Top Trends and Traps in Nonprofit Executive Compensation

Thursday, June 4, 2015, 12:30 – 2:00pm ET
Venable LLP, Washington, DC

Moderator
Jeffrey S. Tenenbaum, Esq., Partner and Chair of the Nonprofit Organizations Practice, Venable LLP

Speakers
Matthew T. Journy, Esq., Counsel, Venable LLP
Charles W. Quatt, Ph.D., President and Founder, Quatt Associates
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• August 6, 2015 – Top Ten "Must Have" Provisions for Nonprofit Meeting Contracts

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 that 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, nonprofit entities are seen as tools of political and social reform, and 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 nonprofits (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 their salaries with those of 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 an 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 from publicly available IRS forms
    • Executive compensation is a major issue in media reports about problems with BCS
    • Issue has been highlighted on HBO and ESPN, in Sports Illustrated and Non-Profit Times, etc.
  – Fiesta Bowl’s CEO, John Junker, is 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 who receive excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  – Monetary penalties imposed on board members and executives who 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 nonexempt purpose is generally a purpose that serves a private rather than a public benefit, and 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 is 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 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 who knowingly approves an excess benefit transaction
  - Liability under Section 4958(a)(2) is joint and several and is 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
  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 overcompensation
  4. Provides organization with a clear and easy explanation of compensation decisions
  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 in representing organizations has shown us that this is clearly not 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 noncomparable organizations
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 purely legal issue
- Do not rely solely on advice of your:
  - Legal counsel
  - Compensation/valuation expert
  - Tax accountant or independent auditor
  - 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 marketplace 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

Strategies for Advising the Board and Management and the Role of Outside Advisers

It may be helpful to provide the Board with decision factors that Board members can use in determining the adequate range for executive salary. These may include:

• What is the market for the position?
• What are compensation trends among peer organizations, and in the geographical area?
• What are relevant contract terms and principles in the organization’s established compensation philosophy and compensation system, including the pay-for-performance system?
• How is the performance of the organization, including its financial performance?
• How should stakeholder opinion be weighed and managed? Key stakeholders may include:
  – The board
  – Membership
  – The public
• What is the staff compensation practice, for example, the differential between executive compensation and staff compensation?
The Role of Compensation Studies and Comparability Analyses

• Defining a defensible approach to determining the market value for a position
• Ensuring competitive compensation data needed by the Board and management as they make decisions about compensation levels
• Serving as the basis for developing a compensation system

Common Pitfalls and Best Practices in Compensation Benchmarking

• The hard-to-defend comparator group
  – Rule: compare to similar organizations, identify the criteria used in the report
• The use of for-profit data
  – IRS red flag—in theory, can be used, but frowned on in practice
  – Limit use of for-profit data to cases where for-profit skill set required and similar NFPs must also recruit from the for-profit sector
    • Example: In public media organizations, content production jobs will often come from the for-profit sector
    • CEOs should be compared to similar NFP positions
Common Pitfalls and Best Practices in Compensation Benchmarking

• Targeting above the 75th percentile
  – Reasonable range of the 75th is generally defensible if:
    • Documented record of achievement; ideally should be able to point to achieving specific goals
    • Experience, skills, background of the individual
    • Rule of thumb: no more than 10% above the 75th
  – VERY careful documentation by the Board and strong rationale for above 75th

• End-of-career compensation that may be difficult to defend
  – Post-retirement “consulting”
  – Sabbaticals that are really deferred compensation

Common Pitfalls and Best Practices in Compensation Benchmarking

• We love the CEO and want to take care of her:
  – Late redress of low retirement savings
  – The “founders’ dilemma”: low pay in the beginning and never fully corrected
  – In the past, compensation consultants would “look back” and estimate underpayment
    • Avoid look-backs, especially if more than two to three years—IRS skeptical (and state AGs perhaps even more so—assumption that past pay was a market transaction)
    • Adjust compensation going forward, consistent with market total remuneration (e.g., additional base, bonus or deferred compensation)
    • One-time performance bonus for recent performance may be defensible
Common Pitfalls and Best Practices in Compensation Benchmarking

- Other forms of Additional Compensation
  - Housing
    - Generally taxable
    - Special exception for colleges and universities
      - Required to accept
      - On institution premises
      - Provided for benefit of the institution
      - Must be reported on 990
    - Failure to report and included as taxable has been issue
  - Below interest loans
    - Interest difference is taxable
    - Not allowed in some jurisdictions (e.g., DC)

- Vacation payout
  - Annual vacation must be consistent with market practice
  - Cap on vacation accrual

- Automobiles
Combining the Executive Search Process with Compensation Determinations

