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NONPROFIT COMPENSATION:
TAX AND CORPORATE GOVERNANCE ISSUES

By

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I. Introduction

Compensation of nonprofit executives is a matter with important tax and corporate governance implications. In recent years, as more nonprofit corporations have sought to hire “professional managers,” we have seen upward pressure on compensation and increasingly complex compensation packages. There is an increased emphasis on oversight by the board of directors and a demand by stakeholders, the public, the IRS and Congress for increased transparency. This outline addresses applicable federal tax laws and best practices for corporate governance.

II. Doctrines of Private Benefit and Private Inurement

A. Requirements for Tax-exempt Status Under Section 501(c)(3)

Section 501(c)(3) of the Code exempts from federal income tax charitable organizations organized and operated exclusively for certain specified charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual. This language gives rise to two requirements: (1) a limitation on private benefit; and (2) a prohibition against private inurement.

B. Limitation on Private Benefit

1. The limitation on private benefit arises from the requirement that an organization be operated exclusively for a charitable purpose. The Treasury Regulations provide that an organization is considered to be operated exclusively for charitable purposes if it engages primarily in activities that accomplish one or more exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c)(1). Conversely, an organization is not operated primarily for exempt purposes if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Id. Further, an organization is not operated primarily for an exempt purpose unless it serves a public rather than a private purpose.

1 The author thanks Gregory N. Kidder, an associate at Steptoe & Johnson, for his assistance.
2. An organization must not be organized or operated for the benefit of private interests such as designated individuals or shareholders. Treas. Reg. § 501(c)(3)-1(d)(1)(ii). Thus, a purpose to benefit private individuals will result in loss of exempt status if the purpose is more than an insubstantial part of its activities. An insubstantial or incidental private benefit, however, is permissible. Rev. Rul. 70-186, 1970-1 C.B. 128. In determining whether a private benefit is insubstantial, it is necessary to balance the public benefits against the private benefit. See Sonora Cmty. Hosp. v. Comm’r, 46 T.C. 519 (1966) (limited charitable care vs. benefit provided to doctors), aff’d, 397 F.2d 814 (9th Cir. 1968); Am. Campaign Academy v. Comm’r, 92 T.C. 1053 (1989) (benefit of campaign education in general vs. benefit to Republican Party).

C. Prohibition Against Private Inurement

1. An organization is not operated primarily for an exempt purpose if net earnings inure in whole or in part to the benefit of any private shareholder or individual. In this context, the term private shareholder or individual refers to “persons having a personal and private interest in the activities of the organization.” Treas. Reg. § 1.501(a)-1(c). These persons, often referred to as “insiders,” are those who, by virtue of a special relationship with the organization in question, are able to influence the expenditure of its funds or the use of its assets.

2. In a typical inurement case, the connection between the payments received by an insider and the value of the services provided by the insider cannot be established or, if there is a connection, the payments are out of proportion to the value provided by the insider to the organization.

3. In Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl.) (1969), the amount of the founder’s compensation increased from year to year, in part because he received a percentage of the church’s revenue. However, there was no indication in the record that the value of the founder’s services also increased from year to year. The organization’s founder and his family also received numerous poorly documented loans and expense reimbursements from the organization. In addition, the founder’s wife rented property to the organization and the founder’s daughter was listed as a salaried employee of the organization. The record was devoid of any evidence showing services performed by the daughter for the organization or the reasonableness of the rental paid by the organization to the wife. The size of the payments received by the founder and his family seemed to be determined by their personal needs, without regard to the value of the services provided to the organization by the founder and his family. The Claims Court held that, because the founder and his family seemed to be “entitled to make ready personal use of the corporate earnings,” a part of the organization’s net earnings inured to their benefit.

4. In Chandler v. Commissioner, 54 T.C.M. (CCH) 1040 (1987), the organization provided rent-free housing and paid personal living expenses of their members. The court rejected the members’ argument that the payments represented reasonable compensation for services because there was no credible evidence that services were in fact rendered. In addition, the court found that, even if the services were rendered, “the value of those services fell far short of equaling or exceeding the value of the benefits received.” Id. at 1042. Concluding that “[m]embers of [the organization] received benefits based in large part, if
not solely, on their personal needs rather than as consideration for services rendered,” the court held that the organization’s earnings inured to the benefit of the members in contravention of the requirements of section 501(c)(3). *Id.*

**D. Comparison of Private Benefit and Private Inurement**

1. Private benefit occurs when a section 501(c)(3) organization is organized or operated for the benefit of any private person or entity that does not comprise a charitable class, whether or not such private person or entity is an insider with respect to the organization. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The doctrine of private inurement, on the other hand, is limited to insider benefits.

