

# Tax Exempt Organizations: Limits On Executive Compensation

Details

Written by Peter F. Imse, Esq.

No part of the net earnings of a charitable §501(c)(3) corporation may inure to the benefit of any private shareholder or individual. This rule is tempered by an acknowledgment of the need to pay individuals for their services. As one court has observed, “the law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts.” World Family Corporation v. Commissioner, 81 T.C. 958 (1983). While the payment of compensation is allowed, special rules apply with respect to compensation paid to parties who exert “substantial influence” over the actions of the corporation.

The question of whether compensation paid by a tax-exempt organization is reasonable or constitutes private inurement to the recipient is subject to a two-part test under IRC §4941. The payment of compensation must be both (a) reasonable and necessary to carrying out the organization’s purposes, and (b) cannot be excessive. In other words, a compensation package is lawful if it is a fair market reflection of the value of the services provided by the recipient to advance the organization’s purposes

Compensation is reasonable if it is “such [an] amount as would ordinarily be paid for like services by like enterprises under like circumstances.” Treas. Reg. 1.162-7(b)(3). Reasonableness is highly dependent on the particular facts, the duties, responsibilities, training, and industry position of the executives to whom compensation is paid. In addition to salary, all sources of payment, including loans, commissions, and payments from other entities, must be combined to decide if the entire package is reasonable. See Church of Scientology v. Commissioner, 83 T.C. 381, 455-56 (1984). The IRS will closely scrutinize compensation packages of tax-exempt organizations that are predicated on an incentive feature by which compensation is a function of revenues received by the corporation, or is otherwise outside the boundaries of conventional compensation arrangements. The Law of Tax-Exempt Organizations, 6th Ed., Hopkins, 278.

The IRS imposes two levels of taxes on unreasonable compensation that is considered to be private inurement to the recipient. Section 4941(a)(1) imposes a “first-tier” tax equal to 25 percent of the amount involved. Section 4941(b)(1) imposes a “second-tier” tax equal to 200 percent of the amount involved, if the excess payment is not corrected before the earlier of the date of mailing a notice of deficiency or the date on which the tax imposed is assessed. Additional penalties and taxes may be assessed if the recipient knew the compensation paid was excessive.

To avoid potential problems with the IRS, tax exempt organizations should periodically review the compensation packages of all officers, executives, and insiders. The Board should independently review or obtain independent market data regarding compensation

paid to persons in similar positions. All members of the Board should have access to such information, even if the Board has a Compensation Committee. Compensation and benefit packages should not exceed what is reasonable in the marketplace. See Guidebook for Directors of New Hampshire Charitable Trusts and Non-Profit Organizations, State of New Hampshire, Department of Justice, Charitable Trusts Unit.

Reprinted from Nonprofit New Hampshire, a publication of the New Hampshire Center for Nonprofits