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## **Compensation: IRS Taking Aim at Executive Pay with Schedule J** **Troy Marine, CPA, Baker Tilly Virchow Krause, LLP**

Executive pay has been a hot button for the IRS for many years. After completing the 2004 Executive Compensation Initiative along with two rather large compliance initiatives regarding hospitals and Colleges & Universities, it appears the IRS wants to better understand how many tax-exempt organizations follow the rebuttable presumption procedures along with the use of the initial contract exception in terms of the compensation process.

### **Rebuttable Presumption Procedures**

The 2009 Form 990 includes a new question on Schedule J specifically requesting whether the organization followed the rebuttable presumption procedures with respect to any amounts paid or accrued pursuant to a contract that was subject to the initial contract exception under section 4958. For this purpose, the initial contract exception is defined as a binding written contract between a tax-exempt organization and a person who is not a disqualified person or was not in a position to exercise substantial influence immediately before entering into certain fixed payment contracts.

To the extent an organization complies with the rebuttable presumption procedures for compensation-related payments to a disqualified person, such payments are presumed to be reasonable. This places the burden of proof on the IRS that the compensation exceeds reasonable, fair market levels. Generally, in order for the IRS to refute the rebuttable presumption procedures, it must develop sufficient contrary evidence to rebut the value of the comparability data relied upon by the organization.

The significance of following the rebuttable presumption procedures in establishing executive compensation cannot be overstated. We need only to look to the Final Report from the 2006 Hospital Compliance Initiative. In this report, the IRS concluded that there was not a sufficient basis to overcome the rebuttable presumption for any of the hospitals which took the time to follow the rebuttable presumption procedures. However, the IRS was determining whether the excise tax under section 4958 should be levied against those hospitals that did not take the steps necessary to establish the rebuttable presumption of reasonableness and were not able to otherwise prove that the compensation paid to disqualified persons was reasonable.

Generally, the rebuttable presumption of reasonableness is met if the following conditions are met:

1. The compensation arrangement or terms of the transfer are approved in advance by the organization's governing body or a committee of the governing body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement,
2. The governing body or committee obtained and relied upon appropriate data as to the comparability prior to making its determination, and
3. The governing body or committee adequately documented the basis for its determination concurrently with making that determination.

**Is your organization aware of the rebuttable presumption of reasonableness and how it affects executive pay?**

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## **FIN 48 Position**

Although the IRS initiatives have provided solid precedent supporting an organization's determination of compensation pursuant to the rebuttable presumption procedures, the IRS may still rebut the presumption if there is sufficient evidence to the contrary. For organizations which fail to meet these standards and are unable to demonstrate the reasonableness of the compensation, the IRS may impose monetary penalties, and, in cases where executive compensation is so egregious, may even revoke the organization's exempt status. Under FIN 48, an organization's tax-exempt status itself is considered a tax position. Therefore, if an organization does not meet the rebuttable presumption of reasonableness in determining executive compensation, it should include this tax position in its FIN 48 analysis.

Moreover, given the current economic environment and a general public perception that executive compensation packages are already excessive, tax-exempt organizations should review their executive compensation policies to ensure they are in compliance with the rebuttable presumption procedures.

We welcome the opportunity to meet with you to discuss how we can help with rebuttable presumption procedures. For more information or any questions you might have on this topic, please contact Troy Marine at 414 777 5376 or Larry Mohr at 612 876 4630.