Best Practices in Nonprofit Compensation

Nonprofit organizations sometimes find themselves walking a thin line when it comes to compensating their employees. The sector may be nonprofit, but it's by no means noncompetitive. Organizations looking to hire the best and the brightest in their fields must offer attractive salary and benefits plans.

If, however, a salary package is deemed in excess of reasonable compensation, the IRS may impose intermediate sanctions on both the individual receiving that salary and the organizational managers who approved it.

In August, the GuideStar Newsletter's Question of the Month asked readers, "Does your organization benchmark employee compensation?" Some 59 percent of respondents answered that they do. Those readers were then asked, "Do you have a clear understanding of intermediate sanctions?" Nearly 65 percent of respondents indicated that they did not.

What exactly are intermediate sanctions?

The phrase "intermediate sanctions" refers to the penalty excise taxes imposed by the Internal Revenue Service when individuals associated with a tax-exempt organization receive excess benefits. Employee compensation is one area that can be subject to intermediate sanctions.

Congress created intermediate sanctions in 1996 as part of the Taxpayer's Bill of Rights 2. The IRS issued final intermediate sanction regulations in January 2002.

Before intermediate sanctions, the only recourse the IRS had when confronted with abusive financial transactions within a nonprofit was to revoke the organization's tax exemption. This one-size-fits-all punishment, however, wasn't appropriate in every situation and sometimes forced the IRS to take no action at all. Intermediate sanctions give the IRS flexibility when dealing with fiscal irregularities among tax-exempt organizations: the ability to mete out appropriate monetary punishment without delivering a death blow to the organization.

Intermediate sanctions may be applied to "disqualified persons" who receive excess benefits and to the organization managers who approve the

transaction. A disqualified person is someone who is "in a position to exercise substantial influence over the affairs of the organization." This definition includes a nonprofit's board members, substantial contributors, and executive officers. It also includes the family members of disqualified persons.

What are the penalties?

A disqualified person who receives an excess benefit is subject to an excise tax of 25 percent of the excess amount. If they do not return the excess to the organization by a set date, an additional tax of 200 percent is imposed.

Organization managers deemed responsible for approving an excess benefit transaction can be held liable for an excise tax of 10 percent of the excess benefit, with a maximum penalty of $10,000 per transaction.

How do intermediate sanctions apply to compensation?

A disqualified person who receives a salary and/or benefits package in excess of "reasonable compensation" may be subject to intermediate sanctions, along with the organization manager(s) who approved the salary.

What is "reasonable compensation"?

The IRS defines reasonable compensation as "the value that would ordinarily be paid for like services by like enterprises under like circumstances."

Compensation is presumed reasonable unless proven otherwise, provided the organization follows a set of standard procedures. Creating this safe harbor is known as establishing a "rebuttable presumption of reasonableness." As long as the following requirements are met, it becomes the IRS's responsibility to prove that a transaction involved excess benefit.

1. The transaction is approved by an authorized body of the organization.
2. The authorized body uses "appropriate data" to determine comparability prior to making a decision.
3. The authorized body documents the basis for its determination while making its decision.

What is considered "appropriate data"?

For organizations with gross receipts of less than $1 million, the compensation for similar positions paid by three comparable organizations is considered appropriate data.

All other organizations must undertake a more detailed analysis of comparable compensation. It's also acceptable to obtain a compensation study from a qualified third party. GuideStar publishes an annual nonprofit salary and benefits report. The 2003 edition of the *GuideStar Nonprofit Compensation Report* will be published in October. The report is unique because it doesn't rely on surveys or questionnaires to obtain its compensation data. Instead, the report is based solely on information from the Forms 990 public charities file with the IRS. Part V of Form 990 (Part IV of Form 990-EZ) asks for a list of officers, directors, trustees, and key employees, along with their titles, hours, compensation and benefits. Part I of Schedule A requests the compensation of the five highest paid employees whose salaries are over $50,000 and who are not officers, directors and trustees.

The 2003 report features compensation data that is searchable by area, job title, or mission. Organizations can use this information to benchmark comparable salaries or for broader compensation research.

What steps can nonprofits take to compensate their employees properly and avoid intermediate sanctions?

- Identify all disqualified persons connected to their organization.
- Follow the procedures for "rebuttable presumption of reasonableness."
- Benchmark employee salaries against comparable peers.
- Consult a lawyer before making any important decisions concerning IRS regulations.

Additional Resources

The final regulations can be viewed in their entirety at the Web site of the Federal Register.