Compensating the Executive of a Charitable Organization

What Charitable Organizations Need to Know About Excess Benefit Transactions or Self-Dealing Under Federal Tax Laws

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Over the last decade, the IRS has assumed a broader role in the governance of tax-exempt organizations and embraced the view that transparency leads to tax compliance. Nowhere is the IRS's approach more evident than in the area of executive compensation. The IRS asks tax-exempt organizations to provide detailed information annually on their Forms 990 regarding the compensation paid to executives as well as the compensation policies and practices that organizations follow. The information submitted can lead to compliance checks or examinations by the IRS.

In setting executive compensation, each charitable organization should be aware of the rules that apply to it. Special excise tax provisions apply to public charities (as well as Section 501(c)(4) social welfare organizations) that provide excessive compensation to certain persons under the excess benefit transaction rules of Internal Revenue Code Section 4958. The private foundation self-dealing rules of Internal Revenue Code Section 4941 prohibit the payment of unreasonable compensation to certain persons by a charitable organization classified for federal tax purposes as a private foundation.

Public Charities and the Excess Benefit Transaction Rules

Internal Revenue Code Section 4958 imposes an excise tax on certain "insiders" (referred to as "disqualified persons") that engage in an excess benefit transaction with a public charity. To understand the application of the excess benefit transaction rules, it is necessary to understand certain terminology.

Definition of Disqualified Person. The definition of "disqualified person" is a key part of Internal Revenue Code Section 4958. It is only transactions with disqualified persons that come within the scope of Internal Revenue Code Section 4958. A disqualified person in general is any person who at any time during the five-year period ending on the date of the transaction was in a position to exercise substantial influence over the affairs of the organization. The following persons are deemed to be in a position to exercise substantial influence over the affairs of the charitable organization:

- *Voting Members of Governing Body*. Any individual serving on the governing body who is entitled to vote on any matter over which the governing body has responsibility.
- *President, Chief Executive Officer or Chief Operating Officer*. Any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the administration, management or operation of the organization. A person who serves as president, chief executive officer or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise.
- *Treasurer, Chief Financial Officer*. Any person who has ultimate responsibility for managing the finances of the organization. A person who serves as treasurer or chief financial officer has the ultimate responsibility unless the person demonstrates otherwise.

In addition, family members of the persons described above are disqualified persons. Family members include the person’s spouse, siblings (whether by whole or half blood), ancestors, children, grandchildren, great-grandchildren and the spouses of siblings, children, grandchildren and great-grandchildren. Also, entities that are 35 percent or more controlled by the persons described above and their family members are disqualified persons. In the case of a corporation, control is based on owning 35 percent or more of the total combined voting power of the corporation.

In addition, other persons can be disqualified persons. If a person does not fall into one of the definite categories of a disqualified person, the determination of whether a person has substantial influence over the affairs of the organization is based on all relevant facts and circumstances. Facts and circumstances that tend to indicate a person has substantial influence over the affairs of an organization include:

- the person founded the organization;
- the person was a substantial contributor to the organization during the current year and four preceding years;
- the person’s compensation is based primarily on revenues derived from activities of the organization that the person controls;
- the person has authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget or compensation for employees;
- the person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization as compared to the organization as a whole; or
- the person owns a controlling interest in a corporation, partnership or trust that is a disqualified person.

Facts and circumstances tending to show the person does not have substantial influence over the affairs of an organization include:

- the person has taken a bona fide vow of poverty as an employee, agent or on behalf of, a religious organization;
- the person is an independent contractor, such as an attorney, accountant or investment manager, whose sole relationship with the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the independent contractor will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);
- the direct supervisor of the person is not a disqualified person; or
- the person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization.

Definition of Organization Manager. Organization managers are also potentially subject to the excess benefits transaction tax under Internal Revenue Code Section 4958. The term “organization manager” includes, with respect to any applicable public charity, 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. In general, the definition

is limited to those officers, directors or trustees of the organization with final authority or responsibility for decisions. Independent contractors such as attorneys, accountants and investment managers, or advisers acting in those capacities, are not considered organization managers. Also, the term "organization manager" does not include any person who was an organization manager during the last five years (unlike the term "disqualified person"). Once an individual ceases acting as an organization manager, the tax on organization managers cannot be imposed on such individual for transactions occurring after the person ceased to act as an organization manager.

Definition of Excess Benefit Transaction. An excess benefit transaction occurs when a disqualified person receives an economic benefit from a public charity, whether directly or indirectly, and the value of the economic benefit received by the disqualified person exceeds the value of the consideration provided by the disqualified person to the organization (including the performance of services). In the context of the compensation of a disqualified person, the types of transactions contemplated by Internal Revenue Code Section 4958 include:

- *Payment of Unreasonable Compensation.* Internal Revenue Code Section 4958 applies to the situation in which a disqualified person receives compensation from the organization that exceeds the value of the disqualified person's services to the organization. It should be noted that in determining the reasonableness of compensation paid in one year, services performed in prior years may be taken into account.
- *Unreasonable Compensation Arrangements Based on Organization's Income.* Internal Revenue Code Section 4958 provides that the IRS can issue regulations to include in the definition of "excess benefit transaction" any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization (but only if such revenue-sharing arrangement results in an excess benefit to the disqualified person). To date, the IRS has not addressed this issue, but has reserved it.