- Often, CEO succession is what makes a Board grapple with executive compensation
- Compensation information can help the search process in the following ways:
  - Understanding what is current market reality at the outset helps set expectations of the search committee—work may need to be done
  - Getting the appropriate market range based on the right comparator groups
  - Providing insight into the appropriate compensation philosophy relative to the board, stakeholders, public perception and the staff
  - Providing insight into the appropriate compensation plan that both reflects market trends and meets the needs of the board and the candidate, including base salary, incentives, deferred compensation, benefits and perquisites

Various Ways to Address Compensation in the Executive Employment Contract

- Employment contracts typically include
  - Base Salary, which may be fixed but is usually provided with annual considerations for adjustment based on performance and market changes
    - Some contracts have guaranteed base salary increases.
    - This is not always advisable
  - Incentive or Bonus Compensation
    - Usually stated as a percentage of base salary, sometimes with a range, based on performance, but usually also cited as discretion of board
    - While it is important to have an annual methodology for making the incentive determination, it is often best to leave the specifics as part of a board-approved annual incentive compensation plan
Various Ways to Address Compensation in the Executive Employment Contract

- Employment contracts typically include:
  - Deferred Compensation
    - Common but not in all contracts
    - Typically tied to a 457(b) or 457(f) plan with terms and vesting date cited
  - Severance
  - Standard Benefits
  - Executive Benefits and Perquisites
    - This can include financial planning, supplemental long-term disability, life insurance, executive medical, clubs and business travel

Incentive Compensation—Examples, How to Structure

- Incentives are a significantly growing practice
- Incentives are typically based on a percentage of base salary
- Incentives can have a range from threshold to target to outstanding
- Incentives are typically tied to organizational goals and leadership with target measures of success
- The measures can be qualitative or quantitative
- Organizational goals are best tied to the strategic priorities and/or the mission goals
  - Some use a balanced score card approach
Incentive Compensation—What Types of Provisions Will Generally Increase the Risk of IRS Scrutiny?

- Incentive bringing compensation beyond market practice
  - Incentives need to be incorporated into the overall value for the position consistent with the marketplace
  - Even for outstanding performance, incentives cannot bring compensation above the market without risk
- Incentive plan design with no cap
- Incentives based percentage of revenues

Questions?

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Jeffrey S. Tenenbaum chairs Venable’s Nonprofit Organizations Practice Group. He is one of the nation’s leading nonprofit attorneys, and also is a highly accomplished author, lecturer, and commentator on nonprofit legal matters. Based in the firm’s Washington, DC office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting charities, foundations, trade and professional associations, think tanks, 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. He also has served as an expert witness in several court cases on nonprofit legal issues.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association’s Outstanding Nonprofit Lawyer of the Year Award, and was an inaugural (2004) recipient of the Washington Business Journal’s Top Washington Lawyers Award. He was one of only seven “Leading Lawyers” in the Not-for-Profit category in the prestigious 2012 Legal 500 rankings, one of only eight in the 2013 rankings, and one of only nine in the 2014 rankings. Mr. Tenenbaum was recognized in 2013 as a Top Rated Lawyer in Tax Law by The American Lawyer and Corporate Counsel. He was the 2015 recipient of the New York Society of Association Executives’ Outstanding Associate Member 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. Mr. Tenenbaum was listed in the 2012-15 editions of The Best Lawyers in America for Non-Profit/Charities Law, and was selected for inclusion in the 2014 and 2015 editions of Washington DC Super Lawyers in the Nonprofit Organizations category. In 2011, he was named as one of Washington, DC’s “Legal Elite” by SmartCEO Magazine. He was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by Martindale-Hubbell. Mr. Tenenbaum 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 as a legislative assistant.

REPRESENTATIVE CLIENTS
AARP
Air Conditioning Contractors of America
Airlines for America
American Academy of Physician Assistants
American Alliance of Museums
American Association for the Advancement of Science
American Bar Association
American Bureau of Shipping
American Cancer Society
American College of Radiology
American Friends of Yahad in Unum
B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS
American Society of Association Executives
New York Society of Association Executives

