

Four Questions to Ask About Executive Compensation at Your Organization

By Stan Reiff, Partner

Nonprofit organizations need to attract and retain qualified leadership. But many nonprofit leaders are unaware of the intricacies of the IRS requirements for executive compensation — and of the significant penalties that can arise if the IRS deems compensation “excessive.”

Nonprofit executive compensation has been under increased scrutiny from the IRS, making it more important than ever to ensure that your organization is following best practices in this area. Working through the questions below will help your organization meet the executive compensation requirements, protect your executives and board members from costly penalties, and maintain public trust.

1. Who in our organization is a disqualified person?

Nonprofit executive compensation requirements focus on excess benefit transactions to certain individuals. The IRS defines an excess benefit transaction as:

... a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, **to or for the use of a disqualified person**, and the value of the economic benefit provided by the organization exceeds the value of the consideration received by the organization. [Emphasis added.]

A disqualified person is any individual who was in a position to exercise substantial influence on the affairs of the tax-exempt organization at any time during the five years prior to when an excess benefit transaction took place (also called the “look-back period”).

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Disqualified persons include:

- Voting board members
- Executives of the organization
- Family members and controlled entities of disqualified persons

Start by listing everyone in your organization who meets the definition of a disqualified person. These are the individuals who need to receive compensation the IRS would consider “reasonable.”

2. What total compensation does each disqualified person receive?

The next step is to determine the total compensation for each disqualified person. This should encompass all cash and noncash benefits received by the individual, including salaries and any bonuses, cash and noncash fringe benefits, severance payments, and deferred and noncash compensation.

Noncash taxable benefits can include, but are not limited to:

- Employee travel – first-class or charter
- Travel for companions
- Club dues
- Premiums paid by the organization on life insurance, where the organization is not the beneficiary
- Personal use of vacation homes or other similar property owned by the organization
- Personal use of automobiles owned by the organization
- Housing allowance
- Personal services (e.g., maid, chef)
- Gift cards
- Polo shirts or other attire

Once you’ve established the total compensation for each individual, be sure to document it.

3. Is the compensation for each disqualified person reasonable and comparable?

Reasonable compensation is the value that would be paid to a person:

- of similar skill, knowledge, and experience;
- in a similar position, with similar duties;
- at a similarly sized organization (which does not need to be tax-exempt); and
- in a similar geographic region

Excessive compensation is compensation that exceeds what would be considered reasonable compensation.

The IRS does not use a standard formula for determining whether compensation is excessive. The burden of proving whether compensation is reasonable is on your organization. You can gather this information by networking and sharing compensation information with similar organizations, and by using [guidestar.org](https://www.guidestar.org) to research Form 990 data from similar organizations. You will then need to analyze and document your findings. This can require a significant investment of time.

4. Have we established the rebuttable presumption of reasonableness for each disqualified person?

Per the income tax regulations, if an organization meets the following three requirements, payments it makes to a disqualified person under a compensation arrangement are **presumed to be reasonable**, and a transfer of property or the right to use property is presumed to be at fair market value.

This is called the rebuttable presumption of reasonableness. If you follow these steps and the IRS still deems the executive compensation excessive, the burden of proving the unreasonableness of the compensation falls on the IRS.

The three requirements for establishing the rebuttable presumption of reasonableness are:

1. The compensation arrangement must be approved in advance by an authorized 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 body must have obtained and relied upon appropriate data as to comparability; and
3. The authorized body must have adequately and concurrently documented the basis for its determination.

Be sure to document all the studies, data, and other analysis used in these steps, along with any

compensation policies and procedures your organization uses.

Know the Penalties

Our nonprofit clients are often surprised to learn that the penalties for excessive compensation can affect the executive and the leadership team — not just the organization.

As noted in the instructions to IRS Form 990, if the IRS deems executive compensation excessive, the executive (disqualified person) must:

- Pay the excess benefit (the portion of the compensation amount that was deemed excessive) back to the organization. This must be paid in cash or cash equivalents — no promissory notes are allowed.
- Pay a 25% excise tax on the excess benefit to the IRS.
- Pay a 200% excise tax on the excess benefit to the IRS if the excess benefit isn't corrected in a timely manner.

In addition, the Form 990 instructions note that “organization managers who participate in an excess benefit transaction knowingly, willfully, and without reasonable cause are liable for a 10% tax on the excess benefit, not to exceed \$20,000 for all participating managers on each transaction.” Organization managers include “any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the organization, regardless of title.”

There are potential nonmonetary repercussions for the organization, as well. If the excess benefit transaction is egregious enough, the IRS has the right to revoke the organization's exempt status. Even if this does not happen, excess benefit transactions must be disclosed on Form 990, which is publicly available. This could result in unwanted media attention or reputational damage.

The Effort Pays Off

While the penalties for excess compensation can be hefty, proper research and planning can help you maintain compliance while offering your leaders the compensation they deserve.

CapinCrouse can help you analyze executive positions and compensation, document and evaluate comparable compensation data, and comply with IRS requirements. Please [contact us](#) to discuss how our [Executive Compensation Study](#) could benefit your organization.

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Stan's professional experience includes over 35 years in ministry operations, public accounting, government accounting, and missions. He provides strategic leadership of the firm's professional advisory and consulting services, including research of emerging issues in the faith-based nonprofit sector and the development and implementation of products and services in response to those needs.

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