

# You're Paying *What?* How to Set Executive Compensation

by Linda M. Lampkin

**A**LMOST 10 YEARS AGO, A COLLEGE professor gave his students the assignment of visiting local charities to pick up a copy of their Forms 990, to get an idea of how accessible these documents really were. Even though the forms have been public since 1942, when the IRS first started requiring them, the students found it a difficult task. In one instance, an organization finally provided the form but omitted the compensation information, stating that it was a “private” nonprofit and did not have to disclose its salaries.

That was clearly wishful thinking on the part of the nonprofit, since the salary information is public and always has been (and of course, there is no “private” public charity!). Congress appeared to recognize that charities in reality would be primarily monitored not by federal and state regulators, but by the people giving them money. Thus, the Form 990 information returns were made public documents, and detailed reporting on executive salaries is required.

At last, the Form 990 really has become an easily accessible document. Each year's Form 990 can be viewed at multiple sites by anyone with access to the Internet (see [www.eri.org/form990](http://www.eri.org/form990), [www.guidestar.org](http://www.guidestar.org), and [www.foundationcenter.org](http://www.foundationcenter.org), for example) and includes compensation for all top-paid employees.

## Why Be Concerned?

Of course, board members are responsible for the organization's mission and strategy, but they also hire the executives who make the organization function. And they must figure out what compensation is needed to attract and retain talented staff, while considering what is in line with the mission and values of the organization and what similar organizations are paying executives.

The availability of Form 990 salary information has led to increased scrutiny from both media and regulators at the federal and state levels. This means that it is just good practice for board members to think about executive compensation and document their practices and policies. While the threat of a newspaper headline or IRS scrutiny might be motivation, the real payoff for this effort is helping ensure appropriate pay for executive staff members who will achieve the goals of the organization.

Even if you think the IRS is unlikely to audit you, there is always the “front page” test: would you be embarrassed by publication of your organization's salaries in a national—or hometown—newspaper? What would your clients or program beneficiaries think of your executive compensation levels? Senator Charles Grassley of the Senate Finance Committee has made high compensa-

tion and payments for personal French chefs and golf club memberships a source of headlines for several nonprofit organizations.

The groups that study charities also review salaries. Each year, the *Chronicle of Philanthropy* reports on executive compensation for the 400 biggest charities. Charity Navigator completed an annual Compensation Study in August 2005, based on an analysis of 20,000 financial documents from nonprofits, and the American Institute of Philanthropy gives a grade for salary level and provides a list of highly paid nonprofit executives on its Web site. GuideStar publishes an annual compensation report, and a subscription with ERI Economic Research Institute gives a user access to all Form 990 compensation data and the ability to search the constantly updated database. Both the IRS and the New York State Charities Bureau have purchased the ERI subscriptions for regulatory purposes.

In addition, recent studies by the National Committee on Responsive Philanthropy and the Urban Institute have focused on compensation paid to foundation executives and trustees.

The June 2005 Report by the Panel on the Nonprofit Sector, convened by Independent Sector in response to the Senate Finance Committee to make recommendations on how to

strengthen transparency, governance, and accountability of charities, made a number of suggestions. The Panel called for more enforcement by the IRS, changes in laws to increase penalties, and more responsibility for involvement of the board in compensation issues.<sup>1</sup>

### IRS Enforcement Efforts

So the IRS says you can't pay excessive compensation, but how much is too much? In August 2004, the IRS launched an enforcement effort to identify and halt abuses by public charities and private foundations that pay excessive compensation and benefits, and hopefully provide more guidance to the sector.<sup>2</sup>

The IRS contacted more than 1,800 public charities and private foundations. About 1,200 of the initial contacts were compliance checks,<sup>3</sup> with the organizations selected because they were missing information on their Forms 990. After additional information was obtained, about 200 of them went through full examinations.

The other 600 initial contacts were already full examinations to determine if compensation was reasonable and in accord with other compensation rules—such as the private foundation rules that apply to loans to disqualified persons, purchase of charity assets at below market prices, or sales by disqualified persons to charities at an inflated price. Disqualified persons are those who are in positions where they may exercise substantial influence over the exempt organization; generally they are high level officers, like the CEO and CFO, but they could also include substantial contributors and people such as heads of departments of a hospital.<sup>4</sup>

With 44 percent of the 1,800 initial contacts resulting in full IRS examinations, it makes sense for a nonprofit to establish appropriate procedures for setting executive compensation and to provide accurate and comprehensive information on Form 990.

