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What you need to know about nonprofit executive compensation

GuideStar by Candid.

Introduction

Like religion, politics, and sports, nonprofit executive compensation often evokes strong emotion. Donors, journalists, state officials, and members of Congress frequently express outrage at the salaries nonprofit CEOs receive, especially if the organizations they head are public charities that rely on donations from the public.

Nonprofit compensation practices can also draw fire from the IRS. The IRS is charged with ensuring that tax-exempt organizations—nonprofits that do not pay federal income tax because they serve the public good—devote their resources to accomplishing their missions. Although these organizations can pay their employees, they must avoid *over*paying them. Excessive executive compensation can trigger an official IRS inquiry or even an examination (audit). Additionally, should the IRS find overpayment at a 501(c)(3) public charity or 501(c)(4) civic league or social welfare organization, it can levy hefty fines on the persons involved.[1]

Thus, to maintain public trust and mitigate risk, nonprofits must be aware of the regulations governing executive compensation, ensure that their practices follow these rules, document their compliance with them, and be prepared to explain to the IRS and the public why the salaries and benefits they offer their leaders are appropriate.

This report outlines what the IRS permits in setting nonprofit executive compensation, the consequences of failing to comply with the regulations, how nonprofit board members can protect themselves and the organizations they serve, the kind of data compensation decisions should be based on, and the importance of reporting compensation accurately in annual IRS filings.

Spotlight on compensation

Nonprofit compensation receives a lot of media coverage, much of it negative. Here are some examples:

"Former college president received severance for agreed-upon resignation"
Tribune-Democrat, Dec. 12, 2019.

"Here's what executives at Oregon's largest nonprofits take home"
Willamette Week, Dec. 4, 2019.

"This Florida nonprofit boss got flak for $761,000 salary. Now she's retiring"
Tampa Bay Times, Nov. 14, 2019.

"IRS forms show Highmark officials reaped $1 million-plus raises last year"
TribLive, Nov. 11, 2019.

"Bernard Tyson net worth: Kaiser Permanente CEO salary was $16M in 2017"
International Business Times, Nov. 10, 2019.

"Public paychecks 2019: The highest-paid St. Louis nonprofit executives"
St. Louis Business Journal, Nov. 10, 2019.

"This Arizona nonprofit health system CEO topped the salary list at $25.5 million in 2017"
Arizona Republic, Oct. 23, 2019.

What's allowed

The IRS allows tax-exempt organizations to pay executives "reasonable" compensation.[2] There is no universal standard defining *reasonable*, however; what's reasonable at one nonprofit may be a gross under- or overpayment at another. The organizations must determine appropriate salary and benefits packages based on the following considerations:

- They can pay their executives market rate.
- Market rate is determined by researching what someone in a similar position would earn at an organization that is of the same size and has a similar mission or field of activity.
- They can look at for-profit compensation when determining market rate, as long as the job, organization size, and organization mission/purpose are comparable.
- The IRS has no standard formula, such as percentage of total revenues or expenses, for determining compensation, nor are there any tables or schedules that define reasonable compensation.

Consequences of not following the rules

Excessive executive compensation is a red flag that can lead to closer IRS scrutiny of any exempt organization. The stakes are even higher for 501(c)(3) public charities and 501(c)(4) civic leagues and social welfare organizations. Penalties for overpayment by these organizations range from fines to revocation of tax-exempt status.

Fines are the more likely consequence. Known formally as *excess benefit transaction excise taxes* and informally as *intermediate sanctions*, the fines can be levied on *both* the executive who received the overpayment *and* the board members who approved it or who knew about the excess but did nothing to prevent it.[3] For example:

The executive director of ABCD Charity received a compensation package of $250,000 in FY 2017. After an examination of the organization, the IRS establishes that $150,000 was the appropriate compensation for the position at that time. As a result of this determination:

— The IRS requires the executive director to repay the $100,000 overpayment to the organization—with interest.[4]

— If the executive director fails to repay this amount, or repays only part of it, a 200 percent excise tax may be imposed on the amount yet to be repaid.[5]

— The IRS may require the executive director to pay an excise tax equal to 25 percent of the overpayment.[6] In this example, the excise tax would be $25,000.

