

Compensation and Corporate Governance in Tax-Exempt Organizations

In 1996, long before corporate governance was the buzzword in the for profit world, Section 4958 was added to the Internal Revenue Code by The Taxpayer Bill of Rights II. Section 4958 contains several "intermediate sanctions" that pose concerns for tax-exempt organizations. Failure to heed them can result in direct financial penalties, not only for direct participants but also for those who approve the arrangements in question.

These intermediate sanctions provided the Internal Revenue Services (IRS) with tools to regulate tax-exempts in the areas of compensation and related transactions. Sound corporate governance in these areas is a defense against sanctions.

The intermediate sanctions apply to three general types of transactions between tax-exempt organizations and "disqualified persons," (i.e., individuals who exercise substantial influence over their organizations):

- **Unreasonable compensation** -- compensating individuals in amounts that exceed the value of services received.
- **Revenue-based compensation** -- paying individuals based in whole or in part on revenues of the tax exempt entity in a manner which results in private inurement.
- **Bargain sales** -- paying more for assets than they are worth, or selling them for less than they are worth.

Section 4958 describes disqualified persons as anyone who is in a position to exercise significant influence over an organization, regardless of title. Disqualified persons are likely to include:

- Directors and trustees
- Top management employees, even if they are not directors or corporate officers
- Certain researchers, coaches or other highly compensated key employees
- Physicians serving on hospitals' medical staffs

Intermediate sanctions impose penalties on three levels:

- **First tier** - Financial penalties amount to 25% of excess or improper payments are first imposed on disqualified persons. Individual directors or executives who approve transactions knowing them to be improper also may be directly penalized in amounts equaling 10% of excess or improper payments, not to exceed \$10,000.
- **Second tier** - Disqualified persons are subject to additional financial penalties equal to 200% of excess or improper payments, if transactions are not undone after IRS notice.
- **Third tier** - If a specific transaction and other factors demonstrate that an organization is no longer operated exclusively for a charitable purpose, the IRS maintains the right to revoke its tax exempt status.

To protect against the possibility of intermediate sanctions, tax-exempt employers can establish a "rebuttable presumption" that compensation transactions are reasonable, and therefore not subject to penalties. Three criteria must be met to establish a rebuttable presumption of reasonableness.

1. **Independent board approval.** The board of a tax-exempt institution under scrutiny must be independent and must approve the transaction.
2. **Comparability analysis.** Board approval of compensation must be based upon appropriate comparability data, which includes:
 - a. Compensation paid by comparable institutions (taxable as well as non-taxable) for functionally comparable positions.
 - b. Compensation patterns or norms in the institution's immediate locale.
 - c. Independent compensation surveys by nationally recognized independent firms.
 - d. Written offers of employment from other firms.
3. **Adequate documentation.** Boards must adequately document the bases for their determinations.

PM&P's well-established processes for developing executive and employee compensation programs are designed to meet the criteria for the rebuttable presumption of reasonableness provision under Section 4958. We advocate taking the following action steps to satisfy Section 4958 requirements:

- Be sure the Board has approved a thoughtful and reasonable compensation philosophy which provides a clear statement of intent covering all significant aspects of the executive compensation program. We often assist Boards in establishing a well articulated and understood compensation philosophy to guide all aspects of executive compensation.
- Be sure that the Board has relied on objective, externally provided data to establish a logical peer group against which compensation and benefits will be compared. We assist Boards with selection of an appropriate peer group.
- Be sure that the institution's total compensation package (cash and benefits) occupy a reasonable competitive position with respect to its peer groups. We benchmark and will value or work with actuaries to value compensation and benefits.
- Be sure that an appropriate balance of base compensation, incentive compensation and benefits exists to ensure that the compensation package as a whole and each of its elements separately, are reasonable.

Our approach is designed to assist the institution with the appropriate process and compensation comparability data to satisfy Section 4958 requirements. However, note that Section 4958 applies to all transactions between the institution and certain individuals considered "disqualified individuals" and not just compensation. We limit the scope of our practice to compensation related transactions.

About Pearl Meyer & Partners

For 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.



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