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PAYING FOR THE BEST: EXECUTIVE COMPENSATION FOR SECTION 501(c)(3) PUBLIC CHARITIES

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PAYING FOR THE BEST: EXECUTIVE COMPENSATION FOR SECTION 501(c)(3) PUBLIC CHARITIES

Executive compensation is one of the most important issues that a public charity must address. Organizations often are pulled in many directions when dealing with executive compensation. Charities need to balance their overall tax-exempt objectives with their need to hire and retain skilled management to accomplish those objectives, their future growth with their financial constraints, and their desire to compensate exceptional service with the public perception of corporate greed. Dealing with executive compensation is a difficult task for all organizations, exempt and taxable alike. For public charities, however, the disclosure requirements and their reliance on goodwill mean executive compensation is not only a difficult issue, it is also a public issue.

The need to address executive compensation has grown significantly over the past few years, as this is an issue that recently has been at the forefront of the Service's attention. The redesign of the Form 990, the extensive discussion of executive compensation in the Interim Report for the College and University Compliance Project, and the Service's rediscovery of Section 4958 all result in a need for charities to evaluate the amount of compensation provided to their executives, assess their risk, and address any potential issues or areas of concern.

In the author's experience, when dealing with executive compensation, charities generally go through three very common and distinct phases—denial, fear, and acceptance.

In the first phase, organization executives simply say that compensation is not a problem for their organization. As such, a major hurdle in this phase tends to be the assumptions and privacy issues of the organization's executives. During this phase, many executives refuse to believe that the amount of their compensation is a significant issue to anyone other than themselves. When it comes to compensation, executives tend to believe two things above all else: (1) they are compensated fairly and, if anything, are under-compensated; and (2) if anyone does care to question their compensation, "it's none of their business." Unlike executives, governing boards do not have such a personal or visceral response to executive compensation; rather, questions from the board tend to focus on risk, both to the organization and to themselves.

During the denial phase, the typical questions asked by organizations include:

- Who cares?
- Does it really matter how much we pay our executives or how we determine executive compensation?
- What are the risks of overcompensation?

Once an organization recognizes that the amount of executive compensation can have serious consequences to the organization's tax-exempt status and could result in significant tax penalties, the organization tends to enter into the fear phase. This phase is often spearheaded by the board of directors. Initially, during this phase, the governing board may view the organization's executives as adversaries in the compensation approval process. Board members may even blame certain executives for placing the organization at risk of revocation and potentially placing the board members at risk of personal liability. During the fear phase, the questions asked by the organization's governing board tend to include:

- How much compensation is reasonable compensation?
- Can we pay executives above the fiftieth percentile?

Eventually, every organization reaches the acceptance phase. This will happen once the organization's executives recognize the need to address the potential issue of overcompensation and the organization's board recognizes that, in order to attract the level of talent necessary to accomplish the its mission, the organization will need to provide reasonable and competitive compensation. Once an organization reaches this point, it is able to rationally analyze its executive compensation and the process used to approve such compensation. The questions then become more appropriately issue-focused, including:

- What can the organization do to protect itself from a finding of excess compensation?
- What are the potential red flags that inform the Service about potential executive compensation issues?

With the Service's recent emphasis on executive compensation and its rediscovery of **Section 4958**, it is important that exempt organizations and their advisors be well aware of the issues relating to executive compensation and the risks of providing excessive compensation, both to the organization and its management.

DENIAL

Many executives consider the amount of their compensation to be a private matter and do not like to discuss or to be questioned about the appropriateness of their salary. When the issue of executive compensation is discussed, executives frequently blow off the issue, saying that no one cares about their compensation and, even if people did care, it is none of their business. This assumption about personal privacy is unfounded and dangerous, however. The list of individuals and entities who care about the types and amount of compensation provided to executives of nonprofit organizations is long. It includes the IRS, state regulators, the media, competing organizations, executives of other exempt organizations, and the organization's own employees. Further, while a particular individual's compensation may be nothing more than a curiosity even to these stakeholders, as a matter of law it is the business of state and federal regulators and of potential donors. Moreover, with the substantial

amount of information that tax-exempt organizations must make available to the public, these interested persons have ample information to satisfy their curiosity, irrespective of whether they have a justifiable need or purpose for obtaining the information. It is this mix of public curiosity and the widespread availability of information about executive compensation that makes the potential risks of excessive compensation so great.

Once an executive acknowledges that people may care about the amount of their compensation, they often fail to recognize the significance of executive compensation. This is largely due to a failure to recognize that, for most organizations, the very premise for the Service's recognition of tax-exempt status is that neither the organization's earnings nor assets inure them to the benefit of a private individual and that the organization's activities do not confer a greater than necessary private benefit. Moreover, many executives of organizations exempt under **Section 501(c)(3)** or **(c)(4)** are almost completely unaware of the substantial penalties that the Code imposes on excessive compensation though **Section 4958**.

Finally, even when they acknowledge that people do care about the amount of their compensation and that it may impact their organizations' exempt status, many executives will perform a quick calculation in their head in which they weigh the value of the benefits that they believe that they provide to the organization against the amount of their compensation. Almost without fail, the executives will determine that, if anything, they are underpaid for the vast number of important services provided to the organization. As such, they quickly dismiss the issue, believing that there is no real risk of overcompensation. This quick calculation often fails to consider all of the risks, however, including loss of exemption and the potential of personal liability for excise taxes should the IRS disagree with their conclusion. Additionally, while many positions relating to executive compensation are defensible, the lack of an appropriate approval process for such compensation may itself lead to a perception of excessive compensation that may result in unwanted public or regulatory scrutiny and perhaps even a proposed adverse determination. Thus, even a fully defensible position may cause an organization to endure significant expense and hardship if the organization's approval process does not sufficiently demonstrate the reasonableness of the amount of executive compensation.

WHO CARES?

As noted above, the list of individuals and organizations that care about the compensation of particular executives is long and the list of reasons why they care is equally long. The first, and probably the most significant, entity on this list is the IRS. Contrary to the belief in privacy held by many executives, executive compensation is the Service's business.

The IRS. In recent years, executive compensation has been a hot topic for all organizations, and charities have not been an exception. The Service's focus on executive compensation has been demonstrated by the information that it seeks from organizations in the Form 990, the Tax-Exempt/Government Entities annual work plans, public statements by IRS officials, publications by the IRS in recent years, and in the actual IRS enforcement efforts, including litigation.

The redesigned Form 990. In 2007, the Service released a redesigned Form 990 with the intention of improving organizational reporting and streamlining IRS enforcement with respect to several important issues. These included executive compensation, governance procedures for approving executive compensation, and the independence of an organization's governing board. Specifically, the

Service added questions to the redesigned Form 990 requesting information that is directly relevant to determining whether the organization is providing reasonable compensation, including:

- *Part VI, "Governance, Management, and Disclosure."* In Part VI a tax-exempt organization must describe the composition of its board of directors, its governance and management structure, and its policies for promoting transparency and accountability to members and beneficiaries. Notwithstanding these requests, the Service has made clear that no particular policy or form of governance is compelled as a matter of law.

- *Schedule J, "Compensation Information."* Organizations are required to provide additional information about officers, directors, and employees who earn more than $150,000 in reportable compensation (as reflected on Forms W-2 or 1099) or $250,000 in total compensation (including nontaxable fringe benefits and expense reimbursements). Affirmative responses to this question on the main body of Form 990 will trigger more detailed reporting requirements in Schedule J. In addition to requiring the organization to break out base compensation, bonus and incentive compensation, other compensation, deferred compensation, certain nontaxable benefits (described below), and compensation reported in prior Forms 990, Schedule J specifically asks whether an organization's compensation approval process takes the steps necessary to establish the rebuttable presumption of reasonableness. Additionally, Schedule J requests information about other benefits that the organization provides to its executives in addition to compensation, including payments for first-class or charter travel, travel for companions, tax indemnification and gross-up payments, discretionary spending accounts, housing allowances and payments for the business use of a personal residence, health or social club dues or fees, and personal services (such as those of a maid, chauffeur, or chef).

- *Schedule L, "Transactions with Interested Persons."* Organizations are also asked whether they have engaged in an excess benefit transaction with an interested person in the past year. If this question is answered affirmatively, the organization must also complete Schedule L. In the current version of Form 990, Schedule L has been structured to incorporate all conflict of interest reporting relating to transactions with interested persons into a single location.

Due to the level of detail and reporting of executive compensation packages in years 2008 and later, substantiating the reasonableness of executive salaries and benefits must be a top priority for all organizations submitting a Form 990, and as every tax-exempt organization knows well, details reported in Form 990 become public information. An organization that pays employees what may be viewed as excessive compensation risks affecting the public perception of the organization as a whole and jeopardizing future fundraising efforts, membership support, and the like.

