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## THE EXECUTIVE COMPENSATION CRISIS IN TAX-EXEMPT ORGANIZATIONS

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Did you know that nonprofits, including tax-exempt hospitals, charities and social-welfare organizations, number in the millions in the US? And that many of these are in California? Did you also know that many of them are on the cusp of an executive compensation crisis? Why? Because most CEOs and board members don't know the tidal wave coming their way and its impact on executive compensation governance and board liability.

Intermediate sanctions<sup>1</sup> (see IRC 4958 and 26 C.F.R. 53.4958) allow the IRS to impose excise tax penalties on both the executive and board members involved with excessive compensation for applicable 501(c)(3) and 501(c)(4) organizations. Board members face potentially personal liability, jointly and severally, up to \$10,000 for each excess-benefit transaction. Organization managers [for applicable 501(c)(3) and 501(c)(4)s] also face up to \$10,000 in fines for any one excess benefit transaction if they are found to have knowingly, willfully, and without reasonable cause participated in the excess-benefit transaction.<sup>2</sup>

Because of this, many boards, CEOs, and organization managers are seeking guidance on how tax-exempt and nonprofit organizations can manage executive compensation during times when performance counts and intermediate sanctions are a reality. Organizations that consistently pay for performance outperform those that don't, so the business case for creating a reasonable, yet high-performance executive reward solution is solid.<sup>3</sup>

### THE BUSINESS CASE FOR EXECUTIVE COMPENSATION CHANGE

The IRS is cracking down on perceived and real uses of compensation that are not reasonable. In 2004, the Exempt Organizations Division of the IRS created new offices to focus on compensation abuses in tax-exempt organizations. One—the Exempt Organizations Electronic Initiatives Office is responsible for acquiring data sources that will aid the IRS in more easily comparing executive compensation paid by tax-exempt organizations. The IRS has placed a priority on reviewing cases where it believes compensation is out of line. The IRS is currently staffing to achieve this objective.

The state of California is also involved. California's Nonprofit Integrity Act of 2004 requires the governing board or authorized board committee to review and approve the compensation of the CEO/President, and the compensation of the CFO/Treasurer, to ensure that the payment is "just and reasonable."

In addition to regulation, the business case for executive compensation change is driven by the following powerful reasons:

**Governance:** Boards have a fiduciary responsibility for managing executive compensation knowledgeably and effectively (due care). Board members are responsible and liable and there is no reason compensation in tax-exempt organizations should be inconsistent with competitive practice and best practice of high-performance organizations.

**Performance culture:** Simply put, organizations that pay for performance outperform those that don't. Organizations that only pay based on tenure and entitlement get what they pay for in the form of less effective executives. How executives are paid is the role model for the rest of the organization.

Organizations now have a powerful business case for change.

## CONSEQUENCES OF INTERMEDIATE SANCTIONS

Some of the realities that are making it hard to get and keep quality board members include the following:

Board members simply do not understand the breadth and seriousness of intermediate sanctions. For example, technically, an automatic excess-benefit transaction occurs each time money or property passes to a "disqualified person" and there is an absence of written contemporaneous substantiation regarding the transaction.<sup>4</sup>

Board members, or the appointed board committee charged with determining compensation, must "obtain and rely"<sup>5</sup> upon appropriate comparability data for purposes of establishing the rebuttable presumption of reasonableness relating to compensation arrangements in order to benefit from this burden shift in the Code. These same board members must not only obtain appropriate compensation comparability data, but also must possess the knowledge and expertise in interpreting the data in order to avail themselves of the safety provided by the Code.

## PROTECTING BOARDS AND ORGANIZATIONS

Effective governance of the executive compensation program is clearly the answer to resolving the pay-for-performance problem. At minimum, this process should include the following steps:

- Select the metrics of organizational performance that best reflect the executive team's responsibilities for the organization's success and future.
- Thoroughly and consistently evaluate executive performance based on these metrics of organizational performance.
- Develop executive rewards that compensate executives based on transparent, clearly established and predetermined changes in these metrics. Executives should earn more when the organization meets goals and less when it doesn't.<sup>6</sup> Moreover, the board must stick to these predetermined guidelines in order to avoid further problems relating to intermediate sanctions.
- Include regular, careful reviews of compensation arrangements in order to avoid excess-benefit transactions. While a board committee may be able to establish the rebuttable presumption of reasonableness per the treasury regulations, each board member must be brought up-to-speed as to why an executive is being paid what he/she is being paid.
- Ensure compensation reasonableness by using data sources that the IRS will accept as appropriate and include unbiased measures of competitive compensation.

Defining compensation opportunity is objective and is the platform for paying for executive performance. Each board should at the very least measure compensation reasonableness as follows:

- Define the competitive market and the market value of the job using a source of information that does not create a conflict of interest and is completely independent of bias or conflict toward organization management and auditors of the organization.
- Consistently apply the compensation data from the independent source to determine the competitive worth of the executive jobs. Make compensation decisions based on unbiased data that can be defended to the state or federal regulator if the compensation arrangement is questioned.
- Utilize an independent "appropriate professional"<sup>7</sup> to recommend compensation levels and systematically follow these recommendations.
- Have this professional compare each facet of executive compensation to the competitive market—cash compensation, deferred compensation, benefits, perquisites, allowances, etc.—to be paid now or in the future. The independent compensation professional should consider:
  - Compensation levels paid by similarly situated organizations—either tax-exempt, nonprofit, or for-profit—for functionally comparable positions;
  - The availability of similar services in the organization's geographic area; and
  - Current compensation surveys compiled by independent firms.

## WHAT SHOULD YOUR ORGANIZATION DO?

Board members of tax-exempt organizations must establish executive compensation programs that are reasonable, competitive, and reward executive performance. The IRS is determined to ensure that applicable nonprofits are following sound procedures for determining executive compensation.

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<sup>1</sup> "Intermediate sanctions" refers to the excise tax penalties associated with excess-benefit transactions. These penalties potentially apply only to those 501(c)(3) and 501(c)(4) organizations described in 26 C.F.R. 53.4958-2(a) et seq.

<sup>2</sup> 26 C.F.R. 53.4958-1(d)

<sup>3</sup> *Pay People Right! Breakthrough Reward Strategies to Create Great Companies*. Zingheim, Patricia K. and Schuster, Jay R. San Francisco: Jossey-Bass Publishers, 2000.

<sup>4</sup> IRS EO CPE Text for FY 2004.

<sup>5</sup> 26 C.F.R. 53.4958-6(c)(2)

<sup>6</sup> HealthPartners represents an important example of the pitfalls associated with rewarding executives who fall short of predetermined goals.

<sup>7</sup> 26 C.F.R. 53.4958-1(d)(4)(iii).

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