Articles

Excess Benefit Transactions

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Background

In 1996 the tax law was changed to provide an "intermediate sanction" for certain exempt organizations which engage in "excess benefit" transactions. Prior to that time, loss of exempt status was the only penalty the IRS could impose on organizations that were not operated exclusively for exempt purposes. The "intermediate sanction" created by Congress was a new tax, intended to be less severe than a revocation of exempt status.

Internal Revenue Code § 4958 imposes a tax on excess benefit transactions for those organizations which are exempt from taxation under Internal Revenue Code § 501(c)(3) or 501(c)(4). An "excess benefit transaction" is a transaction between an individual and an exempt organization where the parties do not benefit equally from the arrangement. Specifically, the individual receives more value than the exempt organization from the transaction. The individual must be a "disqualified person" for a transaction to result in excess benefits.

Disqualified persons are those who were "in a position to exercise substantial influence over the affairs of the organization" at any time during the previous five years. It also includes members of their families or any companies where they control more than 35% of the company. Typically officers, directors and senior staff and members of their families are considered disqualified persons. A major donor can also be a disqualified person if the donor gave the greater of $5,000 or 2% of the total contributions received by the organization in a taxable year.

The excise tax rates vary from 10 to 200%. A tax of 25% of the excess benefit is imposed on disqualified persons who benefit from the transaction. This tax increases to 200% if the excess benefit is not corrected. Any managers or board members who participated in the transaction and knew it was an excess benefit are taxed at 10% of the excess benefit unless their participation was not willful and is due to reasonable cause.

Rebuttable Presumption

The IRS recommends that boards consider meeting the rebuttable presumption of reasonableness for compensation or other transactions with disqualified persons as described in the Internal Revenue Regulations 53.4958-6. The most likely setting for an excess benefit transaction is with executive compensation although the regulations are applicable to all transactions with disqualified persons.

Organizations can establish the rebuttable presumption that compensation is not an excess benefit transaction if:

1. Compensation is set by the baord or a committee of the board. Reg. 53.4958-6(a)(1);
2. The organization relies on appropriate data to evaluate the reasonableness of the compensation. Reg. 53.4958-6(a)(2); and
3. There is contemporaneous documentation of the board or committee's review and approval of the compensation package. Reg. 53.4958-6(a)(3).

The IRS has not challenged compensation arrangements where the organizations were able to create the presumption that the compensation was reasonable. The IRS might not have agreed with the compensation arrangements, but it did not challenge them.

While a compensation arrangement can be reasonable without meeting the presumption of reasonableness, meeting the presumption will minimize the likelihood the IRS will question the compensation arrangement.

Comparables
Small organizations (those with annual revenues under $1 million) will be considered to have used appropriate data as to comparability if they have used data on compensation paid by three comparable organizations in the same or similar communities for similar services. Reg. 53.4958-6(c)(2).

For organizations with annual revenues of $1 million or more, the regulations state: "An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards set forth in §53.4958-4(b), the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value."

Similar job titles do not necessarily mean similar compensation should be paid. Factors to consider in evaluating comparables as outlined in Reg. 53.4958-6(c)(2) are "compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person."

Because most salary surveys and compensation studies are not as comprehensive as the IRS would like, larger organizations often rely on the advice of compensation consultants to review their executive compensation every few years. (The frequency of the review depends on the extent to which changes in executive compensation are made.)

Special care should be used when relying solely on for-profit comparables as this may result in increased scrutiny by the IRS and loss of the rebuttable presumption. Use of for-profit comparables may be acceptable when there are no appropriate nonprofit comparables in the geographic area or if the organization can demonstrate that nonprofit organizations compete with for-profit companies for the same pool of specialized talent.

Hiring a compensation consultant to provide the information on comparables is an excellent way to establish the reasonableness of any comparable salary and benefits information used in setting executive compensation. Normally a compensation consultant will meet with the compensation committee or the full board and review the executive's current compensation package as well as make recommendations for enhancements. The consultant provides information on the comparables used to benchmark the executive's compensation, thus bringing a level of objectivity to what is often a subjective process. In lieu of hiring a compensation consultant, published salary surveys can be used but they must meet the IRS requirements of the factors to be considered in determining the reasonableness of the compensation.

Documentation
Documentation of the board's approval of the compensation arrangements is very important and often overlooked. The documentation should include the terms of the compensation, the date it was approved, the members of the board or committee present during the debate and vote on the compensation, the information on comparable compensation that was used in the decision-making, the actions of any members of the board or committee who had a conflict of interest, and the basis for the determination that the compensation was reasonable under the circumstances. Reg. 53.4958-6(c)(3) In order to avail itself of the presumption of reasonableness, the documentation must be contemporaneous with the action approving the compensation. The IRS defines "contemporaneous" to mean the later of 60 days following the action to approve the compensation or the next meeting of the body that approved the compensation.

Compensation Elements
Everything that is not excluded by the regulations (*de minimis* fringe benefits) should be included in determining the amount of compensation. In addition to salary, fees, bonuses, and severance payments, compensation includes such things as deferred compensation, vacation and other leave, retirement benefits, health and life insurance, housing, personal expenses related to business travel (such as dry cleaning, health club use and movie rentals), personal use of employer-owned property (such as cars, cell phones and computers), non-cash awards, tuition reimbursements, wardrobe allowance, spouse travel expenses, and club memberships. Employment agreements should contain all terms and conditions of the compensation package, not just the salary and any bonus offered.

Expense accounts and other allowances to be used at the discretion of the executive should be included in compensation. The organization should determine a reasonable level for an expense account, set limits and establish and implement an approval and auditing process to review the expenditures. Expense accounts and other allowances are reported with other elements of compensation on the Form 990 in Part V-A.

Compensation Committees
To address concerns about confidentiality of compensation arrangements, some boards delegate the responsibility for establishing compensation to a compensation committee. If there is no specific compensation committee, often the executive committee will fill that role. In rare cases the entire board handles the review and approval of executive compensation as a committee of the whole. Usually a committee assumes the responsibility for reviewing executive compensation arrangements and determining whether they

are reasonable given the duties and responsibilities of the compensated individual. If a committee is used to review compensation, the committee should disclose the executive compensation arrangements it approves to the full board since the board has the ultimate responsibility for the compensation that is paid. Executive compensation should be reviewed on an annual basis even if there is no change in the compensation to be paid.

Conflicts of Interest

Board members with conflicts should recuse themselves from any votes involving their conflict, including votes on compensation. Compensated individuals and those related to them should not be approving their compensation and they should not be on the compensation committee.

Conclusion

Directors should consider all elements of the compensation package when setting compensation. They should also take advantage of the rebuttable presumption that a compensation package is reasonable by: 1) setting all compensation in advance by disinterested persons; 2) using comparables to justify the reasonableness of the compensation; and 3) documenting all decisions about compensation.

Boards should not shy away from paying competitive compensation to retain outstanding executives but they should protect themselves and their organization by making sure the compensation they pay is reasonable.
