Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls

August 23, 2011
12:00 – 2:00 p.m. EDT

Venable LLP
575 7th Street, N.W.
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Moderator:
Jeffrey S. Tenenbaum, Esq.

Panelists:
Matthew T. Journy, Esq.
A.W. (Pete) Smith, Jr.
Travis L. Patton, CPA

Presentations

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Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls

Jeffrey S. Tenenbaum
Matthew T. Journy

August 23, 2011
12:30 – 2 pm ET

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Purpose

- Explain significance of executive compensation
- Explain scope of professional assistance available
- Explain rules and regulations regarding compensation
- Explain consequences of excessive compensation
- Explain how organizations can protect themselves

Significance of Executive Compensation

- **Excessive compensation could result in the following IRS issues:**
  - Revocation of tax-exempt status due to private inurement or impermissible private benefit;
  - Monetary penalties imposed on:
    - Officers, Directors, or Key Employees;
    - The organization's founders;
    - Significant donors.
- **Bad press and employee discontent.**

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;**
  - **Tax accountant or independent auditor; or**
  - **HR director.**

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Professional Resources Available

- **When to seek expert advice – before entering into a contract with any officer, director, trustee, key employee, important donor, etc…**
- **Who to consult:**
  - **Your legal advisors;**
  - **A compensation/valuation expert; and**
  - **Your accountant.**

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Limitations on Executive Compensation

- **Exemption issues**
  - **Private inurement**
  - **Impermissible private benefit**
- **Intermediate sanctions**

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Exemption Issues

- **Private Inurement**
  - **Code generally provides that no part of organizations net earning can inure to the benefit of any private individual or share holder.**
  - **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).**
- **Impermissible Private Benefit**

Exemption Issues

- **Impermissible Private Benefit**
  - **Generally, tax-exempt organizations are required to limit their activities that are exclusively in furtherance in of 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 that private inurement, and is not applicable to organizations exempt under 501(c)(6) or 501(c)(7).**

Intermediate Sanctions

- What are intermediate sanctions?
- Who may be subject to intermediate sanctions?
- What transactions give rise to intermediate sanctions?
- Why you should be concerned?
- Why you should be concerned now?
- What can I do to avoid intermediate sanctions?

What are Intermediate Sanctions?

- **Internal Revenue Code ("Code") section 4958 allows the Internal Revenue Service ("Service") to impose penalties on "disqualified persons" who participate in or approve "excess benefit transactions."**
- **These penalties are commonly referred to as intermediate sanctions.**
- **Similar to "private inurement" concept.**

Who May Be Subject to Intermediate Sanctions?

- **The Code section 4958 penalties may only be imposed on disqualified persons.**
- **Section 4958(f) generally defines the term "disqualified person" to include:**
  - **Any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization;**
  - **Family members of individuals who are in a position to exercise substantial influence;**
  - **A 35-percent controlled entity;**
  - **Any person who is described above with respect to a supporting organization of the applicable tax-exempt organization; and**
  - **Certain donors and donor advisors with respect to donor advised funds.**

Who May Be Subject to Intermediate Sanctions?

- **Treas. Reg. Section 53.4958-3(c) lists specific persons who are in a position to exercise substantial influence, including:**
  - Voting Members of the organization's governing body;
  - President, CEO, COO;
  - Treasurer and CFO;
  - Organization founders; and
  - Some donors.

What Type of Transactions Give Rise to Intermediate Sanctions?

- **Common situations that may result in "excess benefit transactions" include:**
  - **Compensation;**
  - **Payments for services provided to the organization (e.g., back-office service providers);**
  - **Purchase of property by the organization or the sale of property to a disqualified person; and**
  - **Provision of certain fringe benefits (which may be "automatic" excess benefits).**

Why you should be concerned?

- **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.

Why you should be concerned?

- **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.

Why you should be concerned NOW?

- **We have seen the Service assess intermediate sanctions more in the last 18 months than in the previous 6 years combined.**
- **Executive compensation and intermediate sanctions were included on the IRS TE/GE FY 2011 Workplan.**
- **During a recent conversation with an attorney from IRS Office of Chief Counsel, we were told that the Service is developing cases for intermediate sanctions and that the Service will pursue these cases aggressively in court.**
- **This was discussed as a significant issue in the Interim Report for the IRS College and University Compliance Project.**

What Can You Do to Avoid Intermediate Sanctions?

- Use caution when entering into transactions with disqualified persons.
- Develop, implement, and follow a conflict of interest policy that prevents board members and organization executives from participating in decisions that impact them financially.
- Require board approval and documentation of transactions before any payments are made.

What Can You Do to Avoid Intermediate Sanctions?

- Establish 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.

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Questions?

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How Much is Too Much?

