Getting It Right: What You Need to Know about Nonprofit Executive Compensation

Tuesday, September 15, 2015
2:00 – 3:00pm ET

Speakers

Jeffrey S. Tenenbaum, Esq., Partner and Chair of the Nonprofit Organizations Practice, Venable LLP
Matthew T. Journy, Esq., Counsel, Venable LLP

Upcoming Venable Nonprofit Events

Register Now

- **October 15, 2015** – Thriving Amid Turmoil and Change: What All Nonprofits Can Learn from Nonprofit Turnarounds
- **November 17, 2015** – The DOL's Proposed Changes to the FLSA White-Collar Exemption Criteria: What Nonprofits Need to Know about the Current Rules, Where Things Are Heading, and How to Avoid Employee Classification Traps and Pitfalls
- **December 10, 2015** – Privacy and Data Security: Best Practices, Common Pitfalls, and Hot Topics for Nonprofits *(details and registration available soon)*

Purpose

- Explain the consequences of excessive and inadequate compensation
- Explain how organizations can protect themselves
  - Rebuttable Presumption of Reasonableness
  - Incentive Compensation
- Explain and interpret trends in IRS enforcement

Consequences of Excessive and Inadequate Compensation

Current Social Regulatory Perception

- Who cares?
- Is anyone paying attention?
- What are the risks of excessive compensation?
- What are the risks of inadequate compensation?

Who Cares?

- **IRS** – Protects against tax abuse
- **State Regulators** – Consumer Protection
- **Donors** – Concerned about appropriate portion of contribution is used in accordance with donative intent
- **Members** – Concerned that dues are used in accordance with member intent
- **Media** – Excessive compensation makes great news in current economic environment
- **Competitor Organizations** – The pool of available member and donor funds is smaller than ever creating competition for those funds
- **Competing Interests** – More than ever, non-profit entities are seen as tools of political and social reform, potential adversaries are looking at executive compensation as a means to tarnish public image
- Your **Employees**, **Executives**, and **Target Executives**!

Is Anyone Paying Attention?

- Regulators
  - Professionally educated with low income
  - Tend to believe that all non-profits (especially charities) should be run by people with altruistic purposes
- Donors/Members
  - Looking for greatest return on investment or donation
- Media
  - Looking for a story, reporting is inconsistent
- Employees
  - Comparing executive salary to their own
- Executives and Target Executives
  - Comparing the salaries with peers and other offers

Is Anyone Paying Attention?

- IRS
  - IRS Area Manager Peter Lorenzetti recently identified executive compensation as "far and away the most common risk area for nonprofits" and as issue that the IRS will "look at on every audit we do"
  - Executive compensation was discussed as a significant issue in the Report for the IRS College and University Compliance Project
  - We have seen the IRS assess more intermediate sanctions penalties in each of the last five years than in the entire prior decade combined
  - During a recent conversation with an attorney from the IRS Office of Chief Counsel, we were told that the IRS would aggressively pursue these cases in court

Is Anyone Paying Attention?

- Competing Interests and Media
  - Exempt organizations are more frequently being used to obtain very specific goals and even to attack other exempt organizations.
  - *Playoff PAC v. the Bowl Championship Series*
    - Playoff Pac is developing information off of publicly available IRS Forms
    - Executive compensation is a major issue in media reports about problems with BCS
    - Issue has been highlighted on: HBO, ESPN, Sports Illustrated, Non-Profit Times, etc…
  - Fiesta Bowl's CEO John Junker the subject of media scrutiny
    - CEO Fired
    - Sentenced to 8 months in prison
    - IRS has not weighed in on the issue

Risk of Overcompensation?

- Donors/Members/Competitors
  - Competitors that pay executives less compensation will use this information to attract your donors and members
- Media
  - Sensational articles get a lot of focus, and even when misleading, incorrect, or based on incomplete information, retractions are rare and rarely publicized
- Employees
  - Incongruent pay may lead to discontent and turnover
- Organization Executives
  - May be individually liable for IRS penalties
  - The organization may attract the wrong type of executive

Risk of Overcompensation?