American Institute of Architects
American Institute of Certified Public Accountants
American Society for Microbiology
American Society of Anesthesiologists
American Society of Association Executives
America’s Health Insurance Plans
Association for Healthcare Philanthropy
Association for Talent Development
Association of Clinical Research Professionals
Association of Corporate Counsel
Association of Fundraising Professionals
Association of Global Automakers
Association of Private Sector Colleges and Universities
Auto Care Association
Biotechnology Industry Organization
Brookings Institution
Carbon War Room
The College Board
CompTIA
Council on Foundations
CropLife America
Cruise Lines International Association
Design-Build Institute of America
Endocrine Society
Ethics Resource Center
Foundation for the Malcolm Baldrige National Quality Award
Gerontological Society of America
Global Impact
Goodwill Industries International
Graduate Management Admission Council
Habitat for Humanity International
Homeownership Preservation Foundation
Human Rights Campaign
Independent Insurance Agents and Brokers of America
Institute of International Education
International Association of Fire Chiefs
International Sleep Products Association
Jazz at Lincoln Center
LeadingAge
Lincoln Center for the Performing Arts
Lions Club International
March of Dimes
ment’or BKB Foundation
Money Management International
National Association for the Education of Young Children
National Association of Chain Drug Stores
National Association of College and University Attorneys
National Association of Manufacturers
National Association of Music Merchants
National Athletic Trainers’ Association
National Board of Medical Examiners
National Coalition for Cancer Survivorship
National Council of Architectural Registration Boards
National Defense Industrial Association
National Fallen Firefighters Foundation
National Fish and Wildlife Foundation
National Propane Gas Association
National Quality Forum
National Retail Federation
National Student Clearinghouse
The Nature Conservancy
NeighborWorks America
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
Telecommunications Industry Association
Trust for Architectural Easements
The Tyra Banks TZONE Foundation
U.S. Chamber of Commerce
United Nations High Commissioner for Refugees
United States Tennis Association
University of California
Volunteers of America
Water Environment Federation

HONORS
Recipient, New York Society of Association Executives’ Outstanding Associate Member Award, 2015
Recognized as “Leading Lawyer” in Legal 500, Not-For-Profit, 2012-14
Listed in The Best Lawyers in America for Non-Profit/Charities Law, Washington, DC (Woodward/White, Inc.), 2012-15
Selected for inclusion in Washington DC Super Lawyers, Nonprofit Organizations, 2014-15
Served as member of the selection panel for the inaugural CEO Update Association Leadership Awards, 2014
Recognized as a Top Rated Lawyer in Taxation Law in The American Lawyer and Corporate Counsel, 2013
Washington DC’s Legal Elite, SmartCEO Magazine, 2011
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*, now in its second edition, published by the American Society of Association Executives. He also 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. In addition, he is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. Mr. Tenenbaum is a frequent author on nonprofit legal topics, having written or co-written more than 700 articles.

SPEAKING ENGAGEMENTS
Matt Journy is counsel in Venable’s Washington, DC 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.

Mr. Journy also represents nonprofit clients in tax disputes with the IRS. Mr. Journy has represented clients before the IRS during each stage of the IRS examination process, including: the examination stage and administrative appeals process. If the tax controversy is not resolved administratively, Mr. Journy represents the client in court litigation, typically in U.S. Tax Court.

**SIGNIFICANT TAX CONTROVERSY LITIGATION MATTERS**

- Successful representation in U.S. Tax Court of taxpayer accused by IRS of having entered into an “excess benefit” transaction under IRC § 4958. After developing a thorough factual record and expert testimony demonstrating that the transaction between the taxpayer and the tax-exempt organization provided a substantial benefit to the nonprofit entity and thus, did not constitute an “excess benefit” transaction, the IRS conceded the case, acknowledging that taxpayer owed no additional tax.

- Litigated multiple Declaratory Judgment matters contesting the authority of the IRS to issue a final adverse determination letter to organizations recognized as exempt under IRC § 501(c)(3). Settling each case by entering into a closing agreement under which the IRS continued to recognize the organization’s tax-exempt status.

- Litigated and negotiated favorable settlement of deficiency cases resulting from the revocation of a nonprofit organization’s tax-exempt status.

Mr. Journy has appeared frequently before the IRS National Office, representing clients in requests for private letter rulings or technical advice memoranda.

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.
HONORS

Named American Bar Association "Outstanding Nonprofit Lawyer of the Year Award," Young Attorney category, 2014