The Process of Determining
Reasonable Executive Compensation

Pete Smith, Smith Compensation Consulting

IRS Criteria for Reasonableness

- Pay in comparable organizations:
  - Size
  - Mission
  - Geography
- Executives' experience and credentials
- Executive and organization performance
- Existing contracts

Common Compensation Surveys

- GuideStar:
  - CEO Compensation Checkpoint
  - Nonprofit Compensation Report
- Charity Navigator CEO Compensation Report
- Inside NGO Compensation/Benefits Survey
- Compensation Resources' Surveys
- Quatt Associates Surveys

Compensation for Selected Texas Nonprofits

Organization	Expenses (Millions)	Number of Employees	CEO Comp	Percent of Average
A	29.2	270	226,000	79%
B	27.2	32	126,000	44%
C	24.6	24	154,000	54%
D	23.5	27	380,000	132%
E	21.2	89	416,000	145%
F	21.2	31	432,000	150%
G	14.3	20	278,000	97%
Average	23.0	70	287,429	100%

Compensation for Selected Texas Nonprofits

Organization	CEO Compensation	Percent of Average
DePelchin Children's Center	226,000	79%
Operation Homefront	126,000	44%
San Antonio Area Foundation	154,000	54%
American College of Emergency Physicians	380,000	132%
Houston Opera	416,000	145%
Meeting Professionals International	432,000	150%
World Presidents Organization	278,000	97%
Average	287,429	100%

Compensation for Selected Opera CEO's

Organization	CEO Compensation	Percent of Average
Houston	416,000	67%
New York	1,437,000	232%
Los Angeles	979,000	158%
San Francisco	519,000	84%
Chicago	455,000	73%
Washington	450,000	73%
Seattle	369,000	60%
San Diego	328,000	53%
Average	619,125	100%
Median	452,500	

Issues with 990 forms

- Stale data
- Regional differentials
- Change in management mid year
- Impact of special payments
- Vesting of deferred compensation

Targeting Pay Levels

- What is the desired market position?
  - 25th percentile?
  - Median?
  - 75th percentile?
- Internal equity
  - Are salaries competitive only at the top?
- Different policy for difficult jobs to fill?
- Relationship to competitiveness of benefits?

Thoughts for Compensation Strategy

- Equity means targeting everyone's pay the same relative to their market value.
- While we cannot pay like the private sector, we reject the notion that nonprofits should use the dedication of their employees to justify substandard compensation.
- The tax effectiveness of benefits can make them an attractive part of our pay package.

Optics and Compensation

- Determine what is right, then think about the potential for public reaction
- Have the board fully prepared to address any expected criticism
- Be transparent
- If you're pushing the envelope, be prepared for increasing scrutiny

Typical Public Comments

- Pay should be less than the private sector
- Pay should be less than the U.S. President
- Nonprofit execs should work for mission, not compensation
- There are thousands of low-paid people who would be willing to take nonprofit leadership positions at relatively low pay

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Travis Patton
Partner, PwC

August 23, 2011

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Introduction – Transparency and Form 990

Reporting executive compensation, traps on Form 990 disclosures and best practices

Current IRS examination issues and what questions are being asked

Fin 48 (ASC 740), Accounting for uncertainty in income taxes

Reporting executive compensation

One size does not fit all in Form 990 series

- Form 990-N - No compensation information disclosed
- Form 990-EZ - Intermediate disclosure
  - Part IV - Officers, directors, trustees, key employees
  - Highest compensated employees (a.k.a. "HKE") and independent contractors (I.R.C. § 501(c)(3) orgs and certain trusts
- Form 990 - Most significant disclosure
  - Part VII - Officers, directors, trustees, key employees (a.k.a. "ODTKE"), HCE, and independent contractors
  - Schedule J

Reporting executive compensation
Form 990, Part VII

Reporting considerations

- Understanding what is includible in "reportable compensation"
  - Form W-2, Box 5; or Form 1099-MISC, box 7
  - Calendar year vs. fiscal year reporting
- Properly classifying ODTKEs (and former ODTKEs)
- Navigating the different compensation thresholds
- Understanding what constitutes a "related organization"
- Use of management companies

Reporting executive compensation

Form 990, Schedule J, *Compensation Information*

Part I, Questions regarding compensation

- Additional reporting details not required in core form
  - Fringe benefits / perquisites
  - Governance questions / how compensation is determined
  - Severance
  - Nonqualified deferred compensation (e.g., I.R.C. § 457(f) plans)
  - Other special pay arrangements:
    - Equity based-pay
    - Pay based on gross revenue or net earnings
    - Initial contract payments

Reporting executive compensation

Public inspection requirements

When required by I.R.C. § 6104(d):

•Current year return must be provided beginning with the date it is filed with the IRS.

•Must be provided for three years following filing date.

•An exact copy as filed with IRS, excluding contributor names/addresses, must be provided. Compensation cannot be redacted.

•Must be provided in person or by mail

•Internet posting considerations for your organization?

Reporting executive compensation

Public inspection requirements

Shaping the narrative

- Things to consider:
  - The numbers are not the whole story
  - Tell your story through appropriate use of Schedule J, Part III, *Supplemental Information*, and Schedule O, *Supplemental Information to Form 990 or 990-EZ*
  - Is less actually more? Or do you tell the entire story?

Reporting executive compensation

Accurate data gathering, return preparation, and thorough review process key to success

- Same as last year doesn't always work – people and pay changes
- Getting the W-2 is easy, determining other pieces can be hard (e.g., deferred compensation)
- Who controls the process? Is there a project manager within your organization?
- Use of outside firms – accounting, legal, compensation consultant
- What is your internal review process? Will the board or a committee of the board be reviewing the work product?
- Start early!

Current IRS examination issues
What questions are being asked?

