Compensation in Nonprofits

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Compensation

- IRS requires the nonprofit organization to ask 6 key questions when determining compensation:
  - Are the individuals approving compensation following a conflict of interest policy?
  - Is the approval of compensation in advance of payment?
  - Is approval of compensation being documented?
  - Is each Board member's vote regarding the compensation matter being properly documented?
  - Is the compensation payment decision being based on payment(s) made by similarly-situated **nonprofits**, surveys, or other third-party data [benchmarking materials]?, and
  - Did the organization document what benchmarking materials they used in setting compensation and their source?
- Benchmarking: Many states have associations that track nonprofits' compensation data (i.e., Minnesota Council of Nonprofits); you can also search Form 990s to benchmark.
- If an exempt entity answers "no" to any of the six questions, the rebuttable presumption of reasonableness is broken and the IRS can then asks for explanation to make sure compensation is reasonable. Even without the threat of intermediate sanctions (or worse), it is usually easier to follow the IRS roadmap than to create a new pathway to reasonable compensation.
- Areas of HIGH risk: non-fixed payments (bonuses, severance packages, deferred compensation, fringe benefits, and/or retirement), paying Directors (EXTREMELY discouraged, but not prohibited – see IRC §4941), and paying family members or other disqualified persons.

IRS Considerations

Terms: **Private Inurement** – Regs. 1.501(c)(3)-1(c)(2) explains the prohibition against private inurement as follows:

- Private inurement relates to a distribution of earnings problem. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private individuals ("disqualified persons" or "insiders") such as a Director, Officer, or other person having a personal and private interest in the activities of the organization. For the definition of the words "private shareholder or individual," see paragraph (c) of section 1.501(a)-1.
- A 501(c)(3) organization that violates the private inurement doctrine fails to be operated exclusively for one or more exempt purposes and is subject to revocation of its exempt status. (See Treas. Reg. Section 1.501(c)(3)-1(c)(2)).
- For more info: http://www.irs.gov/pub/irs-tege/eotopicc90.pdf
- http://www.nonprofitlawblog.com/private-benefit-rules-part-ii-private-inurement-doctrine/:
  - It is important for public charities to understand the private inurement doctrine does not bar the organization from entering into transactions with insiders. The private inurement doctrine does however bar the organization from providing a disproportionate share of benefits to an insider regardless of whether the inurement conferred is $1 or $1,000.
  - Private inurement violations may be found in situations involving:
    - A compensation arrangement with an insider where there is no upper limit (see People of God Community);
    - A compensation arrangement that is based on factors extrinsic to performance at and benefit to the organization (see G.C.M. 39498) – i.e., compensation arrangements with added considerations such as deferred compensation, bonuses, fringe benefits, or retirement or severance packages;
    - Use of gross or net earnings to provide goods and services to insiders; or
    - Paying more than fair market value in exchange for goods or services provided by an insider.
    - Assignment of rights to intellectual property developed by insiders and funded, in whole or in part, with organizational assets;
    - Use of organizational assets to support, fund, or otherwise invest in an insider's business.

IRS Considerations

Terms: **Excess Benefit Transactions**:

- Codified in section 4958 of the Internal Revenue Code ("IRC").
- The excess benefit transaction rules apply to any entity that has status as a 501(c)(3) public charity or 501(c)(4) organization (i.e., social welfare organizations) at any time during a **five-year look back period** from the date the excess benefit transaction occurred:
  - An **excess benefit transaction** is defined as any transaction in which an economic benefit is provided by the organization directly or indirectly to or for the use of any *disqualified person*, and the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing the benefit. (Treas. Reg. 53-4958-4(a)(1)).
  - A **disqualified person** is a person in a position to exercise *substantial influence* over the affairs of the organization at any time during the five-year look back period from the date of the excess benefit transaction. (Treas. Reg. 53.4958-3(a)(1)).
- The question of disqualification is factual inquiry that looks at actual powers and responsibilities as opposed to titles. Therefore, voting members of a governing body (e.g., directors) and those with the ultimate responsibility for implementing decisions of the governing body (e.g., President) or managing the finances of the organization (e.g., Chief Financial Officer) during the five year look back period would likely be considered disqualified irrespective of their titles in the organization and whether such influence was actually exercised. (See Treas. Reg. 53.4958-3(c)).
- Examples of Excess Benefit Transactions: Loans to and from the organization; compensation for past services
- For more info:
  - http://www.nonprofitlawblog.com/private-benefit-rules-part-iii-excess-benefit-transaction-rules/
  - https://www.guidestar.org/rxa/news/articles/2001-older/excess-benefit-rules-provide-way-to-avoid-penalty-tax.aspx

IRS Considerations

Terms: **Intermediate Sanctions**:

- Federal excise taxes imposed on the organization, its insiders, or both.
- If an excess benefit transaction has occurred, the IRS can levy taxes, commonly referred to as intermediate sanctions, on both the disqualified person who received the excess benefit and the organizational manager(s) who knowingly approved the excess benefit transaction. Pursuant to IRC section 4958, the IRS is authorized to impose the following penalties:
  - 25% excise tax of the excess benefit on the disqualified person who received the excess benefit; and an additional 200% excise tax of the excess benefit if the violation is not corrected within the taxable period.
  - 10% excise tax of the excess benefit on the organizational manager who knowingly participated in the transaction (maximum of up to $10,000).
- Historically, the intermediate sanctions have been used as an alternative penalty to revocation under the private inurement doctrine because the penalty of revocation is so severe. However, the IRS can impose both the intermediate sanctions under the excess benefit transaction rules and revoke tax exempt status under the private inurement doctrine for the same unlawful transaction.
- For more info:
  - http://www.nonprofitlawblog.com/private-benefit-rules-part-iii-excess-benefit-transaction-rules/
  - http://www.irs.gov/pub/irs-tege/eotopich02.pdf
  - http://www.irs.gov/pub/irs-tege/eotopice03.pdf

Thank you!!!

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