

Top Ten Lessons to Learn When Setting Executive Compensation in a Nonprofit Organization

Overview

The issue of compensation and benefit levels for ministry employees is always a sensitive and important topic. The compensation packages for leaders of a ministry or other nonprofit must be “reasonable” or else the organization could risk losing its nonprofit status. In some instances, the IRS may choose not to revoke an organization’s nonprofit status, but rather impose “intermediate sanctions.” Intermediate sanctions typically take the form of a tax penalty levied against the person who received the benefit, and against the board members of the organization who approved the benefit. The challenge is made more difficult because there is no definitive standard of what is “reasonable compensation.”

To help nonprofit leaders better understand how to conform with these requirements, we have outlined below some important strategies to minimize the likelihood of running afoul of the IRS on compensation issues.

The IRS issued two little-known rulings in late 2002, and in each case imposed excise taxes under the intermediate sanctions law. These rulings illustrate how the IRS finds weak points in a tax-exempt organization’s support for compensation paid to an executive, and then exploits that weakness to conclude that the compensation was excessive. Exempt organizations can learn several lessons from these rulings about how to build a stronger defense against the risk of tax penalties for their executive compensation arrangements.

As exempt organizations consider these rulings, it is important to bear in mind the critically important “*rebuttable presumption of reasonableness*.” An exempt organization qualifies for the rebuttable presumption, and places the burden of proof on the IRS, if the compensation arrangement meets three conditions:

1. **Independence.** The compensation arrangement must be considered and approved solely by independent members of the governing board (or

committee of the board), who are unrelated to and not subject to the control of the person(s) involved in the compensation arrangement.

2. **Market Data.** The independent board or committee must obtain and rely on appropriate comparability data, such as compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.
3. **Record.** The independent board or committee must adequately document the basis for its determination, and its meeting minutes must describe in detail the entire process by which it intended to qualify for the presumption.

The battleground in future disputes will most likely address the rebuttable presumption. If there is any chance that the exempt organization has not completely met the three-part test, the IRS is likely to exploit that weakness in an effort to place the burden of proving reasonableness back on the exempt organization. The two recent rulings are prime examples of this IRS approach.

Background on the Recent Rulings

The first ruling, TAM 200243057, addressed whether a used car salesman, who created a tax-exempt organization to accept donations of used vehicles in exchange for tax deductions, received excess compensation. The IRS concluded that the salesman (and his family members) were “disqualified persons” with respect to the exempt organization and had received various types of excess compensation.

The second ruling, TAM 200244028, addressed several technical, but critical, issues in analyzing excise tax liability and the availability of the rebuttable presumption of reasonableness. The primary subject of the ruling was a consulting agreement between an exempt organization (a large hospital system) and both its resigning CEO and the CEO’s spouse.

It should be noted that consulting agreements (typically containing a covenant not to compete, as was the case in this ruling) are frequently used by large exempt organizations to transition from a CEO to a successor, which underscores the importance of carefully considering this ruling. Because the second prong was not met, the ruling concluded that the IRS could place the burden on the taxpayer to prove the amount of compensation considered reasonable for the services provided.

Ten Lessons to Learn

1. *Lesson One: Any written assessments of strategy and conclusions as to legal risk should be prepared by legal counsel and clearly protected by the attorney-client privilege.*

In its first ruling, a resignation letter sent to the salesman by the organization's accountant that detailed facts which jeopardized the organization's tax-exempt status was readily discoverable and apparently served as a "roadmap" for the IRS. The letter was not protected from discovery by the attorney-client privilege.

2. *Lesson Two: Make it clear which compensation amounts are subject to the rebuttable presumption of reasonableness process. Any amounts left out of the process are likely to be presumed unreasonable by the IRS.*

Compensation amounts paid to the salesman in the first ruling were not approved by the organization's board, and were not supported by evidence of the services provided by the salesman. As a result, the IRS presumed that 100% of the compensation amounts constituted excess compensation. The burden was placed on the taxpayer to prove the portion of compensation that might be considered reasonable.