- Who approved the subject compensation policy? Was the compensation for officers, directors, trustees and/or key employees set by officers or by the board? If by officers, which officers were involved?
- What is the composition of the Compensation Committee and how was it determined?
- Are the Compensation Committee members elected or selected? If elected, what is the election process and what are the eligibility criteria that determine who can vote?
- Describe whether there are family/business relationships among the Compensation Committee and the executives, officers and key employees.
- Are any board members, officers, trustees or key employees also board members or officers of any other entity that does business with the exempt organization? If so, what entity and what is the business relationship of that entity with the exempt organization?

Current IRS examination issues
What questions are being asked?

- Provide all employment contracts, agreements, and other contracts with all University X executives, officers, and key employees.
- Provide all deferred compensation plans offered to University X executives and key employees.
- Provide all Agreements and Contracts with the University X or one of its related foundations for compensation paid/shared/etc. with University X employees, personnel, officers, and Board members.
- Provide a detailed listing of all compensation paid to all University X executives, officers, and key employees

FIN 48 (ASC 740), Accounting for uncertainty in income taxes

Executive compensation considerations in your financial statements

- FIN 48 (ASC 740)
  - Generally applicable to uncertain income tax positions
  - Does not apply to employment or excise taxes
- I.R.C. § 4958 – the "intermediate sanction"
  - Provides for a penalty short of revocation of tax-exempt status
  - IRS will assess the penalty excise tax when it determines that executive compensation levels are excessive
- Full revocation reserved for only the most egregious violations of private inurement/private benefit

FIN 48 (ASC 740), Accounting for uncertainty in income taxes

Form 990 reporting requirements

- Schedule D, Part X, line 2 (trigger question on 990 Part IV)

2. FIN 48 (ASC 740) Footnote. In Part XIV, provide the text of the footnote to the organization's financial statements that reports the organization's liability for uncertain tax positions under FIN 48 (ASC 740).

Questions…

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

Speaker Biographies

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Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished author, lecturer and commentator on nonprofit legal matters. Based in the firm's Washington, D.C. office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting trade and professional associations, charities, foundations, think tanks, credit and housing counseling agencies, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, the inaugural (2004) recipient of the *Washington Business Journal*'s Top Washington Lawyers Award, the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. He also was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. He started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill.

REPRESENTATIVE CLIENTS

AARP
American Academy of Physician Assistants
American Association for the Advancement of Science
American Association of Museums
American College of Radiology
American Institute of Architects
Air Conditioning Contractors of America
American Society for Microbiology
American Society for Training and Development
American Society of Anesthesiologists
American Society of Association Executives
American Society of Civil Engineers
American Society of Clinical Oncology
American Staffing Association
Association for Healthcare Philanthropy
Association of Corporate Counsel
Association of Private Sector Colleges and Universities
Automotive Aftermarket Industry Association
The College Board
Council on Foundations
Cruise Lines International Association
Foundation for the Malcolm Baldrige National Quality Award

AREAS OF PRACTICE

Tax and Wealth Planning

Antitrust

Political Law

Business Transactions Tax

Tax Controversies

Tax Policy

Tax-Exempt Organizations

Wealth Planning

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

Financial Services

Consumer Financial Protection Bureau Task Force

GOVERNMENT EXPERIENCE

Legislative Assistant, United States House of Representatives

BAR ADMISSIONS

District of Columbia

EDUCATION

J.D., Catholic University of America, Columbus School of Law, 1996

B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS

American Society of Association Executives

California Society of Association Executives

New York Society of Association Executives

Homeownership Preservation Foundation
The Humane Society of the United States
Independent Insurance Agents and Brokers of America
LeadingAge
Lions Club International
Money Management International
National Association of Chain Drug Stores
National Athletic Trainers' Association
National Coalition for Cancer Survivorship
National Defense Industrial Association
National Fallen Firefighters Foundation
National Hot Rod Association
National Propane Gas Association
National Retail Federation
National Student Clearinghouse
National Telecommunications Cooperative Association
The Nature Conservancy
NeighborWorks America
New York Blood Bank
Peterson Institute for International Economics
Professional Liability Underwriting Society
Project Management Institute
Public Health Accreditation Board
Public Relations Society of America
Recording Industry Association of America
Romance Writers of America
Texas Association of School Boards
Trust for Architectural Easements
Volunteers of America

HONORS

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

AV® Peer-Review Rated by *Martindale-Hubbell*

Listed in *Who's Who in American Law* and *Who's Who in America*, 2005-present editions

ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, published by the American Society of Association Executives, and is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. He also is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. In addition, he is a frequent author for ASAE and many of the other principal nonprofit industry organizations and publications, having written more than 400 articles on nonprofit legal topics.

SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer for ASAE and many of the major nonprofit industry organizations, conducting over 40 speaking presentations each year, including many with top Internal Revenue Service, Federal Trade Commission, U.S. Department of Justice, Federal Communications Commission, and other federal and government officials. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *The New York Times*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine* and other periodicals. He also has been interviewed on nonprofit legal issues on Voice of America Business Radio and Nonprofit Spark Radio.