- IRS
  - Revocation of tax-exempt status for private benefit or private inurement
  - Monetary penalties imposed on individual executives that receive excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Monetary penalties imposed on board members and executives that approve the payment of an excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Loss of goodwill

Enforcement Issues

- Private Inurement
  - Code generally provides that no part of organization's net earnings can inure to the benefit of any private individual or shareholder
  - Focused on pecuniary benefits in excess of fair market value
  - Only applicable to benefits conferred on insiders
  - Applies to organizations exempt under multiple sections of the Code, including but not limited to: 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
  - Inurement is grounds for revocation

Exemption Issues

- Impermissible Private Benefit
  - Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
  - A non-exempt purpose is generally a purpose that serves a private rather than a public benefit, as such is generally called a "private benefit"
  - Provision of an impermissible private benefit is grounds for revocation
  - The private benefit prohibition is imposed on a more limited group of exempt organizations than private inurement, and may not be applicable to organizations exempt under 501(c)(6) or 501(c)(7)

Intermediate Sanctions

- Code section 4958 allows the IRS to impose penalties on “disqualified persons” who participate in or approve “excess benefit transactions”
- These penalties are commonly referred to as the intermediate sanctions
- Similar to “private inurement” concept

Intermediate Sanctions – Penalties

- Penalty for receipt of an excessive benefit:
  - Return the value of the excessive benefit to the organization; and
  - An excise tax of either:
    - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service, or
    - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

Intermediate Sanctions – Penalties

- Penalty on organization managers for approval of an excessive benefit transaction:
  - Section 4958(a)(2) imposes a 10% tax on any organization manager that knowingly approves an excess benefit transaction
  - Liability under Section 4958(a)(2) is joint and several and capped at $20,000 per transaction

The Risks of Undercompensating Nonprofit Executives

- Undercompensating
  - Demotivation
  - Retention risk
  - Hiring risk
  - Loss of executive value/standing relative to stakeholders
  - Cap on compensation that can create motivational problems for executive staff and hiring challenges
  - Compression when recruiting talent at the next level

Protecting Yourself

What Can You Do to Protect Your Organization?

- Use caution when entering into transactions with disqualified persons.
- Develop and implement effective governance policies.
- Establish the rebuttable presumption of reasonability

Effective Governance Models in Compensation Determination

- Board or Committee Charter
  - Annual cycle established
  - Manageable number of committee members
  - Designated process and responsibilities between board and management for:
    - Annual performance goal setting and assessment
    - Compensation planning and decisions systematically organized
    - Organization compensation philosophy
    - Organization compensation budget
    - Responsibilities of Committee versus Board designated
- Processes in place for addressing intermediate sanctions, the rebuttable presumption of reasonableness

The Rebuttable Presumption of Reasonableness

- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value.

- To establish the rebuttable presumption:
  1. The transaction must be approved in advance by disinterested members of the organization's governing body;
  2. The governing body must obtain and rely on valid comparability data in approving the transaction; and
  3. The governing body must contemporaneously document its decision and the reason for its decision.

The Rebuttable Presumption of Reasonableness

Benefits of establishing the “rebuttable presumption”:

1. We have never seen the IRS attempt to rebut the presumption;
2. Provides board members with near absolute protection from excise tax on participation;
3. The very nature of the process, independent members using objective data, significantly mitigates the risk of over compensation;
4. Provides organization with a clear and easy explanation about compensation decisions; and
5. Allows the organization to affirmatively answer all Form 990 questions relating to the policies and procedures that the IRS deems to be most desirable.

The Rebuttable Presumption of Reasonableness

- Section 53.4958-6(e) of the regulations provides that an organization's failure to establish the rebuttable presumption does not create any inference that a transaction is an excess benefit transaction. However, our experience representing organizations represents that this is not clearly the case. Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
- The effect of failing to establish the rebuttable presumption:
  - In recent litigation and examinations, the IRS based its entire position on the fact that an organization failed to establish the rebuttable presumption of reasonableness
  - The IRS will prepare its own valuation, often using non-comparable organizations

