BACKGROUND:
EXECUTIVE COMPENSATION
AT NONPROFIT ORGANIZATIONS

SOURCE: Guidestar www.guidestar.com

What's Allowed

The IRS permits tax-exempt organizations to pay executives "fair and reasonable" compensation. There is no universal standard defining fair and reasonable, however; what's fair and reasonable at one nonprofit may be a gross under- or overpayment at another. Every exempt organization that compensates its leaders must determine appropriate salary and benefits packages based on the following considerations:

- Charities can pay their executives market rate.
- Market rate is determined by researching what someone in a similar position would earn at an organization that is of the same size and has a similar mission or field of activity.
- Charities can look at for-profit compensation when determining market rate, as long as the job, organization size, and organization mission/purpose are comparable.
- The IRS has no standard formula, such as percentage of total revenues or expenses, for determining compensation, nor are there any tables or schedules that define fair and reasonable compensation for an organization.

Consequences of Not Following the Rules

Penalties for excess compensation range from fines to revocation of an organization's tax-exempt status. Fines are the more likely consequence. Known formally as excess benefit transaction excise taxes and informally as intermediate sanctions, the fines can be levied on both the executive who received the overpayment and the board members who approved it or who knew about the excess but did nothing to prevent it.

For example: Say the executive director of ABCD Charity received a compensation package of $250,000 in FY 2008. After an examination (or, in layperson terms, an audit) of the organization, the IRS establishes that $150,000 was the appropriate compensation for the position at that time. As a result of this determination:

- The IRS requires the executive director to repay the $100,000 overpayment to the organization—with interest. If the executive director fails to repay this amount, or repays only part of it, a 200 percent excise tax may be imposed on the amount yet to be repaid.

- The IRS may require the executive director to pay an excise tax equal to 25 percent of the overpayment. In this example, the excise tax would be $25,000.
- The IRS may require each board member who approved the excess compensation, or any board member who knew about the excess but failed to prevent the overpayment, to pay an excise tax equal to 10 percent of the overpayment, not to exceed $20,000 per transaction. In this example, should the IRS decide to impose the excise tax, each board member would owe $10,000.

Protecting Your Organization and Its Leaders

A nonprofit's board can shield its members and the organization's executives from intermediate sanctions and protect the nonprofit from the possibility of revocation of nonprofit status by:

1. Approving compensation in advance; the board must ensure that no one who participates in the decision has a conflict of interest concerning the transaction.
2. Basing its decision on comparability data obtained before the compensation is approved.
3. Documenting the decision-making process at the time it approves the compensation. The IRS specifies that such documentation "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."

By following this process, a board establishes a rebuttable presumption of reasonableness. As the IRS notes, "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."

In other words, it takes solid data to create a solid rebuttable presumption, but if a board bases its decision on solid data, the burden of proving overpayment has occurred falls on the IRS.