What You Need to Know about Nonprofit Executive Compensation

Prepared by GuideStar USA, Inc.

Introduction

Like religion, politics, and sports, nonprofit executive compensation often evokes strong emotion. Donors, journalists, state officials, and members of Congress frequently express outrage at the salaries nonprofit CEOs receive, especially if the organizations they head are public charities that rely on donations from the public. (See the sidebar for specific examples.)

Nonprofit compensation practices can also draw fire from the IRS. The IRS is charged with enforcing the Federal Private Inurement Prohibition, which strictly forbids a tax-exempt organization's decision makers—board members, trustees, officers, or key employees—from receiving unreasonable benefits from the nonprofit's income or assets. Excessive compensation paid to nonprofit executives is the most common violation of this prohibition,[1] and it can cause the IRS to levy hefty fines on the persons involved.

Thus, to maintain public trust and mitigate risk, tax-exempt organizations must be aware of the regulations governing executive compensation, ensure that their practices follow these rules, document their compliance with them, and be prepared to explain to the IRS and the public why the salaries and benefits they offer their leaders are appropriate.

This report outlines what the IRS permits in setting nonprofit executive compensation, the consequences of failing to comply with the regulations, how nonprofit board members can protect themselves and the organizations they serve, the kind of data compensation decisions should be based on, and the importance of reporting compensation accurately in annual IRS filings.

Paying the Price of Excess Compensation

It seems that the nonprofit sector rarely lacks a compensation scandal, and 2011 has been no exception:

- In early January, Senator Charles E. Grassley (R-Iowa) concluded his investigation of six television evangelists by calling for a review of a range of tax issues, including tightening rules on nonprofit executive compensation.[2]
- Also in early January, Arizona officials began investigating the Fiesta Bowl, which is run by four tax-exempt organizations, after a political action committee (PAC) filed complaints with the IRS about practices of three of the bowls that make up the Fiesta Bowl series. Excessive compensation was one of the issues the PAC raised.[3]
- In April, CBS Evening News reported that *Three Cups of Tea* author Greg Mortenson could be liable for as much as $23 million in back taxes for excess compensation he received for his work as executive director of the Central Asia Institute, a nonprofit that he founded.[4]
- In June 2011, Massachusetts officials moved to ban compensation for nonprofit trustees following revelations that the Nellie Mae Foundation pays each of its 15 board members $19,000 to $32,000. Experts predict this ban may soon catch on in other states.[5]

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.[6] 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.[7]
- 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.[8]
- 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.[9] In this example, should the IRS decide to impose the excise tax, each board member would owe $10,000.

In March 2007, the IRS reported that its agents had recommended more than $21 million in excise taxes stemming from excessive nonprofit executive compensation. Amazingly, only 40 individuals at 25 organizations were liable for this $21 million.[10]

Excess compensation continues to be an IRS priority. Today, the IRS includes a compensation review in every examination it conducts of a tax-exempt organization. The IRS has increased resources for the division charged with ensuring exempt organizations' compliance with the U.S. tax code, and in January 2011, it announced that it planned even greater scrutiny of nonprofits.[11]

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."[12]

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."[13]

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.

Finding Solid Comparability Data

To satisfy IRS requirements, nonprofit comparability data must be for "compensation levels paid by similarly situated organizations for functionally comparable positions."[14]

Smaller organizations can rely on the annual returns (see "Reporting Compensation to the IRS—and the Public" below for more information) that their peers file with the IRS. The general rule of thumb is that three comparables will suffice for nonprofits whose annual gross revenues are $1 million or less.[15] The Foundation Center, GuideStar, and the National Center for Charitable Statistics (NCCS) at the Urban Institute all post nonprofits' IRS filings, although the number of organizations covered in these databases differs.

Many larger nonprofits obtain comparability data from external compensation surveys or studies. When assessing whether an organization that relies on such resources has indeed established a rebuttable presumption, the IRS "will look to the independence of any compensation consultant used, and the quality of any study, survey, or other data, used to establish executive compensation."[16] Charity Navigator, ERI Economic Research Institute, and GuideStar all provide compensation surveys or analyses that meet the IRS criteria.

Reporting Compensation to the IRS—and the Public

Almost all tax-exempt organizations are now required to file an annual information return with the IRS.[17] Although nonprofits that file Form 990-N (available to organizations whose annual revenues are $50,000 or less) are not required to provide compensation information, the nonprofits that file Form 990-EZ, 990, or 990-PF must list information on compensation paid directors, trustees, officers, and key employees *and* the five highest-paid employees who (a) are not directors, trustees, officers, and key employees and (b) earn more than $100,000. Providing this information is mandatory, and failure to do so can result in IRS fines.