To determine whether an excess benefit transaction has occurred, generally all consideration and economic benefits exchanged directly or indirectly between the disqualified person and the public charity are considered. In the case of a compensation arrangement, this consideration would include all forms of cash and noncash compensation and categories of pay, such as salary, fees, bonuses, severance pay, deferred compensation, qualified retirement plan benefits, nonqualified deferred compensation and compensatory transfers of property.

Other types of compensation and benefits must be included in the evaluation, even if they are not included in the disqualified person's taxable income. Examples include payments to welfare benefit plans (i.e., medical, dental, life insurance), severance pay, disability benefits, fringe benefits (other than fringe benefits excluded from income under Internal Revenue Code Section 132), expense allowances or reimbursements (unless paid under an accountable plan) and the economic benefits of below-market loans.

Indirect Compensation. Compensation that is paid directly or indirectly must be considered when determining reasonableness. Indirect payments of compensation can occur if the compensation is paid by an entity controlled by the public charity or through an "intermediary."

For purposes of these rules, a public charity is considered to control another entity if:

- In the case of a corporation, the public charity owns more than 50 percent of the stock in the corporation (by vote or value).
- In the case of a partnership, the public charity owns more than 50 percent of the capital or profits interest.
- In the case of a nonstock corporation, the public charity's directors, trustees, employees or agents constitute at least 50 percent of the directors or trustees of the nonstock corporation or the public charity appoints or elects at least 50 percent of the directors or trustees of the nonstock corporation.
- In the case of other entities, such as trusts, the public charity owns more than 50 percent of the beneficial interest in the entity.

Ownership for these purposes is determined using the constructive ownership rules under Internal Revenue Code Section 318.

An "intermediary" is a person (whether tax-exempt or taxable) that indirectly participates in a transaction. An intermediary relationship exists if the public charity provides an economic benefit to the intermediary and either (1) there is an oral or written agreement or understanding that the intermediary will provide an economic benefit to or for the use of the disqualified person, or (2) the intermediary provides an economic benefit to or for the use of disqualified person without a business purpose or an exempt purpose of its own for providing the economic benefit.

Determining Reasonableness of Compensation. Although Internal Revenue Code Section 4958 is silent as to how charitable organizations are to evaluate whether the compensation and other benefits they are providing are reasonable (and therefore not excess benefit transactions), the House Committee Report and the regulations provide that existing tax law standards will apply in determining the reasonableness of compensation arrangements with disqualified persons. Generally, it is necessary to measure the value of the services provided based on what would ordinarily be paid for like services by like enterprises under like circumstances. The type of like enterprises that can be considered are not limited to tax-exempt organizations. The compensation paid by taxable entities can be considered to the extent that they are sufficiently similar to the public charity paying the compensation. In addition, both current and prior services provided by the disqualified person may be considered when evaluating the reasonableness of the compensation.

IRS challenges to compensation paid by a public charity are generally based on factors similar to those that the IRS considers in challenging compensation deductions under Internal Revenue Code Section 162. In fact, the regulations under Internal Revenue Code Section 4958 incorporate the standards of Internal Revenue Code Section 162 for determining the

reasonableness of compensation under Internal Revenue Code Section 4958. Relevant factors under Internal Revenue Code Section 162 include:

- Whether the compensation was the subject of true arm's length bargaining;
- The size and complexity of the public charity;
- The nature of the disqualified person's duties and responsibilities;
- The disqualified person's qualifications and prior compensation;
- The disqualified person's performance;
- How the disqualified person's compensation compares with that of other similarly situated employees of the public charity; and
- Whether an outside investor would be likely to approve the compensation.

The time at which the reasonableness of compensation is determined depends upon whether the compensation is a "fixed payment." A fixed payment is a specific amount or an amount that is determined under a fixed, nondiscretionary formula. That amount or formula must be set forth in a binding written contract, such as an employment agreement. The reasonableness of a fixed payment is generally evaluated at the time the parties enter into the contract, not when the compensation is paid.

Different rules apply, however, to payments that are not fixed payments or that are fixed payments but are paid despite substantial nonperformance under the contract. In these circumstances, the reasonableness of the compensation is determined at the time of payment.

Determination of the reasonableness of benefits included as part of the compensation arrangement between an organization's board and the disqualified person must be made at the same time the board determines that the disqualified person's compensation is reasonable. The board cannot later claim that it intended a particular benefit to be part of the total compensation.