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AREAS OF PRACTICE

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INDUSTRIES

Nonprofit Organizations and Associations

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EDUCATION

LL.M., Georgetown University Law Center, 2006

J.D., Northeastern University School of Law, 2003

B.A., Marquette University, 1999

Matt Journy is an associate in Venable's Washington, D.C. office, where he practices in the Nonprofit Organizations and Associations practice group. In his practice, Mr. Journy counsels trade and professional associations, public charities, private foundations, and other nonprofits on a variety of tax, governance, and general corporate matters, including tax exemption applications, audits, tax planning, joint ventures, unrelated business income tax issues, lobbying, and charitable solicitation, among other issues.

Having worked both as a regulator and tax consultant in the nonprofit community, Mr. Journy draws upon his prior experience to provide clients with reliable and thorough advice on the wide array of legal issues faced by nonprofits. Before joining Venable, Mr. Journy worked at Ernst & Young, LLP in the National Tax Practice, where he provided nonprofit clients with tax advice relating to corporate reorganizations, expenditure responsibility for international grants, fundraising activities, commercial co-ventures, unrelated business income, and post-issuance compliance for private activity bonds. In addition to providing tax advice, Mr. Journy provided tax compliance services, including the technical review of various federal and state tax and information returns. Prior to joining Ernst & Young, Mr. Journy worked in the Tax-Exempt/Government Entities Division of the IRS Office of Chief Counsel, where he prepared legal and technical advice for field agents and composed legal memoranda on a variety of issues affecting tax-exempt organizations.

PUBLICATIONS

- June 29, 2011, Nonprofit Salary Trends and Executive Compensation Issues
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, IRS Nonprofit College & University Compliance Project: Findings, Examinations and Mock Audits
- May 13, 2011, IRS Denies 501(c)(3) Status to Bankruptcy Counseling Agency
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance
- March 8, 2011, Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits
- December 16, 2010, So You Want To Be On The Internet ®
- October 18, 2010, Avoiding UBIT Pitfalls
- June 3, 2010, A Lesson in Compliance: IRS Releases Interim Report on Nonprofit Colleges and Universities Compliance Project (Long Version)
- June 3, 2010, A Lesson in Compliance: IRS Releases Interim Report on Nonprofit Colleges and Universities Compliance Project (Short Version)

- May-June 2010, The IRS Tax-Exempt Examination Process, *Taxation of Exempts*
- April 27, 2010, IRS Provides Guidance to Nonprofits Assisting Homeowners
- April 9, 2010, Legal Traps of Internet Activities for Nonprofits
- March 9, 2010, Intermediate Sanctions: Why You Should Be Concerned about Excess Benefit Transactions and How You Can Avoid Them
- January 12, 2010, FIN 48: What Every Nonprofit Needs to Know
- December 10, 2009, Avoiding IRS Audit Risks: Protecting Your Club's Tax Exemption
- October 6, 2009, Legal Traps of Internet Activities for Nonprofits
- June 17, 2009, Unrelated Business Income Tax
- June 2008, Requirements for Tax-Exempt Status under IRC § 501(c)(7): A Primer for Social Clubs
- June 2008, Advertising Considerations for Tax-Exempt Social Clubs

SPEAKING ENGAGEMENTS

- November 3, 2011, National Business Officers Association / National Association of College and University Business Officers Tax Forum on School, College and University Nonprofit Tax Challenges
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, "Nonprofit Executive Compensation" for Association TRENDS
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- June 13, 2011, "Internal Revenue Service (IRS) Compliance Project: Findings and Examinations; 990 Discussions," 9th Annual Higher Education Compliance Conference
- April 12, 2011, Internal Revenue Code Section 501(q) and Its Critical Implications for the Nonprofit Housing Counseling Industry in Light of Recent IRS Guidance
- April 10, 2011, "Top Tax Issues Relating to Income Generated by State and Municipal Organizations Exempt under Sections 115, 501(c)(3) and 501(c)(4)" at the 2011 IMLA Mid-Year Seminar
- March 8, 2011, Legal Quick Hit: "Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- October 18, 2010, "Confusing Stuff You Need to Know to Keep You and Your Chamber Out of Trouble" for the Western Association of Chamber Executives (WACE)
- June 8, 2010, Legal Quick Hit: "Lessons in Tax Compliance: The Broad Impact of the IRS' Interim Report on the Colleges and Universities Compliance Project" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 9, 2010, "Legal Traps of Internet Activities for Nonprofits" a Lorman Teleconference
- March 16, 2010, The Form 990: Dealing with the Fall Out (Audioconference)
- March 9, 2010, Legal Quick Hit: "Intermediate Sanctions: Why You Should Be Concerned about Excess Benefit Transactions and How You Can Avoid Them" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- February 12, 2010, "Avoiding IRS Audit Risks: Protecting Your Club's Tax Exemption Status from IRS Scrutiny" at the Club Managers Association of America (CMAA) World Conference on Club Management
- January 12, 2010, Legal Quick Hit: "FIN 48: What Every Nonprofit Needs to Know" for the Association of Corporate Counsel
- October 6, 2009, Legal Traps of Internet Activities for Nonprofits
- September 16, 2009, "The Impact of the New IRS Form 990 on Healthcare Philanthropy: The Changes That You Need to Know About" to the Association for Healthcare Philanthropy

A. W. (Pete) Smith, Jr.

Pete Smith has significant governance experience in both the private and public sectors. Mr. Smith now divides his time between serving on corporate and non-profit boards and providing executive compensation consulting services to a broad range of clients , primarily in the non-profit sector.