Public statements by IRS officials, workplans, and publications. On 11/23/10, in a speech to the Practicing Law Institute conference, Lois Lerner, the IRS Director of Exempt Organizations, indicated that the Service was going to once again begin focusing on whether exempt organizations are providing their executives with excessive compensation. This announcement was consistent with anecdotal evidence that practitioners have seen while representing tax-exempt organizations in IRS examinations. Basically, the IRS has rediscovered Section 4958 and has begun using this previously forgotten enforcement tool with a new vigor.

The 11/23/10 announcement about the focus on executive compensation is consistent with other public statements made by IRS officials. For instance, at a Georgetown Law Center conference on Nonprofit Governance on 4/27/11, IRS Area Manager Peter Lorenzetti identified executive compensation as "far and away the most common risk area for nonprofits" and an issue that the Service will "look at on every audit we do."

Additionally, enforcement efforts relating to executive compensation were discussed in the Exempt Organization Implementing Guidelines for fiscal years 2006, 2007, and 2008, and in the IRS TE/GE Fiscal Year 2011 Workplan.

Finally, the Service's focus on executive compensation issues is clearly evinced by the interim report on its College and University Compliance Project ("Interim Report").[1] Published on 5/7/10, the Interim Report summarized the information that the Service received in response to compliance questionnaires sent to more than 400 colleges and universities in October 2008. The Interim Report identified executive compensation as an area of focus moving forward with the Compliance Project. The information in the Interim Report is valuable for all tax-exempt organizations because it provides a roadmap of the issues to be reviewed during future IRS examinations. Two of the most prominent issues discussed in the Interim Report were executive compensation and organization governance.

In reviewing executive compensation and organizational governance, the Interim Report noted that the "questions were principally focused on issues related to excess benefit transaction under section 4958 of the Code."[2] As such, the Service gathered a substantial amount of information about the total amount and type of compensation provided to the officers, directors, trustees, key employees, and highly compensated employees of each surveyed college and university. Additionally, the questions requested information about the compensation approval process used by each organization, including: whether the organization had a written compensation policy, whether the organization used outside consultants to determine the reasonableness of the amount of compensation paid, whether the organization used comparability data to determine the reasonableness of the amount paid to its executives, and whether the organization's compensation approval process was sufficient to establish the rebuttable presumption of reasonableness.

Based on the Service's public and published statements, including the Interim Report, it is clear that executive compensation is a significant issue on which the Service is focused. Thus, it would be wise for organizations to focus their own attention on identifying and addressing potential issues related to executive compensation.

IRS enforcement efforts. All of the information that the Service has publicly disclosed with respect to its review and enforcement activities regarding executive compensation comports with its actual enforcement efforts. As noted by Lois Lerner, the Service has once again started enforcing the provisions of Section 4958.

A quick review of the published rulings by the Service demonstrates that, while the Service published five technical advice memoranda imposing excise taxes under Section 4958 in 2004, it imposed or recommended the imposition of such taxes in only one published TAM or private letter ruling between 2004 and 2011. Additionally, since the Fifth Circuit found that the Service failed to meet its burden in imposing intermediate sanctions in *Caracci,* 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (CA-5, 2006), the Service's enforcement of Section 4958 had been almost nonexistent. Since October 2008, however, the author's

firm has seen 18 cases in which the Service imposed or proposed intermediate sanctions under Section 4958. Additionally, the Service recently litigated a case regarding the imposition of excise taxes under Section 4958 in the United States Tax Court ("Tax Court"). Thus, consistent with its many public statements, the Service's enforcement efforts evince its focus on executive compensation and, in particular, on the enforcement mechanisms of Section 4958.

Others. While the focus of this discussion is on IRS enforcement efforts with respect to executive compensation, to put this issue in its proper perspective, it is important to include a brief discussion on other individuals and entities that may be concerned with the amount of compensation earned by an organization's executives, as well as the motivations for such interest. Those interested include potential donors, competing organizations and interests, the media, and employees.

Potential donors. Due to the economic conditions of recent years, the pool of available donations for charities has dwindled and the competition for funding has increased. Increased competition for more limited donations is making it increasingly important for organizations to use information available to the public, such as the Form 990, to demonstrate that the organization is using its funds to the fullest extent possible to efficiently achieve their exempt missions. This is especially important when trying to attract charitable contributions from potential donors.

Overall, donors are primarily concerned with a charity's exempt mission and a significant concern when making a substantial contribution is how that contribution will be used to accomplish that mission. For many organizations, the list of donors often includes a substantial number of people who take the organization's mission personally because their lives have been affected by the issue that the organization is working to address. Such donors care less about the fairness of the organization's executive compensation than they do about accomplishing the organization's underlying mission. Due to the substantial amount of information disclosed in an organization's Form 990, any potential donor can look at page 10 of a charity's Form 990 and instantly see and compare the portion of an organization's expenses that are comprised of executive compensation with the portion of the organization's total expenses that are used on programs directly related to the organization's mission.

Given the limited pool of charitable donations and the increased competition for them, it is easy for competing organizations that expend a smaller portion of their total expenses on executive compensation to use this information to demonstrate a greater commitment to the accomplishment of the organization's exempt mission, regardless of the veracity of such claims. As such, the provision of excessive compensation, or even high but reasonable compensation, may impact the perception that donors have of the organization and the willingness of such donors to make contributions to a particular charity.

Competing organizations and interests. A recent trend in the world of tax-exempt organizations is for individuals to use information reported in the Form 990 to publicly discredit the tax-exempt status of entities. These attacks tend to focus on competing interests and seek to use media and regulatory attention to change public opinion or even cause the revocation of an organization's tax-exempt status. A recent example of this is a complaint filed with the IRS by Common Cause against the American Legislative Exchange Council (ALEC) in May 2012, in which Common Cause filed a complaint with the Service seeking a review of ALEC's activities. Another example is the Playoff PAC, an organization created for the purpose of eliminating college football's Bowl Championship Series (BCS) and

replacing it with a playoff system (an effort motivated in part by perceived excessive compensation involved in the playoff system). The Playoff PAC example should be considered by all charities that engage in highly politicized or controversial activities and lack adequate compensation approval processes.

The Playoff PAC was able to garner a substantial amount of media exposure by using publicly available information to create the perception that the individual tax-exempt organizations comprising the BCS—the Fiesta Bowl, Sugar Bowl, Orange Bowl, and Rose Bowl—were using the benefits of their status as public charities to engage in prohibited activities such as the provision of excessive compensation. A large part of the Playoff PAC's success appears to be its ability to attract media and public attention to the compensation and compensation practices of the Fiesta Bowl in particular, and the compensation provided to its chief executive officer, John Junker. The perceived abuses, especially those related to executive compensation and extravagant employee benefits, were the subject of multiple media exposes, and were the subject of reports by ESPN, HBO, *Sports Illustrated,* and the *NonProfit Times.* Based, in part, on the efforts of the Playoff PAC and the negative attention it was able to attract to the compensation of the executives of the individual bowl organizations, John Junker was fired and subjected to criminal investigations, and college football's BSC system was recently replaced with a playoff system.

The Playoff PAC example is also indicative of the media attention that compensation issues attract. The success of the Playoff PAC in obtaining its goal of a college football playoff was largely attributable to the public and political pressure that the Playoff PAC was able to impose on the various entities that make up the BCS, such as the individual bowl organizations. Moreover, the general interest in the issues discussed in the media helped focus the public and political attention on the BCS.

As demonstrated by the Playoff PAC example, questions about executive compensation can have a significant impact on an organization and on the individual executives who receive it. Also, compensation that is perceived to be excessive, whether or not it actually rises to the level necessary for enforcement by the Service, is an issue that can generate a lot of attention and potentially lead to significant problems for an organization and its executives.

Employees. Another group that frequently focuses on executive compensation is an organization's employees. The payment of high compensation to an organization's executives may result in complaints or the dissatisfaction of employees who receive substantially lower salaries. While this may be expected and accepted to some degree in any organization, the disparity between executive and staff compensation is often far greater in nonprofit organizations. This can cause issues when an organization pays its chief executive at the 90th percentile while the rest of its staff and management team is paid at the 50th percentile. For the long-term success of the organization, it is important that the organization's employees be qualified and capable because a productive organization is the product of a productive workforce. When an organization clearly favors a single employee or position over others, it may lead to dissatisfaction and high turnover amongst the rest of the employees, which may lead to greater turnover and a less productive organization. Thus, it is important to keep the perceptions of employee compensation in mind when establishing executive compensation.

DOES IT MATTER?

In short, yes. The amount of compensation provided by an exempt organization

to its executives matters. Not only is executive compensation an issue that garners significant attention, it is an issue that can have a significant impact on an organization's qualification for tax-exempt status. Additionally, the payment of excessive compensation can result in substantial financial penalties assessed against the executives who receive it, as well as the board members who approved it.

