trade Association can still be investigated and held liable.

As defined, an impermissible excessive benefit transaction is one in which the economic benefit provided directly or indirectly to a disqualified person exceeds the value received by the organization, including the value from the performance of services. This includes the payment of excessive compensation or an impermissible benefit transaction that is deemed unreasonable.

Potential penalties for participating in such actions can include:

- Being personally liable for returning the value of the excess compensation or benefits back to the organization
- Paying an excise tax of either:
  - 25% of the value of the excessive benefit if returned prior to receiving a deficiency notice from the IRS
  - 200% of the value of the excessive benefit if the benefit or compensation is returned after receiving the IRS deficiency notice
- Board Director or Trustee liability for approval of an excessive compensation or benefit transaction:
  - Assessment of a 10% tax on the Director or Trustee who knowingly approves an excessive benefit transaction
  - Liability under section 4958(a)(2) is joint and several and capped at \$20,000 per transaction
  - Revocation - Loss of Tax Exemption

**So what compensation components and economic benefits should be considered to determine whether a person's compensation is reasonable?**

- Base salary
- Fees
- Incentive compensation and bonuses – short-term and long-term
- Retirement benefits
- Nonqualified deferred compensation plans
- Supplemental Executive Retirement Plans
- Health and welfare benefits – medical, dental, life insurance, short-term / long-term disability
- Other employee benefits – Paid Time Off - where there is a cash value opportunity for cash in or paid at the time of retirement or termination
- Taxable and nontaxable fringe benefits, except fringe benefits described in section 132 of the tax code
- Executive benefits and perquisites
- Expense allowances or reimbursements
- Housing allowance or residence for personal use
- Below market loans
- Foregone interest on loans
- Moving and relocation expenses
- Payment of liability and indemnification insurance premiums
- Severance payments

**In determining whether compensation is reasonable, what factors have been taken into account by courts and other regulatory agencies?**

- The employers compensation philosophy and policy for employees and executives
- Comparing compensation for like industries and like employers
- Utilization of reputable compensation survey sources to determine the fair market value of the compensation paid and to be paid and which is sufficient to satisfy the fiduciary responsibility of the governing body to conduct appropriate due diligence. Survey sources may include both taxable and tax-exempt organizations to allow comparisons to similar positions at similarly situated organizations
- Scope, size, financial position, geographic location and complexity of the employer's business
- Industry categories (NAICS and SIC Codes) of the employer and like employers
- Actual written job and compensation offers from similar organizations competing for the executive
- The nature of the work being performed and the employees qualifications
- The performance of the employee/executive and the business performance of the organization
- General economic conditions at the time compensation is awarded or changed

**When is compensation viewed as reasonable?** The fair market value of economic benefits received for the performance of services is considered reasonable compensation, which is the value that would ordinarily be paid for like services by a like enterprise under like circumstances.

## **As a board director or trustee or CEO of a tax-exempt organization, why would you want to consider creating a Rebuttable Presumption of Reasonableness for your organization and will it protect your organization from governmental scrutiny?**

An important governance strategy exists that every organization subject to intermediate sanctions and/or tax-exempt regulatory compliance regarding executive compensation should consider. This strategy is called the Rebuttable Presumption of Reasonableness.

The basis for creating a “rebuttable presumption” can be found at 26 CFR 53.4958-6 - Rebuttable presumption that a transaction is not an excess benefit transaction.

**In determining the reasonableness of compensation** under the Rebuttable Presumption of Reasonableness, compensation is presumed to be reasonable and a property transfer is presumed to be at fair market value when three requirements for establishing the rebuttable presumption are met. They are:

1. The compensation arrangement must be approved in advance by an authorized governing body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction
2. Prior to making its determination, the authorized governing body obtained and relied upon appropriate compensation and benefit survey data as to comparability of compensation paid
3. The authorized governing body adequately and timely documented the basis for its determination for the compensation decisions concurrently with making that determination.

The documentation of the authorized body should include the terms of the transaction and the date of its approval, the members of the authorized body present during the debate and vote on the transaction, the comparability data obtained and relied upon, the actions of any members of the authorized body having a conflict of interest, and documentation of the basis for the determination.

When done correctly, the Rebuttable Presumption of Reasonableness shifts the burden of proof between the tax-exempt, not-for-profit organization’s governing body and the Internal Revenue Service concerning executive compensation. The Internal Revenue Service may refute the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. As a result, the practice of creating one lends itself to an excellent governance strategy to follow even if it may not directly affect regulatory compliance of your particular credit union.

## **How do we avoid excessive executive compensation and what are some effective business strategies and best practices to follow?**

To ensure that your executive compensation decisions will stand up to the scrutiny of government regulators and agencies, media, and credit union members, you may want to consider adopting some of the following strategies and best practices.

- Make executive compensation transactions a priority in board meetings
- Use caution when entering into transactions with Executives, top employees, highly paid employees and disqualified persons – CEO, CFO, COO, President, Executive Director, Etc. Be sure to conduct the appropriate due diligence in reviewing market survey data to make informed compensation decisions

- Use the Rebuttable Presumption of Reasonableness procedures to shift the burden of proof to the IRS – Government Agency – Attorney General. This is a tax-exempt accepted practice provided by the Federal Government which could provide your organization with added fire power in the event of an audit or regulatory review.
- Establish a Compensation or HR Committee to create a dedicated review of your compensation actions with members who understand the components of a total compensation strategy and package.
- Create a customized executive compensation philosophy and policy for the organization
- Use appropriate and relevant comparable compensation and benefit survey data to conduct a total compensation review for the executive team and highly compensated
- Adopt a comprehensive Conflicts of Interest Policy to help protect directors, trustees and officers from liability
- Adopt a Travel and Expense Reimbursement Policy for all employees and executives
- Use an independent consultant to determine fair market rates for compensation and benefits. By contracting with a reasoned third party compensation consulting firm, this will help to insure impartiality and to avoid any opportunity for a conflict of interest by utilizing in-house sources who report up through organization officers and executives
- Board compensation, if any, should also be reviewed by outside third party advisors
- Be sure to adequately and thoroughly document the basis for any executive or highly compensated compensation transactions and governing body decisions on compensation actions. This would include terms of the approved compensation transaction, date of approval, board/committee minutes, a thorough description of the expert report on comparability data used to make the decisions including who or how the data was obtained.

Whether the Board, Executive or HR/Compensation Committee is overseeing the due diligence process of annually reviewing the compensation of the organization's executives and highly compensated, in the end, it is the board that carries the legal burden associated with improper compensation. It is clear that in order to maintain not-for-profit tax exempt status and avoid tax penalties, it is incumbent upon the governing body of the organization to insure that executives and board members (as applicable) are paid reasonable compensation.

Good governance does not have to be difficult to ensure the payment of reasonable compensation and to satisfy regulatory compliance. However, board directors, trustees, and CEO's must be thoughtful, open to successful board governance strategies and best practices, transparent and consistent in the application of sound and reasonable executive compensation programs to ensure success.