Mr. Smith spent most of his career at Watson Wyatt Worldwide (now Towers Watson), from which he retired as Chairman & CEO in 1999. As President of Smith Compensation Consulting, his clients now include many of the nation's leading nonprofit institutions.

In his thirty year career with Watson Wyatt, Mr. Smith consulted in areas ranging from executive compensation and benefits design to global human resources strategy. His clients included major Fortune 100 corporations, start-ups, technology firms, multinationals, professional services firms, family held businesses, and nonprofits.

Mr. Smith joined Wyatt in Boston in 1968 as acompensation consultant. In 1972, he was named Executive Vice President of Cole Surveys, then the leading provider of financial institution compensation survey data. In 1985, he was appointed Managing Partner of Wyatt's San Francisco office. He was appointed to the Board of Directors in 1986, as Global Compensation Practice Director in 1987, and as Managing Partner of the Washington, D.C. office (the firm's largest) in 1992. In 1993, he was elected President & CEO. During his tenure, he engineered a major transformation of the firm, strengthening its focus, improving its financial results, and substantially extending its worldwide operations – including combining Wyatt with R. Watson & Sons to form Watson Wyatt Worldwide.

The firm recently merged to form Towers Watson.

After retiring from Watson Wyatt, Mr. Smith served as CEO of the Private Sector Council, a non-partisan non-profit dedicated to improving the management of the federal government. At PSC, Mr. Smith advised government officials at the highest levels on a variety of management, governance, and financial issues. While at PSC, Mr. Smith also spent a month in Baghdad advising U.S. and Iraqi officials on the design of Iraqi civil service programs.

A graduate of Harvard and a certified member of the National Association of Corporate Directors, Mr. Smith currently serves on the Boards of Alliance Bernstein, Addx Corporation, Celerant Consulting Government Services, and the Community Foundation of the National Capital Area. He previously served on the Board of the Mid-Atlantic Permanente Medical Group. Active in civic affairs, hehas chaired the Board of Directors of the Association of Management Consulting Firm s and the National Rehabilitation Hospital, is past Vice Chair of the Nonprofit Roundtable of Greater Washington and the Washington Performing Arts Society, and served as a Trustee of American University. He also served on the Independent Review Committee evaluating governance problems at the Smithsonian Institution .More information can be found at www.smithcompensationconsulting.com and at Mr. Smith's blog, non-profit musings.

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Travis is a Partner in PricewaterhouseCoopers' *National Tax Services* office and is a member of the *Exempt Organization Tax Services* practice. For thirteen years, Travis has provided tax services to exempt organizations with a focus on healthcare and higher education.

Travis is resident in Washington, D.C., where he monitors legislative and regulatory developments from Capitol Hill and the Internal Revenue Service. He advises clients on various subject matters including IRS examinations, governance, compensation and benefits, unrelated business income tax, corporate sponsorship payments, scholarships, and Form 990. In addition to Washington metropolitan region, Travis serves clients in New York, Illinois, Indiana, and Alabama, among other areas.

A regular instructor on exempt organization matters, Travis most recently presented at conferences sponsored by the National Association of College and University Business Officers, Georgetown University Law Center, Council for the Advancement and Support of Education, Health Financial Management Association, and Indiana University. Travis is the author of "The IRS's Version of Community Benefit: A Look at the Redesigned Form 990 and New Schedule H," which was published in HFMA's Healthcare Financial Management magazine. Travis also co-authored "Reporting Unrelated Business Income," which was published in the AICPA's Journal of Accountancy, in addition to other published articles.

Travis is a Certified Public Accountant licensed in Virginia and the District of Columbia, and he is a member of the American Institute of Certified Public Accountants and Healthcare Financial Management Association. Travis graduated with a B.B.A. in Accounting from the College of William and Mary and obtained his M.S. in Taxation from American University.

Additional Information

Related Articles

A Lesson in Compliance: IRS Releases Interim Report on Nonprofit Colleges and Universities Compliance Project

The IRS Tax-Exempt Examination Process

How Much Is Enough? Assessing Leadership Pay in Nonprofits

By Pete Smith
Smith Compensation Consulting

High compensation for nonprofit leaders often creates an outcry for federal limits on nonprofit executive compensation. The concern is understandable, but much that's been written about this is off the mark.

Critics objecting to high levels of nonprofit compensation often hold one or more of the following views:

1. Pay for leaders in nonprofits should be reasonable in terms of competitive levels for similar nonprofit executives, and the expectations of donors and funders of charitable organizations. As such, they should almost always be below those paid in the private sector.

2. Pay for nonprofit leaders should be less than some arbitrary standard, such as the salary of the President of the United States.

3. Nonprofit leaders should work primarily for the psychic income of fulfilling important missions; compensation should not be an important factor in recruiting or retaining leaders.

4. The world is full of competent leaders who would work in nonprofit positions for compensation that critics deem reasonable.

The article's main theses are:

1. Except for the first point above, with which I fully agree, most critics of high nonprofit compensation don't have a good understanding of the dynamics of nonprofit leadership or of the pay required to attract and retain top talent.

2. Setting an arbitrary standard to limit nonprofit executive compensation would be a mistake, with damaging unintended consequences.

