

# Compensation and Board Governance

**Beckie Stoner, CPA**  
**July 19, 2011**

**Kerkering, Barberio & Co.**  
**1990 Main Street, Suite 801**  
**Sarasota, FL 34236**  
**[www.kbgrp.com](http://www.kbgrp.com)**



# What Will Be Covered Today

- ❖ **Guidance on the IRS interest in and expectations for board governance**
- ❖ **Executive compensation and the Form 990**
- ❖ **How increased scrutiny for nonprofit compensation impacts the work of nonprofit boards**

# Changing Times

**“A growing segment of the donating public are skeptical about giving to charities...”**

David Mulvihill, VP and General Counsel  
Make a Wish Foundation of America

# Changing Times

- 65% surveyed in 2002 had confidence in Nonprofits prior to 9/11 and Katrina
- 25% surveyed today have confidence in Nonprofits
- *Even though a very small percentage of Nonprofits have been involved in fraudulent or deceptive practices!*

# Changing Times Ethical Challenges

- Enron – fraud and deception – 2001
- MCI/WorldCom – ethics/conflict of interest – 2002
- Sarbanes-Oxley Legislation – 2002
- Red Cross – misdirection of funds – 2005
- AIG – 2009
- Financial Industry – 2009
- Bernie Madoff - 2009

# Changing Times The Findings

- Ineffective Board oversight
- Board deferring to the CEO
- Board didn't receive (or ask for) all the information it needed to make important decisions
- CEO setting policy and strategic direction
- Board lost sight of its role as protector of the organization and its mission
- Board was asleep at the wheel

# Changing Times Congress Reacted

- Fall 2004 – Sen. Grassley writes to Independent Sector, requesting that they develop governance principles for nonprofits, fundraising practices, grant writing practices, etc., that would serve as best practices for all nonprofits

# Changing Times Outcomes

- Panel on the Nonprofit Sector was convened
- 9 months later – first draft of best practices
- October '07 – produced “Principles for Good Governance and Ethical Practice – A Guide for Charities and Foundations”

# Panel for Nonprofit Sector

- “Principles for Good Governance and Ethical Practice”
  - Legal Compliance and Public Disclosure
  - Effective Governance
  - Strong Financial Oversight
  - Responsible Fundraising

# Surviving Changing Times

- Focus on core strengths
- Align everything around your mission
  - Infrastructures
  - Accountability/Metrics
  - Financial Practices and Systems
  - Fund Development

# Board's Legal and Ethical Obligations

## Ethical Obligations

- **Public Trust**

- Nonprofits are organizations created for public philanthropic purposes that function to serve the public of the incorporating state and are accountable to the public of that state

# Board's Legal and Ethical Obligations

## Legal Obligations

- **Three Duties**

- Duty of Care
- Duty of Loyalty
- Duty of Obedience

# Board's Legal and Ethical Obligations

- **Duty of Care**

- Take responsibilities seriously
- Attend meetings
- Read & understand board documents
- Ask pertinent questions
- Know what the organization does & how well it does its work

# Board's Legal and Ethical Obligations

- **Duty of Loyalty**

- Disclose any conflict of interest
- Not enhancing personal benefit
- Focus on the best interests of the organization above all else
- Confidentiality of organization information
- Loyalty when sitting on multiple boards at the same time

# Board's Legal and Ethical Obligations

- **Duty of Obedience**

- Safeguards the Mission
- Maintains the Public Trust
- Involves managing operations and resources in accordance with the Mission and Bylaws

# Sarbanes Oxley Act and Implications for Nonprofits

- **Only two aspects of Sarbanes-Oxley that are directly applicable to nonprofits:**
  - Strengthened whistleblower protection and
  - Retention of documents related to lawsuits

# Sarbanes Oxley Act and Implications for Nonprofits

## Insider Transactions and Conflicts of Interest

- Understand and fully comply with all laws regarding compensation and benefits provided to directors and executives (including "intermediate sanctions" and "self-dealing" laws).
  - Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?
    - a. The organization's CEO, Executive Director, or top management official
    - b. Other officers or key employees of the organization
      - Describe the process in Schedule O.