Nonprofits that complete Form 990—the "long form"—must also answer questions about the methods used to establish and approve executive compensation levels. In many cases, the organizations must define these processes on a supplemental schedule.

Compensation reported to the IRS on Form 990-EZ, 990, or 990-PF is ultimately compensation reported to the public, because these returns are public documents. Anyone can obtain them from the filing organizations, the IRS, or through Web sites such as those for the Foundation Center, GuideStar, and NCCS.

Conclusion

Both the IRS and the public are paying much closer attention to nonprofit executive compensation. Accurate, up-to-date information from a reliable source on compensation at peer organizations is a nonprofit's best tool for protecting its decision makers from costly excise taxes and the organization itself from possible loss of tax-exempt status.

Such information is equally important for preserving the public's trust in specific nonprofits. Even if executive compensation at a nonprofit fits well within the market rate for similar positions at similar organizations, prospective donors, the media, and state and federal officials may think otherwise. As the IRS's February 2009 report on nonprofit hospitals notes, "For some, there may be a disconnect between what, as members of the public, they might consider reasonable, and what is permitted under the tax law."[18] Having reliable comparative data on hand can be the difference between maintaining or losing the public's trust in the integrity of your organization.

1 Karl E. Emerson, Esq., "The Private Inurement Prohibition, Excess Compensation, Intermediate Sanctions, and the IRS's Rebuttable Presumption: A Basic Primer for 501(c)(3) Public Charities" (GuideStar, 2009), p. 2; download at http://www2.guidestar.org/rxg/news/publications/private-inurement-primer.aspx.

2 Suzanne Perry, "Senator's Investigation into Ministries Leads to Tax Review," philanthropy.com, Jan. 7, 2011, http://philanthropy.com/article/Senators-Investigation-Into/125889/.

3 Katie Brown, "Political Heavy Hitters Take on College Bowls," nytimes.com, Jan. 9, 2011, http://www.nytimes.com/2011/01/10/sports/football/10playoff.html.

4 Armen Keteyian, "Greg Mortensen Could Face $20 Million in Back Taxes," cbsnews.com, Apr. 20, 2011, http://www.cbsnews.com/stories/2011/04/20/eveningnews/main20055865.shtml.

5 Lisa Chiu, "Mass. May Soon Ban Pay for Trustees of Nonprofit Groups," philanthropy.com, Jun. 26, 2011, http://philanthropy.com/article/Mass-May-Soon-Ban-Pay-for/128001/.

6 IRS, "Intermediate Sanctions—Excess Benefit Transactions," http://www.irs.gov/charities/charitable/article/0,,id=123303,00.html.

7 IRS, "Intermediate Sanctions—Excise Taxes," http://www.irs.gov/charities/charitable/article/0,,id=123303,00.html.

8 Ibid.

9 Ibid.

10 IRS, "Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II" (Mar. 2007), http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf, p. 1.

11 Eric Frazier, "Nonprofits Face Increased Scrutiny from IRS," philanthropy.com, Jan 10, 2011, http://philanthropy.com/article/IRS-Steps-Up-Scrutiny-of/125908/.

12 IRS, "Rebuttable Presumption—Intermediate Sanctions," http://www.irs.gov/charities/charitable/article/0,,id=173697,00.html.

13 Ibid.

14 IRS, "Governance and Related Topics—501(c)(3) Organizations" (2009), http://www.irs.gov/pub/irs-tege/governance_practices.pdf, p. 4.

15 Lawrence M. Brauer and Leonard J. Henzke, "Intermediate Sanctions (IRC 4958) Update" (IRS, 2002), http://www.irs.gov/pub/irs-tege/eotopice03.pdf, p. 40; Ellis Carter, "Setting Nonprofit Executive Compensation," Charity Lawyer, Mar. 8, 2011, http://charitylawyerblog.com/2011/03/08/setting-nonprofit-executive-compensation/.

16 "Governance and Related Topics," p. 4.

17 For exceptions to this requirement, see "Annual Exempt Organization Return: Who Must File," http://www.irs.gov/charities/article/0,,id=152729,00.html.

18 "IRS Exempt Organizations Hospital Study: Executive Summary of Final Report" (Feb. 2009), http://www.irs.gov/pub/irs-tege/execsum_hospprojrept.pdf, p. 4.

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