

Determining compensation and Excess Benefits

By Dennis Walsh CPA

Congress has long been concerned about financial abuses between exempt organizations and those who control them. This is a classic example of how the actions of a relatively few have created consequences for everyone. Until the so called “intermediate sanction” rules were introduced in the mid 1990’s, the IRS had no way to curtail such abuses short of the death blow of tax exempt revocation.

What are the sanctions?

So along came the intermediate sanction rules of Internal Revenue Code Section 4958. This provision imposes harsh penalties as a result of a so called “excess benefit” to a “disqualified person” (terms explained below). When an excess benefit occurs, not only must it be corrected by returning it to the nonprofit, but the disqualified person must pay a penalty equal to 25% of such excess. The intent is to restore the nonprofit to the position it would be in had the excess benefit transaction not taken place, as well as to hold those who engineer such transactions personally accountable.

Depending on the nature of the transaction, interest must be paid for the time the excess benefit is outstanding as well. In addition, a penalty of 10% is imposed on nonprofit personnel who knowingly and willingly take part in an arrangement resulting in an excess benefit. Further, if the transaction isn’t timely corrected, a second penalty is imposed on the recipient equal to 200% of the excess benefit. Rather draconian, isn’t it?

Who is a “disqualified person?”

A disqualified person is someone in a position to exercise substantial influence over the affairs of your nonprofit, either directly or indirectly through another person or related entity. The term specifically includes board members, officers and substantial contributors. A disqualified person also includes certain family members of a disqualified person, and 35% controlled entities of a disqualified person as well. (For easier reading, the more palatable term ‘insider’ will be used from this point to describe a disqualified person.)

For example, a corporate business that is 50% owned by a board member of a nonprofit is an insider with respect to the nonprofit. Therefore, if the business loans money to the nonprofit and receives interest and other loan terms that are substantially more favorable than what the nonprofit would incur with an unrelated lender, the business may be liable to correct such excess benefit.

It should be pointed out also that the preceding list of insiders is not exhaustive. The term is broadly defined to include anyone in a position to exert substantial influence over the affairs of your nonprofit. For example, the retired founder of a Greensboro nonprofit who leases an office to the organization for payments that exceed fair rental value might be considered an insider, even though no longer an officer, board member, substantial contributor, or related person as discussed above). The influence that the retired founder may exert over individual board members as a result of the past relationship with the organization may be sufficient for the founder to be considered an insider under the excess benefit rules.

What is an “excess benefit” transaction?

While the term “excess benefit” comes up most often in compensation matters, it is generally applicable whenever there is an economic benefit provided to an insider that exceeds the fair market value of the consideration received by the nonprofit in return. Examples of the types of transactions between a nonprofit and an insider that have the potential to trigger the excess benefit sanctions include:

- A sale of property to an insider at less than fair market value
- A purchase of property from an insider at more than fair market value
- A loan to an insider on terms more favorable than what the insider could obtain from other sources of credit
- A loan from an insider on terms more generous than what the insider could receive from other borrowers
- Compensation of an insider, including fringe benefits, that exceed the reasonable value of services provided
- Payments for the use of property leased from an insider that exceed fair rental value
- Providing goods or services to an insider on terms more favorable than those available to program recipients or the public
- Personal use of property (e.g. personal use of a vehicle) that, when added to all other compensation of the insider, exceeds reasonable value for services)
- Cash or other assets embezzled (repayment and the 25% penalty may be the insider’s least concern)

What is reasonable value?

According to the IRS: “In an excess benefit transaction, the general rule for the valuation of property, including the right to use property, is fair market value. Fair market value is the price at which property, or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of all relevant facts.”

In the specific case of compensation, “reasonable compensation is the valuation standard that is used to determine if there is an excess benefit in the exchange of a disqualified person’s services for compensation. Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances.”