Professional Resources Available

Professional Resources Available

- When we see this issue raised by clients – *TOO LATE*
- Executive compensation is not an HR issue, it is not an accounting issue, and it is not a pure legal issue
- Do not rely solely on advice of your:
  - Legal counsel;
  - Compensation/valuation expert;
  - Tax accountant or independent auditor; or
  - HR Director

The Role of Outside Advisers

- Compensation Consultant
  - Working directly with the board on CEO compensation and possibly that of disqualified persons
  - Identifying the appropriate market place and data
  - Market Analysis
  - Pay philosophy and strategy
  - Compensation Plan Design
  - Intermediate Sanctions Opinion
  - Expert testimony and opinions

- Legal Counsel
  - Legal and tax research and opinions
  - Plan drafting, including deferred compensation, severance, and employment contracts
  - Partner in detailed plan design
  - Situations requiring Attorney client privilege

- Executive Search Consultants
  - Ensuring that the organization has appropriately considered its compensation philosophy and developed plans in conjunction with compensation experts and legal counsel – before an offer is given

Lessons Learned:
The Unfair Fight

IRS Enforcement—Exams

- IRS uses incomparable data to determine reasonable compensation
- Actual examples:
  - The amount of compensation provided by an organization located in LA was compared to organizations located in: Kokomo, In; Bethany, OK; Tulsa, OK; Sioux City, IA; and South Portland, ME
  - The compensation of a fulltime CEO was compared to the compensation of CEOs working as "interim director," executive director, "VP/Secretary," and one individual with no listed title
  - In determining the average amount of compensation, in one IRS valuation, the IRS included an organization an organization that did not provide any compensation information for its president, and the report treated this as $0 in compensation for purposes of determining the average compensation for a position

IRS Enforcement—Recent Litigation

- Reason for Transaction
  - Organization was a tax-exempt educational counseling organization
  - CEO's wife was the majority owner of a business that provided back-end services related to the organization's counseling program
  - Largest donor decided to withhold all contributions until the organization dissolved the contractual relationship with back-end service provider
  - Organization decided that it could not continue to exist without the continued support of its largest donor

IRS Enforcement—Recent Litigation

- Facts Regarding Transaction
  - The time remaining on contract between the organization and Service provider was three years
  - The cost of breaching was estimated to be $2.2 million
  - At the time of the transaction, wife owed $600,000 from the purchase of the company
  - Without obtaining a formal valuation, wife agreed to sell the service provider to the organization for the amount that she owed to prevent a personal loss and ensure the organization's continued existence

IRS Enforcement—Recent Litigation

- IRS Position
  - The value of agreement was $0 because wife would not have sued an organization managed by her husband
  - Value of all assets, tangible and intangible, was $15,000 (the amount listed in the contract)
  - Wife received an excess benefit of $585,000
  - IRS issued a deficiency notice for $1.3 million, plus interest
  - IRS internal expert valuation

IRS Enforcement—Recent Litigation

- Facts During Litigation
  - Organization paid for two independent valuation reports, both demonstrated that the value of the company was in excess of $800,000
  - IRS internal expert determined that value was in excess of $700,000
  - IRS refused to consider the report of any expert and continued to assert that the value was $0

IRS Enforcement—Recent Litigation

- Results
  - After almost two years of litigation, the IRS settled the case by fully conceding the deficiency
  - The taxpayer was not required to pay any amount of taxes or penalties, but paid hundreds of thousands of dollars in legal fees
- Lessons
  - A valuation before the transaction could have prevented a lot of stress and saved a lot of money

Questions?

Jeffrey S. Tenenbaum, Esq., Partner, Venable LLP
jstenenbaum@Venable.com
t 202.344.8138

Matthew T. Journy, Esq., Counsel, Venable LLP
MTJourny@Venable.com
t 202.344.4589

To view an index of Venable's articles and presentations or upcoming programs on nonprofit legal topics, see www.Venable.com/nonprofits/publications or www.Venable.com/nonprofits/events.

To view recordings of Venable's nonprofit programs on our YouTube channel, see www.YouTube.com/VenableNonprofits or www.Venable.com/nonprofits/recordings.

Follow @NonprofitLaw on Twitter for timely posts with nonprofit legal articles, alerts, upcoming and recorded speaking presentations, and relevant nonprofit news and commentary.