# Sarbanes Oxley Act and Implications for Nonprofits

- Loans
  - all terms should be disclosed and formally approved by the board
  - the process should be documented and
  - the terms and the value of the loan should be publicly disclosed.
    - Was a loan to or by a current or former officer, director, trustee, key employee, highly compensated employee, or disqualified person outstanding as of the end of the organization's tax year?
      - Complete Schedule L Part II
        - Name of interested person and purpose
        - Loan to or from the organization?
        - Original principal amount
        - Balance due
        - In default? (Yes or No)
        - Approved by board or committee? (Yes or No)
        - Written agreement? (Yes or No)

# Sarbanes Oxley Act and Implications for Nonprofits

- Establish a conflict of interest policy and a regular and rigorous means of enforcing it.
  - Does the organization have a written conflict of interest policy?
    - Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts?
    - Does the organization regularly and consistently monitor and enforce compliance with the policy?
      - Describe in Schedule O how this is done

# Sarbanes Oxley Act and Implications for Nonprofits

## Independent and Competent Audit Committee

- Conduct an annual external financial audit
  - boards of very small organizations, for whom the cost of an external audit may be too burdensome, should at least evaluate carefully whether an audit would be valuable.
- Establish a separate audit committee of the board.
  - Board members on the audit committee should be free from conflicts of interest and should not receive any compensation for their service on the committee.
  - Include at least one “financial expert” on the audit committee.
  - The audit committee should select and oversee the auditing company and review the audit.
  - Require full board to approve audit results.
  - Provide financial literacy training to all board members.

# Sarbanes Oxley Act and Implications for Nonprofits

- Financial Statement Certification
  - Were the organization's financial statements audited by an independent accountant?
    - If "Yes", does the organization have a committee that assumes responsibility for oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant?
      - If the organization changed either its oversight process or selection process during the tax year, explain in Schedule O

# Sarbanes Oxley Act and Implications for Nonprofits

- **Responsibilities of Auditors**

- Rotate auditor or lead partner at least every five years. This does not mean that you need to change firms. Change in the lead partner is sufficient.
- Avoid any conflict of interest in staff exchange between audit firm and organization.
- Do not use auditing firm for non-auditing services that could impair the auditors independence. An exception is tax form preparation with pre-approval from audit committee.

# Sarbanes Oxley Act and Implications for Nonprofits

- Require disclosure to audit committee of critical accounting policies and practices.
- Use audit committee to oversee and enforce conflict-of-interest policy.

# Sarbanes Oxley Act and Implications for Nonprofits

## Disclosure

- Disclose Form 990 and 990-PF in a current and easily accessible way (also required of all nonprofit organizations by IRS law).
- File 990 and 990-PF Forms in a timely manner, without use of extensions unless required by unusual circumstances.
- Disclose audited financial statements.
- Move to electronic filing of Form 990 and 990-PF.

# Sarbanes Oxley Act and Implications for Nonprofits

## Document Destruction

- Have a written, mandatory document retention and periodic destruction policy, which includes guidelines for electronic files and voicemail.
- If an official investigation is underway or even suspected, stop any document purging in order to avoid criminal obstruction.
  - Does the organization have a written document retention and destruction policy?

# Sarbanes Oxley Act and Implications for Nonprofits

## Whistle-Blower Protection

- Develop, adopt, and disclose a formal process to deal with complaints and prevent retaliation.
- Investigate employee complaints and correct any problems or explain why corrections are not necessary.
  - Does the organization have a written whistleblower policy?

## Other Questions Related to Governance Section Of 990

- The number of voting members in the governing body included in the total who are *independent*
  - If members of the governing body do not all have the same voting rights, explain material differences on Schedule O
    - A member of the governing body is considered “independent” only if all four of the following circumstances applied at all times during the organization’s tax year.

