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Critical Tax Compliance Considerations for Tax-Exempt Executive Compensation, Part I



Mark Rosen

MANAGING DIRECTOR



Alexander Yaffe

MANAGING DIRECTOR

Boards of tax-exempt organizations rarely get executive compensation wrong because the regulatory framework is unclear. More often, those rules break down under real-world pressures. IRS Sections 4958 and 4960 define expectations around reasonableness, process, and tax exposure, but compliance ultimately depends on how well that framework holds up in practice.

As the next installment in our Tax-Exempt Compensation Essentials series, these two companion pieces address both sides of that challenge. Part I outlines the regulatory foundation and key risks boards must understand. Part II: From Regulation to Execution: Making IRC 4958 Work in the Real World, examines how to translate those rules into consistent, defensible governance practices.

When overseeing executive compensation in tax-exempt organizations, board members must recognize that their responsibilities extend deeply into the realm of tax compliance. In practice, “compensation oversight” often looks like approving pay decisions shaped by retention concerns, competitive pressure, or a desire to recognize strong performance—while still ensuring that all compensation practices adhere to tax

regulations. Failure to comply with tax requirements can result in significant tax penalties for both executives and the organization, as well as for any board members who knowingly approve improper arrangements.

Compensation must be reasonable and supported by a thorough process, appropriate market data, and clear documentation. If compensation is deemed excessive, tax authorities may impose taxes and financial penalties on those involved. The organization's tax-exempt status may even be at risk if violations are severe or repeated.

Boards can defend their decisions through a structured process that includes:

- Independent approval: actively confirmed, not simply assumed
- Compensation comparisons: drawn from relevant and appropriately constructed peer groups
- Descriptive record-keeping: clearly explaining the board's reasoning, not just its conclusions

These steps help demonstrate compliance and shift the burden to tax authorities to prove any improprieties.

Rigorous processes and clear documentation are critical. Even well-intentioned compensation decisions may face tax scrutiny if records are incomplete or if independence is compromised. Ultimately, the tax consequences of compensation decisions should be a primary concern for board members guiding tax-exempt organizations.

Executive compensation in tax-exempt organizations operates within a regulatory framework that places meaningful responsibility on boards and compensation committees. Oversight is not limited to approving pay levels; it requires attention to process, documentation, disclosure, and tax exposure.

Two provisions of the Internal Revenue Code define that landscape, but they operate in fundamentally different ways:

- Section 4958: Governs reasonableness and intermediate sanctions
- Section 4960: Imposes an excise tax on certain high levels of compensation

Understanding how these rules operate—and how they interact—is essential for effective governance.

Section 4958: Reasonableness and Intermediate Sanctions

Section 4958 applies to compensation and certain transactions between a tax-exempt organization and individuals who exercise substantial influence over it. These individuals, referred to as “disqualified persons,” typically include senior executives, certain key employees, and in some cases directors, trustees, or highly compensated professionals such as physicians or coaches. The determination is based on influence, not title alone.

The statute is designed to prevent “excess benefit transactions,” most commonly unreasonable compensation. Importantly, compensation is evaluated on a total remuneration basis. Salary, bonuses, deferred compensation, retirement benefits, perquisites, and severance arrangements are considered together when assessing whether pay exceeds fair market value.

If compensation is determined to be excessive, significant penalties may apply. The executive can be subject to excise taxes equal to 25% of the excess benefit, with additional penalties if the matter is not corrected. In certain circumstances, board members who knowingly approve improper arrangements may also face financial penalties. In extreme cases, repeated or egregious violations could threaten the organization’s tax-exempt status.

The Rebuttable Presumption of Reasonableness

While the penalties under Section 4958 are substantial, the law provides boards with a clear procedural defense known as the “rebuttable presumption of reasonableness.” When properly followed, this process shifts the burden to the IRS to prove compensation is unreasonable.

The defense requires all three of these elements:

1. Independent approval by disinterested board members
2. Reliance on appropriate comparability data
3. Contemporaneous documentation of the decision-making process

Comparability data typically includes peer organization compensation information, independent survey results, and relevant market data. Board minutes must reflect the materials reviewed and the rationale supporting the final determination.

Process discipline is critical. Even reasonable compensation decisions can be challenged if documentation is incomplete or if independence is compromised.

Section 4960: The 21% Excise Tax

Section 4960, enacted in 2017, introduced a separate layer of exposure for tax-exempt organizations. This distinction is important. While Section 4958 focuses on process reasonableness, Section 4960 is more mechanical. It imposes a 21% excise tax on the organization when compensation paid to certain employees exceeds $1 million in a given year. The tax applies to each dollar over $1 million dollars earned, and also applies to

certain excess severance payments. Once this threshold is crossed, the tax applies, regardless of why the threshold was crossed.

The rule applies to the five highest-compensated employees in any year, and once an individual becomes a “covered employee,” that designation generally continues permanently. This creates a long-term tracking obligation for organizations and requires coordination among compensation, finance, and tax functions. Compensation decisions made today can create tax exposure years later.

Compensation counted toward the $1 million threshold typically encompasses the total rewards package: salary, bonuses, taxable benefits, and vested deferred compensation. In limited cases, compensation for medical services may be excluded, but careful analysis is required. Importantly, there is no rebuttable presumption defense under Section 4960. If compensation exceeds the statutory threshold, the excise tax applies regardless of process.

Governance in Today’s Environment

The regulatory framework does not operate in isolation. Expanded Form 990 disclosure requirements have increased transparency and public scrutiny of executive pay. As a result, compensation decisions are evaluated through multiple lenses—legal compliance, mission alignment, stakeholder expectations, and reputational risk.

In this environment, boards are expected to articulate a clear compensation philosophy, apply a consistent peer group methodology, and document decisions in a manner that withstands scrutiny. Regular committee meetings, engagement of independent advisors, and proactive modeling of potential excise tax exposure are now standard governance practices.

Where Compliance Breaks Down

Executive compensation oversight in tax-exempt organizations requires careful attention to both tax exposure and regulatory requirements. Boards must understand how Sections 4958 and 4960 operate, recognize the financial consequences of noncompliance, and ensure that compensation decisions are grounded in credible data and appropriate documentation.

Understanding the legal framework is only part of the challenge. In practice, the greatest risk rarely stems from misunderstanding the rules. Rather, it stems from how those rules are implemented. Independence must be preserved in deliberations, not simply assumed. Market data must be applied thoughtfully rather than mechanically. Documentation must reflect the reasoning behind decisions, not just the outcomes.

In Part II, we turn from framework to execution, examining how organizations can build the governance processes and compensation practices that allow boards to manage these risks effectively under real-world conditions.

About the Authors

Mark is a consulting team leader who brings 20+ years advising on executive and board pay, including benchmarking, retirement plan design, and tax/accounting and governance considerations.

Alexander brings 20+ years of experience advising tax-exempt boards on executive compensation and succession planning, with deep expertise in physician compensation governance for hospitals and integrated health systems.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.