2. The private benefit doctrine examines whether the organization’s activities serve predominantly exempt purposes as opposed to private purposes. See, e.g., Rev. Rul. 69-266, 1969-1 C.B. 151 (ruling that an organization formed and controlled by a medical doctor to conduct “research programs” consisting of examining and treating patients at prevailing rates was not entitled to exemption because it was merely a guise for the doctor’s private practice of medicine). The private inurement doctrine examines whether the organization’s resources are used in furtherance of its exempt purposes. Organizations may engage in transactions that result in an “incidental” private benefit without losing their tax-exempt status. The prohibition against private inurement, on the other hand, is absolute.

3. Many cases and rulings dealing with compensation issues use the terms “private inurement” and “private benefit” interchangeably or serially without separate analysis. See, e.g., PLR 9546015 (Aug. 16, 1995); Bubbling Well Church of Universal Love Inc. v. Comm’r, 74 T.C. 531, 535 (1980) (“We are not convinced from the information in the administrative record that part of the net earnings did not inure to the benefit of the [founders’] family or, stated another way, that petitioner was not operated for the [founders’] private benefit.”), aff’d, 670 F.2d 104 (9th Cir. 1981). However, the doctrines of private benefit and private inurement are distinct.

**III. Intermediate Sanctions Under Section 4958**

**A. Introduction**

Section 4958 imposes a system of penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations, which are subject to a separate penalty regime under current law) engage in “excess benefit transactions” involving “disqualified persons.” Until the enactment of section 4958 in 1996, the only sanction for transactions benefiting an organization’s insiders was revocation of the organization’s tax-exempt status for violation of the prohibition on private inurement. Excise taxes on excess benefit transactions can be imposed in lieu of, or in addition to, the revocation of exemption. See Treas. Reg. § 53-4958-1; H.R. Rep. No. 104-506, at 57, reprinted in 1996 U.S.C.C.A.N. at 1180

**B. Imposition of Excise Taxes**
1. **In General**

Excise taxes are imposed on “disqualified persons” who benefit from an excess benefit transaction and on “organization managers” who participate in such a transaction knowing that it is an excess benefit transaction. I.R.C. § 4958(a).

2. **On Disqualified Persons**

A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty equal to 25 percent of the amount of the excess benefit. I.R.C. § 4958(a)(1). If the excess benefit transaction is not corrected within a specified period of time, the disqualified person may be subject to a second-tier penalty equal to 200 percent of the amount of the excess benefit. Correction of an excess benefit transaction generally requires the return of the excess benefit, with interest, to the organization within a specified time period. I.R.C. § 4958(f)(6); Treas. Reg. § 53.4958-7; I.R.C. § 4963(e).

3. **On Organization Managers**

   a. An organization manager who participates in an excess benefit transaction with actual knowledge is subject to a penalty equal to 10 percent of the amount of the excess benefit, up to a maximum penalty of $20,000. I.R.C. §§ 4958(a)(2), 4958(d)(2).

   b. The regulations provide that excise taxes ordinarily will not be imposed on organization managers who participate in a transaction that is later determined to be an excess benefit transaction if the organization relied on a reasoned written opinion of a professional that the transaction is not an excess benefit transaction. Treas. Reg. § 53.4958-1(d)(4)(iii). Appropriate professionals on whose opinion organization managers may rely are limited to: attorneys; CPAs with relevant tax law expertise; and independent valuation experts who, among other things, hold themselves out to the public as appraisers or compensation consultants and perform the relevant valuations on a regular basis.

   c. A professional written opinion may be relied upon only if it addresses itself to the facts and the applicable standards and does not merely recite the facts and express a conclusion. *Id.* Reliance on a written opinion may be justified even though the opinion reaches a conclusion that is later determined to be incorrect, as long as the opinion addresses itself to the facts and the applicable standards in a reasoned manner. *Id.* The absence of a written opinion, by itself, is not an indication that an organization manager participated in an excess benefit transaction knowingly. *Id.*

**C. What is a Disqualified Person?**

1. The term “disqualified person” generally means any person in a position to exercise substantial influence over the affairs of a tax-exempt organization at any time during the five-year period ending on the date of the transaction. I.R.C. § 4958(f)(1)(A).

