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DO YOUR EXECUTIVE COMPENSATION ARRANGEMENTS EXPOSE YOUR TAX-EXEMPT ORGANIZATION TO POSSIBLE IRS SANCTIONS?

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Do Your Executive Compensation Arrangements Expose Your Tax-Exempt Organization to Possible IRS Sanctions?

You have finally reached agreement on your new Executive Director's contract. After much internal deliberation, the Compensation Committee ultimately approves a compensation package that significantly exceeds the predecessor's and includes a signing bonus, a substantial base salary, performance-based annual increases, and other perks. You justify the package because you believe that this new leader will bring innovative ideas and drive membership growth of 20% within the first few years. However, if your organization is tax-exempt and subject to IRS intermediate sanction rules, this generous compensation arrangement may carry unintended consequences. It could expose you, the organization, and the new Executive Director to significant tax penalties. This Insight will cover everything you need to know to avoid triggering "excess benefit transactions" and how to correct them if you do.

Overview of the Intermediate Sanction Rules

Section 4958 of the Internal Revenue Code (IRC) imposes an excise tax on "excess benefit transactions." An excess benefit transaction occurs when an applicable tax-exempt organization provides a disqualified person with compensation that exceeds what the IRS views as "reasonable" compensation. Here are a few key terms to know:

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- An **applicable tax-exempt organization (ATEO)** means any organization that is, or was during the five-year lookback period, tax-exempt under section 501(c)(3) or 501(c)(4) of the IRC, subject to exceptions for private foundations, governmental entities, and certain other organizations.
- A **disqualified person** means any individual who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during the five-year lookback period. The term can also extend to such individual's family members, certain entities controlled by them, and more.
- An **organization manager** generally means any officer, director, or trustee of the ATEO, or any individual with similar powers and responsibilities, regardless of title.

More Background. Originally, the IRS's sole enforcement tool to punish tax-exempt organizations for non-compliant transactions was revocation of the organization's tax-exempt status. As an alternative enforcement mechanism, Congress enacted the intermediate sanction scheme under IRC Section 4958. This framework allows the IRS to penalize insiders and complicit managers rather than punishing the entire organization and its beneficiaries by automatically revoking the organization's tax exemption.

What's Considered "Reasonable" Compensation?

To avoid triggering potential sanctions, ATEOs must ensure that compensation arrangements with any disqualified person meet IRS requirements for "reasonable compensation." Under the IRS rules, compensation must be "reasonable" under all the circumstances and an amount that would "ordinarily be paid for like services by like enterprises under the circumstances."

Compensation is calculated on an aggregate basis and must take into account all items of compensation provided by the ATEO in exchange for the performance of services, including, for example, retirement plans, bonuses, deferred compensation, and non-cash arrangements. To determine whether a compensation package is reasonable, the ATEO should conduct comparative research. This data can demonstrate:

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- compensation levels paid by similarly situated organizations (both taxable and tax-exempt), for functionally comparable positions;
- the availability of similar services in the geographic area;
- current compensation surveys compiled by independent firms; and
- actual written offers for similar institutions competing for the services of the person whose compensation is being considered.

Other factors the board can consider in establishing reasonable executive compensation include:

- The duties performed by the executive
- The amount and type of responsibilities assumed by the executive
- The amount of time devoted by the executive to their job duties
- Special knowledge or expertise of the executive
- The individual ability of the executive director
- Any previous training the executive director received
- Compensation paid in prior years
- Prevailing economic conditions
- Living conditions of the particular locality
- The type of activities carried out by your organization and your organization's size

Who Needs to be Concerned?

If the IRS determines that an excess benefit transaction has occurred, an excise tax will be imposed on:

- the **disqualified person** who received the excess benefit; **and**
- any **organization manager** of the ATEO who knowingly participated in the excess benefit transaction, **unless** such participation was not willful and was due to the manager

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acting on behalf of the ATEO with ordinary business care and prudence.

Essentially, everyone who has a significant hand in setting or receiving executive compensation for covered ATEOs should understand the intermediate sanction rules and take proactive steps to avoid triggering them. This could include, for example, individuals serving on the governing body who are entitled to vote (such as the Compensation Committee members who set the Executive Director's compensation); the Executive Director; or the Director of Finance, Treasurer, and/or Chief Financial Officer.