3. Existing controls – board oversight, the threat of fines and sanctions, and public review provide sufficient control of nonprofit compensation, even at the top. But these controls could be strengthened.

<u>Managing Nonprofits Can Be Highly Complex</u>

Imagine you are the CEO of a YMCA in a major metropolitan area. You are responsible every day for hundreds of children in dozens of locations; you need to structure operations and supervision so that none of them are lost or injured or abducted or drowned. This is in addition the normal responsibilities of ensuring financial health, raising funds, coordinating with city and state authorities, developing and motivating staff, etc. Few for-profit positions have a similar level of complexity and risk.

The same can be said of presidents of universities, who must combine significant fund-raising expertise with sufficient diplomacy to influence diverse constituencies (faculty, students, alumnae, trustees) to uphold and improve educational excellence. Ditto for hospital CEO's, with their financial and regulatory imperatives and diverse constituencies.

Leaders of these organizations and many other types of nonprofits are responsible for much more than revenues and profits – they nurture individual growth and development, heal and comfort the sick, shelter the homeless, protect the battered, and in hundreds of other ways improve our communities. Yes, almost all of them are willing to do this for less pay than their jobs would be worth in the private sector. But that does not mean that their pay should be limited to some arbitrary number.

<u>Good Leadership Makes a Difference</u>

One thing I have noticed in my nonprofit work is that there are usually four to five organizations that are considered the leaders in each city's nonprofit sector and that these leaders vary considerably by type of service provided. In city A the top charities might include a foundation or museum, in city B it may include the Girl Scouts or an animal welfare charity, in city C it may include a hospital or a homeless shelter or a zoo.

Whether a cause or result of their success, these top charities almost always attract a high level of contributions. Community leaders want to serve on their boards, where doing so is a badge of honor and acceptance. These charities usually do a good job of measuring outcomes clearly; they have a strong track record of success; they are financially stable.

These charities are not the community leaders just because of what they do – there are always equally worthy charities not in the leadership group. Sometimes their leadership results from a significant economic windfall – the Marin Community Foundation comes to mind. But almost always, somewhere during the organization's growth, an inspirational, highly effective leader brought its performance to a level where it's achievement and value became clearly apparent to the most important and influential individuals in the community. And their involvement – encouraged by this leader – contributed exponentially to its success.

Now let's assume you are a trustee of a nonprofit looking for a new leader and you want someone with the potential to build the organization to one of the premier nonprofits in your community. Or to turn around an organization in trouble. Or to greatly enhance the organization's ability to achieve its mission. The pool of potential candidates includes existing executive directors, nonprofit managers just below the ED level, and for-profit executives, either active or recently retired. Any of these candidates could be independently wealthy, willing to work for little or even no compensation.

But why limit your search to those willing to accept below fair pay? The candidate pool undoubtedly includes qualified people with children in college or other financial needs, without independent financial resources, for whom a decent salary is very important. The best leaders may come from this pool.

Why capping pay is wrong

For most nonprofits, the type of caps being paid is immaterial – few pay their top people close to $400,000 or $500,000. But for the small percentage of nonprofits who do pay this level of compensation, caps would create serious problems.

First, any pay limit set by the IRS on Congress other governing body would be arbitrary. The most common suggestions are limiting nonprofit executive pay to the salary of the President of the U.S. (currently $400,000) or the $500,000 base salary limit being applied by the Treasury Department to organizations receiving government funding under the TARP program. But neither of these numbers reflect the value of the work being performed – they are just politically expedient numbers the public can more readily accept.

Second, any cap would undoubtedly be unfair to nonprofit executives whose scope of responsibilities genuinely reflects greater value than the cap itself. Limiting pay for university investment professionals or basketball coaches or heads of cardiology in medical schools to $400,000 or $500,000 would result in a unsustainable gap between what they can make in the private sector and what nonprofits could pay.

Third, it is likely that a pay cap would lead larger nonprofits to look for other ways to compensate their top people, through expanded benefits, or added time off, or job sharing, or special fees, in order to keep their best talent. The government might try to preclude this through legislation beyond the pay cap, but such legislation would be very complex and costly to administer.

Fourth, the pay cap could actually result in higher compensation for leaders of smaller nonprofits – those below the pay cap. Even $150,000 or $200,000 is higher compensation than the vast majority of nonprofits should be paying their executive directors today – most charities are very small. Providing an official ceiling of $400,000 or $500,000 could put pressure on trustees to raise executive compensation more quickly than they would do absent the cap.

Finally, in the largest nonprofits, a pay cap could cause salary compression, with many executives earning close to the cap even though their responsibilities are substantially less than those of the CEO, creating serious inequities in the compensation structure.

There is a Solution

You won't get rid of excessive pay entirely in nonprofits, no more than in any other sector of the economy. But there are good steps that can be taken to lessen the incidence of egregious pay.

First, the IRS should use existing sanctions more forcefully. These sanctions (known as the "intermediate sanctions") enable the IRS to fine trustees and tax executives in cases of egregious excess compensation. But these sanctions are infrequently used. The IRS should be much more proactive going after cases of apparently excessive compensation.

Further support should come from publications such as the Chronicle of Philanthropy or the Chronicle of Higher Education, and organizations such as the Independent Sector or Charity Navigator. Some of these organizations may be reluctant to bite the hands that feed them, but as the Chronicle of Philanthropy has shown, pointing out specific cases of potential abuse can create change.

