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Covered Employee Compensation: An IRS Compliance Priority for 2022

Among its priorities for 2022, the Internal Revenue Service (“IRS”) [announced](#) a plan to review the impact of excise taxes on nonprofit organizations that pay over \$1 million in compensation to covered employees.

Federal Rules on Nonprofit Employee Compensation

Historically and today, the IRS requires that compensation to nonprofit employees “not exceed what is reasonable under the circumstances.” (Treas. Reg. 1.162-7(b)(3).) Under “excess benefit” rules, the IRS may impose a 10 to 25% excise tax on nonprofit executives and managers who benefit from and knowingly participate in assigning compensation that exceeds the value of services performed. (See Internal Revenue Code section 4958; Treasury Regulation 53.4958-4.) To avoid such tax, the compensated individual must prove that their compensation is reasonable; but can rely on a rebuttable presumption of reasonableness if:

1. Their compensation package was approved in advance by an authorized body of the nonprofit composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement;
2. The authorized body obtained and relied upon appropriate comparability data prior to making its determination; and
3. The authorized body adequately documented the basis for his determination concurrently with making the determination. This means, it had written or electronic records noting: (a) the terms of the transaction that it approved, and the date of its approval; (b) the members of the authorized body who were present during debate on the transaction it approved and who voted on it; (c) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (d) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction. (See Treas. Reg. 53.4958-6(a).)

In late 2017, the IRS implemented Internal Revenue Code section 4960, imposing an excise tax on bright-line criteria. Even if the compensation at issue is “reasonable” under the circumstances,

under section 4960, the IRS imposes a 21% excess tax on “covered” nonprofit employee compensation that exceeds \$1 million. For the purposes of this rule, a covered employee is one who is among the five highest compensated employees of the organization for the taxable year at issue, or was a covered employee of the organization for any preceding taxable year, on and after January 1, 2017. The nonprofit organization is responsible for paying the excise tax imposed by section 4960, and must report the tax on IRS Form 4720.

According to IRS data, there is a high volume of exempt organizations that pay compensation in excess of \$1 million, but fail to report the corresponding excise tax on the Form 4720. Because the IRS has indicated that compensation excise tax is a priority issue for 2022, now is a good time for nonprofits to evaluate whether they are in compliance with federal and state law applicable to employee compensation.

State Requirements Applicable to nonprofit Employee Compensation

Those organizations evaluating compensation for IRS purposes, should also ensure that their practices comply with California law. California Government Code section 12586, part of the Nonprofit Integrity Act of 2004, requires that nonprofit organizations subject to the Act “review and approve” the compensation and benefits of its president or chief executive officer, and its treasurer or chief financial officer to ensure that such compensation and benefits are “just and reasonable.” Nonprofit boards, or authorized board committees, must review and approve compensation and benefits initially upon hiring its president or chief executive officer, and its treasurer or chief financial officer. They must additionally review and approve the compensation and benefits assigned to these individuals whenever the term of employment is renewed or extended, and whenever the officer’s compensation (including benefits) is modified.

Nonprofit boards, or authorized subcommittees, need not review and approve adjustments to officer compensation and benefits if the modification at issue applies to substantially all of the organization’s employees – e.g. an across the board cost of living increase, or change in benefits plans. (See Gov. Code, § 12586, subd. (g).)

LCW attorneys are available to assist nonprofit organizations in implementing strategies to support compliance with state and federal executive compensation requirements.

Is your nonprofit interested in soliciting or receiving restricted gifts?

If so, see NonprofitPRO’s recent article, penned by LCW attorneys Heather DeBlanc, Casey Williams, and Victoria Gómez Philips on “[*Restricted Giving: The Legal Requirements Nonprofits Should Consider Before Accepting Restricted Donations.*](#)”

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