Exempt status implications of compensation. A charity that provides excessive compensation may jeopardize its tax-exempt status if paying that compensation results in providing a substantial private benefit or causes the organization's net earnings to inure to the benefit of a private individual or shareholder.

Private benefit. Generally, for an organization to qualify as exempt under Section 501(c)(3), it must be both organized and operated exclusively for exempt purposes that provide a public benefit. For purposes of Section 501(c)(3), exempt purposes include religious, charitable, scientific, testing for public safety, literary, or educational purposes. If a substantial amount of an organization's activities are in pursuit of a non-exempt purpose, the organization may not qualify for recognition of tax-exempt status.

Non-exempt purposes include any purpose that serves a private interest rather than a public interest, which is often described as a "private benefit." To be recognized as exempt under Section 501(c)(3),"it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests."[3] It is extremely important for organizations to avoid conferring any prohibited private benefits because, as the Supreme Court has pointed out, the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.[4]

It is notable that the private benefit doctrine looks only to whether a substantial portion of an organization's activities confer a benefit to private individuals, and not to the relationship that the private beneficiaries have with the organization. As such, the provision of a private benefit can result in the loss of exempt status if the benefit flows to individuals who control the organization's activities or to disinterested third parties. As such, an organization's activities may confer an impermissible private benefit on an individual even if the individual is completely unrelated to the organization. For instance, in *American Campaign Academy,* 92 TC 1053 (1989), the Tax Court determined that, where an organization's activities provided a substantial benefit to the Republican Party and Republican candidates for political office, the organization was not primarily engaged in exempt activities even though the Republican Party was independent of the organization.

In the context of compensation, the Seventh Circuit noted that where an organization was so irresponsibly managed that it paid an unrelated company substantially more than would have been accepted for fundraising services, "it could be argued that [the organization] was in fact being operated to a significant degree for the private benefit of [the fundraiser]."[5] Therefore, to the extent that an organization is providing excessive compensation, it is possible that the organization may be jeopardizing its exemption by conferring a prohibited private benefit even if the compensation is not provided to an individual who controls the organization's operations.

Private inurement. In addition to the prohibition on private benefit, charitable organizations are prohibited from allowing any part of their net earnings to inure them to any private individual or shareholder.[6] Private inurement is similar to private benefit, sharing common and often overlapping elements; in fact, the Tax Court has noted that "the private inurement may be arguably subsumed within

the private benefit analysis."[7] However, private inurement is more limited in the scope of the beneficiaries' relationship to the organization and with respect to the types of benefits resulting in inurement. As private inurement is subsumed by, and a more limited application of, the private benefit doctrine, the Service has correctly taken the position that "all inurement is private benefit, but not all private benefit is inurement."[8]

The private inurement doctrine is derived from Section 501(c)(3), which provides that, to be recognized as exempt, "no part of the net earnings" of the organization may inure to the benefit of "any private shareholder or individual." The term "private shareholder or individual" refers to persons having a personal and private interest in the activities of the organization.[9] More generally, the private benefit doctrine prohibits a charity from siphoning "its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager."[10] Thus, unlike the private benefit doctrine, private inurement is applicable only to transactions between a tax-exempt organization and an "insider" (i.e., someone having a close relationship with and/or the ability to exert influence over the tax-exempt organization).

Another limitation on the application of the private inurement doctrine is the type of benefits that may result in private inurement. As discussed above, the private benefit doctrine looks to whether an organization's activities confer a substantial benefit on private individuals. As such, the nature of the benefit of the organization's activities are considered in determining whether an organization has conferred an impermissible private benefit, and whether it is possible for an organization's activities to confer a substantial benefit on an unrelated party even where no pecuniary benefit is conferred, as was the case in *American Campaign Academy*. However, because the Code prohibits the inurement of an organization's "net earnings," there generally needs to be a monetary aspect to benefits conferred to invoke the private inurement doctrine. More general benefits such as a larger pool of informed political campaign managers to serve a single political party will not result in inurement.

Two common situations that may result in private inurement are, first, an insider's exercising control over the net earnings of an organization "to make ready personal use of the corporate earnings"[11] and, second, an insider's receiving a return benefit from an organization that exceeds that value of the goods or services that the insider provided to the organization. In the context of employee compensation, the first situation is most often seen with respect to inadequate controls over expense reimbursements. Where the organization pays or reimburses an insider for personal expenses, courts have ruled that the organization's net earnings inured to the benefit because the insider "was free to make personal use of such corporate funds for himself and his family when, if, and as he chose to do so."[12] Moreover, in these situations, courts have determined the existence of private inurement through the personal use of corporate earnings even where the combined total value of the benefit and the total amount of compensation would not have been an unreasonable or excessive amount of compensation.[13]

The other type of situation that may give rise to private inurement is directly related to overcompensation. For purposes of private inurement, the term "net earnings" has been interpreted to include all expenses other than those ordinary and necessary for the operation of an organization.[14] As such, courts have repeatedly held that salaries that are "excessive salaries do result in inurement."[15] Thus, executive compensation may constitute private inurement if the amount of the compensation is greater than fair market value and the

payment of such compensation results in an unreasonable return benefit to the executive.

Personal liability of officers and directors resulting from excessive compensation. In addition to the private benefit and private inurement prohibitions, which may result in the revocation of an organization's tax-exempt status, the Code seeks to protect an exempt organization's assets from being used for the benefit of the individuals in control by imposing an excise tax on certain individuals who receive excessive benefits. Section 4958 imposes excise taxes (referred to commonly as the "intermediate sanctions") against certain individuals and private entities that receive better than fair market value in transactions with qualifying organizations.[16] Additionally, Section 4958 imposes an excise tax on all organization managers who knowingly participate in the transaction that resulted in the provision of an excessive benefit.

The focus of the Code's intermediate sanctions provisions are very similar to its proscription on private inurement—a transaction that provides excessive benefit to an individual or an entity that is closely connected with and/or has the ability to exert substantial influence over the tax-exempt organization. However, an important distinction between the two doctrines concerns the type of sanctions that are allowed. Under the private inurement provisions, only the tax-exempt organization may be penalized and the sole penalty available is the revocation of the organization's tax-exempt status. By contrast, the intermediate sanctions provisions impose penalties short of revocation in the form of excise taxes on the individual or entity that benefited from the better-than-fair-market-value transaction, as well as on the individual exempt organization managers who knowingly approve such "excess benefit transactions." It is important to understand that Section 4958 does not prohibit organizations from paying *any* compensation to individuals who control the organization or from entering into any transactions with such individuals. Rather, it simply penalizes individuals who enter into and approve "excess benefit transactions."

Generally, an excess benefit transaction is defined to include "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit."[17] As such, Section 4958 applies only to transactions in which (1) an applicable tax-exempt organization provides a benefit (2) to a disqualified person, either directly or indirectly;[18] and (3) the value of the benefit received from the applicable tax-exempt organization by the disqualified person exceeds the value of the consideration provided to the organization.[19] Each of these elements is discussed in detail below.

Applicable tax-exempt organization. For a benefit to result in an excess benefit transaction, it must be provided by an applicable tax-exempt organization. For purposes of Section 4958, "applicable tax-exempt organization" generally "includes any organization that was described in section 501(c)(3) or (4) and was exempt from tax under section 501(a) at any time during a five-year period ending on the date of an excess benefit transaction."[20] However, certain organizations such as private foundations, governmental units, and exempt organizations whose income is excluded from gross income under Section 115 are excepted from the definition of an applicable tax-exempt organization.[21]

Therefore, while executive compensation remains a significant issue for private foundations and organizations exempt under other provisions of Section 501(a), the provision of excessive compensation by these organizations will not result in

the imposition of Section 4958 intermediate sanctions.

Disqualified persons generally. In addition to requiring a benefit from an applicable tax-exempt organization, that benefit must be conferred on a disqualified person, either directly or indirectly, to result in an excess benefit. Generally, the term "disqualified person" is defined to include individuals in a position to exercise substantial influence over the affairs of an organization at any point during the five-year period ending on the date of the transaction, and their family members.[22]

Disqualified persons—Substantial influence. In determining whether a person has substantial influence, the Service looks to the individual's position within the organization, his or her responsibilities, and the facts and circumstances relating to his or her employment. Additionally, the regulations expressly deem certain individuals not to have substantial influence.