# Other Questions Related to Governance Section Of 990

- They were not compensated as an officer or other employee of the organization (or a related organization).
- They did not receive more than \$10,000 of total compensation or other payments from the organization (or a related organization) as an independent contractor
- They (or a family member) were not involved in a transaction with the organization that is required to be reported in the organization's Schedule L.
- They (or a family member) were not involved in a transaction with a taxable or tax-exempt related organization of a type and amount that would be reported in Schedule L if required to be filed by the related organization.

## Other Questions Related to Governance Section Of 990

- Did the organization contemporaneously document the meetings held or written actions undertaken during the year by the following:
  - The governing body?
  - Each committee with authority to act on behalf of the governing body?

## Other Questions Related to Governance Section Of 990

- Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?
  - For each family and business relationship, identify the individuals and describe their relationship in Schedule O.
    - Stating “family relationship” or “business relationship” without greater detail is sufficient.

# Other Questions Related to Governance Section Of 990

- Has the organization provided a copy of this Form 990 to all members of its governing body before filing the form?
  - Describe in Schedule O the process, if any, used by the organization to review this Form 990.
- Describe in Schedule O whether (and if so, how), the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.

## Who's Who? – Defining Position Reporting Compensation Part VII, Section A

- Officer
  - Elected to manage daily affairs
    - e.g. President, Vice President, Secretary, Treasurer, possibly Board Chair
  - Determined by reference to:
    - Organizing documents
    - Bylaws
    - Resolutions of governing body
  - Served at any time during tax year.

## Who's Who? – Defining Position Reporting Compensation Part VII, Section A

- An officer is also deemed to include:
  - Top management official
    - Ultimate responsibility for implementing decisions of governing body, or
    - Supervising the management, administration, or operation of the organization
  - Top financial official
    - Ultimate responsibility for managing finances
  - Top management & financial officials are deemed to be officers rather than key employees.

## Who's Who? – Defining Position Reporting Compensation Part VII, Section A

Who Must Be Listed	If Reportable Compensation Is Greater Than
Current officers, directors, or trustees	N/A
Current key employees	\$150,000
Current five highest compensated employees (HCEs)	\$100,000
Former officers, key employees, and HCEs	\$100,000
Former directors or trustees	\$10,000

# EXECUTIVE COMPENSATION

- Pay no more than reasonable compensation and no more than fair market value for property
  - Jeopardize their tax exempt status and their managers risk substantial excise taxes if they enter into arrangements or transactions that either
    - permit private inurement of the organization's net earnings or assets or
    - result in private benefit that is more than incidental to the public benefit served

### Geography

Just like the for-profit sector, salaries at nonprofits differ based on the part of the country in which the entity is located. Here's how the median pay for the various regions compare to the overall median pay (\$147,273):

- ⬆ **Higher CEO Pay:** Northeast (\$185,000) and Mid-Atlantic (\$164,575)
- ⬇ **Lower CEO Pay:** Mountain West (\$108,000), South (\$128,678), Southwest (\$130,505), Midwest (\$139,012) and Pacific West (\$139,066).

In comparison to last year's data, each region experienced an increase in median pay. Median pay increased the most in the Mid-Atlantic (5.5%) and the least in the Mountain West (3.7%).

Region	2008 Median Salary	# of Charities	Median Raise	Median Total Expenses
Mid-Atlantic	\$164,575	443	5.5%	\$5,247,075
Midwest	\$139,012	490	4.2%	\$5,990,281
Mountain West	\$108,000	107	3.7%	\$3,752,524
Northeast	\$185,000	645	5.1%	\$6,807,934
Pacific West	\$139,066	543	4.1%	\$4,934,564
South	\$128,678	525	4.4%	\$4,954,985
Southwest	\$130,505	252	4.9%	\$4,822,989
<i>Grand Total</i>	<i>\$147,273</i>	<i>3,005</i>	<i>4.7%</i>	<i>\$5,321,963</i>

[www.charitynavigator.org](http://www.charitynavigator.org)

## Geography (cont.)

### Location and Size

This year, in response to requests from Board compensation committees and others who use this study as part of their benchmarking analysis, we drilled down further to examine the variation that occurs not just by location, but also by size.<sup>4</sup> We determined that regardless of size, charities in the Northeast have the highest median pay and charities in the Mountain West have the lowest.

