

When the Revenue Agent Comes Calling: Nonprofit Executive Compensation

06.16.16 | Linda J. Rosenthal, JD



In *When the Revenue Agent Comes Calling*, we explained that the Enron and Worldcom scandals in the early 2000's had a profound effect on charity regulators at all levels of government. They have doubled-down on the scrutiny of 501(c)(3) organizations (and public charities, specifically) on issues of governance, organizational control, and conflict of interest as well as on compensation and financial oversight.

IRS revenue agents use [Form 14114](#), "Governance Check Sheet," in audits of public charities. It's a 2-page form with distinct sections on (a) governing body and management; (b) compensation; (c) organizational control; (d) conflict of interest; (e) financial oversight; and (f) document retention. Most of the questions are also on the Form 990. "It is a 'very specific roadmap' for exempt organizations to compare their practices and policies with what the IRS wants to see and to make adjustments where necessary."

Compensation Evaluation

We've [already](#) described the questions on "governing body and management." Next up is the section on "compensation."

The Internal Revenue Service takes a keen interest both in the amount of executive compensation as well as the process by which a public charity's board of directors determines the compensation level.

From the perspective of the IRS, the payment of "reasonable" compensation is a matter of responsible governance in the public interest. It is also important for purposes of [avoiding violation of the inurement/private benefit restrictions](#) of Section 501(c)(3) of the Internal Revenue Code.

"Excessive compensation paid to nonprofit executives is the [most common violation](#)" of these

restrictions.

What are the rules? In a nutshell, “[t]he IRS –

permits tax-exempt organizations to pay executives ‘fair and reasonable’ compensation. There is no universal standard defining fair and reasonable, however; what’s fair and reasonable at one nonprofit may be a gross under- or overpayment at another.

There is “no standard formula, ... nor are there any tables or schedules....” so this determination is complicated.

The Internal Revenue Service offers a recommended 3-step process:

- Designate an independent body.
- Conduct a “comparability review.”
- Document who was involved and the process that was used to conduct the review, “as well as the disposition of the full board’s decision to approve the compensation.”

In any event, on the Form 990, Schedule O, nonprofits must describe the process they use to determine and approve executive compensation.

For California nonprofits, California Government Code section 12586(g) prescribes similar, though not identical, requirements for executive compensation decisions. Any such determination must be reviewed and approved “to ensure that the payment is ‘just and reasonable.’” It must occur when the executive is first hired, when the term is renewed or extended, and if and when the compensation amount or terms are modified.

Form 14114: Compensation Questions

Part 3 of the IRS Governance Audit Checksheet is “Compensation,” questions 13-15 with subparts. There are answer options in pull-down menus. The revenue agent is directed to ask:

- Whether there are “compensation arrangements for all officers, directors, trustees, and key employees approved in advance by an authorized body of the organization composed of individuals with no conflict of interest with respect to the compensation arrangement”
- If the authorized body “relies on comparability data in making compensation determinations”
- If comparability data is considered, whether it was based on one or more of: (a) Exempt organizations; (b) Non-profit entities not exempt from tax; (c) Governmental entities; (d) For-profit entities; or (e) Other [with explanation]
- If the basis for all compensation determinations is contemporaneously documented

Conclusion

For more information on this important but complex issue, these are excellent resources:

Guidestar: [What You Need to Know About Nonprofit Executive Compensation](#)

National Council of Nonprofits: [Executive Compensation](#)

Nonprofit Law Blog: [Executive Compensation – The Legal Issues](#)

Nonprofit Law Blog: [Nonprofit Compensation: Tips on Using Comparability Data](#)

IRS: [Form 990](#), and [instructions to Form 990](#)

IRS: [FAQs about setting executive compensation](#)

– *Linda J. Rosenthal, J.D., FPLG Information & Research Director*