3. *Lesson Three: The Board must take the primary role in reviewing and approving all forms of compensation to executives. If the Board believes any payment may be improper or excessive, it has an affirmative duty to correct the situation.*

According to the IRS, the governing board had a duty to make efforts to obtain repayment of any payments known by the board to be improper. Because the board failed to do so, the payments constitute excess compensation according to the first ruling.

4. *Lesson Four: The rebuttable presumption process should apply to every form of compensation provided to potentially disqualified persons. Fringe benefits in particular are presumed to be entirely subject to intermediate sanctions unless they are treated as compensation and approved in a manner that qualifies for the rebuttable presumption.*

A leased automobile provided to the salesman by the organization was found not to be compensation. As a result, the IRS treated the entire value of this benefit as "automatic" excess compensation.

5. *Lesson Five: The IRS will leave no stone unturned in its search for unreasonable compensation. The Board or Committee must be aware of, review and approve all arrangements.*

In all, the IRS concluded that 11 forms of salary, benefits, and other forms of remuneration constituted excess compensation. The IRS has a keen interest in thoroughly examining every type of pay or benefit provided by an exempt organization to a disqualified person.

6. *Lesson Six: Do not assume that, once an executive ceases to serve in an executive position, the intermediate sanctions risk ends. Any payments made within five years after executive status ends must be supported as reasonable.*

Because a five-year lookback period is used to determine whether someone is a "disqualified person," the IRS concluded that the former CEO continued for the entire five-year consulting period to be a disqualified person in the second ruling.

7. *Lesson Seven: Make sure that inside or outside expertise is present at the review and approval meeting, and demonstrate the expertise in the meeting minutes. This can be done in several ways, including having outside expertise present (by phone or in person) at the meeting.*

The IRS concluded in the second ruling that, although a board-level committee went through a process to determine reasonableness, the second prong of the three-part test was *not* met. The committee received and relied on a report from an independent compensation consulting firm, but the record did not indicate that any committee members had "particular knowledge or expertise" in determining the reasonableness of a hospital CEO's compensation.

8. *Lesson Eight: Use current comparability data, or indicate in the meeting minutes why the comparability data remains valid despite the passage of time since the data was gathered.*

In the second ruling, the committee relied on a consultant’s report that has been prepared nine months before the effective date of the consulting agreement, and this was considered to be out of date.

9. *Lesson Nine: Make sure that the meeting minutes provide a complete picture of the Board’s or Committee’s determination of reasonable compensation. The minutes should reflect all compensation elements reviewed, including the comparison data, and the thought process of the Board or Committee as to why the approved elements were considered to be reasonable.*

In the second ruling, the IRS found that the committee did not specifically address certain compensation elements such as whether the payments made to the CEO’s spouse would be reasonable in relation to her services.

10. *Lesson Ten: Consider and support the reasonableness of every disqualified person’s compensation—including amounts paid for services provided by the spouses of executives.*

The amount of compensation allocable to the CEO’s spouse must be analyzed for reasonableness by taking into consideration the value provided by the spouse alone, based on the spouse’s education, experience, knowledge of the health care industry, services for the organization, and ability to harm the organization through services for a competitor. The IRS does not permit reasonableness to be determined for the former CEO and spouse as a “team.”

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These recent IRS rulings demonstrate how seriously the IRS takes the process of evaluating the reasonableness of executive compensation, and has announced its intention to focus on this area in coming months. The IRS will work to undermine the rebuttable presumption of reasonableness and to place the burden of proving reasonableness on the exempt organization.

The rebuttable presumption continues to be the most important protection an exempt organization can have for its executive compensation arrangements. With proper planning and good professional advice from an independent compensation consultant and from legal counsel, an exempt organization can ensure that its review and approval process for executive compensation fares better than those addressed in these recent rulings.

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