- ⬆️ **Highest CEO Pay is in the Northeast** for small (\$120,000), medium (\$178,620) and large (\$351,539) charities
- ⬇️ **Lowest CEO Pay is in the Mountain West** for small (\$80,790), medium (\$120,000) and large (\$194,374) charities

Region	Size					
	Large		Medium		Small	
	Median Salary	# of Charities	Median Salary	# of Charities	Median Salary	# of Charities
Mid-Atlantic	\$300,000	121	\$172,500	165	\$105,530	157
Midwest	\$255,861	144	\$152,737	173	\$84,215	173
Mountain West	\$194,374	20	\$120,000	37	\$80,790	50
Northeast	\$351,539	210	\$178,620	246	\$120,000	189
Pacific West	\$267,048	121	\$155,442	207	\$95,939	215
South	\$269,057	129	\$145,701	184	\$91,750	212
Southwest	\$229,009	54	\$139,925	100	\$90,555	98

#### Footnote

<sup>4</sup>Size is defined by total expenses such that small are charities with total expenses <\$3.5 million, medium charities are those with total expenses between \$3.5 and \$13.5 million and large charities have total expenses >\$13.5 million.

[www.charitynavigator.org](http://www.charitynavigator.org)

**Size**

Not surprisingly, there is a predictable relationship between the size of a charity and the CEO's salary - the larger the charity the higher the median pay. Here's how the median pay for the various sizes of charities compare to the overall median pay (\$147,273):

- ① **Higher CEO Pay:** Large organizations with total expenses greater than \$13.5 million (\$280,000) and medium sized charities with total expenses between \$3.5 and \$13.5 million (\$157,056)
- ② **Lower CEO Pay:** Small charities with total expenses under \$3.5 million (\$95,481)

Size	2008 Median Salary	# of Charities	Median Raise
Large	\$280,000	799	6.0%
Medium	\$157,056	1,112	4.4%
Small	\$95,481	1,094	3.9%

These figures demonstrate that as the size, and thus the complexities of running a non-profit increases, so does the salary of the institution's top executive. So much so that if we probe deeper into the top tier of charities (by size), we see even larger salaries. Charities with total expenses of \$13.5 million and greater pay their CEOs in the range of a quarter million dollars to almost three quarters of a million dollars. In illuminating this information, it is not our intention to give donors, who often bemoan this level of pay, a reason to not support a great charity. Rather, we want donors to understand and appreciate that the top nonprofit leaders, those who are sought after for their ability to manage multi-million dollar institutions and who are tasked with the mammoth goal of making the world a better place, command significant salaries. On the other hand, it is evident that seven-figure salaries do not seem warranted, even in the largest sized charities.

Size	2008 Median Salary	# of Charities
\$13.5 - \$25 Million	\$211,899	266
\$25 - \$50 Million	\$265,005	229
\$50 - \$100 Million	\$336,104	139
\$100 - \$200 Million	\$378,942	81
\$200 - \$500 Million	\$429,754	46
Over \$500 Million	\$695,379	38

[www.charitynavigator.org](http://www.charitynavigator.org)

## Biggest Paychecks

Some CEO salaries raise more eyebrows than others. The following list reveals which charity within each category pays its CEO the most. For context and comparison purposes, the table includes the median pay for each category as well as the total expenses for the charity with the highest salary in each category.

