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**ATTORNEY-CLIENT
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TO: **Members of the Board of Directors**
Uncharted Shores Academy

FROM: **Chastin H. Pierman, Esq.**
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DATE: **April 1, 2020**

SUBJECT: **Executive Compensation Due Diligence Requirements**

INTRODUCTION

Prior to any Board action to approve any decisions regarding executive compensation (including approval of base salary increases, incentive compensation, bonuses, etc.), the Board must first exercise due diligence (review of comparable compensation practices) to ensure compliance with IRS restrictions on excess compensation for nonprofit executives, including a charter school Chief Executive Officer ("CEO"), Chief Financial Officer ("CFO"), and other positions with substantial influence over the affairs of the organization. The Board's review and approval of the executive compensation must occur: initially upon hiring the executive; whenever the term of employment, if any, is renewed or extended; and whenever the officer's compensation is modified. However, separate review and approval is not required if the modification of compensation extends to substantially all employees.

Most importantly, by following the requirements set out below, the Board will be best protected from potential IRS penalties and sanctions related to excessive executive compensation. At a minimum, following the steps below establishes a rebuttable presumption of reasonableness and provides nonprofit Board members with increased protection from excise tax on participation in these salary decisions. Further, it is not uncommon for this issue to draw attention from the charter granting agency and related oversight agencies, as well as members of the public.

SUMMARY OF IRS COMPENSATION REQUIREMENTS

In reviewing the reasonableness of compensation for nonprofit executives, the IRS considers "compensation" broadly and will look at the value of salary, as well as non-fixed compensation (incentive compensation/bonuses), and benefits. If the IRS determines compensation is not reasonable, severe consequences (discussed below) may result. Thus, the best way to avoid risk of penalties is to go through the process of establishing reasonable compensation in advance of any salary increase, and for the Board to properly document it has engaged in such a process.

This approach will also meet the legal requirements specific to California nonprofits under the California Nonprofit Integrity Act.[1]

Although the IRS has the ability to revoke a nonprofit entity's tax exempt 501(c)(3) status for awarding excessive compensation, it will typically impose "intermediate sanctions" on disqualified persons who participate in or approve these excess benefit transactions. These IRS penalties attach against the individual decision-maker (i.e. the Board member or officer participating in the decision) and are considered by the IRS to be a lesser penalty than revocation of tax exempt status.

The IRS will impose penalties on persons who participate in or approve excess benefit transactions, as well as against the executive in question, as follows:

The executive who was determined to have received excessive compensation must return to the nonprofit the value of the excessive benefit <u>and</u> the IRS may also impose an excise tax of either:

- 25% of value of the excessive benefit paid out, if it is repaid prior to IRS issuance of a notice of deficiency; or
- 200% of the value of excessive benefit paid out, if it is repaid after the IRS issues a notice of deficiency.

The IRS will also impose a 10% penalty on organization managers (i.e. Board members) who approved the excessive benefit transaction. Liability on this is joint and several, and will be capped at $20,000 per transaction.

<u>STEPS TO AVOID EXCESSIVE COMPENSATION CLAIMS</u>

To avoid excessive compensation claims, the Board should do the following:

1. Follow all applicable conflict of interest laws and policies (under the California Corporations Code, Political Reform Act, etc.). For IRS purposes, the definition of "interested persons" is broader than the definition in the California Corporations Code. "Interested" for the purpose of approving executive compensation means anyone compensated by the nonprofit, a family member of anyone compensated by the nonprofit, and <u>employees working for/under any person whose salary is at issue (i.e. the executive in question)</u>.

2. Develop a summary or chart of compensation comparisons to establish a "rebuttable presumption of reasonableness" regarding the amount of compensation paid to the executive at issue. In developing a comparable compensation summary or chart, the Board must obtain and rely on valid comparability data in approving the transaction. Without comparability data, the Board cannot establish a rebuttable presumption of reasonableness and is not protected

[1] The Nonprofit Integrity Act of 2004 sets forth a requirement in Government Code Section 12586(g) that compensation paid to the CEO (or equivalent) and CFO (or equivalent) must be just and reasonable.

from IRS sanctions. The Board may require the assistance of its financial services or back office services provider to compile the comparability data.

Comparability Data – What constitutes "comparable"?

- Amounts paid by similarly situated organizations (in terms of size, budget, location, activities). A good place to start on this is by looking at other similarly sized and located organizations' Form 990s, which are available public documents, as well as the public salary data for similarly situated public school district employees.
- Availability of similar services in the geographic area.
- Compensation surveys prepared by independent firms.
- Actual written offers for the employee made by competing organizations.
- The Board must examine and rely on data from <u>at least three (3) comparable organizations to establish a rebuttable presumption of reasonableness</u>.

3. The <u>disinterested members</u> of the Board must approve each transaction <u>in advance</u> of any increase in compensation. If not approved in advance, review is better late than never. However, it will not meet the requirements for establishing the rebuttable presumption of reasonableness.

4. Contemporaneously document the Board's decision regarding salary and the reason for its decision (i.e. by approving a Board resolution).

   Adequate documentation must note:

   - The terms of the transaction that was approved.
   - The date of approval.
   - The Board members who were present during debate on the transaction that was approved.
   - The Board members that voted on the transaction that was approved.
   - The comparability data obtained and relied upon by the authorized body.
   - How the data was obtained.
   - Any actions taken by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

Should the Board need any clarification or assistance in developing the most effective process to maximize the Board's goals while also meeting these critical requirements, and protecting the Board from IRS penalties and sanctions, please do not hesitate to contact our office.