Recognized in Legal 500, Not-For-Profit, 2013 and 2014

PUBLICATIONS

- March/April, 2015, Enjoining the IRS-Using Litigation to Stop a Revocation
- January 30, 2015, Federal Court Orders IRS to Release Digitally Readable Forms 990
- January 27, 2015, IRS Publishes New Revenue Procedures Addressing Applications for Tax-Exempt Status
- November/December 2014, Groundbreaking (or Not) Ruling Holds Form 1023 Not Required upon Incorporation
- October 2, 2014, Nonprofit Tax Issues: Where the IRS Is Today, and Where Congress Is Headed
- May/June 2014, Mitigating the Income Tax Expense of a Retroactive Revocation for EOs
- November/December 2013, Tools for Bypassing IRS Delays in EO Applications
- October 25, 2013, The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations (NGO General Counsel Forum Fall Meeting)
- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- July 2013, Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations (article – long version)
- April 18, 2013, An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency’s 501(c)(3) Status
- March 2013, IRS Denials of Tax-Exempt Status to Mortgage Foreclosure Assistance Providers Offer Lessons for Housing Counseling Agencies
- March/April 2013, Using Section 7428 to Resolve Exempt Status Controversies, Taxation of Exempts, Volume 24, Number 5
- February 5, 2013, IRS Releases Exempt Organizations 2012 Annual Report and 2013 Workplan
- February 4, 2013, IRS Examinations of Nonprofit Housing Counseling Agencies
- October 11, 2012, Nonprofit Executive Compensation and Incentive Compensation: Keys to Protecting Your Organization and Its Leaders from IRS Sanctions
- September 28, 2012, Protecting Tax-Exempt Status: The Importance of Intangible Asset Valuation
- May 15, 2012, IRS to Focus on Housing Counseling Agencies
- March 20, 2012, All About UBIT: What Nonprofit Leaders Need to Know
- October 24, 2011, Unrelated Business Income Tax for Nonprofits: The Basics
- August 23, 2011, Nonprofit Executive Compensation: Avoiding the Treacherous Tax and Governance Pitfalls
- June 29, 2011, Nonprofit Salary Trends and Executive Compensation Issues
- 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
- May-June 2010, The IRS Tax-Exempt Examination Process
- April 27, 2010, IRS Provides Guidance to Nonprofits Assisting Homeowners
- April 9, 2010, Legal Traps of Internet Activities for Nonprofits
- 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 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 13, 2014, "Tax Litigation" for ALI’s Advanced Course on EOs
- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- December 4, 2013, "How to Protect Your Tax-Exempt Status – Beyond the Basics" at the NYSSCPA and FAE Exempt Organizations Conference
- October 25, 2013, "The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations” at the NGO General Counsel Forum Fall Meeting
- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders
Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector

- July 9, 2013, Legal Quick Hit: "A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations" for the Association of Corporate Counsel’s Nonprofit Organizations Committee
- April 18, 2013, "An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies" at the 1st Annual Institute on Not-for-Profit Law
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency’s 501(c)(3) Status
- July 10, 2012, Legal Quick Hit: "The Next Generation of Nonprofit Executive Compensation: The Keys to Withstanding IRS Scrutiny" for the Association of Corporate Counsel’s Nonprofit Organizations Committee
- 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
- 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’s Nonprofit Organizations Committee
• 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
Charles W. Quatt, Ph.D.

Charles Quatt is President and Founder of Quatt Associates, Inc. Mr. Quatt specializes in compensation, employee opinion surveys, organizational development, performance management systems and strategic planning. His clients included Fortune 500 companies as well as a number of not-for-profit and government organizations.

In addition to his consulting practice, Mr. Quatt has conducted seminars and instructed at American University, Georgetown University, Marymount University, the University of Maryland, and Virginia Tech Business School.

Before establishing Quatt Associates, Mr. Quatt served for almost ten years as a Director of Management Consulting and Practice Leader for the Hay Group, an international management consulting firm.

Mr. Quatt also worked as a Human Resources Manager for General Electric Company and for Mobil Corporation. At both General Electric Company and Mobil Corporation, Mr. Quatt's responsibilities included organizational development, compensation, performance management, survey research, and employee relations.

Prior to his corporate engagements, Mr. Quatt served as a Faculty Member for six years at Harvard and Princeton Universities. He has a Ph.D. from Harvard University and was a Lehman Scholar at Harvard. He co-authored a book with Brian Vogel of Quatt Associates on executive compensation in not-for-profit organizations. The third edition of *Nonprofit Executive Compensation: Planning, Performance and Pay* was published by BoardSource in October of 2014.
Denise Grant leads the firm's Washington, D.C. office. She recruits Chief Executive Officers for nonprofit organizations and top executives for corporate clients. Denise is also a member of the firm's CEO/Board Services Practice, and has significant experience working with complex and high profile nonprofit organizations and companies to help them assess and implement leadership solutions.

Previous Experience

Prior to joining Russell Reynolds Associates, Denise had a successful career in the legal and public policy arena in Washington, D.C. with leadership roles in a trade association, a corporation, and on Capitol Hill. She practiced law for nearly a decade as an attorney with Morgan, Lewis & Bockius LLP and as Assistant General Counsel of a significant association. During her career, Denise represented large, global companies and non-profit organizations on legislative and regulatory matters before Congress, Federal Agencies, and state and local governments. Denise was also at a Fortune 100 company, where she served in a variety of leadership roles. Earlier in her career, Denise served as Legal Counsel to a member of the United States Senate leadership.

Additional Professional Activities

Denise is a member of the Board of Directors for the Wolf Trap Foundation for the Performing Arts, as well as the Bryce Harlow Foundation. She is a member of the Bar of the District of Columbia and is admitted to practice before a number of federal courts, including the United States Court of Appeals for the D.C. Circuit and the United States Supreme Court.

