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



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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: Understanding IRC 4958 and 4960, outlined the regulatory foundation and key risks boards must understand. Part II examines how to translate those rules into consistent, defensible governance practices.

Boards of tax-exempt organizations generally understand the regulatory framework governing executive compensation. Sections 4958 and 4960 establish clear rules around reasonableness, process, and excise tax exposure.

Knowing the rules, however, is not the same as implementing them effectively. Most compensation challenges do not arise from misunderstanding the law, but from

breakdowns in governance process—independence is assumed rather than tested, market data is accepted without sufficient scrutiny, and documentation confirms outcomes without capturing the reasoning behind them.

Compensation Oversight Is an Annual Process

Effective compliance is built through a repeatable annual process, not a single meeting.

Well-functioning compensation committees follow a structured cycle:

- Confirming independence and conflicts at the outset
- Reviewing and, where necessary, recalibrating the peer group
- Aligning market data with the organization's compensation philosophy
- Conducting deliberations in executive session
- Documenting decisions in a manner that satisfies regulatory requirements

When that structure is absent, decisions become reactive—driven by retention concerns, competitive pressures, or timing constraints rather a consistent framework.

While a committee's primary attention is appropriately focused on annual processes, when off-cycle actions are required (e.g., approving the compensation for a newly hired CEO or other executive) it is critical that the same diligence and processes are employed.

The Rebuttable Presumption Is a Discipline, Not a Box to Check

The rebuttable presumption is often treated as a checklist. In practice, it is a process standard. If independence, data selection, and documentation are not embedded in how decisions are made, the presumption exists on paper but not in substance.

Independence: Legal Minimum vs. Real-World Influence

The regulations define conflict in technical terms. A committee member cannot be a disqualified person, related to one, or have a material financial interest affected by the compensation arrangement. Many boards stop there. But governance risk does not begin and end with the regulatory definition.

Consider a reciprocal board relationship: CEO A serves on CEO B's board and votes on CEO B's pay. CEO B serves on CEO A's board and votes on CEO A's pay. The organizations have no formal relationship.

Technically, that may not violate the literal 4958 conflict definition. But from a governance perspective, it raises legitimate questions about independence. When scrutiny comes, the analysis will not be limited to whether a technical definition was satisfied. It will focus on whether the authorized body was genuinely free from influence. Public perception will

follow the same line of inquiry.

There is a meaningful difference between regulatory independence and practical independence.

Boards should be asking:

- Are independence affirmations updated annually?
- Are potential conflicts discussed openly rather than simply disclosed?
- Are executive sessions held without management present?
- Are recusals expected when relationships could impair objectivity—even if not technically disqualifying?

Influence rarely announces itself. It enters through familiarity, reciprocity, and deference. A board that aims only to satisfy the minimum definition of independence is leaving itself exposed.

Comparability Data: Where Judgment Quietly Enters

The second element—reliance on appropriate comparability data—is often treated as a consultant's responsibility. It is not. Data informs decisions. It does not make them. The most consequential choices are embedded in how the data is defined and applied:

- How the peer group is constructed
- Whether size, complexity, and mission are applied consistently year over year
- Where the organization positions itself relative to market percentiles
- How performance factors into that positioning

Peer groups drift upward. Market positioning ratchets incrementally. Retention pressures compress deliberation. None of these violate a regulation individually, but without a clearly articulated philosophy and consistent application, decisions become reactive rather than principled.

If questioned, a board must be able to explain not only what the market data showed, but why it interpreted and applied that data in a particular way. "Because that is what similar organizations pay" is not a strategy. It is an observation. Reasonableness under 4958 requires judgment. Good governance requires that judgment be explicit.

Documentation: A Regulatory Requirement, Not an Administrative Detail

Documentation under IRC 4958 is not about helpful meeting minutes, it is what determines whether the rebuttable presumption applies. The Treasury Regulations are specific about what must be reflected in the written record. To secure the presumption, the documentation must include:

- The terms of the compensation arrangement and the date approved
- The members of the authorized body present during debate and those who voted

- The comparability data obtained and relied upon—and how it was obtained
- Any actions taken with respect to members who had a conflict of interest
- The basis for the determination

There are also important timing requirements. The record must be prepared within required timeframes and reviewed and approved promptly afterwards.

If these elements are not reflected in the minutes, the organization does not obtain the presumption—even if the compensation itself is reasonable. This is where many boards unintentionally weaken their position.

Minutes that simply state the committee “reviewed market data and determined compensation to be reasonable” are insufficient. The record must document the data used, how it was evaluated, who was present and/or voted, and how conflicts were addressed.

If a member with a potential conflict was present during discussion and the minutes do not reflect how that was handled, ambiguity is created—and ambiguity undermines protection. It opens up speculation and provides an entry point for doubt. At the same time, the objective is not to create a transcript. It is to ensure the record demonstrates that each regulatory element of the rebuttable presumption was deliberately satisfied.

When compensation becomes controversial, the minutes become the primary evidence that the authorized body followed the rules. If required components are missing, the organization may find itself defending the substance of the decision without the procedural shield the statute was designed to provide.

Managing Section 4960 in Practice

Section 4960 is often treated as a calculation, rather than a plan design question, and the most common surprises arise from timing:

- Deferred compensation vesting in a single year
- Severance arrangements triggering excess parachute rules
- Failure to track covered employees over time

Unlike Section 4958, there is no process defense. Once the threshold is crossed, the tax applies. As a result, organizations need to model compensation outcomes in advance—not after decisions are made. This requires coordination between the compensation committee, finance, and tax advisors. Otherwise, organizations can inadvertently trigger excise tax even when compensation decisions appear reasonable.

State Charity Law: A Different Lens of Review

IRC 4958 is a federal tax regime. State charity regulators evaluate executive compensation through a fiduciary lens. That distinction matters.

In high-profile situations, state Attorneys General often become involved not because an excess benefit is obvious, but because questions arise about whether directors fulfilled their duty of care. The inquiry shifts from technical compliance to governance discipline: Were directors informed? Did they deliberate? Did they act independently and prudently?

A process that technically satisfies federal requirements but appears informal, inconsistent, or opaque can still invite scrutiny at the state level. Boards should assume their decisions could be examined through both lenses.

Designing a Process That Holds Up

Operationalizing compliance requires structure and repetition:

- A board-approved compensation philosophy that defines market positioning and performance expectations
- Clear, pre-established criteria for peer group construction
- Annual independence and conflict assessments
- A calendarized process that prevents rushed or improvised decisions
- Executive sessions to insulate deliberation from management influence
- Documentation standards aligned explicitly with regulatory requirements
- Clearly defined processes and responsibilities for handing off-cycle compensation decisions

This is not about adding paperwork. It is about creating a disciplined system that holds up under pressure.

Designing an effective compensation governance system requires more than familiarity with the statute. It requires understanding how compensation discussions actually unfold—where influence arises, where documentation falls short, and where well-intentioned boards unintentionally weaken their own protection.

Compliance is not a binder on a shelf. It is a process practiced annually, in the room, under real-world pressures.

It does not fail for lack of information. It fails when process breaks down under pressure: time constraints, competitive dynamics, and reliance on incomplete or inconsistently applied data.

Organizations that build a disciplined, repeatable approach—reinforcing independence, applying market data thoughtfully, and documenting decisions in line with regulatory expectations—are far better positioned when questions arise.

About the Authors

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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.