— The IRS may require each board member who approved the excess compensation, or any board member who knew about the overpayment but failed to prevent it, to pay an excise tax equal to 10 percent of the excess, not to exceed $20,000 per transaction.[7] In this example, should the IRS decide to impose the excise tax, each board member would owe $10,000.

In March 2007, the IRS reported that its agents had recommended more than $21 million in excise taxes stemming from excessive nonprofit executive compensation. Amazingly, only 40 individuals at 25 organizations were liable for this $21 million.[8]

Excess compensation continues to be a priority for the IRS—every examination of a tax-exempt organization includes a compensation review.[9]

Protecting your organization and its leaders

A nonprofit's board can shield its members and the organization's executives by:

1. Approving compensation *in advance;* the board must ensure that no one who participates in the decision has a conflict of interest concerning the transaction.

2. Basing its decision on comparability data obtained *before* the compensation is approved.

3. Documenting the decision-making process *at the time* it approves the compensation. The IRS specifies that such documentation "should include the terms of the transaction and the date of its approval, the members of the authorized body present during the debate and vote on the transaction, the comparability data obtained and relied upon, the actions of any members of the authorized body having a conflict of interest, and documentation of the basis for the determination."[10]

By following this process, a board establishes a *rebuttable presumption of reasonableness*. As the IRS notes, "The Internal Revenue Service may refute the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body."[11]

In other words, it takes solid data to create a solid rebuttable presumption, but if a board bases its decision on solid data, the burden of proving overpayment has occurred falls on the IRS.

Finding solid comparability data

To satisfy IRS requirements, nonprofit comparability data must be for “compensation levels paid by similarly situated organizations for functionally comparable positions.”[12]

Smaller organizations can rely on the annual returns (see “Reporting Compensation to the IRS—and the public” below for more information) that their peers file with the IRS. The general rule of thumb is that three comparables will suffice for nonprofits whose annual gross revenues are $1 million or less.[13] Candid (through its 990 Finder and the GuideStar database) and the National Center for Charitable Statistics (NCCS) at the Urban Institute all post nonprofits’ IRS filings, although the number of organizations covered in each database differs.

Many larger nonprofits obtain comparability data from external compensation surveys or studies. When assessing whether an organization that relies on such resources has indeed established a rebuttable presumption, the IRS “will look to the independence of any compensation consultant used, and the quality of any study, survey, or other data, used to establish executive compensation.”[14] Charity Navigator, ERI Economic Research Institute, and GuideStar all provide compensation surveys or analyses that meet the IRS criteria.

Reporting compensation to the IRS—and the public

Almost all tax-exempt organizations are now required to file an annual information return with the IRS.[15] Although nonprofits that file Form 990-N (available to organizations whose annual revenues are $50,000 or less[16]) are not required to provide compensation information, the nonprofits that file Form 990-EZ, 990, or 990-PF must report compensation paid to directors, trustees, officers, and key employees, plus the five highest-paid employees who (a) are not directors, trustees, officers, and key employees and (b) earn more than $100,000. Providing this information is mandatory; failure to do so can result in IRS fines.

Nonprofits that complete Form 990—the "long form"—must also answer questions about the methods used to establish and approve executive compensation levels. In many cases, the organizations must define these processes on a supplemental schedule.

Compensation reported to the IRS on Form 990-EZ, 990, or 990-PF is ultimately compensation reported to the public, because these returns are public documents. Anyone can obtain them from the filing organizations, the IRS, or through websites such as those for Candid and NCCS.

Conclusion

Both the IRS and the public are paying close attention to nonprofit executive compensation. Accurate, up-to-date information from a reliable source on compensation at peer organizations is a nonprofit's best tool for protecting (1) its decision makers from costly excise taxes and (2) the organization itself from possible loss of tax-exempt status.