The regulations set out four categories of individuals who are deemed to have a substantial influence over the affairs of an organization due to their position within the organization:

- *Voting members of the organization's governing body.* Any person who serves on the organization's governing body, and is entitled to vote on any matter over which the governing body has authority, has substantial influence over the affairs of an organization.[23]
- *Presidents, chief executive officers, and chief operating officers.* Any person, regardless of title, who has the ultimate responsibility for implementing the decisions of the governing body is a disqualified person. If the authority is divided among two or more people, each person with such authority is deemed to have substantial influence.[24]
- *Treasurers and chief financial officers.* Any person, regardless of title, who has the ultimate authority for managing an organization's finances is deemed to have substantial influence.[25]
- *People with material financial interests in a provider-sponsored organization.* This category is specific to hospitals. If a hospital participates in a provider-sponsored organization, any person with a material financial interest in the provider-sponsored organization has substantial influence with respect to the hospital.[26]

Aside from the general categories of individuals deemed to have substantial influence, the most important thing to take from the definitions of these categories is that a person does not have to have a particular title in the organization to be deemed to have substantial influence. Rather, the regulations look to an individual's responsibilities within the organization. As such, organizations cannot avoid the impact of Section 4958 through the use of creative titles.

As individuals with substantial influence, each of these groups of individuals are considered disqualified persons and may be subject to intermediate sanctions. Additionally, the approval of excessive compensation to any of these individuals may result in excise taxes imposed on a charity's board members who approve the payment of such compensation.

The scope of individuals who have substantial influence over an organization is not limited to the organization's management or even to people actually employed by an organization. The regulations provide multiple circumstances in

which an individual, regardless of his or her position within an organization, may be deemed to be a disqualified person based on all relevant facts and circumstances.[27] Facts and circumstances that are indicative of substantial control include the following:

- The person is the founder.[28]
- The person is a substantial contributor.[29]
- The person's compensation is primarily based on the organization's revenue or the revenue of a particular function of the organization that is controlled by the person.[30]
- The person has or shares the authority to control a substantial portion of the organization's capital expenditures, operating budget, or employee compensation.[31]
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's overall activities.[32]
- The person owns a controlling interest in a business that is itself a disqualified person.[33]

Based on this list, it is important to recognize that certain individuals, even those seemingly unrelated, may be disqualified persons.

This is frequently an issue for third-party management companies and fundraising organizations that are hired as independent contractors. Independent contractors hired to manage an organization's day-to-day or fundraising activities usually control a substantial portion of the organization's overall activities. Also, organizations that hire independent contractors to provide these services often are cost-conscious and prefer to pay such contractors on the basis of the organization's net revenue, believing that compensation that is a direct result of successful performance is necessarily reasonable. However, based on the facts and circumstances, such independent contractors may be deemed to be disqualified persons because of (1) the substantial control that the contractors exert over a substantial portion of the organization's activities and (2) the fact that the contractors' compensation is based on the organization's revenue or on the organization's fundraising revenue.

In addition to facts that are indicative of substantial influence, the regulations also list facts that indicate the absence of substantial influence for purposes of determining whether an individual is a disqualified person. Facts indicating a lack of substantial influence include the following:

- The person has taken a vow of poverty.[34]
- The person is an independent contractor whose only economic benefit is customary fees for advice rendered.[35]
- The person's direct supervisor is not a disqualified person.[36]
- The person does not participate in management decisions affecting the entire organization.[37]

Based on its consideration of all of these facts, the Service will determine whether the person is a disqualified person.

While it is useful for organizations to understand the facts-and-circumstances

test, this is something that the author's firm has rarely seen the Service use to determine whether an individual is a disqualified person for purposes of Section 4958. In most situations, it can be difficult for the Service to demonstrate substantial influence based on the facts and circumstances. As such, to the extent that these arrangements appear to be reasonable, compensation for such people presents significantly less risk than compensation to individuals who are disqualified persons due to their position within the organization.

If an individual is not a disqualified person because of his or her position within an organization,[38] or due to a material financial interest in a provider-sponsored organization, then—irrespective of the facts or circumstances of employment—an individual who is not a "highly compensated employee" as defined by Section 414(q)(1)(B)(i) is deemed not have substantial influence for purposes of Section 4958.[39] Section 414(q)(1)(B)(i) defines the term "highly compensated employee" to include employees with compensation in excess of a defined amount of compensation that is adjusted for cost of living increases. Therefore, in 2012, unless a person is a disqualified person due to his or her position within an organization, that person will not be deemed to have substantial influence over an organization regardless of the surrounding facts or circumstances of his or her employment if that person earns less than $115,000.[40]

As the individual will not be considered to have substantial influence over the organization, that person will not be subject to intermediate sanctions under Section 4958 regardless of the reasonableness of his or her salary.

Disqualified persons—Family members. Family members of individuals who exert substantial influence are also disqualified persons for purposes of Section 4958. The regulations limit individuals considered to be family members to a disqualified person's spouse; brothers and sisters (by whole or half-blood); spouses of brothers or sisters; ancestors; children (including legally adopted children); grandchildren; great-grandchildren; and spouses of children, grandchildren, and great-grandchildren.[41] Therefore, in addition to concerning itself with reasonableness of the compensation of an organization's management, a governing board must also consider the reasonableness of compensation provided to the family members of those individuals who are employed by the organization.

Excessive benefit. Finally, the most important element of an excess benefit transaction is the existence of the excessive benefit. As the name "excess benefit transaction" implies, without an excessive benefit, there is no issue under Section 4958.

An excess benefit is the amount by which a benefit received by a disqualified person exceeds the value of the consideration provided by the disqualified person to the organization.[42] As such, to determine whether there is an excess benefit transaction, the Service must determine the value of the benefit received by the disqualified person, the value of the consideration provided by the disqualified person to the organization (such as the value of his or her services), and the amount by which the consideration provided by the charity exceeds the value of the consideration received by the disqualified person.

WHAT ARE THE RISKS?

Even after an executive recognizes that people care about his or her compensation and that the amount of compensation does matter, many executives believe this to be an academic question without any real risk. As previously mentioned, however, this belief is incorrect. The risks associated with

overcompensation are significant, and they are borne by both the organization and by the individuals in control of the organization's activities.

Risks borne by the organization. As discussed above, if a tax-exempt organization is found to be in violation of the private inurement proscription, the Service has the power to revoke the organization's tax-exempt status. As revocation is the only penalty for engaging in activities that provide a substantial private benefit, the entire risk of this issue rests with the organization, not management.

It is also important to understand the scope of the risk with respect to inurement and private benefit. If an organization's activities confer a private benefit, the conferring of such a benefit will be fatal to the organization's exempt status only to the extent that the Service determines that the private benefit is substantial in light of the organization's total operations.[43] As such, in *American Campaign Academy,* the Service did not revoke the organization's exempt status because the Republican Party received *some* benefit from the organization due to the qualified campaign managers educated by the organization. Rather, the organization's exempt status was revoked because the organization's graduates "served on campaigns of candidates who were predominantly affiliated with the Republican party"[44] and "the placement of 85 of petitioner's graduates in the campaigns of 98 Republican Senatorial and Congressional candidates conferred a benefit on those candidates."[45] Thus, the substantiality and purpose of the benefit, not its existence, caused the revocation.

Unlike the private benefit doctrine, the prohibition against private inurement is absolute. As such, for purposes of applying inurement, the Service has taken the position that "any taking of the profits (net earnings) is fatal to exemption; the concept does not even go so far as looking at the quality of the organization's charitable activities."[46] Moreover, in applying the private inurement doctrine, the courts have expressly refused to consider whether the total amount that inured to an individual would have been reasonable if paid as compensation.[47] Therefore, the payment of excessive compensation to an organization's managers, or the provision of substantial benefits in addition to compensation, presents significant risks to an organization's exempt status, even when the provision of such benefits is isolated and small in amount.

Risks borne by management and the governing body. In addition to the risks that excessive compensation creates for tax-exempt organizations, the approval and payment of excessive compensation also create a substantial amount of risk of personal liability for individuals who receive excessive benefits and the organization managers who approve the payment or otherwise participate in excess benefit transactions.

Taxes on disqualified persons who receive excess benefits. As discussed above, Section 4958 imposes excise taxes on disqualified persons who receive an excessive benefit from an applicable tax-exempt organization. If the Service determines that a disqualified person received an excessive benefit, under the "initial tax" imposed by Section 4958(a)(1), the Service may impose an excise tax of up to 25% of the amount of excessive benefit on the disqualified person. Additionally, the disqualified person is required to "correct" the excess benefit transaction by "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."[48] Finally, if more than one person is liable for the tax imposed on an excess benefit transaction, each person is jointly and severally liable for the amount of the tax owed.[49] Therefore, under Section 4958(a)(1), a disqualified person could be liable for an amount equal to 125% of

the amount of an excessive benefit received from an applicable tax-exempt organization.

In addition to the initial tax, Section 4958(b) imposes an "additional tax" on disqualified persons who fail to correct the excess benefit transaction before the Service issues a notice of deficiency regarding the excess benefit. The additional tax imposed by Section 4958(b) is equal to 200% of the portion of the uncorrected amount of the excess benefit transaction.[50] Therefore, if a disqualified person receives an excessive benefit and does not timely correct the excess benefit transaction, the person may be liable for up to 225% of the excessive amount of the benefit.