- *Examples of Fringe Benefits That Should Be Considered.* In making a determination as to whether a compensation package is reasonable, all possible benefits must be considered, including use of a company car or plane; use of company credit cards; use of lodges or vacation homes; free meals; club memberships; unsupervised expense accounts; clothing allowances; sports/luxury boxes and theater tickets; below-market loans and leases; free accounting, estate planning or legal services; paid sabbaticals; excess contributions to pension plans; reimbursement by the organization of excise tax liability; and premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes.
- *Mid-Year Changes in Compensation.* If, for example, a disqualified person takes an unexpected trip during the year that arguably is not an expense in furtherance of the exempt purposes of the organization, the organization's board should decide before paying the expense whether the benefit to the disqualified person would make the disqualified person's compensation unreasonable and follow the steps required to give rise to the rebuttable presumption of reasonableness (discussed below) before it pays the expense.

Compensatory Intent Requirement. One of the more problematic aspects of the excess benefit transaction rules, and a proverbial "trap for the unwary," is the requirement that the payments to a disqualified person be specifically intended as compensation for services provided by the disqualified person. The public charity must clearly indicate its intent to treat the benefit as compensation when the benefit is paid. Failure to establish contemporaneous compensatory intent generally will result in an "automatic" excess benefit transaction (i.e., the compensation is automatically an excess benefit because it is treated as having been paid without any exchange of consideration from the disqualified person).

To establish compensatory intent, contemporaneous substantiation of such intent is required. There are two primary means of establishing contemporaneous substantiation.

Contemporaneous Tax Reporting. The primary method for establishing contemporaneous compensatory intent is to show that the compensation was properly reported for federal tax purposes. This method can be accomplished by showing that the compensation was reported by the public charity (or other payor where the compensation was paid indirectly) on Form W-2 or Form 1099, as appropriate. Even if the public charity did not properly report the compensation, contemporaneous substantiation is shown if the disqualified person reported the compensation on his or her individual income tax return. If compensation is not reported in the originally filed report or return, reporting it in an amended report or return is sufficient to establish contemporaneous substantiation of compensatory intent provided that the amended return or report is filed before the initiation of an IRS examination of the public charity or the disqualified person who received the compensation. In addition, a public charity's failure to report compensation will not prevent the establishment of compensatory intent if the reporting failure was due to reasonable cause. However, the conditions to establish reasonable cause in this context are relatively narrow.

Contemporaneous Written Documentation. A public charity may also establish compensatory intent through other written evidence. This evidence may include, but is not limited to, an approved employment contract that was executed by the parties before the compensation or benefit was paid or provided. Similarly, documents indicating that the public charity followed the required steps for establishing a rebuttable presumption of reasonableness can be relied upon to establish compensatory intent.

The requirement to show compensatory intent does not apply to compensation that is excludable from the disqualified person's income. This exception covers employer-provided health plan coverage, contributions to and benefits under tax-advantaged retirement plans (such as Section 401(a) and Section 403(b) plans) and certain fringe benefits. However, even though compensatory intent is not required to be established for such compensation, it generally must be taken into account in evaluating the reasonableness of the total compensation payable to the disqualified person (except for the limited exclusions discussed above).

Initial Contract Exception. An important exception from the excess benefit transaction rules is available for some forms of compensation paid under an employment agreement or other binding written contract between the public charity and a person who was not a

disqualified person immediately before entering into the contract. This initial contract exception is most commonly available when a public charity plans to hire a new employee who will be a disqualified person once he or she begins employment. However, it is also available for employment agreements and compensation arrangements that are put in place with existing employees before they experience a change in position or responsibility (or other circumstances) that cause them to become a disqualified person.

The practical usefulness of this exception is limited by the fact that it applies only to "fixed payments." As discussed earlier, a fixed payment is any payment of cash or property that is either of a specific amount or that is determined under a fixed formula. The amount or the formula must be described in the written contract. In addition, the contract must specify the services for which the compensation will be paid.

A formula does not fail to be a fixed payment merely because payment is conditioned on future specified events or contingencies. However, in no event may the formula allow any person to exercise discretion when calculating either the amount payable under the formula or whether a payment will be made. For example, a fixed payment would include an annual base salary described in an employment agreement, subject to automatic adjustment in future years by reference to changes in an objective cost of living standard. However, a contract provision that allows for periodic salary adjustment at the discretion of the organization generally would not qualify as a fixed payment. Similarly, a purely discretionary bonus program, or even a bonus program with objective metrics that allowed for discretionary adjustments upward or downward in the amount payable, would not qualify as a fixed payment. Nevertheless, payments to tax-qualified retirement plans or other tax-favored benefit plans (such as education and adoption assistance programs) are treated as fixed payments for purposes of this exception despite an organization's discretion to vary the amount of benefits under those plans.

The initial contract exception also has certain other relevant requirements. First, the exception applies only if the person substantially performs his or her obligations under the contract. As a result, the person's actual services (and performance of other obligations) generally must be consistent with those required in the contract for the exemption to be available. Second, if a contract provides that it is terminable or subject to cancellation by the organization (other than as a result of a lack of substantial performance by the person) without the person's consent and without substantial penalty to the organization, the contract is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective. As a result, the exception will generally be lost as soon as termination or cancellation without penalty is permitted because the individual will likely be a disqualified person at that time and not eligible for the exception after that time.