Education

Denise received her B.A., magna cum laude, from Transylvania University in Business and Economics, and her J.D. from the University of Kentucky College of Law, where she was a member of the Law Review.
Additional Information
PAYING FOR THE BEST: EXECUTIVE COMPENSATION FOR SECTION 501(c)(3) PUBLIC CHARITIES
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"). 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." 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...
The 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. 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.

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].” 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. 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. 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.”

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. 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.” 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” 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.” 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.

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. As such, courts have repeatedly held that salaries that are “excessive salaries do result in inurement.” 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. 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." 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; 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. 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.” 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.

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.  

**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.

- **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.

- **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.

- **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.

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.\textsuperscript{27} Facts and circumstances that are indicative of substantial control include the following:

- The person is the founder.\textsuperscript{28}
- The person is a substantial contributor.\textsuperscript{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.\textsuperscript{30}
- The person has or shares the authority to control a substantial portion of the organization's capital expenditures, operating budget, or employee compensation.\textsuperscript{31}
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's overall activities.\textsuperscript{32}
- The person owns a controlling interest in a business that is itself a disqualified person.\textsuperscript{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.\textsuperscript{34}
- The person is an independent contractor whose only economic benefit is customary fees for advice rendered.\textsuperscript{35}
- The person’s direct supervisor is not a disqualified person.\textsuperscript{36}
- The person does not participate in management decisions affecting the entire organization.\textsuperscript{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, 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. 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.

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. 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. 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. 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” 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.” Thus, the substantiability 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.” 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. 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.” 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. 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. 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.” 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.” "Participation" includes both active participation, such as voting in favor of the transaction, and passive participation, such as silence or inaction. 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.

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.” 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.” 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.” Rather, “the valuation method must take into account, and correspond to,” the attributes of the transaction being valued.

**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” and “all other compensatory benefits, whether or not included in gross income for income tax purposes.” 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. 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.” 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.\textsuperscript{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;\textsuperscript{64} (2) by reporting the benefit as compensation on the organization’s Form 990;\textsuperscript{65} (3) by including the amount in a written employment contract;\textsuperscript{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;\textsuperscript{67} or (5) through written evidence demonstrating the organization’s belief that the benefit was not taxable.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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. 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.

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:

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. 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" and did the organization "follow the rebuttable presumption procedure" with respect to executive compensation.

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.\textsuperscript{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."\textsuperscript{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.\textsuperscript{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,\textsuperscript{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. 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." 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." 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. 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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6 Section 501(c)(3).
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8 IRM 7.76.3.11.1(1).
9 Reg. 1.501(a)-1(c).
10 United Cancer Council, supra note 5 at 165 F.3d 1176.
14 Church of Scientology of California, 60 AFTR 2d 87-5386, 823 F2d 1310, 87-2 USTC ¶9446 (CA-9, 1987).
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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).
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25 Reg. 53.4958-3(c)(3).
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27 Reg. 53.4958-3(e)(1).
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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).
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38 For purposes of this definition, family members of disqualified persons are deemed to have substantial influence.
39 Reg. 53.4958-3(d)(3).
41 Reg. 53.4958-3(b)(1).
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44 American Campaign Academy, supra note 7 at 1071.
45 Id. at 1073.
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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 establish 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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NONPROFIT EXECUTIVE COMPENSATION

PLANNING, PERFORMANCE, AND PAY

BRIAN H. VOGEL &
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CHAPTER 1
Understanding the Board’s Role in Setting Chief Executive Compensation

In one sense, the board’s role in setting chief executive compensation is simple: The board is responsible for recruiting and hiring the chief executive, overseeing the chief executive’s performance, and, if necessary, firing him or her. Setting the chief executive’s compensation is also part of this responsibility.

However, the board’s responsibility is more complex than this simple statement would suggest. The board must not only create a compensation plan that will be an effective tool both in recruitment and in performance evaluation — it must also set compensation in light of its responsibilities to the organization.

• Mission responsibility: The board ensures that the organization will achieve its mission through oversight of the organization’s long-term strategy and objectives. This means that the board must hire a chief executive who will be effective in implementing that strategy, leading the organization toward mission achievement. The compensation structure is an essential element of the board’s ability to attract such a chief executive. However, the compensation structure itself must also reinforce the organization’s strategy. A strategic compensation structure will reward success and send the appropriate signals if performance falls short; it will work best if it is part of an overall performance management plan tied to board-approved annual and long-term goals and objectives.

• Fiduciary responsibility: The board has a duty to maintain the organization’s financial integrity. The board must strike a balance that allows it to hire the best possible chief executive without breaking the bank.

Paying too low a salary can result in difficulty recruiting and retaining an effective leader, to the detriment of managerial decision making and ultimately of the organization’s overall effectiveness. A CEO salary that is too low can also depress salaries throughout the organization. Salaries for other positions at levels that are not market-competitive impair an organization’s ability to hire and retain qualified and effective candidates for those positions.
Paying too high a CEO salary, on the other hand, can create mistrust among stakeholders, incur public disapproval, and potentially subject the organization to legal and press scrutiny.