### IRS Advice for Boards

The IRS is currently preparing a final report based on its findings. In the interim, an IRS phone forum in May<sup>5</sup> included some advice on appropriate procedures for nonprofits and their boards:

- Set compensation in advance on the basis of appropriate comparability data. Even if a board has a compensation committee, the full board still has the ultimate responsibility over compensation.
- Make sure that no one involved in setting the salary has a conflict of interest.<sup>6</sup> (A board or compensation committee member with a conflict of interest should recuse himself from decision-making or leave the board or compensation committee. Alternatively, the organization can end the business relationship causing the conflict, use a process to generate disinterested bids, or hire a consultant to examine the terms of the relationship to make sure that they are fair and reasonable.)

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- Document all decisions on compensation.
- Avoid penalties by reporting all economic benefits to officers, directors, and key employees on Form 990.
- File Form 990 on time.

The IRS has actually provided a checklist for organizations that can be used to establish procedures that will help them avoid an IRS investigation.

### If the IRS Does Examine Your Organization's Compensation

Expect the following questions if your organization's compensation practices are examined by the IRS:

- How do you establish compensation—what are your policies and procedures?
- What are the duties and responsibilities of the officers, directors, trustees, and key employees listed in Part 5?
- Did the board approve the compensation (and provide copies of the approval and any employment contracts and agreements)?
- Does the compensation reported agree with the W-2s and 1099s issued?
- Did individuals use the organization's property for any purpose other than to further the organization's exempt purpose? If so, was this reported as compensation on the W-2s and 1099s?

Follow the checklist and the burden of proof that the organization is breaking the rules moves to the IRS.<sup>7</sup>

### Deciding What's Comparable

The IRS regulations call for "reasonable" compensation, defined as the amount that would ordinarily be paid for "like services" by "like enterprises," whether taxable or tax-exempt, under "like circumstances."

*"Like Services"*: Jobs appropriate for comparison are similar in duties and responsibilities (level of involvement; regional scope; number of employees; size of budget; number of functions, departments, facilities, or entities managed, etc.).

The number of hours worked per week also needs to be similar. Obviously, the pay for a full-time person should not be compared to pay for a part-time person. Check that a salary is for an entire year (rather than part of a year), and that it is not for a final year

of service that may include additional payments such as severance.

*“Like Enterprises”*: Comparable organizations should be of similar size, based on budget, revenues (gross revenue or net revenue), number of employees, and number of persons served by the organization during a specific period of time, etc. Whether the organization is independent or part of a group may also be relevant. They should also be in similar industries (nonprofit or for-profit or both, but the IRS typically doesn’t want to see only comparisons with for-profit companies).

*“Like Circumstances”*: Similar circumstances means collecting information on and assigning a value to any items in addition to base salary. These may include personal use of employer-owned property, spouse travel expenses, club memberships, and the like. Remember that if all benefits intended as compensation are not documented, they may be treated as automatic excess benefit transactions, even if the total compensation is reasonable. The value of these additional items should be roughly comparable, but the mix may be different.

The IRS also lists geographic area as relevant. If there are no comparables in your geographic area, it’s okay to go outside of that area, but adjustments may be necessary if they are from areas where the cost of living is very different. The IRS also acknowledges that competing offers for the services of the executive can be considered.

Small organizations should have at least three comparables. The implication is that larger organizations should obtain more than three.

## Deciding What to Pay

With comparables in hand, what should the salary level be? The IRS does not have a rule for what is too high and probably will not provide such a rule. It is common sense that if compensation is at or below the average for the relevant market, the IRS is unlikely to investigate. The higher above the

## What Not to Do on Form 990

The nonprofits that were included in this IRS compliance check were chosen because their Form 990 was blank or, if answered, didn’t include a required schedule or explanation for:

- Schedule A, Part 3—List of transactions between related individuals or leases of property to officers, directors, or shareholders
- Part 4, Line 50—Receivables from trustees, officers, directors, and key employees
- Column B of Part V—List of each listed officer, trustee, or key employee, even if not compensated
- Question 89—Checkbox for “Entered into an excess benefit transaction”

average the compensation is, the better the evidence needed by the nonprofit that the compensation is reasonable.

If salaries are less than what is average, then an organization might be concerned about attracting and retaining the highly skilled and motivated staff members needed to achieve the goals.

