I. INTRODUCTION

A nonprofit organization’s board of directors must make many difficult and important decisions. Among the most challenging is the appropriate compensation package for the organization’s chief executive. The compensation decision is fraught with peril, from the perspectives of public relations, legal compliance and human resources. The decision is likely to be scrutinized closely by funders, customers and employees, and possibly by state regulators, the Internal Revenue Service (“IRS”) and the general public. Designing and following an effective approval process that is independent, transparent and fair is a cornerstone of good governance. A compliant approval process protects the organization, its board, and the chief executive.

This outline sets out the potential consequences under the federal tax law of an inadequate executive compensation approval process. It then describes a procedure set out in Treasury regulations that an organization may follow – and which all nonprofit boards should consider following – to establish a presumption that executive compensation is reasonable.

II. BACKGROUND

A. Statutory Prohibition Against “Private Inurement.”

A nonprofit organization that is qualified under Section 501(c)(3) or 501(c)(4) of the Internal Revenue Code1 (“Code”) will cease to qualify for federal tax exemption if it permits any of its assets to “inure” to the benefit of any “insider.” Such so-called “private inurement” can potentially occur in any situation that involves an economic relationship between an exempt organization and an insider. Private inurement occurs when an exempt organization provides a benefit, either directly or indirectly, to an insider, where the value of that benefit exceeds the value of any consideration the organization receives in return. Examples of private inurement

1All Sections references are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations thereunder.
include an organization’s sale of an asset to a director at a price that is below fair market value, or purchase of an asset from a director at a price that exceeds fair market value.

While the concept of an “insider” is not precisely defined in the federal tax law, it clearly extends to the voting members of an organization’s governing board and its chief executive. An arrangement under which an organization provides a compensation package to its chief executive that exceeds the fair market value of the services performed may constitute private inurement and could provide a basis for revocation of the organization’s federal tax exemption.

B. Overview of “Excess Benefit” Rules.

1. Enactment in 1996.

Under prior law, the IRS’s only enforcement option to address a private inurement situation was to revoke the organization’s federal tax-exempt status. Congress gave the IRS a broader array of enforcement tools in 1996 when it enacted Section 4958 of the Code, which sets out the “excess benefit” rules (also known as the “intermediate sanctions” rules). The purpose of those rules is to penalize insiders (the excess benefit rules use and define term “disqualified persons”) who benefit from private inurement transactions, as described in detail below. The IRS has the authority to impose financial sanctions in the form of excise taxes against a disqualified person as an alternative to, or in addition to, revoking the organization’s tax-exempt status in a situation that presents private inurement and “excess benefit.”

2. Applicable Organizations.

The rules apply to excess benefit transactions with Section 501(c)(3) organizations that are classified as “public charities” and with Section 501(c)(4) organizations. They do not apply to transactions with Section 501(c)(3) organizations that are classified as “private foundations,” which are subject to a stricter regime regarding transactions with insiders, known as the “self-dealing rules.” The self-dealing rules are not addressed here.

3. Establishing a “Rebuttable Presumption.”

To avoid private inurement, and the risk of an excess benefit transaction, an organization must ensure that its executive compensation arrangements and other transactions with insiders are at arm’s length and are fair to the organization. As set out in detail below, the organization’s board of directors is well-advised to follow certain procedures under which it may establish a presumption that a transaction with an insider is reasonable and therefore not an excess benefit transaction.

III. EXCISE TAXES ON EXCESS BENEFIT TRANSACTIONS

A. What Is an “Excess Benefit Transaction”?

In general, an “excess benefit transaction” is any transaction in which a Section 501(c)(3) public charity or a Section 501(c)(4) organization provides an economic benefit, either directly or indirectly, to a “disqualified person,” where the value of that economic benefit exceeds the value of any consideration the organization receives in return. In analyzing potential excess
benefit transactions, all economic benefits exchanged between a disqualified person and the organization are taken into account. Excessive compensation, below market loans, and reimbursement of excessive expenses that benefit a disqualified person are all examples of excess benefit transactions.

B. Who Is a “Disqualified Person”?

A disqualified person is a person (an individual or an entity) who is in a position to exercise “substantial influence” over the affairs of the tax-exempt organization, or who was in such a position at any time during the five-year period ending on the date of the transaction. Organizations must be alert to this five-year look-back rule in approving arrangements with former board members and executives.