Under this section of the Code, if an organization's chief executive officer received $200,000 in total compensation and the Service determines that the reasonable amount of compensation was $100,000, the Service could assess intermediate sanctions against the individual. Under these facts, if the CEO corrects the excess benefit, then he or she will have received $200,000 in total compensation and would have been required to pay an excise tax to the IRS of $25,000 while returning $100,000 to the organization. If the CEO did not correct the excess benefit described above, he or she would have received $200,000 in total compensation and would be liable for $225,000 in excise taxes under Section 4958. Thus, it is clear that, under Section 4958, the risks of excessive compensation on those receiving the compensation are significant.

Taxes imposed on participating organization managers. In addition to imposing taxes on disqualified persons who receive excessive benefits, Section 4958(a)(2) "imposes a tax equal to 10 percent of the excess benefit on the participation of any organization manager who knowingly participated in the excess benefit transaction."[51] For purposes of this provision, an "organization manager" generally includes "any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title."[52] "Participation" includes both active participation, such as voting in favor of the transaction, and passive participation, such as silence or inaction.[53] Finally, "knowing" requires that the organization manager (1) has knowledge that the fact of the transaction could cause the transaction to be an excess benefit transaction, (2) is aware of the law prohibiting excess benefit transactions, and (3) is aware that the transaction is an excess benefit transaction or fails to make an attempt to ascertain whether the transaction is an excess benefit transaction.[54]

If these conditions are met, the payment of excessive compensation could result in the assessment of an excise tax on the organization managers as well as the individual who received the excess benefit. Additionally, because of the broad definition of the term "participation," an individual who receives an excessive benefit also "participated" in the transaction. As such, the recipient of the excessive benefit may be liable for the 10% excise tax on organization managers in addition to being liable for the taxes imposed by Sections 4958(a)(1) and 4958(b).

FEAR

Once the risks are explained, many organizations panic. This is especially true of three types of organizations—those that have been pushing the envelope with respect to compensation, those with a passive board that has generally complied with the every recommendation made by management, and those that have been controlled by members of a single family. While panicking, an organization's board will want definitive answers and may take drastic measures to correct any

perceived issues. At this point, boards will want to know: what is reasonable compensation; what does the IRS look to in determining whether compensation is reasonable; and whether the organization needs to remove all board members who are related, through family or business, to officers or other board members. It is also common at this point for board members to ask to resign from the board based on concerns about personal liability.

HOW MUCH IS REASONABLE COMPENSATION?

Unfortunately, there is no single or easy answer to this question. Reasonable compensation is based on the facts and the circumstances of each employment situation. In determining the precise amount of reasonable compensation, one must consider a multitude of factors about the organization, its activities, and the individual employee being compensated. In some situations, an organization's president may be overcompensated while receiving an annual salary of $20,000 at the 70th percentile. In other situations, an individual may be reasonably compensated with an annual salary of $800,000 at the 80th percentile. As a result, it is impossible to define what reasonable compensation is; it is only possible to explain what the Service looks to in determining whether a compensation amount is reasonable.

Property transactions. For property transactions, the regulations define fair market value as "the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of all relevant facts."[55] While generally applying the definition of fair market value used in the regulations, courts have noted that the "willing buyer" and "willing seller" are hypothetical individuals, and that the "hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage."[56] Moreover, when determining fair market value, "the hypothetical sale should not be construed in a vacuum isolated from the actual facts that affect the value."[57] Rather, "the valuation method must take into account, and correspond to," the attributes of the transaction being valued.[58]

Reasonable compensation. In determining whether an amount of compensation is reasonable, the Service must first determine the value of the benefit. With respect to compensation for services, the regulations provide that, with the exception of certain specified benefits, the amount of compensation paid to a disqualified person includes "all forms of cash and noncash compensation"[59] and "all other compensatory benefits, whether or not included in gross income for income tax purposes."[60] The regulations provide that compensation for purposes of Section 4958 does not include nontaxable fringe benefits, expense reimbursement payments made according to an accountable plan, or de minimus fringe benefits.[61] Thus, the scope of compensation for purposes of Section 4958 goes well beyond the scope of compensation for purposes of federal income taxes.

While the regulations broaden the type and amount of compensation subject to Section 4958, they narrow the definition of services provided in exchange for such compensation, stating that a taxable "economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid."[62] Organizations are not required to demonstrate such intent for non-taxable benefits, such as employer-provided health benefits, contributions to qualified pensions, employer-provided benefits under a Section 127 education assistance program, or employer-provided benefits under a

Section 137 adoption assistance program.[63]

For purposes of the contemporaneous demonstration of intent to treat certain benefits as compensation, the regulations require that an organization demonstrates its intent (1) by reporting the value of the benefit as taxable income on the individual's Form W-2;[64] (2) by reporting the benefit as compensation on the organization's Form 990;[65] (3) by including the amount in a written employment contract;[66] (4) by including the amount in a written document demonstrating that an authorized body intended an amount to be paid as compensation, i.e., board meeting minutes;[67] or (5) through written evidence demonstrating the organization's belief that the benefit was not taxable.[68] In addition to these methods, if an employee reports an amount as wages on his or her individual income tax return, Form 1040, the amount will be characterized as compensation.

Once it determines the total amount of the benefit received by the disqualified person, the Service will compare the amount that the organization paid to the value of the services to determine whether there was an excess. For purposes of this analysis, the "value of services" is "the amount that would ordinarily be paid for like services by like enterprises."[69] Unfortunately, this is not very clear and there is not much additional guidance on this issue. In the 2003 continuing professional education program, however, the Service noted that in evaluating the reasonableness of compensation, it will consider the following:

- The amount of compensation paid by similarly situated organizations, both taxable and exempt, for functionally comparable positions.
- The availability of similar services in the geographic area of the applicable exempt organization.
- Current compensation surveys.
- Actual written offers from competing organizations.[70]

CAN EXECUTIVE COMPENSATION EXCEED THE 50TH PERCENTILE?

Yes, executive compensation can exceed the 50th percentile. As the reasonableness of executive compensation depends on the facts and circumstances of each situation, the same amount of compensation may not be appropriate for two seemingly similar positions. As such, organizations should not strive to pay amounts identical to what is paid by other organizations. Rather, organizations should use the information provided by other organizations to determine the appropriate amount of compensation for individuals with similar responsibilities within their organization. Moreover, the regulations pertaining to the rebuttable presumption discussed below recognize that there may be situations in which an organization may intentionally decide to provide compensation that is either above or below the range of reasonableness demonstrated by the comparability data and, in such situations, the regulations merely require the organization to "record the basis for its determination." [71] Thus, it is not necessary for every organization to pay every executive at the 50th percentile; in fact, blindly paying at a particular percentile may lead to inappropriately high or low levels of compensation.

ACCEPTANCE

Once the organization has acknowledged and accepted that it must pay

compensation to its officers and employees, and that there are risks associated with the overcompensation of such individuals, the organization will start to be productive in its assessment of risks and its efforts to address such risks.

HOW TO PROTECT THE ORGANIZATION AND OFFICIALS?

The best way for an organization to protect itself from the risks of excessive compensation is to: (1) establish the rebuttable presumption of reasonableness, (2) establish compensation and conflicts of interest policies that ensure independence on all decisions related to compensation, (3) obtain the advice of experts where prudent, and (4) avoid raising red flags through IRS filings.

Establish the rebuttable presumption of reasonableness. The regulations establishing the rebuttable presumption of reasonableness set forth a procedure that allows exempt organization directors to evaluate compensation levels paid to insiders. [72] The benefit of following the procedure is that doing so creates a "rebuttable presumption" that the payment amounts are reasonable. In short, all of the following three steps are necessary to establish a presumption that the amount of compensation is reasonable:

(1) The compensation arrangement is approved in advance by an authorized body of the organization, and that body is composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement.

(2) The authorized body obtained and relied upon appropriate data as to comparability (such as valid salary surveys) prior to making its determination.

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination.

The IRS still may "rebut" the presumption, but only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. It should also be noted that under the regulations, an organization's failure to establish the rebuttable presumption of reasonableness should not create a presumption about the existence of an excess benefit.[73]

For the first of the above steps, the "authorized body" may be the members of the board of directors of an organization or a committee established by the board. Of course, individuals who are having their compensation reviewed may not be members of such a body, nor may relatives of such individuals or others who may have a conflict of interest with regard to the determination.

For the second of the above steps, "adequate comparability data" may include a comparison with the compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; a review of the availability of similar services or expertise in the geographic area of the applicable tax-exempt organization; and a review of current compensation surveys compiled by independent firms.

Finally, for a decision to be documented adequately, the written or electronic records of the authorized body must note all of the following:[74]

(1) The terms of the transaction that was approved and the date it was approved.

(2) The members of the authorized body who were present during debate on the

transaction that was approved and those who voted on it.

