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HealthCare Appraisers' Industry Insight

WHAT TAX-EXEMPT ORGANIZATIONS NEED TO KNOW ABOUT EXECUTIVE COMPENSATION

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According to GuideStar, there are more than 50,000 not-for-profit healthcare facilities and programs in the United States.¹ Although guided by their core missions and values, not-for-profit organizations must also satisfy the rules that exempt them from federal and state income taxes. Among these rules is proper oversight of executive compensation, which is critical for 501(c)(3) public charities, 501(c)(4) civic leagues and social welfare organizations, and 501(c)(29) qualified nonprofit health insurance issuers as excessive compensation is often a red flag for the IRS.

When dealing with any type of wrongdoing or mismanagement by a not-for-profit, the IRS historically had only one recourse: revoke the tax-exempt status of the organization. Today, IRC section 4958, generally referred to as “intermediate sanctions,” provides for an intermediate penalty to address inappropriate transactions and unreasonable compensation. By meeting certain IRS requirements, an organization establishes a “rebuttable presumption” that compensation is reasonable, thereby shifting the burden of proof to the IRS that compensation is unreasonable. These requirements are:²

1. Executive compensation arrangements are approved in advance by an authorized, independent body of the organization with no conflict of interest with respect to the compensation arrangements;
2. The authorized body obtained and relied upon appropriate comparability data prior to making its determination; and
3. The authorized body adequately documented the basis for its determination concurrently with making that determination.

AUTHORIZED, INDEPENDENT BODY

To satisfy the first requirement of the rebuttable presumption, compensation arrangements should be approved by an authorized body of individuals, all of whom have no conflict of interest with respect to the arrangement. The regulations identify five conditions to establish absence of conflicts for members, if such member:

1. Is neither a “disqualified person” (“DQP”) nor anyone related to a DQP who is, or will, participate in, or economically benefit from, the compensation arrangement;
2. Is not in an employment relationship subject to the direction or control of a DQP economically benefitting from the compensation arrangement;

¹ <https://www.guidestar.org/NonprofitDirectory.aspx?cat=4>

² <https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions>



3. Does not receive compensation or other payments subject to approval by a DQP economically benefitting from the compensation arrangement;
4. Has no material financial interest affected by the compensation arrangement; and
5. Does not approve a transaction providing economic benefit to any DQP participating in the compensation arrangement where that DQP in turn has approved, or will approve, a transaction providing economic benefits to the member (*i.e., quid pro quo*).

APPROPRIATE COMPARABILITY DATA

The authorized body has “appropriate comparability data” if, given the knowledge and expertise of its members, it has information adequate to determine whether the compensation arrangement in its entirety is reasonable. Relevant information as to comparability of compensation includes (but is not limited to):

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
- The availability of similar services in the organization’s geographic area;
- Current compensation surveys compiled by independent firms; and
- Actual written offers from similar institutions competing for the services of the DQP.

The IRS regulations state that the authorized body must use its judgement, given the knowledge and expertise of the members, to determine whether the information gathered is enough to satisfy the IRS standard that “the compensation arrangement in its entirety is reasonable.” The unique facts and circumstances of the organization will apply when determining whether appropriate data was reviewed. This data provides the context for executive compensation decisions that are specific to and support the needs of the organization.

CONCURRENT DOCUMENTATION

To satisfy the third requirement of the rebuttable presumption, the regulations require that the documentation includes the following:

- The terms of the compensation arrangement that was approved and the date of approval;
- The members who were present during the debate and those who voted on it;
- The comparability data obtained and relied on by the authorized body and how the data was obtained;
- Any actions taken by a member of the authorized body who had a conflict of interest with respect to the compensation (*e.g., abstention*); and
- If a member determines that reasonable compensation is higher or lower than the range of comparability data obtained, the basis for determination must be recorded.

It is important to maintain meeting minutes that demonstrate the processes followed, reports received, and decisions made by the authorized body.

Overpaying executives can lead to penalties ranging from fines to revocation of an organization’s tax-exempt status. While meeting the three requirements set forth in IRC section 4958 is often a difficult and time-consuming task, organizations have the ability to outsource these functions. Specifically, intermediate sanctions allow organizations to obtain “reasonableness letters” from independent compensation consultants as support for the reasonableness of executive compensation.

