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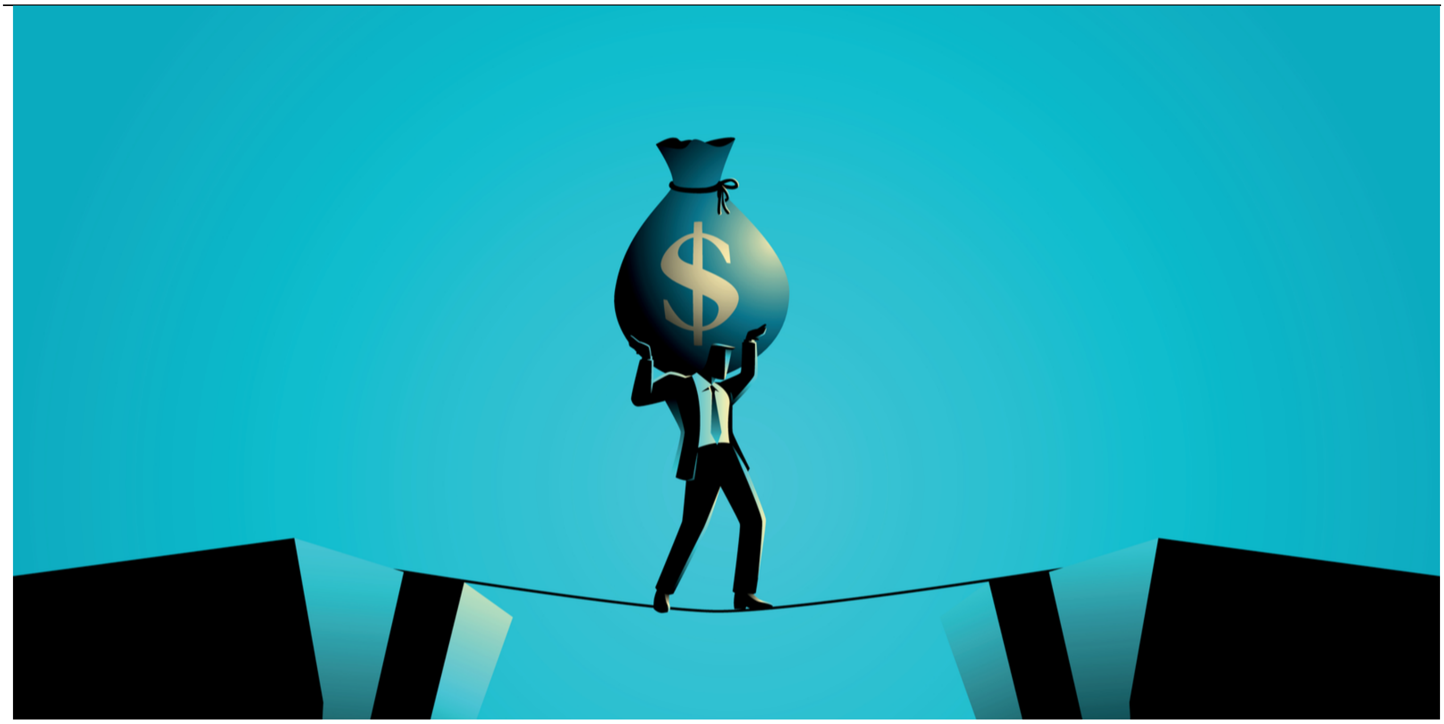
Managing Nonprofit Risks: Executive Compensation

Nonprofit Organizations



Nonprofit executive compensation has been a hot topic with the US Internal Revenue Service (IRS) for some time. It is important for organizations and their governing boards to understand the risks that arise in this area and put good practices in place to mitigate such risk.

The IRS requires that tax-exempt organizations include the compensation paid to officers, directors, trustees, key employees, and the highest compensated employees on their annual Form 990 Information Return. (For purposes of this article we will refer to compensation arrangements for these positions as “executive compensation.”)

Many states also require this information to be provided as part of annual charitable solicitation registrations.

This 990 reporting includes detailed questions about the amount of compensation paid and the process by which an organization determined that this compensation was “reasonable compensation.” This is important because the standard “is used to determine if there is an excess benefit in the exchange of a disqualified person’s services for compensation.”

In order to establish a rebuttable presumption that executive compensation is reasonable, the IRS requires that organizations implement the following three-step process:

1. The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction.

2. The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction.

3. The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction.

If the IRS refutes the compensation arrangements established using this methodology and determines that the organization does not satisfy the requirements to establish a rebuttable presumption, the IRS will revert to a facts and circumstances determination of reasonableness.

- "…[O]nce an employee is a covered employee, he or she continues to be a covered employee for subsequent tax years."
- "[R]emuneration paid for medical services is not taken into account for purposes of identifying the five highest-compensation employees."
- Remuneration is defined as wages and is "treated as paid when there is no substantial risk of forfeiture of the rights to the remuneration."

In recent years, the scrutiny of excessive executive compensation was directly addressed with the passage of the Tax Cuts and Jobs Act of 2018. The new provisions added to the Internal Revenue Code, "imposes an excise tax equal to the rate of tax [imposed on corporations] under section 11 (currently 21 percent) on the amount of remuneration in excess of $1 million and any excess parachute payment paid by an applicable tax-exempt organization to a covered employee."

> With the increased focus on excessive executive compensation, it is important for governing boards to recognize their role in managing the risks relating to executive compensation.

The IRS issues guidance in December 2018 to provide clarity to the new law, for example: The IRS includes in its Good Governance Practices information sheet that "it will review and organization's application for exemption and annual information returns to determine whether the organization has implemented policies relating to executive compensation."

States also focus on the issue from a corporate governance perspective. For example, the Maryland Attorney General's office has a recommended Executive Compensation Policy as one of the key policies that a charity should adopt. New York's Charities Bureau includes the requirement of governing boards to approve executive compensation in its FAQs on Governance-Duties of Board Members.

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As part of a governing board's fiduciary duties of care, loyalty, and obedience, it is critical that boards review executive compensation with the above IRS parameters, as well as with their conflict of interest policies and prohibition on private inurement policies to ensure that they are approving appropriate compensation arrangements that are in the best interests of the organizations they serve.

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