1. Automatically Disqualified Persons.

The following categories of individuals are automatically considered to have “substantial influence” by virtue of their positions with the exempt organization, and are therefore disqualified persons. An individual’s authority and responsibilities rather than the individual’s title determine whether he or she holds one of these positions.

a. Voting Members of the Governing Body. This category includes any individual serving on the organization’s governing body who is entitled to vote on any matter over which the governing body has authority (i.e., members of the board of directors or board of trustees).

b. President, Chief Executive Officer, or Chief Operating Officer. This category includes any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. This category can also include senior-level or other executive-level employees.

c. Treasurer and Chief Financial Officer. This category includes any person who, regardless of title, has ultimate responsibility for managing the organization’s finances.

d. Family Members. Family members of any of the above disqualified persons are themselves considered automatically to be disqualified persons. Family members are defined as a person’s spouse, brothers and sisters, spouses of brothers and sisters, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren and great grandchildren.

e. Controlled Entities. An entity in which disqualified persons own more than a 35% interest is a disqualified person. The 35% interest is measured by combined voting power in the case of a corporation, by profits interest in the case of a partnership, and by beneficial interest in the case of a trust.
2. **Facts and Circumstances Govern All Other Cases.**

For all individuals or entities that do not fall into one of the above categories, the determination of whether the individual or entity has substantial influence, and is therefore a disqualified person, depends upon all relevant facts and circumstances. Persons who may be deemed to have substantial influence include: the organization’s founder, a substantial contributor, persons who have or share authority to control or determine a substantial portion of an organization’s budget, or who manage a segment or activity of the organization that represents a substantial portion of its activities, assets, income or expenses.

C. **What Excise Taxes May Apply?**

1. **Taxes on “Disqualified Persons.”**

The IRS has the authority to impose excise taxes on “disqualified persons” who engage in “excess benefit transactions” with applicable tax-exempt organizations. A disqualified person who benefits from an excess benefit transaction is subject to an initial tax of 25% of the excess benefit, i.e. the amount by which the benefit provided, directly or indirectly, by the tax-exempt organization to the disqualified person exceeds the value, such as from the person’s performance of services, that the organization received from the disqualified person. In the case of compensation that is determined to exceed reasonable compensation, the excise tax applies only to the amount in excess of reasonable compensation.

An additional tax of 200% of the excess benefit may apply if the disqualified person does not “correct” the transaction by restoring any excess benefit to the organization within a certain time period. The disqualified person must place the organization in the position in which it would have been if the disqualified person had dealt with the organization under the highest fiduciary standards.

2. **Taxes on “Organization Managers.”**

The IRS also has the authority to impose excise taxes on “organization managers,” such as the organization’s officers, directors or trustees, who “participate” in a transaction knowing that it is an excess benefit transaction. The excise tax is 10% of the excess benefit, up to a maximum of $20,000 per transaction. “Participation” by an organization manager includes not only affirmative action, such as knowing approval of an excess benefit transaction, but also silence or inaction when an individual is under a duty to speak or act.

D. **Initial Transaction Exception.**

Under an exception set out in Treasury regulations, the excess benefit rules do not apply to an arrangement with an applicable exempt organization that involves a fixed payment to a person under an initial contract with the person. The rationale for this rule is that prior to the point when a person assumes a position of substantial influence (e.g., a new CEO under an initial employment agreement), the person does not yet have substantial influence over the organization and therefore is not yet a “disqualified person.” This “initial transaction” exception has been criticized, however, and the IRS has given some signals that it could be changed in the future.
The exception is limited to fixed payments. Any change in compensation or any payment that is discretionary in amount after the organization and the person enter into the initial contract may potentially give rise to an excess benefit.

IV. DESIGNING AN EFFECTIVE APPROVAL PROCEDURE: ESTABLISHING A REBUTTABLE PRESUMPTION OF REASONABLENESS

A. Overview of “Rebuttable Presumption” Procedures.

By following certain procedures, an exempt organization may create a “rebuttable presumption” that a compensation arrangement or other arrangement with a disqualified person is reasonable, and therefore does not give rise to an excess benefit. To create the presumption, an organization must satisfy the following: (1) an “authorized body” must approve the transaction or arrangement in advance; (2) the authorized body must obtain and rely upon “appropriate data” as to comparability in approving the transaction or arrangement; and (3) the authorized body must adequately document the basis for its determination concurrently with making the determination.²

If an organization does not follow the rebuttable presumption procedures, there is no inference created under the federal tax law that the transaction or arrangement is an excess benefit transaction. The federal tax law does not require that an organization follow the procedures. Rather, the rebuttable presumption procedures represent good governance practices that a prudent board may choose to follow to document the reasonableness of its actions and to protect the organization, the board, and disqualified persons in their relationships with the organization. The three elements of the rebuttable presumption procedures are set out in more detail below.

B. Specific Requirements to Invoke the Rebuttable Presumption.

1. Approval by an Authorized Body.

   a. Overview. A compensation arrangement or other economic transaction with a disqualified person must be approved in advance by an “authorized body” (i.e., the board of directors or a committee of the board with appropriately delegated authority) composed entirely of individuals who do not have a conflict of interest with respect to the transaction.

   b. Authorized under State Law. A key decision point for any organization is whether the full board or a committee of the board (i.e., those members of the board or committee who do not have a conflict of interest with respect to the transaction) should approve executive compensation.