Category	Median Pay/ Category	Highest Compensation	Charity Name	Total Expenses	Supplemental Information Provided By Charity on Form 990
Animals	\$106,030	\$725,485	Wildlife Conservation Society	\$197,389,730	Base compensation: \$503,927; Expense account and other allowances: \$221,558 which includes estimated value of housing provided as condition of employment
Arts, Culture, Humanities	\$190,550	\$2,649,540	New York Philharmonic	\$65,067,908	Base compensation: \$850,000 plus distribution of deferred compensation (includes contributions and earnings on such amounts)
Education	\$272,645	\$2,049,976	Evans Scholars Foundation	\$15,216,197	Base compensation: \$195,000; Bonus & incentive compensation: \$160,000; Other compensation: \$1,694,976 which consists of one time distribution of deferred compensation.
Environment	\$120,000	\$454,125	Conservation International	\$135,290,726	
Health	\$144,080	\$1,024,776	The Scripps Research Institute	\$364,666,641	

(chart continues on next page ⇒)

[www.charitynavigator.org](http://www.charitynavigator.org)

## Biggest Paychecks (cont.)

Category	Median Pay/ Category	Highest Compensation	Charity Name	Total Expenses	Supplemental Information Provided By Charity on Form 990
Human Services	\$122,082	\$661,634	YMCA of Greater Houston	\$109,098,649	
International	\$136,771	\$683,014	Foreign Policy Association	\$4,604,348	
Public Benefit	\$168,490	\$947,999	The Heritage Foundation	\$64,645,625	Base compensation: \$413,856; Bonus & incentive compensation: \$521,300; Other compensation: \$12,843
Religion	\$90,000	\$648,537	Educational Media Foundation	\$68,990,148	Base compensation: \$320,414; Bonus & incentive compensation: \$85,231; Other compensation: \$242,892; Additional Note: CEO received non-fixed bonus as part of compensation.

While this list is sure to astound many donors, salaries really should be judged in the context of the charity's overall performance.

[www.charitynavigator.org](http://www.charitynavigator.org)

# Charity Navigator's "Advice to Donors" Regarding Compensation

- Obtain comparison data
- Find out if the charity has a Compensation Committee
- Be cautious if the charity has given the CEO a loan
- Consider the performance of the charity in relation to the CEO's pay
- Be skeptical of charities that report zero CEO compensation

# Charity Navigator's "Advice to Charities" Regarding Compensation

- Have an *INDEPENDENT* compensation committee
  - responsible for reviewing the CEO's performance
  - ensuring that the CEO's pay is appropriate

# The IRS and the “Rebuttable Presumption”

- Approved in advance by an independent board or compensation committee
- Relying on appropriate comparability data
- Adequately and concurrently documented

## Example: Establishing a Rebuttable Presumption for Compensation

- The Board or a Committee thereof should approve Disqualified Person (DP) "total compensation", including all cash compensation, fringe benefits (taxable and nontaxable) and all other economic benefit provided.
- Comparative information to demonstrate total compensation is reasonable should be provided to the Board or Committee thereof.
- Documentation should be maintained that shows the Board or Committee used the information provided to determine reasonableness of DP compensation. This should include documentation as to why the particular comparative data is appropriate and why DP should be paid the approved compensation.

## RESOURCE R503

**Rebuttable Presumption Documentation for Compensation to a  
Disqualified Person by a Section 501(c)(3) or (c)(4) Organization<sup>a</sup>**  
(See Key Issues 4E and 34G)