- **Legal and public responsibility:** The board must ensure that the organization complies with legal standards and meets the test of public and stakeholder scrutiny. This is not just an ethical responsibility. The IRS’s intermediate sanctions regulations, which are explained in detail in Chapter 6, require that compensation for certain high-ranking individuals at most 501(c)(3) and 501(c)(4) organizations, including chief executives, not exceed an amount defined as reasonable by the regulations’ standards. Board members who knowingly participate in the approval of compensation found to violate the standards are subject to personal liability and a fine of up to $20,000. Executives who receive excessive compensation are subject to even more severe penalties.

- **Private foundations,** although not subject to the intermediate sanctions regulations, are subject to both the IRS’s rules against self-dealing and, like all nonprofits, to the private inurement doctrine (see Chapter 6, pages 71-73). Self-dealing is a transaction in which someone who is in a fiduciary relationship with an organization acquires or makes use of property that belongs to the organization for his or her own benefit; such transactions may trigger excise tax penalties similar to those imposed under intermediate sanctions. The private inurement doctrine requires that the nonprofit organization receive a benefit more or less equal to the gain to any “insider” such as a senior executive (in other words, performance of the CEO or other executive’s duties must be commensurate with his or her compensation). The same doctrine applies to 501(c)(6) trade associations and other nonprofits. The IRS can strip an organization of its nonprofit status for violation of the private inurement doctrine. State regulators have been especially fierce with private foundations found to overcompensate “insiders.”

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**Q: Is there a legal cap on executive compensation?**

The legal cap is that “excess” compensation cannot be paid — i.e., more than is justified by the benefit the executive brings to the organization and by the compensation practices of “like organizations” in the marketplace.

Therefore, board members setting CEO pay need to be familiar with the IRS intermediate sanctions rules and related legal doctrines, such as the private inurement doctrine. They also need to understand the state law applying to their nonprofit. If the board considers deferred compensation arrangements, it needs to understand the federal tax law governing such arrangements. See our discussion of legal issues in Chapters 6 and 8.
ESTABLISH A PROCEDURE

To fulfill its duties in these three areas of responsibility, the board needs to establish a procedure for determining chief executive compensation before it begins the recruiting and hiring process or the review for a current chief executive. A formal, structured review of compensation by the board is especially important; it establishes a “rebuttable presumption of reasonableness,” which shifts the burden of proving that compensation is excessive to the IRS; it also exempts board members from personal liability if certain procedures are followed (see Chapter 6). This procedure should be formally outlined in writing for future reference.

The board should begin by determining its internal structure for overseeing chief executive compensation. That structure may take one of three forms.

1. **Whole Board.** In small and medium-sized nonprofits and in nonprofits with small boards, oversight of chief executive compensation may be handled by the board as a whole.

2. **Compensation Committee or Task Force.** Where the board is too large and unwieldy or does not feel up to the task of managing the compensation process as a group, it may delegate oversight of chief executive compensation to a special compensation committee or task force. A smaller committee can devote its attention as needed to the often-detailed process of managing compensation matters. Over time, committee members can also develop experience and expertise in this area. In many organizations, the compensation committee also reviews the senior staff compensation levels suggested by the chief executive the board or an assigned committee should review which persons are subject to the intermediate sanctions regulations, although the CEO should propose compensation for those persons, with the CEO’s decisions subject to board review. The committee will also often take the lead in setting annual performance objectives and reviewing chief executive and organizational performance. A sample compensation committee charter can be found in Appendix III.

3. **Executive Committee.** If the board wishes to delegate compensation matters to a smaller committee but does not have the desire or personnel to form a separate compensation committee, chief executive and key staff compensation may be handled by the board’s executive committee.

For the sake of simplicity, the remainder of this book will refer to the compensation committee as taking the lead in managing the chief executive compensation process. This implies no judgment as to the appropriate structure for any particular board. As used here, the term “compensation committee” applies to any board group that is managing the process.
Q: Should the entire board be aware of and/or approve the chief executive’s salary and benefits each year?

The authors strongly recommend that the entire board review and, ideally, approve the chief executive’s salary and benefits. The board may delegate responsibility for producing recommendations and the data to back them up to a smaller group or committee of board members. However, the final compensation package should be approved by the board as a whole. There is one caveat: Only independent board members (i.e., those whose compensation or employment are not subject to the chief executive, or stand to otherwise benefit from approving the chief executive’s compensation) should be involved in the final approval process.