(3) The comparability data obtained and relied upon by the authorized body and how the data was obtained.

(4) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

(5) If the authorized body determines that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination.

(6) For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate, and complete within a reasonable time thereafter.

Institute policies ensuring independence. Two of the most important policies that can be used to protect an organization against the possibility of excessive compensation are a conflict of interest policy and a compensation policy that establishes the rebuttable presumption of reasonableness. These policies will help in three very important ways. First, the implementation of these policies will increase the independence and thoroughness of the compensation approval process, which by its nature will decrease the probability that an organization will provide unreasonably excessive compensation. Second, as discussed in greater detail below, implementation of the policies will be reported on the organization's Form 990, which leads to the perception of a compliant organization. Third, the use of such policies will result in the rebuttable presumption of reasonableness, which will itself lead to several substantial benefits relating to the perceived reasonableness of executive compensation.

Obtain the advice of experts. Obtaining the opinion and advice of an independent expert in the compensation approval process is a valuable tool to protect the organization from paying unreasonably high compensation. Additionally, the regulations provide that where a governing body obtains and relies on the reasoned written opinion of a professional with respect to the elements of the transaction, the governing body will not be deemed to have knowingly participated in an excess benefit transaction, even if the amount of compensation is subsequently determined to be excessive for purposes of Section 4958.[75] As such, the reliance on the well-reasoned advice of an organization's legal counsel, an accounting firm with expertise regarding relevant tax law matters, or an independent compensation valuation expert can be used to protect the governing body and other organization managers from excise taxes imposed by Section 4958(a)(2).

Avoid raising red flags in IRS filings. The easiest way for the Service to find organizations that provide unreasonably excessive compensation is by reviewing the information sent to the IRS every year on Form 990. As previously discussed, Form 990 requests a substantial amount of information related to executive compensation, including: "did the organization engage in an excess benefit with a disqualified person"[76] and did the organization "follow the rebuttable presumption procedure" with respect to executive compensation.[77]

With questions that are specific to whether an organization provided excessive benefits, it is important for organizations to understand what is reported in their

annual Forms 990, and tailor their compensation practices to the information reported. For instance, in Part V, Form 990 requests a substantial amount of information about governance procedures, including whether an organization has implemented policies not required by the Code. While these policies are not required, the absence of these policies will not go unnoticed, especially for organizations that pay significantly higher amounts of compensation than their peers.

In short, one way that an organization can protect itself is by understanding the Form 990, and establishing a compensation policy that is responsive to the compensation information reported on the form.

Finally, if an organization suspects that it may have engaged in one or more excess benefit transactions in the past, it should consult with legal counsel expert in the area before simply conceding that fact through checking the relevant box on the Form 990. There are multiple ways to deal with problems like this.

OTHER ISSUES

When dealing with excess benefit transactions, the Service's enforcement of the **Section 4958** is as important as, if not more important than, the content of the law itself. About six years ago, an organization was under examination for periods during which its highest executives had taken about $50 million from the organization through transactions with corporations controlled by the executives. However, the Service, still hurting from its loss in the *Caracci* case, did not even raise the issue of intermediate sanctions, choosing instead to pursue revocation on the basis of private inurement and public benefit. In that era, just after the *Caracci* decision, excessive compensation was an exemption issue only and intermediate sanctions were no more than an afterthought. Today, however, intermediate sanctions are an issue explored in every examination with potential compensation issues. Unlike six years ago, when the Service ignored a potential $50 million issue, within the last two years the Service has raised automatic excess benefit transaction issues for total proposed assessments of less than $750.

IRS ENFORCEMENT OF SECTION 4958

Based on the recent experience of the author's firm, the Service does not play fair when it comes to enforcement of **Section 4958**. The Service's current enforcement efforts appear to have three purposes: (1) assessing an extremely high excise tax for the purpose of achieving a quick settlement, (2) making inappropriate inferences from organizations that fail to establish the rebuttable presumption of reasonableness, and (3) asserting very small penalties under the automatic excess benefit provisions of the Code.

Unsupported excessive penalties. To demonstrate that a transaction resulted in an excessive benefit to a disqualified person, the Service must demonstrate that the benefit received by the disqualified person exceeded the fair market value of the consideration provided to the applicable tax-exempt organization. It is therefore not sufficient for the Service merely to assert the existence of an excessive benefit. Rather, it must demonstrate the existence of a benefit that exceeded the fair market value of all consideration provided, including consideration provided in years other than those in which the benefit was conferred.

At least one court has ruled that it is arbitrary and erroneous for the Service to

impose a Section 4958 excise tax based on a valuation analysis that is provided by an individual who lacks sufficient expertise and who based his valuation on incomparable data.[78] In the *Caracci* decision, the court denied the imposition of intermediate sanctions where the Service's position was based on a valuation resulting from "a brief, intermediate internal analysis." Further, the court noted that where the Service took a position based on a valuation that was clearly erroneous and:

> "so incongruous as to call [the Commissioner's] motivation into question...[i]t can only be seen as one aimed at achieving maximum revenue at any cost...seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement—or, failing that, then a compromise judgment—somewhere between the value returned by the taxpayer...and the unsupportedly excessive value eventually proposed by the Commissioner."[79]

Therefore, when asserting an excise tax under Section 4958, not only is it necessary for the Service to provide a valuation demonstrating the excessive value of the benefit received, it is necessary for the Service to demonstrate the accuracy and reasonableness of it valuation. However, as in *Caracci*, the Service's current enforcement efforts appear to be focused on intimidation and not reasonable efforts to determine the value of all of the consideration exchanged between the parties.

As an example, in a recent Tax Court case handled by the author's firm regarding intermediate sanctions, the Service determined that a disqualified person's sale of property to a public charity conferred a benefit of $0 on the charity because, in the Service's unsupported opinion, the charity could have obtained the property from the disqualified person without charge.[80] More significant than the unsupported nature of the Service's position is the fact that, during discovery, the taxpayer learned that, prior to issuing the notice of deficiency, an IRS valuation engineer actually analyzed the transaction and determined that the value of the consideration received by the charity exceeded the amount of consideration provided to the disqualified person. As such, in this case, the Service disregarded the reasoned opinion of its own valuation expert in determining an excise tax in excess of $1 million.

In situations such as the *Ossenfort* case,[81] the Service's determination, as unreasonable as it may seem, puts the taxpayer in a precarious situation. First, the Tax Court rules favor the IRS. Second, the expense of litigation, viewed in conjunction with the possibility of having to pay even a portion of the proposed penalty upon losing the case in court, makes it very difficult to justify continued litigation by compounding the potential harm that could result. Thus, in the *Ossenfort* case handled by the author's firm, even though the Service conceded the entire amount of tax provided by the notice of deficiency and agreed that the total amount of tax owed by the taxpayer was $0, the Service was able to punish the petitioner by waiting to settle the case until just over a month before the trial.

The substantial delay in conceding the case essentially allowed the Service to punish the taxpayer by forcing her to endure to the stress, public embarrassment, and expense of litigation for almost two years. As a result, throughout the litigation of an issue for which the Service fully conceded, the author's client was forced to deal the with self-doubt and public pressures resulting from the litigation. These pressures, in addition to the potential penalty in excess of $1 million, caused the taxpayer to consider the giving up the fight several times before the Service finally conceded the case. Fortunately for the author's client, she was committed to her cause and saw the case through until

its conclusion, vindicating her perseverance and efforts.

Inappropriate inferences regarding the rebuttable presumption. As previously mentioned, the regulations provide that the fact that a transaction between an applicable tax-exempt organization and a disqualified person is not subject to the presumption of reasonableness does not create any inference that the transaction is an excess benefit transaction.[82] However, this is not the case in the Service's current enforcement of Section 4958. In the Tax Court, the Service has effectively taken the position that the taxpayer's failure to contemporaneously establish the value of the consideration provided to the charitable organization is in itself evidence of an excess benefit transaction. Additionally, in other situations, the Service has used the lack of the presumption of reasonableness to base its position on weak and easily distinguishable comparability data.

In litigation, the Service's position is that because the notice of deficiency is presumed to be correct, it is the taxpayer's obligation to prove the value of the consideration that the tax-exempt organization received in the transaction. As such, the Service has taken the position that it is not required to produce anything aside from its theory in order to sustain its position. In fact, the Service has said in some instances that it does not even intend to use a valuation expert to support its position at trial.