1. Name of disqualified person: \_\_\_\_\_
  2. Title, position description, and responsibilities: \_\_\_\_\_  
\_\_\_\_\_
  3. Duration of contract (one year, two years, etc.): \_\_\_\_\_
  4. Types of appropriate comparable data relied upon in approving compensation package<sup>b</sup> (check applicable boxes):
    - Compensation paid by similarly situated organizations (taxable and tax-exempt) for functionally comparable positions.<sup>c, d</sup>
    - Availability of similar services in the geographical area.
    - Current independent compensation surveys.<sup>e, f</sup>
    - Written employment offers to the disqualified person from other similar institutions, dealing at arm's length.
    - A written employment agreement between the disqualified person and another organization; or written employment agreements between similarly situated persons and similarly situated organizations.
  5. Explain fully (in an attachment) how the comparable data was relied upon.
  6. Explain fully (in an attachment) how the comparable data relied upon was obtained.
  7. Office or file where comparability data is kept: \_\_\_\_\_
  8. Annual compensation supported by appropriate comparable data:
    - Cash:
      - Salary \_\_\_\_\_
      - Bonus or contingent payment (estimate) \_\_\_\_\_
      - Fees \_\_\_\_\_
    - Noncash:
      - Deferred compensation \_\_\_\_\_
      - Premiums paid on insurance coverage (life, health, disability, liability, etc.) \_\_\_\_\_
      - Payments to welfare benefit plans \_\_\_\_\_
      - Club membership(s) \_\_\_\_\_
      - Automobile \_\_\_\_\_
      - Foregone interest on below market loan(s) \_\_\_\_\_
      - Other (excluding nontaxable benefits under IRC Sec. 132 and expense reimbursements under an accountable plan) \_\_\_\_\_
- Maximum total compensation per appropriate comparable data \_\_\_\_\_

Resource R503

9. Annual aggregate compensation package approved:

Cash:

- Salary \_\_\_\_\_
- Bonus or contingent payment (estimate) \_\_\_\_\_
- Fees \_\_\_\_\_

Noncash:

- Deferred compensation \_\_\_\_\_
- Premiums paid on insurance coverage (life, health, disability, liability, etc.) \_\_\_\_\_
- Payments to welfare benefit plans \_\_\_\_\_
- Club memberships \_\_\_\_\_
- Automobile \_\_\_\_\_
- Foregone interest on below market loan(s) \_\_\_\_\_
- Other (excluding nontaxable benefits under IRC Sec. 132 and expense reimbursements under an accountable plan) \_\_\_\_\_

- Total compensation approved<sup>9</sup> \_\_\_\_\_

10. Name of authorized body: \_\_\_\_\_

11. Members of authorized body on date of approval:

Member	Title/Position	Background (education, experience, etc.)
_____	_____	_____
_____	_____	_____
_____	_____	_____

12. Members of authorized body present during discussion of compensation package and vote cast:

Member	In Favor	Opposed
_____	_____	_____
_____	_____	_____
_____	_____	_____

13. Members of authorized body having a conflict of interest with respect to the compensation arrangement and how the conflict was handled (e.g., left room during discussions and votes):

Member	Nature of Conflict	Action Regarding Conflict
_____	_____	_____
_____	_____	_____
_____	_____	_____

14. For a non-fixed payment (such as a discretionary bonus) subject to a cap:

- Date authorized body obtained appropriate comparability data indicating that a fixed payment of up to a certain amount would be reasonable compensation: \_\_\_\_\_
- Amount of such fixed payment (cannot exceed above amount): \_\_\_\_\_
- Maximum amount payable under contract (both fixed and nonfixed payments): \_\_\_\_\_

Resource R503  
(Continued)

R-72

990 3/1/1

15. Date compensation package approved: \_\_\_\_\_
16. Date of checklist *preparation* (must be done by the later of the next meeting of the authorized body or 60 days after authorized body approved compensation): \_\_\_\_\_
17. Name of person preparing checklist: \_\_\_\_\_
18. Date of checklist *approval* by authorized body (must be within a reasonable time after preparation date above):  
\_\_\_\_\_

Resource R503  
(Continued)

# Rules to Live By

- The best source of compensation data that the IRS has is Form 990 data.
- Most local organizations, that I have spoken with, utilizing comparability data use the Nonprofit Resource Center's Nonprofit Compensation & Benefits Report
- The more the compensation of executives strays above Form 990 norms, the more likely the IRS is to question it, thus
- The more rigorous the organization needs to be in following proper procedures and documenting the reasons for what might appear to excessively high compensation.