Most important, the Boards of Trustees should do their homework with a thorough periodic review of top officer compensation. This review should address these questions:

- Does the organization have a compensation policy, and if so what is the intended position of the organization's compensation against the peer groups to which it will be compared. If the intended position is above average (e.g., 75th percentile), is this strategy supported by the organization's size and complexity and/or the background, experience, and performance of the executives being reviewed?

- Is the peer group against which the organization being compared truly representative, in terms of size, mission, scope, and geography?

- How does the top executive's market position compare to that of other executives and employees in the organization? If the CEO is the only executive at the 75th percentile while everyone else is at or below average, is there a clear justification for the difference?

- How transparent is the entire compensation package? Are there special benefits or perquisites that apply only to the top officer, and if so is there a justification for this? Will this justification stand up to public scrutiny?

With strong board oversight, a stronger and more active IRS, and aggressive publicity about questionable compensation, we can strengthen nonprofit compensation generally and reduce the incidents of abuse.

Pete Smith is the President of Smith Compensation Consulting. The former CEO of Watson Wyatt Worldwide (now Towers Watson), his practice focuses on providing executive compensation consulting services to the nonprofit community.

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2010 Form 990
Return of Organization
Exempt From Income Tax

Compensation Data
Core Form Part VII
and Schedule J

February 2011

The 2010 instructions now provide that duplicate copies of the Part VII, Section A table are to be used in place of Schedules J-2. Schedule J-2 no longer exists.

Part VII Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors

Check if Schedule O contains a response to any question in this Part VII . . . . . . New in 2010 . . . . . ☐

Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

1a Complete this table for all persons required to be listed. Report compensation for the calendar year ending with or within the organization's tax year.

- List all of the organization's **current** officers, directors, trustees (whether individuals or organizations), regardless of amount of compensation. Enter -0- in columns (D), (E), and (F) if no compensation was paid.
- List all of the organization's **current** key employees, if any. See instructions for definition of "key employee."
- List the organization's five **current** highest compensated employees (other than an officer, director, trustee, or key employee) who received reportable compensation (Box 5 of Form W-2 and/or Box 7 of Form 1099-MISC) of more than $100,000 from the organization and any related organizations.
- List all of the organization's **former** officers, key employees, and highest compensated employees who received more than $100,000 of reportable compensation from the organization and any related organizations.
- List all of the organization's **former directors or trustees** that received, in the capacity as a former director or trustee of the organization, more than $10,000 of reportable compensation from the organization and any related organizations.

List persons in the following order: individual trustees or directors; institutional trustees; officers; key employees; highest compensated employees; and former such persons.

☐ Check this box if neither the organization nor any related organization compensated any current officer, director, or trustee.

This requirement is not new but has been added to the form itself for clarity.

These numbers are new in 2010.

(A) Name and Title	(B) Average hours per week (describe hours for related organizations in Schedule O)	(C) Position (check all that apply): Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former	(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
(1)										
(2)										
(3)										
(4)										
(5)										
(6)										
(7)										
(8)										
(9)										
(10)										
(11)										
(12)										
(13)										
(14)										
(15)										
(16)										

Part VII **Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees** *(continued)*

(A) Name and title	(B) Average hours per week (describe hours for related organizations in Schedule O)	(C) Position (check all that apply): Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former	(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
(17)										
(18)										
(19)										
(20)										
(21)										
(22)										
(23)										
(24)										
(25)										
(26)										
(27)										
(28)										
1b Sub-total . . . ▶										
c Total from continuation sheets to Part VII, Section A . . . ▶										
d Total (add lines 1b and 1c) . . . ▶										

These numbers are new in 2010.

Changes to the instructions now provide that, if additional space is needed, duplicate copies of the Part VII, Section A table are to be used in place of Schedules J-2. Schedule J-2 no longer exists.

New in 2010

2 Total number of individuals (including but not limited to those listed above) who received more than $100,000 in reportable compensation from the organization ▶

			Yes	No
3	Did the organization list any **former** officer, director or trustee, key employee, or highest compensated employee on line 1a? *If "Yes," complete Schedule J for such individual* . . .	3		
4	For any individual listed on line 1a, is the sum of reportable compensation and other compensation from the organization and related organizations greater than $150,000? *If "Yes," complete Schedule J for such individual* . . .	4		
5	Did any person listed on line 1a receive or accrue compensation from any unrelated organization or individual for services rendered to the organization? *If "Yes," complete Schedule J for such person* . . .	5		

Section B. Independent Contractors

1 Complete this table for your five highest compensated independent contractors that received more than $100,000 of compensation from the organization.

(A) Name and business address	(B) Description of services	(C) Compensation

2 Total number of independent contractors (including but not limited to those listed above) who received more than $100,000 in compensation from the organization ▶

SCHEDULE J (Form 990)

Department of the Treasury
Internal Revenue Service

Compensation Information

For certain Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

▶ Complete if the organization answered "Yes" to Form 990, Part IV, line 23.

▶ Attach to Form 990. ▶ See separate instructions.