2. Under the regulations, several categories of persons are treated as disqualified persons *per se*, simply by virtue of their relationship to, or position with, the applicable tax-exempt organization. These categories include: (i) family members of
disqualified persons; (ii) voting members of the organization’s governing body; (iii) senior officers including presidents, chief executive officers, chief operating officers, and any person, regardless of title, who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration or operation of the organization; and (iv) treasurers, chief financial officers, and any person, regardless of title, who has ultimate responsibility for managing the finances of the organization. Treas. Reg. § 53.4958-3(c).

3. In all cases not falling within the per se categories of disqualified persons, substantial influence resulting in a finding that the person is a disqualified person is determined from the facts and circumstances of each case. Treas. Reg. § 53.4958-3(e). Under the facts-and-circumstances test, individuals other than directors or executive officers of the organization may be treated as disqualified persons with respect to the organization. The regulations identify factors that tend to show substantial influence, including whether the person (i) is a founder; (ii) is a substantial contributor; (iii) receives compensation based primarily on revenues derived from activities of the organization, or of a particular department or function of the organization that the person controls; (iv) shares authority to determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees; (v) 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; (vi) owns a controlling interest (measured by either vote or value) in a corporation, partnership or trust that is a disqualified person; or (vii) is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons. Treas. Reg. § 53.4958-3(e)(2).

a. For example, a lower-level employee may be treated as a disqualified person with respect to an organization because his or her compensation is primarily based on revenues derived from activities of the organization. Id.

b. Employees who (1) do not fall within the above per se categories; (2) are not substantial contributors; and (3) receive less than a certain amount of economic benefit from the organization ($100,000 in 2006) are deemed to lack substantial influence over the affairs of the organization. Treas. Reg. § 53.4958-3(d).

c. The regulations also identify the factors that tend to show lack of substantial influence, including the following: (i) that person’s direct supervisor is not a disqualified person; or (ii) the person does not participate in any management decisions affecting the organization as a whole or 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. Treas. Reg. § 53.4958-3(e)(3).
D. What is an Organization Manager?

1. The term “organization manager” refers to any officer, director or trustee of an organization or any individual having powers or responsibilities similar to those of officers, directors or trustees. I.R.C. § 4958(f)(2).

2. The regulations define this term very broadly as any person who “[r]egularly exercises general authority to make administrative or policy decisions . . . .” Treas. Reg. § 53.4958-1(d)(2)(B).

3. The regulations also treat as an organization manager any person who serves on a compensation committee of the organization’s governing body if that committee attempts to invoke the rebuttable presumption of reasonableness (discussed below) with respect to compensation paid by the organization to its disqualified persons. Treas. Reg. § 53.4958-1(d)(2)(ii).

E. What is an Excess Benefit Transaction?

1. General Definition

   a. An excess benefit transaction is a transaction in which a tax-exempt organization provides an economic benefit to a disqualified person in excess of the value of the consideration received in return from such person. I.R.C. § 4958(c)(1).

   b. In the context of compensation paid to a disqualified person, the question is whether total compensation exceeds the value of the services provided by the disqualified person to the tax-exempt organization.

2. What Constitutes Total Compensation?

   a. General Rule. For purposes of determining whether an excess benefit transaction has occurred, total compensation includes all economic benefits provided by the exempt organization in exchange for the performance of services, unless expressly excluded by the regulations. Treas. Reg. § 53.4958-4(b)(1)(ii)(B).

   b. Economic Benefits Excluded from Total Compensation.

   Among the disregarded benefits are employment-related fringe benefits that are excluded from income under section 132 of the Code. Treas. Reg. § 53.4958-4(a)(4)(i). Also disregarded are business expense reimbursement payments under an arrangement that requires each business expense to be substantiated to the employer and requires employees to return any excess reimbursements to the employer. Treas. Reg. § 53.4958-4(a)(4)(ii).

   c. Economic Benefits Included in Total Compensation

      i. Salary;

      ii. Fees;
iii. Bonuses;

iv. Severance payments;

v. Deferred benefits provided under a qualified pension, profit-sharing or stock-bonus plan;

vi. Unless excludable as a de minimis fringe benefit, the payment of liability insurance premiums for, or reimbursement by the organization of, any penalty, tax or expense of correction in connection with an excess benefit transaction; any excessive or unreasonable expense incurred in connection with a civil proceeding arising out of performance of services for the organization; and, any expense resulting from an act or failure to act with respect to which the person acted willfully and without reasonable cause;

vii. Payments to plans providing medical, dental, life insurance, severance pay and disability benefits;

viii. Fringe benefits other than (1) services provided by an employer to an employee at no additional cost to the employer; (2) certain discounts offered by an employer to an employee on goods or services offered by the employer to the general public; (3) property or services provided to an employee for the convenience of the employer; (4) de minimis benefits; (5) reimbursements for certain transportation, parking and moving expenses; and (6) certain retirement planning services;

ix. Expense allowances and reimbursements, except expense reimbursement payments under an arrangement that requires each business expense to be substantiated to the employer and provides for the return of excess reimbursements by the employee; and

x. The economic benefit of below-market loans, to the extent of the interest forgone or the difference between the amount of the loan and the present value of all payments which are required to be made over the life of the loan. Treas. Reg. § 53.4958-4(b)(1)(ii)(B).