# Tax under IRC §4958 – Excess Benefits Transactions

- Intermediate Sanctions apply to IRC §501(c)(3) or 501 (c)(4) organizations, except Private Foundations & governmental units or affiliates of governmental units

# Tax under IRC §4958 – Excess Benefits Transactions

- First Tier Tax - IRC Sec. 4958(a)
  - 25% Imposed on *disqualified person who benefits*
  - 10% Imposed on organization managers who *knowingly participate or approve transaction*
- Second Tier Tax - IRC Sec. 4958(b)
  - 200% Imposed on *disqualified person if transaction is not corrected within the correction period*
- **NO TAX IS IMPOSED ON EXEMPT ORGANIZATION**

# Tax under IRC §4958 – Excess Benefits Transactions

- Any transaction that directly or indirectly benefits a *disqualified person in excess of the value of the consideration* (benefit) received by the *participating tax-exempt organization from the disqualified person*.

# Tax under IRC §4958 – Excess Benefits Transactions

## Excess Benefit Transactions- Examples

- **Non-FMV Transaction-** Rents, Loans, acquisitions or sales, organization assumes a disproportionate risk in an organization/disqualified person joint venture.
- **Unreasonable Compensation-** Officers, Directors and/or Senior Management (including bonuses and fringe benefits in excess of FMV of services provided).
- **Contracts for a percentage of revenue** that violate the private inurement proscription- e.g. compensation based on uncapped percentage of revenue, or based on future revenue streams, etc.

# Tax under IRC §4958 – Excess Benefits Transactions

## Excess Benefit Transactions- Exceptions

- **Fixed-payment Initial Contract-** binding written contract between tax-exempt organization and a person who is not a disqualified person immediately prior to entering into contract (Reg. 53.4958-4(a)(3)).

***Exception does not apply if the contract is materially modified or if the person fails to substantially perform his/her obligations.***

# Tax under IRC §4958 – Excess Benefits Transactions

## Disqualified Person (IRC Sec. 4958(f)(1) and Reg. 53.4958-3)

- Individual who was in a position to exercise *substantial influence* over the affairs of the organization, at any time during the five-year period (look back period) ending on the date of the transaction. This includes:
  - Persons in a position to exercise substantial influence by virtue of the powers and responsibilities they hold (President, CEO, CFO, Treasurer, voting members of the governing body, etc),
  - Certain Family Members related to a disqualified person or
  - An entity that is owned, 35% or more, by a disqualified person.

# Tax under IRC §4958 – Excess Benefits Transactions

## Not A Disqualified Person

- Persons deemed not to have substantial interest (Reg. 53.4958-3(d)):
  - Tax exempt organizations described in IRC 501 (c)(3) and certain IRC 501 (c)(4) organizations or
  - Employees receiving economic benefits of less than a specified amount (currently \$80,000) in a taxable year **and** not considered by statute to be a disqualified person **and** who is not a substantial contributor to the organization taking into account only contributions received by the organization during its current taxable year and the four preceding taxable years.
- Facts and Circumstance govern in all other cases

# Tax under IRC §4958 – Excess Benefits Transactions

## Automatic Excess Benefits

- An economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to treat it as such
  - An organization will clearly indicate its intent to treat an economic benefit as compensation if it establishes contemporaneous substantiation of its intent, such as reporting the economic benefit as compensation on a federal tax information return or an amended return (filed prior to the commencement of an IRS audit)

# Tax under IRC §4958 – Excess Benefits Transactions

## Automatic Excess Benefits (cont.)

- In February, 2004 IRS issued a CPE article to its agents describing how "automatic" excess benefits should be treated.
  - Compensation without written contemporaneous substantiation or other benefits or payments through non-accountable plan will be treated as compensation under IRC 4958.
  - Reimbursement of expenses/other benefits provided through an accountable plan are disregarded under IRC 4958.