If the contract also provides for payments that do not qualify as fixed payments, the exception still applies to any fixed payment. However, nonfixed payments are subject to the general reasonableness test described above. In determining the reasonableness of the nonfixed compensation, all compensation is taken into account (even compensation that qualifies as a fixed payment). For example, if an initial contract with a newly hired chief financial officer provides for a fixed base salary and a right to an annual bonus determined at

the discretion of the chief executive officer of the public charity, the base salary will be eligible for exemption under the initial contract rule but the discretionary bonus will not. Consequently, the reasonableness of each annual bonus payment must be evaluated based on the total value of the annual salary and the bonus payment, as well as any other compensation paid outside the contract.

As a general matter, material changes to a contract, including renewals or extensions, are treated as creating a new contract. The new contract must then be analyzed to determine whether it qualifies under the initial contract exception. If the person is a disqualified person at the time of the material change creating the new contract, the initial contract exception will no longer be available. However, the new contract may still qualify for the exemption if the person is not a disqualified person when the new contract is deemed to be established.

Revenue Sharing. Internal Revenue Code Section 4958 authorizes the Treasury Department to develop regulations that include as excess benefit transactions situations in which the economic benefits received by a disqualified person "are determined in whole or in part by the revenues of 1 or more activities of the organization." To date, the IRS has not issued final regulations on such revenue-sharing arrangements.

Absent final regulations, such arrangements should generally be subject to the general reasonableness standard under Internal Revenue Code Section 4958. However, the statutory language of Internal Revenue Code Section 4958 adds a condition that the revenue-sharing arrangement not result in private inurement, as prohibited under Internal Revenue Code Section 501(c)(3). Consequently, consideration should be given to structuring such arrangements in a manner that is consistent with the general standards that the IRS has considered relevant in favorably ruling on incentive compensation arrangements for employees of tax-exempt organizations. These principles include mechanisms in the arrangement to assure that actual incentive compensation payments, when combined with salary and other compensation, are reasonable in the aggregate.

Rebuttable Presumption of Reasonableness. The House Committee Report provided an important planning tool for protecting against the application of the excess benefit transaction excise tax, which has been incorporated into the regulations under Internal Revenue Code Section 4958. The public charity may establish a rebuttable presumption that the compensation paid to the disqualified person is reasonable.

There are two primary benefits of establishing the rebuttable presumption. First, as a general rule, if the requirements for establishing the rebuttable presumption have been met, a director's participation in a transaction will be due to reasonable cause. Thus, the participating directors cannot be subjected to the 10 percent excise tax imposed on organization managers. Second, meeting the requirements for the rebuttable presumption shifts the burden of proof to the IRS. The IRS will then have the burden of rebutting the presumption by challenging the validity or independence of comparables or proving that the comparables do not reflect functionally similar positions.

In the case of a contract providing for a fixed payment, the rebuttable presumption arises at the time the parties enter into the contract. The same rule applies for retirement benefits. If the contract does not involve a fixed payment (except in the case of certain payments subject to a cap), the rebuttable presumption can arise only after discretion is exercised, the exact amount of the payment is determined, or the formula is fixed, and the three requirements to establish the rebuttable presumption (addressed below) are met.

The rebuttable presumption of reasonableness will arise only if the following conditions are met *in the case of compensation arrangements*:

Approval by Authorized Body. The terms of the compensation arrangement must be approved in advance by an authorized body of the public charity composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement. An authorized body is the board of directors; a committee of the board of directors, which may be composed of individuals permitted under state law to serve on such committee, to the extent that state law allows the committee to act on behalf of the board of directors; or, to the extent permitted under state law, other parties authorized by the board of directors to act on its behalf by following procedures specified by the board of directors in approving property transfers. For purposes of determining whether an individual has a conflict of interest, a member of the authorized body does not have a conflict of interest with respect to a compensation arrangement only if the member:

- Is not a disqualified person participating in or economically benefiting from the compensation arrangement, and is not a member of the family of any such disqualified person;
- Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement;
- Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement;
- Has no material financial interest affected by the compensation arrangement; and
- Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement, who in turn has approved or will approve a transaction providing economic benefits to the member.

Many public charities will establish an independent compensation committee composed of nonemployee members of the board to serve as the authorized body for all compensation matters related to disqualified persons.

Appropriate Data as to Comparability. The authorized body must obtain and rely upon appropriate data as to comparability before making its determination. An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine if the compensation is reasonable. In the case of a compensation arrangement, relevant information includes:

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.
- The availability of similar services in the geographic area.
- Current compensation surveys compiled by independent firms.
- Actual written offers from similar institutions competing for the services of the disqualified person.

For certain small organizations reviewing compensation arrangements, the authorized body is considered to have appropriate data for comparability if it has data on compensation paid by three comparable organizations in the same or similar communities. A small organization is one having gross receipts of less than $1 million per year.