d. Treatment of Travel Expenses

i. Treas. Reg. § 53.4958-4(a)(4)(i) excludes “nontaxable fringe benefits” from the scope of compensation for purposes of section 4958. “Nontaxable fringe benefit” is defined as “an economic benefit that is excluded from income under section 132, except any liability insurance premium, payment, or reimbursement that must be taken into account under paragraph (b)(1)(ii)(B)(2) of this section.” The Preamble to the Temporary Regulations under section 4958 discussed this provision specifically with respect to travel expenses.

By referring to fringe benefits excluded from income under section 132, the temporary regulations adopt existing standards under section 162 and section 274 (which are incorporated into section 132) to determine whether payments or reimbursements of travel expenses of an employee--
or any other expenses—should be disregarded for section 4958 purposes or, instead, treated as part of the disqualified person's compensation.

**ii. Section 132(a) excludes from gross income certain “fringe benefits,” including, among other things, “working condition” fringe benefits. Section 132(d) states, “For purposes of this section the term ‘working condition fringe’ means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.”**

**iii. Travel with Spouse**

(a) The Treasury regulations under section 162 state:

Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip. See Treas. Reg. § 1.162-2(c).

(b) The case law has applied the “bona fide business purpose” standard narrowly. The notable case finding for the taxpayer on this issue is United States v. Disney, 413 F.2d 783 (9th Cir. 1969). In Disney, the Ninth Circuit held that Roy Disney’s wife accompanied him on business trips for a bona fide business purpose because Walt Disney Productions had a “long-standing company policy that the wives of company executives should accompany their husbands” and that this policy’s purpose was to promote Walt Disney Productions’ “special image” of providing “‘wholesome entertainment; designed to appeal to the entire family.” The court stated, “The critical inquiries are whether the dominant purpose of the trip was to serve her husband’s business purpose in making the trip and whether she actually spent a substantial amount of her time in assisting her husband in fulfilling that purpose.”

(c) Subsequent case law has interpreted this standard narrowly and established that a primary purpose to socialize is not sufficient to establish a bona fide business purpose. See, e.g., Zeidler v. Comm’r, 71 T.C.M. (CCH) 2602 (1996); Hosbein v. Comm’r, 50 T.C.M. (CCH) 530 (1985); Fenstermaker v. Comm’r, 37 T.C.M.(CCH) 898 (1978); Weatherford v. United States, 418 F.2d 895 (9th Cir. 1969); Danville Plywood Corporation v. United States, 899 F.2d 3 (Fed. Cl. 1990).

(d) Moreover, such case law establishes that a company policy of paying expenses for spousal travel is not determinative of whether there is a bona fide business purpose for attendance. See Fenstermaker v. Comm’r, 37 T.C.M.(CCH) 898 (1978).

(e) The fact that payment of a spouse’s travel expenses is not excluded from “compensation” does not mean that such payment necessarily constitutes an
excess benefit transaction. It does, however, mean that such payment must be included with “compensation” for purposes of determining whether total compensation is reasonable.

F. Rebuttable Presumption of Reasonableness

1. General Requirements

   a. Section 53.4958-6 of the regulations establishes a rebuttable presumption that compensation is reasonable if the compensation arrangement with a disqualified person satisfies the following requirements:

      i. the compensation arrangement was approved by an independent board (or an independent committee authorized by the board) that is composed entirely of individuals who do not have a conflict of interest with respect to the arrangement;

      ii. the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and

      iii. the authorized body adequately and timely documented the basis for its determination. Treas. Regs. §§ 53.4958-6(a), 53.4958-6(c)(2), 53.4958-4(b)(1)(ii).

