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A Trap for the Unwary – Nonprofit Organization Compensation Arrangement Considerations for High Caliber Executives

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Like any for-profit company, nonprofit organizations want to attract and retain high caliber executives to achieve and further their missions. To accomplish this, a nonprofit organization may have to offer a particularly robust compensation arrangement to the executive, especially because other nonprofit or for-profit organizations likely want to engage the services of such executive given the executive's talent and proven high-quality performance.

When negotiating a compensation arrangement, nonprofit organizations that are tax-exempt under Section 501(c)(3), (4), or (29) should be aware of the potential for triggering an excess benefit transaction that may be subject to excise taxes under Section 4958 of the Internal Revenue Code, known as "intermediate sanctions." In this blogpost, we briefly summarize the intermediate sanction excise taxes and some considerations for nonprofit organizations when designing and negotiating an executive's compensation arrangement.

Intermediate Sanction Excise Taxes

Section 4958 of the Internal Revenue Code imposes on a disqualified person of a nonprofit organization that is tax-exempt under Section 501(c)(3), (4), or (29) a first tier 25% excise tax on the amount of an excess benefit transaction. If the excess benefit transaction is not timely corrected, Section 4958 imposes on the disqualified person a second tier 200% excise tax on the amount of the excess benefit transaction.

If the IRS determines that a nonprofit organization provides unreasonably high compensation to an executive that results in an excess benefit transaction, the executive is responsible for the Section 4958 excise tax. In addition, the directors, trustees, or executives of the nonprofit organization who approved the transaction may also each be liable for a 10% excise tax on the excess benefit transaction (capped at $20,000 each).

Additionally, depending on the facts and circumstances of an excess benefit transaction, the IRS may propose revocation of tax-exempt status, whether or not Section 4958 excise taxes are imposed.

Creating a Rebuttable Presumption of Reasonableness

Pursuant to regulations under Section 4958, a nonprofit organization may help protect against a finding by the IRS of an excess benefit transaction by creating a rebuttable presumption that a compensation arrangement was reasonable. Payments under a compensation arrangement are presumed to be reasonable if a nonprofit organization satisfies the following three requirements:

1. The compensation arrangement is approved in advance by an authorized body of the nonprofit organization (for example, the Board of Directors or the Compensation Committee) composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement.
2. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination. Relevant information may include:
    1. Compensation levels paid by similarly situated nonprofit and for-profit organizations for functionally comparable positions;
    2. The availability of similar services in the geographic area of the nonprofit organization;
    3. Current compensation surveys compiled by independent firms; and
    4. Actual written offers from similar institutions competing for the services of the executive.
3. The authorized body adequately documented the basis for its determination concurrently with making that determination.

If the nonprofit organization satisfies these three requirements, then the IRS may rebut the presumption only if it develops sufficient contrary evidence to rebut the comparability data relied upon by the authorized body.

Proskauer Perspectives

As a general matter, it is a best practice for a nonprofit organization to engage a compensation consultant to engage in a compensation benchmarking analysis based on a custom peer group. This serves two important purposes. First, a nonprofit organization can determine an appropriate compensation arrangement to offer an executive. And second, a nonprofit organization can utilize the analysis to satisfy the second requirement of creating a rebuttable presumption of reasonableness.

To attract and retain a high caliber executive, a nonprofit organization may have to offer a compensation arrangement that is significantly above the 50th percentile of the identified peer group. Depending on the facts and circumstances, it may be reasonable and justifiable to offer a very robust compensation arrangement, even between the 90th and 100th percentiles.

In such an instance, issues may arise if an executive attempts to negotiate for an incrementally more generous compensation arrangement, which is not uncommon to expect as part of a negotiation. Such increases in compensation may not just come in the form of obvious economic items like increases in base salary or bonus amounts, but could also come up in respect of certain perquisites, including enhanced retirement contributions, significant expense reimbursement obligations, security services for the executive (unless as a nontaxable working condition fringe benefit), company paid executive medical exams, and others. Increasing the amount of compensation and certain perquisites offered which deviates from the suggested maximum ranges in a compensation benchmarking analysis may give the IRS the contrary evidence it would need to rebut a presumption of reasonableness, and the IRS may impose excise taxes or even potentially a loss of tax-exempt status.

Considering the potential for excise taxes and loss of tax-exempt status, it is important for both nonprofit organizations and executives to be mindful of possibly engaging in excess benefit compensation arrangements and to engage competent legal counsel. Proskauer’s Tax and Employee Benefits and Executive Compensation teams are advising nonprofit organizations and executives on designing and drafting executive compensation arrangements. Please contact a member of our teams with questions.

Law Intern Nicole Arslanian assisted with writing this blogpost.

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