OMB No. 1545-0047

2010

Open to Public Inspection

Name of the organization

Employer identification number

Part I Questions Regarding Compensation

			Yes	No
1a	Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items. ☐ First-class or charter travel ☐ Housing allowance or residence for personal use ☐ Travel for companions ☐ Payments for business use of personal residence ☐ Tax indemnification and gross-up payments ☐ Health or social club dues or initiation fees ☐ Discretionary spending account ☐ Personal services (e.g., maid, chauffeur, chef)			
b	If any of the boxes on line 1a are checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above? If "No," complete Part III to explain . . .	**1b**		
2	Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in line 1a? . . .	**2**		
3	Indicate which, if any, of the following the organization uses to establish the compensation of the organization's CEO/Executive Director. Check all that apply. ☐ Compensation committee ☐ Written employment contract ☐ Independent compensation consultant ☐ Compensation survey or study ☐ Form 990 of other organizations ☐ Approval by the board or compensation committee			
4	During the year, did any person listed in Form 990, Part VII, Section A, line 1a, with respect to the filing organization or a related organization:			
a	Receive a severance payment or change-of-control payment from the organization or a related organization?	**4a**		
b	Participate in, or receive payment from, a supplemental nonqualified retirement plan? . . .	**4b**		
c	Participate in, or receive payment from, an equity-based compensation arrangement? . . .	**4c**		
	If "Yes" to any of lines 4a–c, list the persons and provide the applicable amounts for each item in Part III.			
	Only section 501(c)(3) and 501(c)(4) organizations must complete lines 5–9.			
5	For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the revenues of:			
a	The organization? . . .	**5a**		
b	Any related organization? . . .	**5b**		
	If "Yes" to line 5a or 5b, describe in Part III.			
6	For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the net earnings of:			
a	The organization? . . .	**6a**		
b	Any related organization? . . .	**6b**		
	If "Yes" to line 6a or 6b, describe in Part III.			
7	For persons listed in Form 990, Part VII, Section A, line 1a, did the organization provide any non-fixed payments not described in lines 5 and 6? If "Yes," describe in Part III . . .	**7**		
8	Were any amounts reported in Form 990, Part VII, paid or accrued pursuant to a contract that was subject to the initial contract exception described in Regulations section 53.4958-4(a)(3)? If "Yes," describe in Part III . . .	**8**		
9	If "Yes" to line 8, did the organization also follow the rebuttable presumption procedure described in Regulations section 53.4958-6(c)? . . .	**9**		

Language added to clarify, but the rule has not changed.

Part II **Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees.** Use duplicate copies if additional space is needed.

For each individual whose compensation must be reported in Schedule J, report compensation from the organization on row (i) and from related organizations, described in the instructions, on row (ii). Do not list any individuals that are not listed on Form 990, Part VII.

Note. The sum of columns (B)(i)–(iii) must equal the applicable column (D) or column (E) amounts on Form 990, Part VII, line 1a.

These numbers are new in 2010.

If additional space is needed, disclosures previously made on Schedules J-1 are to be made on duplicate copies of Part II of Schedule J. Schedule J-1 no longer exists.

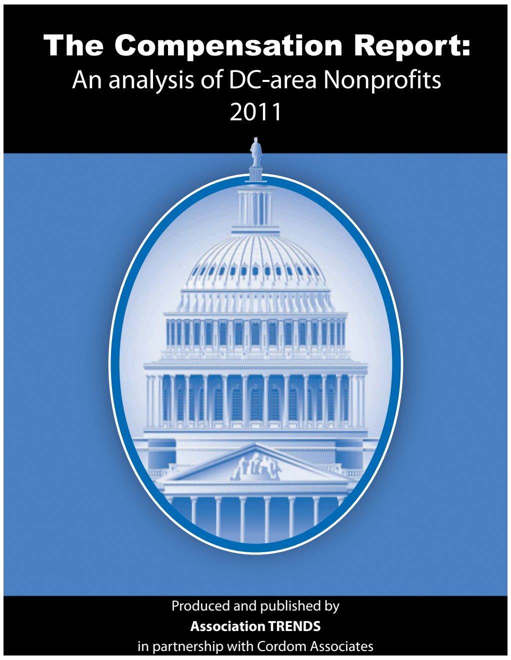
(A) Name		(B) Breakdown of W-2 and/or 1099-MISC compensation			(C) Retirement and other deferred compensation	(D) Nontaxable benefits	(E) Total of columns (B)(i)–(D)	(F) Compensation reported in prior Form 990 or Form 990-EZ
		(i) Base compensation	(ii) Bonus & incentive compensation	(iii) Other reportable compensation				
1	(i)							
	(ii)							
2	(i)							
	(ii)							
3	(i)							
	(ii)							
4	(i)							
	(ii)							
5	(i)							
	(ii)							
6	(i)							
	(ii)							
7	(i)							
	(ii)							
8	(i)							
	(ii)							
9	(i)							
	(ii)							
10	(i)							
	(ii)							
11	(i)							
	(ii)							
12	(i)							
	(ii)							
13	(i)							
	(ii)							
14	(i)							
	(ii)							
15	(i)							
	(ii)							
16	(i)							
	(ii)							

Part III Supplemental Information

Complete this part to provide the information, explanation, or descriptions required for Part I, lines 1a, 1b, 4c, 5a, 5b, 6a, 6b, 7, and 8. Also complete this part for any additional information.

The 2011 Compensation Report

An analysis of DC-area nonprofits



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