2. Independent Authorized Body

   a. For purposes of the rebuttable presumption of reasonableness, compensation arrangements may be approved by (i) a board of directors; (ii) a board of trustees; (iii) a governing body that is equivalent to a board of directors or trustees; (iv) a properly constituted committee of the governing body that is permitted under applicable state law to act on behalf of the governing body; or (v) to the extent permitted by state law, other persons authorized by the governing body to act on its behalf in approving compensation by following procedures specified by the governing body. Treas. Reg. § 53.4958-6(c)(1)(i).

   b. For purposes of the rebuttable presumption, the authorized body that approves a compensation arrangement must be composed of persons who are disinterested with respect to that compensation arrangement. Treas. Reg. § 53.4958-6(a)(1). A member of the governing body does not have a conflict of interest with respect to a compensation arrangement or property transfer only if the member:

      • Is not a disqualified person participating in, or economically benefiting from, the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person;

      • Is not in an employment relationship subject to the direction and control of any disqualified person participating in, or economically benefiting from, the compensation arrangement or property transfer;
• Does not receive compensation or other payments subject to approval by any disqualified person participating in, or economically benefiting from, the compensation arrangement or property transfer;

• Has no material financial interest affected by the compensation arrangement or property transfer; and

• Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member. Treas. Reg. § 53.4958-6(c)(iii).

c. In order to meet the requirement of an independent authorized body, any member of the authorized body who has a conflict of interest and persons who are not members of the authorized body (e.g., officers and employees) must not participate in the meetings of the authorized body during which the governing body debates and votes on the compensation arrangement. Treas. Regs. §§ 53.4958-6(a)(1), 53.4958-6(c)(1)(ii). It is permissible, however, for such persons to meet with members of the authorized body in order to answer questions with respect to the compensation arrangement. Treas. Reg. § 53.4958-6(c)(1)(ii).

3. Appropriate Data as to Comparability

The governing body authorized to approve compensation arrangements has appropriate data as to comparability when it is able to determine from all available information the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances. Treas. Reg. § 53.4958-6(c)(2)(i). Information relevant to determining the reasonableness of compensation 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 of the applicable tax-exempt organization;

• Current compensation surveys compiled by independent firms; and

• Actual written offers from similar institutions competing for the services of the disqualified person. Id.
4. **Contemporaneous Documentation**

   a. The governing body’s determination that a particular compensation arrangement was reasonable is considered to be properly and timely documented if the following information is reflected in the governing body’s written or electronic records (e.g., minutes of board meetings) before the later of: (1) the next meeting of the governing body; or (2) 60 days after the governing body’s final action with respect to the arrangement:

   • The terms of the transaction that was approved;
   • The date the transaction was approved;
   • The members of the governing body who were present during debate on the transaction and those who voted on it;
   • The comparability data obtained and relied upon by the governing body;
   • An explanation of how the comparability data was obtained;
   • Whether any member of the governing body with a conflict of interest with respect to the transaction participated in the debate on the transaction, was consulted with respect to the transaction or was otherwise involved in the consideration of the transaction; and
   • If the governing body determines that reasonable compensation for a specific arrangement or fair market value of specific property is higher or lower than the range of comparability data obtained, the basis for that determination. Treas. Reg. § 53.4958-6(c)(3).

   b. The language of the regulations makes clear that contemporaneous documentation is required with respect to *each* compensation arrangement considered and approved by the authorized body. In other words, the compensation arrangement for each employee must be documented separately.

5. **Effect of Obtaining a Rebuttable Presumption of Reasonableness**

   a. If the organization satisfies the criteria for a rebuttable presumption set forth above, then intermediate sanctions will not be imposed on the disqualified person involved in the transaction unless the Service rebuts the presumption by developing sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the board or other governing body. Treas. Reg. § 53.4958-6(b); H.R. Rep. No. 104-506, at 57, reprinted in 1996 U.S.C.C.A.N. at 1180; H.R. Rep. No. 104-280, at 367; Bluebook, supra, at 58.
b. Furthermore, if the organization satisfies the criteria for a rebuttable presumption, intermediate sanctions will not ordinarily be imposed on organization managers who approved the transaction. Treas. Reg. § 53.4958-1(d)(4)(iv).

c. Evidence sufficient to rebut the presumption could include establishing that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position. H.R. Rep. No. 104-506, at 57, reprinted in 1996 U.S.C.C.A.N. at 1180; Bluebook, supra, at 58.

i. With respect to a fixed payment, rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date the parties enter into the contract pursuant to which the payment is made. Treas. Reg. § 53.4958-6(b).

ii. With respect to a non-fixed payment (whether or not subject to a cap), rebuttal evidence may include facts and circumstances up to and including the date of payment. Id. The fact that the rebuttable presumption of reasonableness is not applicable to compensation does not create an inference that the compensation is an excess benefit transaction. Treas. Reg. § 53.4958-6(e).