In other situations, the Service has used the lack of the rebuttable presumption to base its position on weak and distinguishable evidence. As noted above, under the regulations, to rebut the presumption of reasonableness the Service must develop "sufficient contrary evidence to rebut the probative value of the comparability relied upon by the authorized body."[83] Where there is no comparability data to rebut, however, the Service has based its position on a selective and incomparable set of data. For example, on one occasion, in support of its determination of intermediate sanctions, the Service compared the compensation of the chief executive officer of an organization located in Los Angeles to organizations located in places such as Kokomo, Indiana; Bethany, Oklahoma; Sioux City, Iowa; and South Portland, Maine. In fact, in the Service's study, of the 13 organizations listed in the Service's comparability report, only three organizations were located in cities with populations greater than 500,000. Additionally, one of the 13 organizations included in the Service's comparability report did not report any information regarding the compensation of its chief executive officer, whom the Service incorrectly included in the report as a full-time employee who received compensation of $0. Therefore, because the Service was not required to develop sufficient information to rebut information used by the taxpayer, it developed a flawed report it could use to support the position that it wanted to take.

Automatic excess benefit transactions. Another way in which the Service is able to force taxpayers into quick and unchallenged assessments is by characterizing a payment as an automatic excess benefit.

The regulations provide that if "an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction."[84] Thus, any benefit provided to a disqualified person will be an automatic excess benefit subject to the correction provisions of Section 4958 unless the organization demonstrates its intent to provide the benefit in exchange for services through contemporaneous documentation.

Automatic excess benefit transactions, especially those resulting from

reimbursement of business expenses, tend to be the result of poor recordkeeping and not an intentional effort to gain substantial excessive benefits. As such, these are most often found in small organizations that lack the sophistication or administrative processes of larger, more established organizations. Also, unlike $50 million excesses, the lower amounts of unsupported reimbursements are unlikely to be challenged because it is simply not cost-effective to pay for outside counsel to contest a $700 penalty. Thus, through the enforcement of the automatic excess benefit transaction rules, the Service is able to assess penalties under **Section 4958** without challenge.

RECOMMENDATIONS

In light of the substantial scrutiny executive compensation attracts and the Service's current enforcement efforts, it is important that charities take certain precautions to protect themselves against the perception or possibility that they are providing excessive executive compensation. One of the most important things organizations can do to protect themselves is to create and implement a compensation approval policy that establishes the rebuttable presumption of reasonableness. A second way in which organizations can protect themselves, and especially their boards of directors, is to obtain advice regarding the reasonableness of compensation. Finally, for transactions that involve insiders of the organization, but are not necessarily compensation arrangements, the implementation and use of a thorough conflict of interest policy can help avoid excess benefit transactions. Implementation of these recommendations can protect an organization and its managers by providing several distinct advantages.

First, by their nature, policies that focus on independence and reliance on third-party information in approving compensation diminish the risk of paying greater than fair market value. As the approving body is independent, there are no biases to cause the approval of an excessive amount of compensation. Additionally, because the process is based on a review of objective data, the results of the independent body's analysis are more likely to be within the range of reasonable compensation.

Second, as discussed above, even though the presumption of reasonableness is "rebuttable," the author's firm has never seen the Service undertake the effort to actually challenge the presumption of reasonableness. To rebut the presumption, the Service must develop "sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body" of the charity.[85] This is a fairly high standard, however, and the firm has not seen the Service develop the factual information necessary to rebut a presumption (though there have been situations in which the Service has carefully analyzed the information used to establish the rebuttable presumption before deciding not to pursue intermediate sanctions). Thus, it is clear that the use of the rebuttable presumption, though not a true safe harbor (a pseudo-safe harbor, if you will), is a very effective tool for protecting the organization and its managers from the imposition of intermediate sanctions.

Third, as discussed above, the regulations provide that the reliance on professional advice in approving a transaction precludes the knowing participation in a transaction. Therefore, by instituting a compensation approval policy that requires the organization's governing body to obtain and use the advice of an independent expert in establishing the rebuttable presumption of reasonableness, the organization will automatically protect the members of its governing body from being taxed as organization managers who knowingly

participated in an excess benefit transaction.

CONCLUSION

Executive compensation is a very significant issue for both public charities and the individuals who control them. As such, it is extremely important for organizations to take great care in establishing the amount of compensation for its executives—not only to ensure the organization is retaining the most effective executive personnel, but of equal importance, to protect the organization's tax-exempt status and prevent the imposition of intermediate sanctions, both on the executive and/or the organization's managers. By implementing the appropriate policies and determining compensation based on appropriate data, charities can limit their exposure to the consequences of excess benefit transactions, continue to provide executives with competitive compensation for their services, and avoid an unnecessary and often painful journey through the denial and fear phases of executive compensation.

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This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

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11 Founding Church of Scientology, 24 AFTR 2d 69-5187, 188 Ct Cl 490, 412 F2d 1197, 69-2 USTC ¶9538 (Ct. Cl., 1969).

12 John Marshall Law School, 48 AFTR 2d 81-5340, 81-2 USTC ¶9514 (Ct. Cl., 1981) at 81-5348.

13 Founding Church of Scientology, 24 AFTR 2d 69-5187, 188 Ct Cl 490, 412 F2d 1197, 69-2 USTC ¶9538; John Marshall Law School, 48 AFTR 2d 81-5340, 81-2 USTC ¶9514.

14 Church of Scientology of California, 60 AFTR 2d 87-5386, 823 F2d 1310, 87-2 USTC ¶9446 (CA-9, 1987).

15 Founding Church of Scientology, *supra* note 11; See also, Mabee Petroleum Corp., 43 AFTR 872, 203 F2d 872, 53-1 USTC ¶9334 (CA-5, 1953) ("The familiar principle that corporate net earnings may not be

channeled to officers in the form of excessive and unreasonable salaries is too well settled to require citation of authority.").

16 See, generally, Section 4958.

17 Reg. 53.4958-4(a)(1).

18 Section 4958(c)(1)(A).

19 *Id.*

20 Reg. 53.4958-2(a)(1).

21 Reg. 53.4958-2(a)(2).

22 Section 4958(f)(1). Other persons may also be disqualified persons, including certain controlled organizations and certain donors and donor advisors. However, such persons are not discussed in this article because they are unlikely to be compensated as officers of an exempt organization. Similarly, only individuals can be compensated as executives, so other entities that may be disqualified persons are not discussed in this article.

23 Reg. 53.4958-3(c)(1).

24 Reg. 53.4958-3(c)(2).

25 Reg. 53.4958-3(c)(3).

26 Reg. 53.4958-3(c)(4).

27 Reg. 53.4958-3(e)(1).

28 Reg. 53.4958-3(e)(2)(i).

29 Reg. 53.4958-3(e)(2)(ii).

30 Reg. 53.4958-3(e)(2)(iii).

31 Reg. 53.4958-3(e)(2)(iv).

32 Reg. 53.4958-3(e)(2)(v).

33 Reg. 53.4958-3(e)(2)(vi).

34 Reg. 53.4958-3(e)(3)(i).

35 Reg. 53.4958-3(e)(3)(ii).

36 Reg. 53.4958-3(e)(3)(iii).

37 Reg. 53.4958-3(e)(3)(iv).

38 For purposes of this definition, family members of disqualified persons are deemed to have substantial influence.

39 Reg. 53.4958-3(d)(3).

40 News Release IR 2011-103, 10/20/11, available at www.irs.gov/newsroom/article/0,,id=248482,00.html.

41 Reg. 53.4958-3(b)(1).

42 Reg. 53.4958-1(b).

43 IRM 4.76.3.11.1(3).

44 American Campaign Academy, *supra* note 7 at 1071.

45 *Id.* at 1073.

46 IRM 4.76.3.11.1(3).

47 See Founding Church of Scientology, *supra* note 11 at 412 F.2d 1202 ("If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient's salary, in increased by the amount of the distribution or benefit, would still have been reasonable.").

48 Section 4958(f)(6).

49 Reg. 53.4958-1(c)(1).

50 Reg. 53.4958-1(c)(2)(i).

51 Reg. 53.4958-1(d)(1).

52 Reg. 53.4958-1(d)(2)(i).

53 Reg. 53.4958-1(d)(3).

54 Reg. 53.4958-1(d)(4)(i).

55 Reg. 53.4958-4(b)(1)(i).

56 Estate of True, TC Memo 2001-167, RIA TC Memo ¶2001-167, 82 CCH TCM 27 , 1184.

57 Estate of Andrews, 79 TC 938 , 956 (1982).

58 Caracci, 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (CA-5, 2006).

59 Reg. 53.4958-4(b)(1)(ii)(B)(1).

60 Reg. 53.4958-4(b)(1)(ii)(B)(3).

61 Reg. 53.4958-4(a)(4).

62 Reg. 53.4958-4(c)(1).

63 Reg. 53.4958-4(c)(2).

64 Reg. 53.4958-4(c)(3)(i)(A)(1).

65 Reg. 53-4958-4(c)(3)(i)(A)(2).

66 Reg. 53.4958-4(c)(3)(ii)(A).

67 Reg. 53.4958-4(c)(3)(ii)(B).

68 Reg. 53.4958-4(c)(3)(ii)(C).

69 Reg. 53.4958-4(b)(1)(ii).

70 Brauer and Henzke, "Intermediate Sanctions (IRC 4958) Update," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 2003* (2002) at E-22.