Accordingly, good governance may require looking beyond your nonprofit to answer questions such as:

- What is the total pay package Executive Director Brown should receive based on what is customary in our area for a similarly qualified person?
- What would be the terms for a lease of a similar office not owned by board member Smith?
- What terms of financing would we be able to obtain from a bank if we don’t borrow from Treasurer Jones?

Creating a presumption of reasonableness – the safe harbor test

Helping to take some of the vagueness out of these rules and giving nonprofits some practical guidance, the IRS included within the regulations for Section 4958 a procedure that may create a presumption that the cash or other economic benefit provided to an insider represents a reasonable exchange of value. If the steps described below are properly followed, the burden of proof will rest with the IRS to show that the value given up by your nonprofit in an applicable transaction includes an excess benefit. Although the IRS may attempt to rebut the presumption, as long as you’ve done your homework the Service will have a formidable challenge to clearly demonstrate your terms are unreasonable. In short, following these steps goes a long way to reduce the likelihood of the IRS prevailing in an excess benefit challenge.

Moreover, this is a sound governance practice for your nonprofit to follow in transactions with related persons that involve not only compensation for services, but arrangements such as the leasing of property or the borrowing of money. Of course, this is ultimately about good stewardship practices and the transparency that stakeholders rightfully expect from your nonprofit.

The required steps as stated in the Treasury Regulations are:

- 1) The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization (i.e. your board or a board committee), 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 obtains and relies upon appropriate data as to comparability, and

- 3) The authorized body adequately and timely documents the basis for its determination concurrently with making that determination (no later than the next board meeting).

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
- Documentation of the basis for the determination

As would be the case for any board action involving a conflict of interest, the subject of the transaction and any one else with a conflict of interest, if a voting member of the board, must not participate in the vote. Your conflict of interest policy should state procedures for such situations.

Regarding comparable compensation data, the Treasury Regulations also state that in general, relevant information includes, but is not limited to:

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions
- The availability of similar services in the geographic area of the applicable tax-exempt organization
- Current compensation surveys compiled by independent firms
- Actual written offers from similar institutions competing for the services of the disqualified person

Special Rule for Small Organizations

There is a special rule for “small” organizations that helps take some of the pain out of identifying comparable salary data (requirement #2). For nonprofits with annual gross receipts (including contributions) of less than \$1 million, the authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services.

Sources of compensation data

A good source of compensation data is the IRS Form 990. Organizations required to file Form 990 must separately report the compensation of certain individuals. The easiest way to retrieve 990 data is GuideStar.org. Using GuideStar, you may be able to identify local nonprofits with comparable positions and print hard copy to support your other documentation. If you are not a GuideStar member, you can obtain basic access without cost. (Note: If your

nonprofit doesn't provide current information to GuideStar, you should consider doing so at least annually so that donors and other stakeholders will have timely and important information about your activities in addition to what is reportable on Form 990.)

Other relevant compensation data may be obtained from advertised job openings or the salary package of the subject employee with a recent employer, assuming the requirements of the positions are comparable. There are also published state and national for-profit and nonprofit wage surveys available from commercial sources on the Internet.

Once you develop relevant salary data, remember that you are not strictly bound by the compensation range of the three comparable positions. Ideally, of course, you would like the end salary package to fall in a range between the high and low positions, but if you settle above the high end of the range, the rationale should be documented in the corporate minutes along with the other required information. For example, "Mary has demonstrated above average ability creating effective programs for the homeless population in High Point, as evidenced by ..." (identify credentials, achievements, awards, years of experience, educational factors, etc.).

Ultimately, these are guidelines for the exercise of due diligence by your board. Of great importance is that the board documents how it exercised such diligence and reasonableness in crafting transactions with insiders. Failing to qualify for the presumption of reasonableness safe harbor discussed earlier does not result in an excess benefit transaction. Rather, in such event you will have to shoulder the burden of demonstrating that the compensation package, lease terms, borrowing terms, or other economic benefit provided to the insider represents a fair exchange of value, should the IRS come to call.

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