IV. Reasonable Compensation

A. Overview

Reasonable compensation generally has the same meaning for purposes of the private inurement doctrine and intermediate sanctions. In the case of private inurement, the definition has been developed through case law. For excess benefits transactions, the definition is found in the statute and regulations.

B. Reasonable Compensation under the Private Inurement Doctrine

1. It is well established that the payment of compensation to a trustee, officer or other person for services to a tax-exempt organization does not result in private inurement or private benefit if the compensation is reasonable and in furtherance of the organization’s exempt purposes. See World Family Corp. v. Comm’r, 81 T.C. 958 (1983), non-acq. in part, 1984-2 C.B. 2; B.H.W. Anesthesia Found., Inc. v. Comm’r, 72 T.C. 681 (1979), non-acq., 1980-2 C.B. 2; Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953).

2. Whether compensation is reasonable is a question of fact to be decided in light of all the circumstances. Founding Church of Scientology, 412 F.2d 1197; Enter. Ry. Equip. Co. v. United States, 161 F. Supp. 590 (Ct. Cl. 1958). Factors similar to those considered in determining reasonable compensation for taxable businesses under section 162 of the Code also apply in determining what constitutes reasonable compensation for purposes of the private inurement rule. World Family Corp., 81 T.C. 958. Such factors include:

a. Whether similar enterprises would pay similar compensation for similar services. Treas. Reg. § 1.162-7(b)(3); B.H.W. Anesthesia Found., 72 T.C. 681; TAM
b. The value of the services provided to the organization. For example, an amount of compensation that may be reasonable for a full-time position may result in private inurement when the employee only works part time. *Mabee Petroleum*, 203 F.2d 872. The amount of compensation may not be based on personal needs of the employees. *Chandler v. Comm’r*, 54 T.C.M. (CCH) 1040. See also GCM 39498 (Apr. 24, 1986) (guaranteed minimum salary for physicians measured amount they could earn in private practice, not the value of their services to the hospital).


C. Reasonable Compensation Under Section 4958

1. The value of services provided by a disqualified person is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under the circumstances (*i.e.*, reasonable compensation). Treas. Reg. § 53.4958-4(b)(1)(ii).

2. As under the private inurement doctrine, section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than benefits expressly disregarded as discussed above) provided to a person and the rate at which any deferred compensation accrues. *Id.* The fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. *Id.* The value of services is determined on the basis of the services actually performed by each disqualified person. See TAM 200244028 (June 21, 2002).

3. For purposes of determining whether an excess benefit transaction occurred, all consideration and benefits exchanged between an organization and a disqualified person are generally taken into account, regardless of whether such exchanges occurred in one year or in multiple years. Treas. Regs. §§ 53.4958-4(b)(1)(ii)(B), 53.4958-4(a)(1). For example, in determining the reasonableness of compensation that is paid (or vests or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. Treas. Reg. § 53.4958-4(a)(1).

D. Automatic Excess Benefits

1. With the exception of certain pre-tax benefits, an economic benefit is not treated as compensation for services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation for services when the benefit is paid. Treas. Reg. § 53.4958-4(c)(1).
2. The pre-tax benefits that do not require an indication of intent (although they are still treated as part of the person’s total compensation package) include, but are not limited to, employer-provided health benefits, benefits paid under adoption assistance or education assistance programs, and contributions to a qualified pension, profit-sharing or stock bonus plan. Treas. Reg. § 53.4958-4(c)(2).

3. The effect of this rule is that amounts intended to be treated as compensation will be treated as an excess benefit even if the total compensation is reasonable if the organization fails to comply with the rules for indicating its intent to treat an economic benefit as compensation.

4. An indication of intent must be contemporaneous and in writing. Treas. Reg. § 53.4958-4(c)(1). Intent can be evidenced by reporting the economic benefit as compensation on Form W-2, Form 1099, Form 990, Form 1040 of the recipient, or in timely prepared board minutes or resolutions. Treas. Reg. § 53.4958-4(c)(3). Failure to report the economic benefit as required under the may be excused if the failure occurred due to a reasonable cause. Treas. Reg. § 53.4958-4(c)(3)(B).