Questions to consider if compensation levels are above-average include:

- Does the salary represent a high (and hard-to-justify) proportion of the organization’s revenues and/or expenses?
- Does the executive have a particularly outstanding track record of achievement outside and/or within the organization?
- How difficult would it be to replace the executive?
- Were there written offers from unrelated enterprises competing for the executive that needed to be matched?
- Was there a shortage of qualified people in the job market?
- Did special circumstances (such as undoing damage from bad publicity, recovering from mismanagement, or launching a plan to grow in an area new

to the organization requiring different expertise or experience) require an executive with special qualifications?

## What’s a Nonprofit to Do?

Good compensation practices mean having established policies and procedures, doing the homework of finding and assessing comparables, making decisions based upon them, and then recording the actions taken. You are not likely to get in trouble with the IRS if you develop and follow procedures for setting compensation and if you make an honest, responsible effort to determine appropriate compensation based on your size, revenues, organizational structure, and mission. Be sure to:

- Document the policies and procedures in advance and include them in board minutes.
- Collect comparable salaries (for like services, in like enterprises, in like circumstances). Surveys and databases of salary information, as well as the Form 990 images on the Web make the data more easily available than ever before.

Filing Form 990 completely, accurately, and on time is key. Because of the IRS interest in compensation, some new questions were added in tax year 2005:

- Question 75a. Enter the total number of voting officers, directors and trustees.
- Question 75b and c. Enter information about entities related to the exempt organization (EO) and compensation paid by entities related to the EO.
- Part V-B. Record compensation paid to former officers, directors and trustees.
- Schedule A. List the five highest compensated independent contractors for non-professional services.

If an organization doesn’t clearly indicate that an economic benefit is compensation for services, it can trigger an automatic 25 percent tax on the value of the benefit, called an “automatic excess benefit transaction.” For example, if personal use of an automobile is not

reported, there is an automatic 25 percent tax on the amount of the benefit.

If the IRS is conducting a compliance check, the organization can avoid the tax by amending its Form 990. However, the moment an IRS compliance check turns into an examination, it is then too late to file an amended return and the 25 percent tax will be charged.

Because this IRS initiative revealed that some nonprofits spread compensation for officers and other insiders among several affiliated organizations, for-profits, or management companies, this year's Form 990 was also amended to collect information on compensation paid by related organizations.

## Summary

Information on nonprofit executive compensation has been public since Forms 990 were first filed more than 40 years ago, but for many years it has been expensive and difficult to actually use. Now with better disclosure regulations, the Internet, and improved technology, along with the increased size of the sector and scrutiny of its compensation practices, the data is finally becoming easily available—both to those reviewing the pay levels and also those responsible for setting them.

Research and adherence to some good management practices can help ensure that charitable dollars are spent on achieving the mission, with fewer efforts defending the organization from questions by the IRS, state charity regulators, the media, Congressional committees, the charity watchdogs, and even individual donors. Board members have the ultimate responsibility and need to do this right!

## Endnotes

1. See Panel on the Nonprofit Sector, *A Final Report to Congress and the Nonprofit Sector on Governance, Transparency, and Accountability*, June 2005. Pages 66–67.
2. Although the IRS has not identified specific levels of compensation that would

trigger investigations, it seems likely that criteria for such investigations would be based on those noted in the study. For example, a human services organization with a budget of \$250,000 paying an executive a \$100,000 salary that effectively limited the services of the organization and was considerably above other executives of the same size organization would be suspect. Or another example, such as a nursing home, where there were both private and nonprofit providers in which the salary paid to the director was comparable to other directors in the for-profit providers, but not with the nonprofit providers, might also trigger an investigation.

3. A compliance check is a review to determine whether an organization is adhering to recordkeeping and information reporting requirements, a tool to help educate organizations about the reporting requirements and to increase voluntary compliance.

4. See Treasury Reg. 53.4958–3 and IRM 7.27.30.3.

5. See script and slides at [www.irs.gov/charities/article/0,,id=158408,00.html](http://www.irs.gov/charities/article/0,,id=158408,00.html).

6. Not covered by the compensation arrangement; not subject to the direction and control by the person covered by the compensation arrangement being reviewed; not receiving payments subject to approval by the person covered by the compensation arrangement; not having a material financial interest affected by the compensation arrangement; not able to approve a compensation arrangement for the person who in turn has approved or will approve an economic benefit for that member.

7. See [www.irs.gov/charities/article/0,,id=158408,00.html](http://www.irs.gov/charities/article/0,,id=158408,00.html)

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