71 Reg. 53.4958-6(c)(3)(ii).

72 Reg. 53.4958-6.

73 Reg. 53.4958-6(e).

74 Reg. 53.4958-6(c)(3).

75 Reg. 53.4958-1(d)(4)(iii).

76 Form 990, Part IV, Line 25a.

77 Form 990, Schedule J, Part 1, Line 9.

78 Caracci, *supra* note 58.

79 *Id.* at 98 AFTR 2d 2006-5264, 456 F3d 444, 2006-2 USTC ¶50395 (quoting Estate of Dunn, 90 AFTR 2d 2002-5527, 301 F3d 339, 2002-2 USTC ¶60446 (CA-5, 2002)).

80 Ossenfort, Docket No. 024352-10.

81 *Id.*

82 Reg. 53.4958-6(e).

83 Reg. 53.4958-6(b).

84 Reg. 53.4958-4(c)(1).

85 Reg. 53.4958-6(b).

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ARTICLES

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ASSOCIATION EXECUTIVE EMPLOYMENT CONTRACTS: TERM, TERMINATION AND COMPENSATION

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Hiring a new executive, especially a president or chief executive officer, is always a major undertaking for any association. A great deal of time and effort, and often monetary resources, are invested in finding quality candidates, interviewing the most promising ones, and making a decision about to whom to extend an offer.

During the courtship process, neither party, understandably, wishes to think about, or talk about, the divorce. But, sooner or (hopefully) later, the relationship between the executive and the association will end. For the protection of the association, as well as in fairness to each party, it is important that the possibilities of when and how the relationship can end be clearly expressed in the written agreement and that the executive candidate be presented with the material terms and conditions of their newly offered employment prior to their acceptance of the offer and, importantly, prior to the time they notify their existing employer that they are leaving (or prior to the time that they decline other offers).

This article touches briefly on three key elements of association executive employment contracts – term, termination (including severance pay), and compensation. While it does not endeavor to cover all of the material considerations or possible ways to address these aspects of employment contracts, it highlights some of the issues that tend to be the most important to consider. Finally, note that the provisions regarding term and termination need to be coordinated and read hand-in-hand; they are intimately related.

The Term of the Agreement

Initial Term. Often, the initial term is two or three years. A key factor for associations (and indeed, the executive) to consider when assessing the length of the term is the variety of ways in which the term can end prior to expiration, which is discussed below.

Renewal Term. The agreement should specify clearly what happens at the end of the initial term. There are several options.

First, the agreement could simply *expire* upon the end of the term, with no obligation on either party to continue employment (remember that parties are always free to negotiate extensions if both parties desire to continue the relationship; sometimes it is advantageous for one party or the other to set up such a renegotiation).

A common provision in executive agreements is an *automatic renewal* in the absence of some affirmative notice to the contrary. For example, if one party does NOT provide notice at least 180 days prior to the expiration of the initial term, the agreement might renew automatically for one year.

It is important that both the executive and the association's board remain aware of any approaching deadlines for notices and adhere carefully to the specified procedures for providing notice, as set out in the agreement. This need is particularly acute when, as is typically the case in associations, there are significant changes in director and officer composition year to year.

Termination of the Agreement

Notice by the executive, no cause or reason. Although by no means required, many agreements have provisions that allow the executive to terminate early—without the need for a reason or cause—by giving certain notice. Typically, an executive candidate will want such a provision, particularly if the association will have a similar right. If the association agrees to such a provision, the notice period should take into consideration the hiring cycle and lead time required. That is, if the search process

takes six months, the agreement might specify a notice period of six months.

Notice by the association, no cause or reason. Associations should carefully consider including in the agreement a provision that allows the association to end the agreement early without cause. Establishing cause sufficient for terminating an agreement can be difficult and costly, and result in public embarrassment to the association and the executive. See the discussion below regarding severance pay that typically accompanies such a no-cause termination.

Termination for cause. The agreement should contain a provision for termination for "cause." Cause should be defined. Typically, it includes such things as malfeasance, breach of the agreement, fraud, embezzlement, dishonesty, or gross negligence. Be careful of definitions of cause that require convictions of crimes; no association wants to await the outcome of a criminal proceeding. Drafting cause provisions requires a balancing of the need for protection desired by both the executive and the association. Generally, with a termination for cause, no severance is paid to the executive, which is why the definition is so critical.

What happens when the agreement terminates? The agreement should specify what happens in *each* of the circumstances under which the agreement can end; in the examples outlined above, this includes four contingencies:

- Expiration of the term (and renewal terms, if any);
- Executive gives notice;
- Association gives notice (termination not for cause);
- Termination for cause.

The interests of the parties here are clearly distinct; the executive is looking for as much security as he or she can get, and the association wants to have as little expense as possible tied up in a person who is no longer performing services for the association. The negotiations should find the right balance between the needs of the parties.

If the agreement is ended early by the *executive giving notice*, typically there is no compensation due beyond that due during the time the executive works for the association. If the agreement *expires*, or if the *association gives notice* prior to the end of the specified term (without cause), there are two alternative approaches that are often taken. Under one approach, no compensation is due beyond the notice period and severance might be included under the second. However, it is increasingly the norm for associations to provide some severance pay in the case of separations based on both the expiration of the term and termination without cause. Severance pay is another area in which the needs of the parties need to be carefully balanced. Many factors may need to be considered, including length of service of the executive, the expected lead time for the executive to find new employment, and the impact on the association to be paying both the departed executive and a new executive, among other factors.

If the executive is terminated for cause, the agreement typically provides that the executive receives nothing beyond what was due prior to termination.

Compensation

Obviously, base salary should be clearly set out in an agreement. Typically, an initial salary is specified, with provisions made for future adjustments. However, associations should be cautious about specifying guaranteed increases for future years. While an executive will want some degree of security, that interest must be balanced against the uncertainty of future budgets, the economic environment generally, and the undetermined performance of the executive. Moreover, as the past two years have demonstrated, it can be very awkward for an association to grant significant pay increases to executives while staff members are subject to pay freezes, or worse, layoffs.

Many agreements also provide a bonus opportunity, often tied to the attainment of yet-to-be-specified goals. It is important, however, that the agreement specify that other factors may be considered by the board or its designated committee. From the association's standpoint, it is important to retain discretion with respect to payment of bonuses, and to clearly spell out in the agreement that discretion is retained. The executive often will seek some level of objectivity in the bonus measurement, generally in terms of meeting specified goals or goals to be mutually determined each year. Both associations and executives should be careful regarding trying to established fixed goals in an employment contract, as it can be very difficult to project what factors may become more or less significant in future years.

Associations also must be careful if providing medical, dental or retirement benefits to an executive that are more generous than the benefits provided to non-executives. Associations should consult with a qualified benefits attorney to assess whether the associations' plans permit such benefits and whether the benefits might run afoul of non-discrimination requirements, with potentially adverse tax consequences. Deferred compensation arrangements—more common in larger association executive employment agreements—also have to be carefully structured to not violate the IRS' strict rules in this area, governed principally by Internal Revenue Code ("IRC") Section 409A.

Bear in mind that total compensation provided to an executive of a tax-exempt association—whether exempt under IRC Section 501(c)(6) or 501(c)(3)—must be "reasonable" (at or below fair market value), under the IRC proscription against private inurement. Serious violations in this area can put the tax-exempt status of the association at risk. Executives of Section 501(c)(3) and 501(c)(4) organizations also are personally subject to potentially severe "intermediate sanctions" penalties should they receive either compensation that exceeds fair market value or non-business-related benefits, perks and the like that are not treated as taxable income. In addition, board members and other association leaders that approve such arrangements can be personally subject to intermediate sanctions penalties. There are certain steps that an association can take to minimize the risk that a compensation package will be deemed unreasonable (*i.e.*, approval of the compensation by a group of disinterested decision makers, reliance on appropriate benchmarking or comparability data, and contemporaneous documentation of the same). Finally, the newly revised IRS Form 990 reporting requirements mandate disclosure of certain executive perks such as first-class travel and the payment of social or health club dues. When discussing compensation and benefits for a new executive, remember that certain extras added to sweeten the deal may be subject to public scrutiny.

There are typically many other components in an executive employment contract that are beyond the scope of this article. Some of those components include conflict of interest and ethics provisions, confidentiality, non-competition and non-solicitation, and the like. Some contracts contain alternative dispute resolution procedures, including arbitration provisions. As with the topics covered in this article, it is to the benefit of executive and association alike to have a clear understanding of those rights and obligations prior to the executive candidate accepting employment, and prior to the public announcement of the new executive's hiring; fruitful, thoughtful negotiation and a comprehensive, well-prepared contract will address these issues and find the appropriate balance between the needs of the parties.

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