E. Initial Contract Exception

1. General Rule

Section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract, except if the person fails to perform substantially the person's obligations under the initial contract during that year. Treas. Reg. § 4958(a)(3). “Initial contract” means a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person within immediately prior to entering into the contract. Treas. Reg. § 4958(a)(3)(iii)

2. Changes to Initial Contract

a. A written binding contract that provides that the contract is terminable or subject to cancellation by the applicable tax-exempt organization (other than as a result of a lack of substantial performance by the disqualified person) without the other party's consent and without substantial penalty to the organization is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective.

b. Additionally, if the parties make a material change to a contract, it is treated as a new contract as of the date the material change is effective. A material change includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any amount payable under the contract.

c. It is advisable to obtain comparables even if the initial contract exception is applicable because, once the contract is viewed as a new contract, the reasonableness of the compensation will be determined without regard to the initial contract exception and must be justified by comparables. Thus, a contract that was not an excess benefit
transaction when it was an initial contract may become an excess benefit transaction upon renewal, even though the terms remain the same.

V. Incentive Compensation Issues

A. Under Section 4958

1. Revenue-Sharing Transactions

a. In enacting the excess benefit transaction rules, Congress recognized that revenue-sharing transactions raise unique issues. Section 4958(c)(4) gives the Commissioner the authority to treat revenue-sharing transactions (such as incentive compensation based on profits or revenues) as excess benefit transactions if such revenue-sharing transactions constitute private inurement.

b. Section 4958 further provides that revenue-sharing transactions will be treated as excess benefit transactions only to the extent provided in the regulations. To date, the Treasury Department has not issued any regulations specifically addressing revenue-sharing arrangements. Until such regulations are issued, the Service will examine revenue-based compensation under the same rules (i.e., the fair market value standards) that are applicable to all contractual arrangements between exempt organizations and disqualified persons. See Preamble to the Final Regulations under section 4958, T.D. 8978, 2002-7 I.R.B. 500 (effective Jan. 22, 2002).

2. Timing of Reasonableness Determination

a. Overview. Under certain circumstances, the time for determining the reasonableness of an incentive compensation plan may be the time that it is paid rather than the time that the plan is adopted or that a disqualified person becomes a participant in a plan.

b. Fixed Payments

i. Fixed payments pursuant to a contract between an exempt organization and a disqualified person are tested for reasonableness for section 4958 purposes under the facts and circumstances existing on the date the parties entered into the contract. Treas. Reg. § 53.4958-4(b)(2)(i). If the compensation satisfies the definition of a fixed payment, it is tested for reasonableness as of the date of the contract even though the compensation is subject to a substantial risk of forfeiture. Treas. Regs. §§ 53.4958-4(b)(2)(i), 53.4958-4(b)(2)(ii), Ex. 2.

ii. For purposes of Treas. Reg. § 53.4958-4(b)(2)(i), the term “fixed payment” means an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. Treas. Regs. §§ 53.4958-4(b)(2)(i), 53.4958-4(a)(3)(ii)(A). A fixed formula may incorporate an amount that depends upon future specified events or contingencies (such as an amount of revenues generated by one or more activities of the organization) as long as no person has discretion over the making of the payment or calculating the amount of the payment. Id.
iii. A performance-based bonus will not be treated as a fixed payment (regardless of whether such bonus is subject to a cap) if the amount of such bonus is subject to the discretion of the organization’s authorized body. See Treas. Reg. § 53.4958-4(a)(3)(vii), Ex. 2. In example 2, T, an exempt organization, hired S as its chief financial officer by entering into a 5-year written employment contract with S. S was not a disqualified person with respect to T prior to entering into the contract. The contract provides for an annual base salary of $200,000 and an annual performance-based bonus of up to $100,000. The contract provides that the Board of Directors of T will determine the amount of the annual bonus as of the end of each year during the term of the contract, based on the board’s evaluation of S’s performance. The example concludes that, while S’s base salary is a fixed payment, the annual bonuses are not fixed payments because the amount of the payment is not specified in the contract and the board of T has discretion over the amount, if any, of the bonus payment. Thus, S’s base salary is a fixed amount but the annual bonuses payable under T’s contract with S are not. See also Treas. Reg. § 53.4958-4(c)(2)(iii), Ex. 3 (payment of discretionary performance-based bonus to a disqualified person not a fixed payment).

iv. A performance-based bonus will be treated as a fixed payment if the amount is determined by a formula based on any objective, rather than subjective, measure (such as a level of revenues from a given activity). Treas. Reg. § 53.4958-4(a)(3)(vii), Ex. 5. In example 5, J, a tax-exempt performing arts organization, hired W as its chief executive officer by entering into a written employment contract with W. Under the contract, J agreed to pay W a base salary in the amount of $x and an annual bonus equal to 2 percent of the total season subscription sales that exceed $100z. The example concludes that both the base salary and the bonus payment under the contract are fixed payments because no one exercises discretion when calculating the amount of the payment or deciding whether the payment will be made.

c. Non-Fixed Payments. In the case of any payment that is not a fixed payment under a contract (whether or not the payment is made in the form of cash or property and whether or not the payment is subject to a substantial risk of forfeiture), reasonableness is determined under all facts and circumstances, up to and including the date of payment. Treas. Reg. § 53.4958-4(b)(2)(i). After the payment has been made, the circumstances existing at a later time are not considered in determining the reasonableness of the payment. Id.