      It is possible for an organization to establish the rebuttable presumption under the federal tax law through approval by a committee of the board, but only if the committee has authority to act on behalf of the board under State law. The committee must be properly appointed and vested with the authority to act on behalf of the board. Most states require that the full board,

²The rebuttable presumption procedures are set out at Treas. Reg. § 53.4958-6.
rather than the chair or another officer, appoint a committee that has authority to act on behalf of the board. The committee must also be properly configured under state law. For example, many states require that a committee of the board that has delegated authority to act on behalf of the board be composed solely of board members.

c. No Conflict of Interest. In order for the rebuttable presumption to be established, any member of the board or committee who has a conflict of interest, as defined in the tax law, with respect to the transaction or compensation arrangement may not take part in or be present for the discussion or vote on the transaction. Specifically, a participating member:

i. may not be a disqualified person who is economically benefiting from the compensation arrangement or transaction, or a family member of the disqualified person;

ii. may not be in an employment relationship subject to the direction or control of a disqualified person involved in the transaction;

iii. may not have a material financial interest (directly or through a family member or entity) affected by the transaction or compensation arrangement;

iv. may not be receiving compensation or other payments that are subject to the approval of the disqualified person involved in the transaction; and

v. may not be in a position to approve a transaction that provides economic benefits to a disqualified person involved in the transaction who in turn has approved or will approve economic benefits to the board or committee member.

2. Appropriate Comparability Data.

The rebuttable presumption procedures require that the authorized body consider appropriate comparability data when determining the reasonableness of any compensation arrangement or other transaction.

The body approving the transaction will be deemed to have considered appropriate data if it has considered information sufficient (given the knowledge and expertise of the board or committee members) to determine whether the economic benefits payable under the transaction are reasonable.

With respect to compensation arrangements, relevant information includes, but is not limited to:

a. compensation levels paid by “similarly-situated” organizations, both taxable and tax-exempt, for “functionally comparable positions;”
b. the availability of similar services in the geographic area;

c. current compensation surveys compiled by independent firms; and

d. actual written offers from other organizations for the individual’s services.

When considering a compensation arrangement, it is essential that the board or committee approve, and obtain comparability data supporting, all elements of a compensation package, both cash and non-cash, whether taxable or not, including but not limited to salary, bonus, deferred compensation, supplemental executive retirement plans (SERPs) and other benefits.

It is also important that the manner in which the comparability data is obtained be free of conflict of interest. In particular, the executive to be compensated, or a subordinate to that executive, should not be the person responsible for obtaining the comparability data. The board or committee should consider engaging an independent compensation consultant to prepare a report and a reasonableness opinion. The board or committee should also consider whether it may be desirable to have legal counsel engage the compensation consultant for purposes of maintaining the attorney-client privilege.

3. Adequate Concurrent Documentation.

The final factor required for invoking the rebuttable presumption is that the board or committee must adequately document the basis for its decision concurrently with making the decision (e.g., through board minutes) in its written or electronic records. In order to be considered “adequate,” the documentation of the board’s decision must include all of the following:

a. significant terms of the transaction;

b. the approval date;

c. the members who were present during debate on the transaction and those who voted on it;

d. the comparability data considered in approving the transaction;

e. how the data were obtained;

f. any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest (e.g., recusal); and

g. the reasons for any deviations from the comparability data.
For the transaction to be documented “concurrently,” the board’s or committee’s decision must be documented before the later of the next board meeting, or 60 days after approval of the transaction. Records must be reviewed and approved by the authorized body as reasonable, accurate, and complete within a reasonable time period thereafter.

V. PUBLIC DISCLOSURE OF COMPENSATION AND APPROVAL PROCESS ON IRS FORM 990

All elements of executive compensation must be reported on the organization’s annual Form 990 information return, including cash and noncash compensation, such as salary, bonuses, severance payments, deferred payments, retirement benefits, fringe benefits, and other arrangements such as vehicles, meals, housing, personal and family educational benefits, below-market loans, payment of personal or family travel, entertainment, and personal use of an organization’s property. The Form 990 return is publicly available online at Guidestar.org, and audiences such as journalists, donors, patients, customers and unions review with interest the disclosures regarding executive compensation.

Not only is the compensation package itself on public view, but the process by which the organization approves the compensation is itself disclosed. The Form 990 includes questions such as whether the process for determining the compensation for the organization’s CEO, Executive Director or other top management official include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision. An organization that is unable to answer “yes” to this question will not instill confidence regarding its governance procedures. All board members should review the disclosure of executive compensation, and the disclosure of the board’s process in approving executive compensation, before the Form 990 is filed each year.

This memorandum is a general summary of the “excess benefit” rules under the federal tax law. It is not intended to provide specific legal advice to any organization or individual and is not a substitute for the tailored advice that would be provided by legal counsel.