



The IRS Evaluates Pay, Too!

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When human resources professionals think about how to structure their organization's pay practices, they generally strive to be competitive, equitable, cost-effective, and legal. Alas, they may think less frequently about the potential tax consequences of paying any individuals more than the IRS deems legitimately deductible as a business expense!

The IRS rules about "excess" compensation are different for non-profits than they are for for-profits. Both kinds of employers need to be aware of the regulations, but those in nonprofits must meet more stringent standards and may face more serious consequences if they get it wrong.

For-Profit Employers

Section 162(a) is a provision of the Internal Revenue Code, a United States taxation law. It concerns deductions for business expenses. If an expense is not deductible, then Congress considers the cost to be a consumption expense. Section 162(a) requires six different elements in order to claim a deduction: 1) it must be an ordinary, 2) and necessary, 3) expense, 4) that was paid or incurred during the taxable year, 5) in carrying on, 6) a trade or business activity.

These elements have been interpreted by the courts and administrative agencies to determine if a certain expense is deductible as a business expense. Its application to employee and executive compensation is notable with respect to whether salaries, bonuses, and/or other compensation elements meet the test of being "ordinary" and "necessary." For example, if an employee's salary level is "necessary" for the employer to be competitive based on labor market data for comparable jobs in other organizations, then it would appear to qualify as a tax-deductible expense under IRC Section 162(a). Therefore, compensation in excess of market indicators might not be deductible.

Non-Profit Employers

Organizations that qualify for tax exemption under IRC Section 501(c)(3) are subject to a "reasonableness" criterion when it comes to compensation, the interpretation of which may vary. Determining reasonableness is complicated and time consuming, requiring us to "compare and contrast" the information available to us. Fortunately, the Treasury has issued Regulations provide excellent guidance on which we can base how much compensation is "reasonable."



There is something called the “private inurement doctrine” which requires that a non-profit organization be organized and operated so that no part of its net earnings inures to the benefit of any private shareholder or individual. Compensation must be "reasonable" and excessive compensation can result in a finding of private inurement. Once the IRS identifies excessive compensation, it may impose an excise tax or revoke the organization's exempt status, or it may choose to do both. Because either consequence is severe, organizations are extremely concerned that the compensation paid to their employees is reasonable.

Treasury Regulations define reasonable compensation as, "...the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation.)" This guidance does not refer to a person's title, experience, skills, compensation or work history or any other personal criteria. Rather, the criteria refer to job characteristics.

As a defensive measure, a non-profit organization may shift the burden of proof in this matter to the IRS by choosing to invoke something called a “rebuttable presumption” that its employees’ compensation levels are reasonable. This creates a measure of safety for the organization because, once the presumption is invoked, the IRS must prove that the compensation is NOT reasonable in order to assess the excise tax or threaten an organization's status. To invoke the presumption, an organization must do three things:

- (1) The compensation arrangement must be approved in advance by an authorized body of the organization that is composed entirely of individuals who do not have a conflict of interest,
- (2) This authorized body must obtain and rely upon appropriate data as to comparability prior to making its determination, and
- (3) The authorized body must adequately document the basis for its determination concurrently with making that determination.

If these three requirements are satisfied, then the Internal Revenue Service may rebut the presumption only if it develops sufficient contrary evidence.