Increased Compensation Scrunity Coming From All Sides

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The Internal Revenue Service is not the only authority taking a deeper look at executive compensation reporting. Lawmakers, state attorneys general, the media and watchdog groups are seeking more transparency surrounding compensation paid to the nation's top nonprofit executives. In December of 2013, Massachusetts Attorney General's office (AGO) released a report titled "Massachusetts Public Charities CEO Compensation Review" in which they provided a review of CEO compensation data based on 25 of Massachusetts largest public charities which included health plans, hospitals, and universities. The Massachusetts AGO's study is based on analysis of data covering the three year period between 2009 and 2011. The AGO evaluated findings from a prototype "Schedule EC" designed to evaluate CEO compensation in depth, and also analyzed additional information from charities regarding how they determined the compensation as appropriate.

The review by Massachusetts Non-Profit Organizations/Public Charities Division of the Office of the Attorney General follows in the wake of a report that the IRS released in May of 2013 which also reviewed executive compensation among other hot-topic items in their "Colleges and Universities Compliance Project". These studies and reports do not stand alone, and provide clear evidence of the increased and continued examination of executive compensation for all tax-exempt organizations.

The stage is set for more scrutiny

As the IRS continues to prioritize CEO compensation as a main area of focus, the stage has been set for more jurisdictions to follow suit. In fact, New York and New Jersey have already issued regulations that limit the amount of executive compensation paid by organizations that are provided state funds; and Florida, Illinois, Massachusetts and New Hampshire have also proposed reform surrounding non-profit executive compensation limits.

The heightened scrutiny is not surprising given that executive compensation at both for-profit and not-for-profit companies has grown steadily in the recent years, however, public charities executive compensation typically garners more attention and debate than its corporation counterpart. Understandably, this revolves around the sentiment that the larger the compensation package is the less money there will be for charitable activities. Given that tax exempt organizations' top compensation is available for public disclosure this sensitive topic continues to be a highlighted issue not only for taxing authorities, but the general public as well. Donors want to give to further missions worthy of their philanthropy, not provide top executives with a rock and roll lifestyle.

Watchdog groups report responding to many donor inquiries about how much executives should be making and what is fair. The American Institute of Philanthropy researches compensation reported on the publicly disclosed IRS's Form 990 and provides a Top 25 Compensation package report on their Charity Watch website. The salaries range from $773k to $2.2 million, and while they note that some of the figures include severance packages and other deferred compensation, there were still plenty over the $1 million mark that did not report these additional items of pay. Charity Navigator, America's largest charity evaluator, prepares CEO compensation studies on an annual basis.

In their "2013 CEO Compensation Study" they examined CEO compensation at 3,929 mid to large sized charities in America and commented that "while most nonprofit leaders earn reasonable salaries, a handful earns excessive wages." Charity Navigator reported that the typical charity CEO earns just $125,000 and while they defended six-figure pay for some nonprofit executives, "it is evident that seven-figure salaries do not seem warranted, even in the largest-sized charities," it said.

Despite this persistent analysis, the taxing authorities do give weight to the fact that just because an organization is tax exempt does not necessarily mean it is not a complex organization in its own right needing highly skilled and thus competitively compensated executives to further their missions and program service accomplishments. For this purpose, the IRS does provide for terms and conditions of a compensation arrangement that, if followed, allows tax exempt organizations to establish a presumption that the compensation is reasonable under federal tax law.

Reasonable compensation

Payments under a compensation arrangement are presumed to be reasonable is presumed to be at fair market value, if the following three conditions are met:

1. The transaction is approved by an authorized body of the organization which is composed of individuals who do not have a conflict of interest concerning the transaction.

2. Before making its determination, the authorized body obtained and relied upon appropriate data as to comparability. There is a special safe harbor for small organizations. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services.

3. The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

    a. The terms of the approved transaction and the date approved;

    b. The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;

c. The comparability data obtained and relied upon by the authorized body and how the data was obtained;

d. Any actions by a member of the authorized body having a conflict of interest; and

e. Documentation of the basis for the determination before the later of the next meeting of the authorized body or 60 days after the final actions of the authorized body are taken, and approval of records as reasonable, accurate, and complete within a reasonable time thereafter.

Presumption of reasonableness

Organizations that establish a rebuttable presumption of reasonableness through the above measures limit the IRS's ability to contest the arrangements put in place. The Service's guidance notes that "this provision gives taxpayers added protection if they faithfully find and use contemporaneous persuasive comparability data when they provide the benefits."

Similarly, the Massachusetts AGO delved into assessing the reasonableness of compensation packages in their study; however, the office states that it "believes that [the IRS's] process alone may not assure reasonable compensation and that there are additional considerations that should be included." The "Schedule EC" developed by the AGO requests similar information to the IRS Schedule J (Form 990), however, it also asks for narrative explanations on any unclear figures or programs to increase clarity to its users. Additionally, the study cites that in some cases compensation is reported nearly a year and a half after it is being paid and states that "the delay is an obstacle to transparency." The AGO is committed to implementing a revised schedule as part of their Form PC that results in increased transparency and timeliness of reporting.

The studies and reports performed by the IRS and the Massachusetts AGO serve as indicators to all tax exempt organizations that executive compensation and the transparency surrounding its determination are of high concern and should be considered carefully. Nonprofit and charitable organizations and their boards should be aware of the financial risks and responsibilities surrounding their executive compensation arrangements for federal, state, and even public reputation purposes.

Areas of concern

Since the public's trust and perception, as well as expanding donor fund bases are keys to keeping and growing a charitable organization, it is highly advisable that nonprofit organizations follow the IRS's guidelines to prevent tax consequences such as private inurement, impermissible private benefit, excess benefit transactions, intermediate sanctions, and revocation of exempt status. Recent IRS enforcement litigation has cropped up in the areas of reimbursed business expenses, compensation, and business transactions with executives. These areas of concern can be easily avoided with proper practices and documentation. Assessments, fines, penalties, and revocation can be prevented by exempt organizations that establish and follow compensation and reimbursement policies and perform succinct valuations of comparability data based on industry surveys, documentation of compensation for persons holding similar positions in similar organizations, expert compensation studies, and other comparable data.

We highly advise nonprofit organizations to rely on qualified professionals for the reporting of compensation to the IRS, as well as establishing the necessary rebuttable presumption, and determining best practices for board oversight of executive compensation to alleviate risk. As experts in the nonprofit field, with professionals who develop, audit and provide excellent employee benefit plans, Raffa is uniquely qualified to help determine the appropriate level and type of compensation for your executive-level staff.

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