A frequently asked question is whether the organization should retain a third-party compensation consultant to assist in collecting and evaluating comparability data. The regulations do not require that the comparability data relied on to approve the arrangement be provided by an independent compensation consultant or other third-party adviser. However, reliance on data provided by such a person may insulate the board or committee members from potential penalties under the excess benefit transaction rules if the requirements for the presumption are not met and the compensation is found to be unreasonable. In addition, a compensation consultant generally will have ready, available access to a broader and more detailed set of compensation data than the organization can compile on its own. Finally, a compensation consultant may also be helpful in advising the board or committee on related issues, such as identification of appropriate peer organizations for compensation comparability, advice on compensation arrangement design and delivery and advice on new trends in exempt organization compensation practices.

Required Documentation. The authorized body must adequately document the basis for its determination concurrently with making that determination. For a decision to be documented adequately, the written or electronic records of the authorized body must note the following:

- The terms of the compensation arrangement that was approved and the date of the approval;
- The members of the authorized body who were present during the debate on the compensation arrangement that was approved and those who voted on it;
- The comparability data obtained and relied upon by the authorized body and how the data was obtained; and
- Any actions taken with respect to consideration of the compensation arrangement by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the compensation arrangement.

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 period thereafter.

Excise Tax Imposed on Disqualified Person. The tax imposed on the insider or disqualified person who receives excessive compensation is equal to 25 percent of the amount of the excess benefit and is paid by the disqualified person. (The public charity is never subject to any tax under Internal Revenue Code Section 4958.) If the excess benefit is not corrected, the disqualified person will be subject to an additional excise tax equal to 200 percent of the amount of the excess benefit.

Excise Tax Imposed on Organization Managers. Any "organization manager" who participates in the transaction knowing that it is an excess benefit transaction is also liable for an excise tax of 10 percent of the amount of the excess benefit unless such participation is not willful and is due to reasonable cause. An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

The maximum aggregate tax that can be imposed on all the organization managers for any single excess benefit transaction is $20,000. An organization manager must have actual knowledge of facts that would support treating the transaction as an excess benefit transaction. In addition, the manager must be aware that there are limits on excess benefit transactions. Finally, the manager must negligently fail to make reasonable attempts to ascertain whether this was an excess benefit transaction.

The regulations under Internal Revenue Code Section 4958 offer a safe harbor for organization managers based upon reliance upon professional advice. An organization manager will not be subject to tax if the manager fully discloses the factual situation to an appropriate professional and then relies on the reasoned written opinion of the professional with respect to elements of the transaction within the professional's expertise. Appropriate professionals include legal counsel, CPAs or accounting firms with expertise regarding the relevant tax laws and independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the type of property or services involved and include in the written opinion a certification that they meet these requirements. Also, a manager's participation will not ordinarily be considered "knowing" if the requirements for the rebuttable presumption of reasonableness (discussed previously) are met.

Correction of an Excess Benefit Transaction. To correct an excess benefit transaction, the disqualified person must undo the excess benefit to the extent possible and take any additional steps 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. Correction requires payment of the correction amount, which is the excess benefit plus interest at the applicable federal rate, compounded annually. Generally, correction may be made only by making a cash payment. In the case of an ongoing contract, the contract may be modified to correct going forward. If correction is made for less than the full correction amount, the 200 percent tax is imposed on only the unpaid portion.

Reporting Compensation on the Public Charity's Form 990

Reasons for Redesign of Form 990 in 2008. The IRS redesigned the Form 990 filed by certain public charities in 2008. The IRS was guided by the following principles in redesigning the Form 990:

- The Form 990 should reflect the manner in which the nonprofit sector operates in the 21st century and the increasing size, diversity and complexity of the sector.
- The Form 990 should enhance transparency and accountability by providing the IRS and the public with a realistic picture of the organization and its operations, along with a basis for comparing the organization to other organizations.
- The Form 990 should promote compliance by ensuring that it accurately reflects the organization's operations and use of assets, thereby enabling the IRS to assess efficiently the risk of noncompliance.
- The Form 990 should minimize the burden on filing organizations by asking questions in a manner that makes it relatively easy to fill out the form and does not impose unwarranted additional recordkeeping or information-gathering burdens to obtain and substantiate the requested information.

Compensation Reporting on the Redesigned Form 990. The redesigned Form 990 expands the number of persons whose compensation must be reported by the filing organization and provides for further specifics on the compensation of certain individuals. Certain basic compensation information must be reported by the filing organization. The core Form 990 (i.e., the part of the form that must be completed by all filing organizations) requires disclosure about compensation of certain persons as reported on a Form W-2 or Form 1099. The list of persons whose compensation must be disclosed is expanded on the new Form 990 and includes:

- Current officers and directors.
- Up to 20 key employees (who are not officers or directors) who are defined as persons with certain responsibilities who have reportable compensation greater than $150,000 from the filing organization and related entities.
- The five highest paid current employees whose reportable compensation exceeds $100,000.
- Former directors whose reportable compensation exceeds $10,000.