How much is the excise tax?

Intermediate sanctions can be substantial.

- **For a disqualified person,** the amount of the excise tax is 25% of the excess benefit (the amount of compensation exceeding "reasonable" compensation) **if** the disqualified person immediately returns the excess compensation, plus interest, to the ATEO. However, if this correction is not timely made, the disqualified person will be required to pay an additional tax equal to 200% of the excess benefit.
- **For organization managers**, the amount of the penalty tax is equal to 10% of the excess benefit, up to a maximum of $20,000 with respect to any single excess benefit transaction.

Certain executives or managers who approve an excess benefit transaction *and* improperly benefit from it can be liable as **both** a disqualified person and as an organization manager.

Note on Other Excise Taxes. While this Insight focuses on the intermediate sanction rules under Section 4958, tax-exempt organizations must also consider IRC § 4960. **Section 4960 applies much more broadly – covering nearly all tax-exempt organizations, as well as some governmental and political organizations – but focuses on very high, corporate-level executive compensation packages.**

Specifically, Section 4960 imposes a 21% excise tax on compensation exceeding $1 million and on any "excess parachute payment" (certain payments upon a

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separation of service that exceed a specified "base amount").

- **For tax years 2018-2025**, this tax was triggered only when such excess compensation or parachute payment was paid to **one of the organization's five highest paid employees**.
- However, the "Big Beautiful Bill," which President Trump signed into law last year, greatly expanded these rules. **Starting with the 2026 tax year**, Section 4960 excise taxes apply to excess compensation or parachute payments paid to **any current or former employee** of the organization.

Unlike the intermediate sanctions rules, the Section 4960 excise tax is **imposed on the organization** itself, potentially increasing the true cost of a high-compensation arrangement.

Can a Tax-Exempt Organization Take Steps to Avoid the Penalties?

Yes. If your organization performs an internal audit and discovers the problem quickly enough, it can correct the error and thereby avoid triggering excise taxes under Section 4958.

- To correct an excess benefit transaction, the excess benefit portion of the transaction must be undone to the greatest extent possible. In practical terms, this means that the overpaid executive will have to pay back the portion of compensation that is excessive.
- You can imagine the problems that would result in having to ask someone to repay a portion of their negotiated (and contracted-for) compensation. For this and other reasons, an organization's best course is to ensure that the institution's compensation packages are proper in the first place with appropriate documentation.
- Best practices when approving executive compensation include making sure none of the voting board members have a conflict of interest; obtaining and relying on appropriate comparability data or obtaining an opinion from a third-party compensation expert; and documenting the basis for the board's determination at the time a decision is made.

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If the organization did not do its homework, however, and now suspects there's a problem, you will want counsel involved to help find the best way to address the situation.

What is a Preventive Audit?

To avoid the possibility of intermediate sanctions, you should consider having an attorney-client privileged audit of your organization's compensation plans. In most tax-exempt organizations, an audit would likely include only the organization's top executives. The cost of the audit would be reasonable compared to the substantial penalties that could be imposed for even an unintended violation of the law.

Of course, a preventive audit is only helpful if your organization can respond to its findings. Many executive compensation agreements fix compensation for a defined term or require severance before any reduction can be made. Where such agreements are in place, an organization that discovers potentially excessive compensation faces a difficult reality: it may be contractually bound to continue paying amounts that could trigger intermediate sanctions liability. This tension underscores the importance of proactively building compliance safeguards into the front end of the compensation-setting process, **before agreements are signed**, rather than relying solely on retrospective audits to identify and correct problems.

Conclusion

If you have questions about the intermediate sanctions area or concerns about your organization's compensation plans, or if are considering an attorney-client privileged audit of your organization's compensation plans, please contact the authors of this Insight, your Fisher Phillips Attorney, or any member of our Non-Profit and Tax-Exempt Organizations team. We will continue to monitor all developments related to non-profits and tax-exempt organizations, so make sure you are subscribed to Fisher Phillips' Insight System to receive the most up-to-date information.

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