# Executive Compensation Central to Board's Fiduciary Duties

- IRS regulations spell out precisely who are the responsible parties in cases when audits uncover “excess” compensation. This may include not only presidents and senior executives but also board members, if they approve the compensation knowing it to be excessive
- The best protection for any board is to create a strong and independent compensation process that is readily understandable and defensible to stakeholders

# Ten Ways to Stay Straight

1. Administer compensation process under direct control of board or committee of the board
2. Only include independent members
3. Board (not management) should be responsible for engagement of any compensation consultant who should report directly to the chairman of the board or committee
4. Compensation review process should include not only president but other senior management covered under the intermediate sanction rules
5. Compensation review should include all elements of compensation

# Ten Ways to Stay Straight

6. Rely on market data
7. Make sure everything is reflected in the minutes
8. Approve any “perks” such as club dues or spousal travel
9. Review sufficiency of internal controls concerning expense reimbursement for senior staff
10. Executive compensation & benefits should be accurately and fully reported on all IRS forms including 990 and W-2s

# Ten Pitfalls to Avoid

1. Letting management drive the executive compensation process
2. Obtaining faulty market data
3. Allowing the responsibility for compensation decisions to rest with the compensation consultant
4. Overlooking the forest for the trees
5. Failing to ask for a reasonableness opinion

## Ten Pitfalls to Avoid

6. Leaving other disqualified persons out of the compensation review process
7. Allowing insufficient time for discussion, debate, and action
8. Inadequately documenting decisions
9. Maintaining ambiguous lines of authority
10. Overlooking involuntary terminations

# What are IRS Agents Doing?

- IRS Agents are focusing their attention on:
  - Employment Agreements
  - Deferred Compensation Agreements
  - Bonus Agreements, Retirement Agreements,
  - Severance Agreements
  - Purchase! Sale Agreements, Loans, etc ...
  - Fringe benefits (taxable and nontaxable)
  - Expense reimbursements

# IRS Initiatives

- Payroll tax audits
- Executive Compensation Compliance Initiative
  - IRS will continue to evaluate exempt organization's compensation, review loan arrangements, and assess intermediate sanctions and employment taxes.

# Tax Exempt Compensation Enforcement Project

- EOCU has contacted nearly 2,000 charities - seeks more information about their compensation practices and procedures
- Charities contacted cut across multiple industries
- Hospitals at the top of the list of those contacted

# Tax Exempt Compensation Enforcement Project

- Focus on *total compensation (salary, bonuses, benefits)*
  - How individual amount was established and reported?
  - Does the amount represent the total economic benefits received for the year?
  - Does the organization make loans to employees? How are the terms for these deals set?
  - Is compensation reasonable as compared to assets, size and primary activity of the organization?
  - Provide documentation supporting reasonableness of compensation (employment contract, etc.)
  - Did Board of Directors approve the amount?
  - Did individual use any owned or leased property for any purpose other than to further the organization's exempt purpose?

## Panel of the Nonprofit Sector Section Relating to Compensation

- “Strengthening Transparency Governance Accountability of Charitable Organizations” - final report to Congress and the Nonprofit Sector, June 2005
- Report was provided to Senate Finance Committee and contains many suggested best practices for charities to follow.

# Recommended Best Practices Related to Board Compensation

- Generally discourages the payment of compensation to board members
- If paid, board should review compensation of other comparable organizations
- Organizations should make relevant information available to peer organizations

## Recommended Best Practices Related to Executive Compensation

- Approval of CEO compensation using the Rebuttable Presumption annually
- Independent compensation consultant
- Review of staff salary periodically

# What Should You Do?

- Governance policies should be reviewed
  - Changes should be made where needed
  - IRS feels that these disclosure requirements will improve tax compliance
- The responses to the questions will be scrutinized by the IRS, donors, interested parties, etc.
- Governance relates to consistent management, cohesive policies and well-defined processes

# What Should You Do?

- Educate the Board and Key Executives
- Identify the Disqualified Persons
- Review Compensation Approval Procedures
- Review Expense Reimbursement Procedures
- Review Expense Substantiation



# Questions



---

# Thank You!

**Kerkering, Barberio & Co.  
1990 Main Street, Suite 801  
Sarasota, FL 34236**

**(941) 365-4617**

**[www.kbgrp.com](http://www.kbgrp.com)**