With respect to each of these persons, the filing organization must disclose on the Form 990 the name and title of the person, average weekly hours, reportable compensation from the filing organization, reportable compensation from related organization(s) and the estimated amount of other compensation from the organization and related organization(s), such as housing, education assistance or insurance. In addition, the filing organization must identify the total number of individuals being paid more than $100,000 regardless of whether specifically reported on the Form 990.

The filing organization is required to identify any independent contractors, such as law firms, accounting firms, investment managers and other consultants, who receive more than

$100,000 from the filing organization and also must identify the services provided and the amount of compensation paid.

If certain requirements are met, the filing organization must provide additional and more detailed compensation information on new Schedule J. Schedule J must be filed if (1) the filing organization is required to list any *former* officer, director, key employee or five highest compensated employees in the core Form 990; (2) the sum of reportable compensation and other compensation paid to any individual listed in the core Form 990 exceeds $150,000; or (3) the filing organization participated in an arrangement in which an unrelated organization paid compensation to at least one of its officers, directors, key employees or five highest compensated employees for services performed for the filing organization. For persons required to be reported on Schedule J, the filing organization must break down its reporting or executive compensation into components, including regular wages and salary, bonus and incentive compensation, other reportable compensation, deferred compensation, and fringe or nontaxable benefits, including expense allowances and reimbursements. Schedule J also requests information about the filing organization's general compensation practices. For any persons whose compensation was reported in the core part of the Form 990, the filing organization is required to disclose whether any of the following were provided by the filing organization to the person:

- First-class or charter travel.
- Travel for companions.
- Tax indemnification and gross-up payments.
- Discretionary spending account.
- Housing allowance or residence for personal use.
- Payments for business use of personal residence.
- Health or social club dues or initiation fees.
- Personal services (e.g., maid, chauffeur, chef).

If any of these are provided, the filing organization must disclose whether it has a written policy regarding payment or reimbursement of these expenses and, if not, provide an explanation as to why it does not have such a policy. Schedule J also inquires whether substantiation is required before making such a reimbursement or payment.

In connection with the establishment of the chief executive officer's compensation, Schedule J asks whether any of the following were used:

- Compensation committee.
- Independent compensation consultant.
- Form 990 of other organizations.
- Written employment contract.
- Compensation survey or study.
- Approval by the board or a compensation committee.

For any persons whose compensation was reported on the core part of the Form 990, the filing organization is required to disclose whether any of those persons:

- Received a severance or change in control payment.
- Participated in or received a payment from a supplemental nonqualified retirement plan.
- Participated in or received a payment from an equity-based compensation arrangement.
- Received pay contingent upon the revenues or net earnings of the filing organization or any related organization.
- Received any nonfixed payments not based on revenues or net earnings.

Schedule J also provides space for supplemental information in the event the filing organization believes it appropriate to provide further explanation (whether for the benefit of the public or the IRS) regarding a particular compensation package, practice or arrangement.

Private Foundations and the Self-Dealing Rules

Charitable organizations that are classified as private foundations for federal tax purposes are not subject to the excess benefit transaction rules. Instead, private foundations are subject to the self-dealing rules of Internal Revenue Code Section 4941. These self-dealing rules impose an excise tax on acts of direct or indirect self-dealing between the foundation and a disqualified person with respect to the foundation. It does not matter whether the act of self-dealing results in a benefit or detriment to the private foundation.

The self-dealing rules apply to any "direct" or "indirect" act of self-dealing. Direct self-dealing occurs when the private foundation is a party to the transaction with the disqualified person. An act of indirect self-dealing occurs when a disqualified person engages in a transaction with an organization controlled by the private foundation or by persons who are officers or directors of the foundation. Indirect self-dealing can arise with respect to an organization controlled by the private foundation or by the private foundation's directors or officers. If the private foundation or its directors or officers can use their votes or authority to cause another organization to engage in a transaction that would be self-dealing if engaged in directly by the private foundation, that transaction constitutes indirect self-dealing and is subject to the excise tax.

Definition of Disqualified Persons. Disqualified persons are defined as:

- Substantial contributors to the private foundation.
    - A substantial contributor is any person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation if such amount is more than 2 percent of the total contributions or bequests to the foundation before the close of the tax year of the foundation in which the contribution or bequest is received.
    - Once a person is a substantial contributor, the person remains a substantial contributor except under very limited circumstances after the passage of 10 years.
    - Any payment of money or transfer of property to the private foundation for adequate consideration would not be a contribution and would not cause the

payor or transferor to become a disqualified person. On the other hand, a payment for inadequate consideration could result in a contribution.

- Foundation managers (directors, trustees and officers) of the private foundation.
- Any 20 percent owner of a business that is a substantial contributor to the private foundation.
- Any family member of the persons described above (which, in the case of a private foundation, includes a spouse, ancestors and children; grandchildren, great-grandchildren and spouses of children, grandchildren and great-grandchildren; but not siblings).
- Any corporation, partnership, trust or estate in which persons described above have more than a 35 percent interest.
- Any government official.