There are several reasons why it is best practice for the full board to review and approve the final compensation package. The board should be comfortable that the compensation package complies with the intermediate sanctions regulations. Nonprofit chief executive compensation is also public information that must be reported on the organization’s IRS Form 990. All board members should consider the public scrutiny that may be generated by the compensation package, and fully prepared to justify the package. There is now an additional reason for the board to consider public reaction to the decision on chief executive compensation. The IRS Form 990 asks whether the Form 990 has been shared with the board. A board that does not review and, ideally, approve the 990 (including the chief executive compensation, which must appear on it) may face questions about the effectiveness of the organization’s governance process.

Review and final approval of chief executive compensation by the full board (regardless of whether or not a separate committee is responsible for the major responsibilities involving compensation) is, as noted, something the authors strongly recommend as good practice. In fact, the authors consider it vital because chief executive compensation is public domain information. It is disappointing, therefore, that, according to the BoardSource Nonprofit Governance Index 2014, only 65 percent of full boards approve the chief executive’s total remuneration package, and only 75 percent review the package using comparable data. Each board member should understand and be able to justify the full board’s compensation decision, as well as the board’s overall process for setting and reviewing chief executive compensation, including the respective roles of the full board and any smaller committee(s). As board members seek to determine which internal structure (the full board or a compensation committee) will work best for their organization, the answers to these questions may provide guidance:
1. Is our board small and efficient enough to handle chief executive compensation matters as a group? Would the two-step process of committee work followed by full board review be more cumbersome for us than full board discussion of these matters?

2. Are we more comfortable with assigning oversight of chief executive compensation to our executive committee, or to a separate compensation committee?

3. Do we have board members who are willing and able to take the lead as part of a compensation committee, executive committee, or special task force?

4. Do we currently have access to the expertise we need to make informed decisions, either among our board members or with outside resources (e.g., legal advisor, compensation consultant, accountant, board members from other organizations)?

Once the board has decided on the appropriate structure for managing compensation, it then needs to consider and approve the subsequent steps in its overall procedure for establishing chief executive compensation. It is the responsibility of the board chair to coordinate the process and to ensure that the appropriate board members and committees fulfill their roles in the process. This includes the review of compensation for intermediate sanctions purposes (see discussion on pages 73-76).

The committee must exclude any person with a conflict of interest — that is, anyone whose employment is subject to the person whose compensation he or she would approve, or anyone who would otherwise stand to benefit financially from approving the compensation.

Although the tasks in setting compensation are outlined in a sequential way here and in the Chapters that follow, the overall process is not a linear one. The compensation committee will need to start with some sense of the possibilities and constraints that its mission, goals, and budget dictate for salary, benefits, and other compensation, and use those as reference points throughout the study and research process. Completion of each of the tasks outlined here will help the committee develop a realistic and effective compensation plan.

The board should also review its governance procedures and structure regularly, and make changes as necessary to ensure its continuing effectiveness and compliance with legal standards.
BOARD/COMPENSATION COMMITTEE CHECKLIST FOR ESTABLISHING A CHIEF EXECUTIVE COMPENSATION PLAN

___ Ensure that board has complete information on current compensation (see this Chapter, below).

___ Ensure that the chief executive compensation plan supports the organization’s mission, goals, and strategy (Chapter 2).

___ Establish the chief executive job description and profile (and title, if necessary) (Chapter 3).

___ Develop the organization’s compensation philosophy (Chapter 4).

___ Understand the marketplace; acquire and analyze appropriate market data on compensation practices in comparable organizations (Chapter 5).

___ Ensure that the compensation level and structure will meet legal requirements; establish a process for documenting the chief executive compensation decision and ensure that the process is followed; retain legal counsel if necessary (Chapter 6).

___ Review compensation for purposes of stakeholder and public scrutiny (Chapter 7).

___ Establish the compensation level and plan (Chapter 8).

___ Establish an ongoing process for reviewing chief executive compensation and job performance. The process should include setting annual and long-term goals, conducting annual performance reviews, and adjusting compensation each year based on market and performance (Chapter 8).

___ Identify negotiation points with respect to the chief executive contract (Chapter 9).

___ Ensure the compensation of other disqualified persons is reasonable, meets federal and state legal requirements, and is consistent with the organization’s mission and purpose (see Chapter 6, box on page 86).

It is essential that the compensation committee start with accurate, detailed, and complete information about the current compensation packages for the chief executive and other senior staff. In particular, the compensation committee should review the chief executive’s employment contract (if he or she has one). Particularly in situations where the full board has not previously been involved in setting chief executive compensation, full disclosure of the base pay level, the types and amounts of bonuses, and all benefits, as well as the rationale for each, is crucial (several prominent nonprofits have been embarrassed in recent years when chief executive perquisites not revealed to the full board became public knowledge). Organization
staff must provide complete and detailed compensation information when the board requests it; typically, the board establishes a formal reporting mechanism through which the staff provides compensation information to the board chair, the chair of the compensation committee, or the compensation committee as a whole.

