EXECUTIVE COMPENSATION

INSIGHT

Executive Compensation for Tax-Exempt Organizations

What We Can Learn From the IRS Compliance Project for Colleges and Universities

To better understand practices regarding executive compensation and other business activities of tax-exempt colleges and universities, the Exempt Organizations Division of the Internal Revenue Service Tax Exempt and Government Entities Division launched a Compliance Project in 2008. On April 25, 2013, the IRS issued its report. The *Final Report of the Colleges and Universities Compliance Project* is based on 400 questionnaire responses and 34 examination results.

SullivanCotter has summarized the key findings and takeaways relevant to executive compensation. While the report pertains to higher education institutions, these findings have broader implications for the executive compensation governance practices of all tax-exempt organizations.

Implications for Executive Compensation

20%

of organizations failed to establish the rebuttable presumption of reasonableness standard for compensation.

As it relates to executive compensation, the IRS report focused on compliance with Internal Revenue Code (IRC) Section 4958, which applies to private tax-exempt colleges and universities. The report focused on whether "reasonable compensation" is being paid to officers, directors and other "disqualified persons" at these organizations. Under Section 4958, penalties called intermediate sanctions could be imposed on individuals who receive excessive compensation and the persons who approved it.

Although the majority of institutions examined by the IRS attempted to meet the rebuttable presumption of reasonableness standard, 20% of the organizations surveyed failed to do so.

SullivanCotter
AND ASSOCIATES, INC.

According to the report, concern about the peer groups used for executive compensation comparison purposes was the primary reason that organizations failed to establish the rebuttable presumption of reasonableness. Four important issues emerged:

- **Institutions were using peers that were not considered "similarly situated"** according to the IRS definition.

- **Compensation studies did not clearly or contemporaneously document** the selection criteria for peer institutions, nor did the studies explain why chosen peers were deemed comparable. For higher education institutions, the IRS report indicated that appropriate comparability factors include the following:

    1. Type (e.g., private or public, liberal arts, research university).
    2. Size of undergraduate enrollment.
    3. Faculty size.
    4. Location (region; urban, rural or suburban).
    5. Endowment size.
    6. Tuition and cost to attend.
    7. Selectivity (e.g. SAT ranges).
    8. Age of the institution.

- **Institutions that did not document the rationale for determining the peer groups** left the IRS to decide on the appropriate peer group.

- **Compensation surveys did not specify whether amounts reported included only salary** or included other types of compensation, as required by the intermediate sanctions rules.[1]

Actions for Good Governance

Although the IRS report focuses on colleges and universities, its findings apply more broadly. Other tax-exempt organizations should apply the lessons learned from this report and consider the following in their compensation decisions:

1 Establish the rebuttable presumption of reasonableness:

- The IRS gives deference to organizations that have followed the prescribed process to establish the rebuttable presumption of reasonableness of compensation for disqualified persons.

- Organizations should develop board governance processes to establish the rebuttable presumption of reasonableness and demonstrate due diligence when making compensation decisions.

- By doing so, an organization shifts the burden of proving unreasonable total compensation to the IRS in the event of an audit. In addition, it protects organization managers (e.g., board members) from penalties that may be assessed if the compensation is found to be unreasonable.

[1]Section § 53.4958-4. These include all forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and deferred and noncash compensation; the payment of liability insurance premiums or the payment or reimbursement by the organization of taxes or certain expenses under section 4958, unless excludable from income as a de minimis fringe benefit, all other compensatory benefits, whether or not included in gross income for income tax purposes; taxable and nontaxable fringe benefits, except fringe benefits described in section 132; and foregone interest on loans.

Establishing the Rebuttable Presumption of Reasonableness

Good governance processes will go far to demonstrate the due diligence of a board or compensation committee in making appropriate and reasonable compensation decisions. If the following steps are not taken, an organization bears the burden of proving reasonableness.

- Use an independent body to review and establish the amount of compensation in advance of actual payment.
- Use permissible comparability data to inform compensation decisions.
- Document the process used to establish the compensation amount contemporaneously.

2 Define appropriate peer comparability criteria:

- The report highlights the importance of establishing appropriate peer groups for compensation comparison purposes. While some of the criteria identified are unique to higher education, similar types of criteria are applicable to other tax-exempt organizations.
- The board or its compensation committee should determine, validate and document its criteria for peer groups that are used for comparability – and make sure these follow the definitions in IRS regulations. Comparability includes the following:
  - Compensation levels paid by similarly situated organizations (taxable and tax exempt).
  - Compensation surveys compiled by independent firms.
  - Actual written offers from similar institutions.
  - Independent appraisal of the value of total compensation.
- A compensation committee that includes dissimilar institutions in its peer group should clearly define the valid business reasons for such inclusions.

3 Review and compare all forms of compensation, including its total value:

- Use “tally sheets” to capture all forms of compensation, benefits and perquisites provided to the executive.
- Rely on compensation surveys that report all forms of compensation, including base salary, incentives, retirement income and other benefits data. If a survey does not have incentive and benefits data, consider using a tested methodology to determine market total compensation.
- As needed, use IRS Form 990 information to determine or supplement the market total compensation data.

4 **Contemporaneously document the governing body's meeting minutes, including survey information, findings, discussions and rationale for its decisions so, if scrutinized, the board's perspective is well reasoned and understood.**

Additional Safeguards

For tax-exempt organizations seeking to go beyond the rebuttable presumption of reasonableness, SullivanCotter recommends the following measures:

- Establish a standing compensation committee, not an ad-hoc committee, and ensure that the committee consists of independent board members.
- Create a charter defining the committee's responsibilities.
- Develop a board-approved compensation philosophy that provides compensation guidelines to the committee. This is a useful tool to establish the rationale for compensation decisions. It also provides "institutional memory" as committee members and executives turn over.
- Maintain an annual calendar to guide committee activities each year.
- Conduct a periodic executive compensation program audit to verify that the program is aligned with the organization's pay philosophy, mission, strategic and operating goals and objectives for attraction and retention.
- Ensure that compensation advisors are independent.
- Conduct regular board education regarding compensation trends and the activities of the compensation committee.

Conclusion

The report serves as a reminder that executive compensation remains a priority for the IRS and is likely to continue to be highly scrutinized. All tax-exempt organizations would be well served to review their executive compensation governance processes to ensure that their programs are above reproach.

CONTACT US
WWW.SULLIVANCOTTER.COM
888.739.7039