Payment of Compensation and Reimbursement of Expenses. Although there are exceptions available, the private foundation self-dealing rules define an act of self-dealing to include a private foundation's payment of compensation to or reimbursement of the expenses of a disqualified person with respect to the foundation. Notwithstanding this general rule, self-dealing does not include a private foundation's payment of compensation (and the payment or reimbursement of expenses) to a disqualified person for personal services that are reasonable and necessary to carrying out the exempt purpose of the foundation if the compensation or reimbursement is not excessive.

In general, "the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager." Such an advance should not ordinarily exceed $500 unless the advance is to "cover extraordinary expenses anticipated to be incurred in fulfillment of a special assignment (such as long distance travel)."

Like public charities, private foundations must determine the reasonableness of compensation in accordance with the standards under Internal Revenue Code Section 162. For compensation, a reasonable amount means only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

Unlike the excess benefit transaction rules that apply to public charities, the private foundation self-dealing rules do not allow the private foundation to establish a rebuttable presumption of reasonableness. Nevertheless, private foundations may still find it helpful to take the other steps that public charities do with respect to raising the rebuttable presumption of reasonableness, including making the determination of the reasonableness of compensation in advance, obtaining and relying on appropriate data as to comparability, and documenting the basis for its determination concurrently with making that determination.

Amount of Tax on Act of Self-Dealing. The penalty imposed on an act of self-dealing is a two-tier excise tax that is imposed not on the private foundation but on the disqualified person. Taxes can also be imposed on foundation managers (i.e., directors, trustees or officers) who participate in the transaction. Again, there is no self-dealing tax imposed on the

private foundation. An additional and confiscatory tax is imposed if the act of self-dealing is not corrected within the statutorily defined correction period.

An initial tax of 10 percent of the amount involved with respect to the act of self-dealing is imposed on any disqualified person who participates in an act of self-dealing. In addition, any foundation manager who participated in an act of self-dealing is liable for a tax of 5 percent of the amount involved (up to $20,000 per act for all foundation managers) unless such participation was not willful and was due to reasonable cause.

In addition to paying the initial tax, the disqualified person must correct the self-dealing by undoing the transaction and restoring the private foundation to the position it would have been in had there been no self-dealing. If the act of self-dealing is not corrected, an additional tax of 200 percent of the amount involved is imposed on the disqualified person, and an additional tax of 50 percent of the amount involved is imposed on directors and officers who refuse to agree to part or all of the correction (with an aggregate cap of $20,000).

With respect to any act of self-dealing, the amount involved means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received. The fair market value is determined on the date on which the act of self-dealing occurred.

Liability of Foundation Managers for Participation in Act of Self-Dealing. The self-dealing rules impose an excise tax on foundation managers (the directors, trustees and officers of the private foundation) who participate in an act of self-dealing "knowing that it is such an act." The tax is not imposed if the participation is not willful and is due to reasonable cause. Participation includes silence or inaction on the part of a foundation manager if the foundation manager is under a duty to speak or act, as well as affirmative action by the foundation manager. One court has held that participation can include knowledge without opposition.

If more than one foundation manager is liable for the tax imposed with respect to an act of self-dealing, the foundation managers are jointly and severally liable for the tax. In addition, the maximum amount of tax that can be imposed collectively on all participating foundation managers for any one act of self-dealing is $20,000.

A foundation manager is not liable for tax unless the following circumstances are present:

- A self-dealing tax is imposed on the disqualified person;
- The participating foundation manager knows that the act is an act of self-dealing; and
- The participation by the foundation manager is willful and is not due to reasonable cause.

For purposes of these rules, a foundation manager will be considered to have participated in a transaction "knowing" that it is an act of self-dealing only if the foundation manager (1) has actual knowledge of sufficient facts so that, based solely upon such facts, the transaction would be an act of self-dealing, (2) is aware that such an act under these circumstances may violate the self-dealing rules and (3) negligently fails to make reasonable attempts to

ascertain whether the transaction is an act of self-dealing. “Knowing” does not mean having reason to know.

A foundation manager’s participation will be “willful” if it is voluntary, conscious and intentional. No motive to avoid the restrictions of law or the incurrence of any tax is necessary to make the participation willful. But, participation is not willful if the foundation manager does not know that the transaction in which he is participating is an act of self-dealing.

A foundation manager’s participation is due to reasonable cause if the foundation manager exercised his responsibility on behalf of the private foundation with ordinary business care and prudence. The regulations also provide a safe harbor for reliance upon advice of counsel in a reasoned, written legal opinion that does more than recite the facts and express a conclusion.

Tax Reform Proposals Affecting the Excess Benefit Transaction and Self-Dealing Rules

On February 26, 2014, Rep. Dave Camp (R-MI), as chairman of the U.S. House of Representative’s Ways & Means Committee, released a discussion draft of a forthcoming “Tax Reform Act of 2014” (the Draft). The Draft’s broad reforms include changes to the Internal Revenue Code that directly impact tax-exempt organizations, as well as donors to charitable organizations. Relevant to the compensation of executives of charitable organizations, the Draft contains proposals modifying both the excess benefit transaction rules and the private foundation self-dealing rules.

