Executive Compensation: What You Need to Know

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Q: What should I know about the Internal Revenue Service's current position regarding executive compensation?

A: While the IRS has always been concerned about the appropriateness of amounts paid to association executives, it has stepped up its enforcement efforts in recent years. In 2007, the IRS redesigned its Form 990, such that it now specifically calls for expanded disclosures regarding the filing organization's transactions with insiders, including highly compensated executives. In 2010 and again in 2013, the IRS announced plans to make executive compensation a specific focus of its enforcement activities.

In general, the IRS derives its authority to monitor executive compensation from the doctrine of "private inurement," which applies to most not-for-profit organizations, including charities, social welfare groups and business leagues. The doctrine provides that no part of an organization's net earnings may inure to the benefit of certain individuals, including those compensated for the performance of services. To the extent overpayment of executive compensation is adjudged to constitute private inurement of the organization's net earnings to the executive, the IRS has the authority to revoke the organization's tax-exempt status.

Several years ago, in an effort to provide the IRS with a means to address executives' "excess benefits" without taking the drastic step of revoking the exemption of a charity or social welfare organization, Congress adopted Section 4958 of the Internal Revenue Code for Section 501(c)(3) and 501(c)(4) organizations. Under Section 4958, the IRS can impose penalties on both the executive receiving the alleged overcompensation and the organization's managers, including volunteer directors, who authorize the payment. Specifically, any executive who benefits from an excess benefit transaction is responsible for repaying the organization the excess payment, with interest, along with an excise tax of 25 percent. If the executive fails to make the repayment on time, he or she becomes liable for a 200 percent excise tax on the amount not repaid. In addition, any board member who approves an excess benefit transaction is charged an excise tax equal to 10 percent of the overpayment, up to a maximum of $20,000 per transaction. The IRS refers to those penalties as "intermediate sanctions" because, in contrast to the penalty for a finding of private inurement, they do not involve revocation of the organization's exemption.

In addition to fixing penalties, the regulations adopted under Section 4958 also established "safe harbor" provisions, which, if followed, shield exempt organization directors and executives from intermediate sanctions. Briefly, to fall within the safe harbor protections, a Section 501(c)(3) or 501(c)(4) organization must: (1) authorize a group of directors, none of whom has a conflict of interest, to set executive compensation in advance; (2) have the determining group collect appropriate comparability data and use that data to make compensation decisions prior to their being approved; and (3) document the decision-making process (e.g., comparability data used, votes, basis of determination) at the time compensation is approved. Organizations that comply with those criteria establish a "rebuttable presumption of reasonableness." In other words, the burden of proving an overpayment shifts from the organization to the IRS, which substantially improves the organization's chances of successfully defending an alleged overpayment.

With the intermediate sanction and safe harbor regulations available to it, the IRS has had greater flexibility, and has expressed significantly increased interest, in pursuing what it perceives as excess benefit violations. In response, many association boards, even those exempt under Section 501(c)(6), have elected to comply with the safe harbor requirements. Among other things, they have established compensation committees and retained consultants to provide the required comparability data. That data often consists of information regarding compensation paid to executives who serve comparable roles in organizations with a comparable mission and size in the same geographic region. Boards use that information as a starting place for making a reasonableness determination regarding their own executive. Upon review, the board may determine that its executive's performance warrants payment of compensation at a level above or below the range of reasonableness demonstrated by the comparability data. Such action is defensible, provided the board records the basis of its determination at the time it arrives at its decision, as required by the safe harbor regulations. Attempts to validate decisions after the fact will not receive safe harbor protection.

Whether the organization is tax-exempt as a charity or social welfare group subject to intermediate sanctions under IRC Section 4958, or as a business league subject only to the restrictions of the private inurement doctrine, directors of not-for-profit boards should proceed carefully when setting executive compensation. At a minimum, they should familiarize themselves with the safe harbor governing executive compensation and consider adopting practices consistent with its requirements. If appropriate for their organization, they should collect and review comparable data and make compensation decisions based on that data, along with information regarding the individual performance record of, and any other special circumstances relating to, their own executive. Finally, they should be sure to document the basis for any such decisions in the minutes of the meetings at which those decisions were made.

The answers provided here should not be construed as legal advice or a legal opinion. Consult a lawyer concerning your specific situation or legal questions.