After the board has done this preparatory work, it should draft a formal document outlining the compensation process. This is useful for legal reasons: For example, in helping establish the “rebuttable presumption of reasonableness” protecting board members of 501(c)(3) and (c)(4) organizations from personal liability for compensation found to violate intermediate sanctions regulations, it will also provide some protection to boards of other types of nonprofits. From a practical standpoint, a formal document can also serve as a more detailed checklist for the board or compensation committee. The first part of the document should outline the relationship between chief executive compensation and the organization’s mission. These details will be discussed further in subsequent Chapters.

USING CONSULTANTS

Compensation consultants can help boards understand the market and assist them in negotiating the complexities of executive compensation plans. A compensation consultant is a neutral advisor who can offer knowledge and experience gleaned from many different organizations. By using a consultant who is experienced in, and knowledgeable about, nonprofit compensation practices, the board can receive additional assurance that it properly understands the marketplace and its options for setting compensation. The prospective chief executive can also be assured that he or she is being paid at a level that is appropriate to the marketplace. An opinion from an independent valuation expert can also help protect the board from personal liability under the IRS regulations.15

Some nonprofit organizations might, therefore, be well served by a compensation consultant. However, final responsibility for establishing, monitoring, and ensuring the appropriateness of executive compensation rests with the board.

If you decide to use a compensation consultant, the first step is to determine the expertise the organization needs. The consultant should have experience in designing chief executive compensation for the nonprofit sector and ideally for the organization’s particular part of the nonprofit sector. The consultant should have a good understanding of base salary, incentive, and deferred compensation options. He or she should fully understand, and have experience with, the intermediate sanctions regulations.

One of the best ways of assessing these qualifications is through references and referrals from other similar organizations. The references should cover

• integrity, commitment, and technical competence
• knowledge of the particular sector and market in which the organization operates
• timeliness and good project management
• ability to work with staff, senior management, and the board

Once a consultant is hired, the lines of reporting and responsibility should be made clear. The consultant’s relationship with the executive should be clearly defined early in the process. While the consultant may work closely with the organization’s staff, the consultant’s client must be the board, and the board should designate a single contact or small working group to manage the relationship. The board should then give the consultant a clear and complete project plan and access to relevant documents and information.

It is the consultant’s duty to present the board with a comprehensible and competent analysis and recommendation. The board member(s) working with the consultant must provide adequate instructions and feedback to ensure that the product delivered by the consultant meets this standard. The consultant should also be available to meet with the full board to explain all findings and recommendations once they are made.

**Fundamentals of the Board–Consultant Relationship:**

1. The consultant should report to the board, not the staff. The consultant should, however, have access to staff, which is the only source of compensation information. It is good practice, too, for the consultant to understand any issues, concerns, and expectations executives may have with compensation.

2. Prospective consultants may be identified by the compensation committee or another subcommittee; it is advisable that the full board be informed of the final hiring decision. The compensation committee or other designated members of the board should give the consultant direct guidance on what is needed.

3. The board should use the consultant as a resource as fully as possible, asking what the consultant thinks, would recommend, and believes are the advantages and disadvantages of taking a particular action under consideration.

4. The board should use the consultant to probe and challenge members’ assumptions, and should also probe and challenge the consultant’s assumptions.
5. Designated members of the board should review drafts of the consultant’s reports before they are presented to the full board for consideration.

6. The board should review the consultant’s performance regularly, including knowledge of the marketplace, timeliness, and completeness of performance.

**Summary: Action Steps for the Board**

- Ensure the board understands the role its mission, fiduciary, and legal responsibilities must play in setting chief executive compensation.

- Assign a body to oversee chief executive compensation.

- Depending on circumstances, this body may be the compensation committee, the executive committee, or the full board.

- The authors strongly recommend that, regardless of which body has primary oversight, final review and approval of chief executive compensation rest with the full board.

- Ensure that board members understand and are able to justify compensation decisions. Pay attention to the questions in the Form 990 concerning compensation and the board’s role in reviewing it.

- The board chair should coordinate the process and ensure that members and committees are fulfilling their assigned responsibilities.

- Ensure that any board members with a conflict of interest are excluded from compensation decisions.

- Ensure that the board has complete and accurate information on the compensation received by the chief executive and other relevant senior staff.

- Ensure that consultants, if utilized, are formally retained by and report to the board.

- Draft a formal document outlining the compensation process.
  
  - This helps boards establish a “rebuttable presumption of reasonableness,” a protection from liability for organizations subject to IRS intermediate sanctions regulations.
  
  - A formal document also serves as a guide for members to follow through the process.

- Review governance procedures and structure regularly, making changes as necessary. Consider using a consultant to assist the board in obtaining fair and accurate market information and expertise.