The Draft adds a new organizational-level tax with respect to excess benefit transactions. In addition to the taxes currently imposed on disqualified persons and organization managers, a new 10 percent excise tax would be imposed on an organization that is involved in an excess benefit transaction. This new tax can be avoided if the organization demonstrates that it followed certain “minimum standards of due diligence” to prevent the provision of an excess benefit to a disqualified person. The proposed minimum standards mirror the current requirements for establishing the rebuttable presumption of reasonableness — approval of the transaction by an independent body after considering comparability data.

Significantly, the Draft eliminates the rebuttable presumption of reasonableness for purposes of imposing the excess benefit transaction excise tax on disqualified persons and an organization’s directors and officers, which increases the risks associated with compensation and other transactions with disqualified persons. In addition, the Draft eliminates the ability of directors and officers to rely on professional advice as a safe harbor against the excise tax. Finally, the Draft expands the definition of “disqualified persons” for purposes of this tax to specifically include athletic coaches and investment advisors.

In connection with the self-dealing rules, the Draft imposes a new 2.5 percent excise tax on private foundations that engage in self-dealing, in addition to the excise taxes currently applicable to disqualified persons and directors and officers. As with the changes to the safe

harbor for purposes of the excess benefit transaction rules, the Draft eliminates the professional advice safe harbor available to directors and officers of private foundations.

Conclusion

Compensation levels paid by charitable organizations, as well as the practices followed by those organizations when determining compensation, are likely to continue to receive scrutiny from both the IRS and Congress. When setting executive compensation, both public charities and private foundations are best served by policies and procedures that comply with the tax laws and minimize the tax risk for the individuals involved.

Planning to Avoid the Excess Benefit Transaction Rules. All public charities should strive to take steps to identify potential excess benefit transactions and to raise the rebuttable presumption of reasonableness in all cases where a compensation arrangement involves a disqualified person with respect to the organization. The following steps should be implemented and reviewed on a regular basis:

- *Identify Disqualified Persons.* Public charities should regularly identify disqualified persons in their organizations. As discussed above, the process for identifying disqualified persons requires not only identification of the persons who hold certain positions in the organization, but also those persons whose specific responsibilities and authorities provide them with the ability to substantially influence the affairs of the organization (without regard to whether they actually exercise those authorities and responsibilities). In addition, transactions with a disqualified person's family members and 35 percent controlled corporations should be identified.
- *Periodically Review Compensation Arrangements for Disqualified Persons*. Public charities should have a process for regularly reviewing the compensation of their disqualified persons to confirm that the compensation, if not otherwise exempt from the excess benefit transaction rules, is reasonable. This review requires consideration of a number of factors. First, all compensation of any kind paid to the disqualified persons should be identified, including compensation paid by related parties. Second, each item of compensation should be evaluated to determine whether it may be excluded when performing the reasonableness test. Next, the reasonableness of the nonexcludable compensation should be evaluated based on the general standards applicable under Internal Revenue Code Section 162, including consideration of appropriate comparable compensation data.
- *Establish Standards for Independent Review and Approval*. Where compensation for a disqualified person is set annually or on some other periodic basis, consideration should be given to implementing compensation-setting procedures designed to comply with the rebuttable presumption of reasonableness. The public charity should make certain that the independent board or committee establishing the rebuttable presumption is truly independent and that any conflict of interest is avoided. This standard may necessitate establishing a standing compensation committee for these purposes.
- *Establish Procedures for New Compensation Arrangements.* Public charities should adopt procedures for evaluating whether new compensation arrangements can be

structured to be exempt under the initial contract exception or whether a rebuttable presumption of reasonableness can be established for the arrangement. Because of the various limitations associated with the initial contract exception, reliance on the rebuttable presumption of reasonableness may be the more appropriate alternative for addressing potential excess benefit transaction issues. It is important to remember that the three requirements for the rebuttable presumption must be satisfied before any of the proposed compensation is paid.

- *Establish Procedures for Emergency Situations.* Public charities should consider procedures for handling unexpected benefits that become payable to disqualified persons during the year. The procedures should follow the steps necessary to obtain the rebuttable presumption of reasonableness. For example, in the case of reimbursement of expenses not otherwise covered under an accountable plan, the organization should consider requiring the disqualified person to initially pay the expense, with later reimbursement from the organization once the proper steps are taken to secure the rebuttable presumption of reasonableness.

Planning to Avoid the Self-Dealing Rules. While operating under a different set of rules than public charities, private foundations should also take steps to identify potential self-dealing transactions and ensure that compensation paid to disqualified persons is reasonable. While the rebuttable presumption is not available to private foundations, similar steps should be followed by private foundations where possible to reduce the tax risk to the individuals involved.