Such information is equally important for preserving the public's trust. Even if executive compensation at a nonprofit fits well within the market rate for similar positions at similar organizations, prospective donors, the media, and state and federal officials may think otherwise. As the February 2009 IRS report on nonprofit hospitals notes, "For some, there may be a disconnect between what, as members of the public, they might consider reasonable, and what is permitted under the tax law."[17] Having reliable comparative data on hand can be the difference between maintaining or losing the public's trust in your organization.

Endnotes

1 "2019 Instructions for Form 4720," U.S. Internal Revenue Service (IRS), Nov. 19, 2019, p. 1, irs.gov/pub/irs-pdf/i4720.pdf; "Applicable Tax-Exempt Organization," IRS, last reviewed or updated Feb. 25, 2019, irs.gov/charities-non-profits/charitable-organizations/applicable-tax-exempt-organization; "Intermediate Sanctions—Excess Benefits Transactions," IRS, last reviewed or updated Aug. 7, 2019, irs.gov/charities-non-profits/charitable-organizations/intermediate-sanctions-excess-benefit-transactions.

2 Publication 557, "Tax-Exempt Status for Your Organization," IRS, Jan. 2019, p. 62, irs.gov/pub/irs-pdf/p557.pdf.

3 "Intermediate Sanctions—Excess Benefit Transactions"; "Intermediate Sanctions—Compensation," IRS, last reviewed or updated Feb. 22, 2019, irs.gov/charities-non-profits/charitable-organizations/intermediate-sanctions-compensation; "Intermediate Sanctions—Excise Taxes," IRS, last reviewed or updated June 5, 2019, irs.gov/charities-non-profits/charitable-organizations/intermediate-sanctions-excise-taxes.

4 "Intermediate Sanctions—Excess Benefit Transactions"; "Intermediate Sanctions—Excise Taxes."

5 "Intermediate Sanctions—Excise Taxes."

6 Ibid.

7 Ibid.

8 "Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II," IRS, Mar. 2007, irs.gov/pub/irs-tege/exec._comp._final.pdf, p. 1.

9 "Governance Check Sheet," IRS, Dec. 2009, irs.gov/pub/irs-tege/governance_check_sheet.pdf.

10 "Rebuttable Presumption—Intermediate Sanctions," IRS, last reviewed or updated Nov. 18, 2019, irs.gov/charities-nonprofits/charitable-organizations/rebuttable-presumption-intermediate-sanctions.

11 Ibid.

12 "Governance and Related Topics—501(c)(3) Organizations," IRS, Feb. 4, 2008, p. 4, irs.gov/pub/irstege/governance_practices.pdf.

13 Lawrence M. Brauer and Leonard J. Henzke, "Intermediate Sanctions (IRC 4958) Update," IRS, 2002, p. 40, irs.gov/pub/irs-tege/eotopice03.pdf; "Nonprofit Executive Compensation and Excess Benefit Transactions—Legal Alert," The Law Project, Oct. 30, 2014, thelawproject.org/2014/10/nonprofitexecutive-compensation-and-excess-benefit-transactions-legal-alert.

14 "Governance and Related Topics," p. 4.

15 For exceptions to this requirement, see "Annual Exempt Organization Return: Who Must File," IRS, last reviewed or updated Aug. 6, 2019, irs.gov/charities-non-profits/annual-exempt-organization-return-who-must-file.

16 "Form 990 Series Which Forms Do Exempt Organizations File Filing Phase In," IRS, last reviewed or updated June 19, 2019, irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in; "Information Needed to File e-Postcard," IRS, last reviewed or updated May 13, 2019, irs.gov/charities-non-profits/information-needed-to-file-e-postcard.

17 "IRS Exempt Organizations Hospital Study: Executive Summary of Final Report," IRS, Feb. 2009, irs.gov/pub/irs-tege/execsum_hospprojrept.pdf, p. 4.

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