3. Timing of Rebuttable Presumption

a. In the case of a fixed payment, the availability of the rebuttable presumption is determined under the general timing rules for determining reasonableness of fixed payments, i.e., at the time the parties entered into the compensation arrangement. See Treas. Reg. § 53.4958-4(b)(2)(i).

b. In the case of a payment that is not fixed, the availability of the rebuttable presumption is generally determined at the time the amount can be ascertained. Treas. Reg. § 53.4958-6(d)(1). If the amount of a non-fixed payment, however, is subject to a cap, the rebuttable presumption of reasonableness may be established at the time the contract of employment is entered into if: (i) prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount would
be reasonable; (ii) the maximum amount payable under the contract (taking into account both fixed and non-fixed payments) does not exceed the amount established in (i) above; and (iii) the other requirements for invoking the rebuttable presumption of reasonableness are satisfied. Treas. Reg. § 53.4958-6(d)(2).

4. Effect of Obtaining a Rebuttable Presumption of Reasonableness

a. With respect to a fixed payment, rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date the parties enter into the contract pursuant to which the payment is made. Treas. Reg. § 53.4958-6(b).

b. With respect to a non-fixed payment (whether or not subject to a cap), rebuttal evidence may include facts and circumstances up to and including the date of payment. Id. The fact that the rebuttable presumption of reasonableness is not applicable to compensation does not create an inference that the compensation is an excess benefit transaction. Treas. Reg. § 53.4958-6(e).

5. Status as Disqualified Person

An incentive compensation plan may cause individual who is not an officer or director and, thus, not per se a disqualified person to be treated as a disqualified person. As noted above, a factor indicating that a person who is not per se a disqualified person is a disqualified person is whether the person receives compensation based primarily on revenues derived from activities of the organization, or of a particular department or function of the organization that the person controls. Treas. Reg. § 53.4958-3(e)(2). Thus, a lower-level employee may be treated as a disqualified person with respect to an organization if, under an incentive compensation plan, his or her compensation is primarily based on revenues derived from activities of the organization. Id.

B. Incentive Compensation Based on Profits or Revenues

As noted above, section 4958(c)(4) gives the Commissioner the authority to treat revenue sharing transactions as excess benefit transactions if they constitute private inurement.

1. Case Law

a. The courts have established broad parameters for determining whether a compensation arrangement that is contingent upon the revenues or profits of the organization results in impermissible private benefit or private inurement.

b. In cases where a founder or other insider received a percentage of revenues or profits without regard to the services performed by the employee, the courts have found that the payment results in a prohibited private inurement in violation of section 501(c)(3). See People of God Cmty. v. Comm’r, 75 T.C. 127 (1980); Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969); Gemological Inst. v. Comm’r, 17 T.C. 1604 (1952), aff’d per curiam, 212 F.2d 205 (9th Cir. 1954). The underlying rationale was that compensation based on the organization’s profits or revenues was not commensurate with the value of services provided to the organization. See, e.g., People of God Cmty, 75 T.C. 127 (1980)(payment of a
predetermined percentage of gross tithes and offerings received by a Christian religious organization to its ministers resulted in private inurement because value of ministers’ services not related to gross receipts of the ministry); *Lorain Avenue Clinic v. Comm’r*, 31 T.C. 141 (1958) (holding that a clinic’s system of compensating its physicians resulted in private inurement because it was based on a ratio of the revenues generated by the physicians to the total revenues of the clinic); *Birmingham Business College, Inc. v. Comm’r*, 276 F.2d 476 (5th Cir. 1960) (holding that salaries paid by a school to its teachers who were also shareholders of the school resulted in private inurement because the salaries were in proportion to the amount of stock held by each teacher-shareholder).

c. In contrast, where contingent payments are dependent upon the employee’s successful performance of his job, the courts have found that the payments do not result in private inurement. See, e.g., *World Family Foundation v. Comm’r*, 81 T.C. 958 (1983) (approving a contingent fee of 10 percent to 20 percent of each donation to the organization’s fundraisers, including the organization’s president, was based on the funds raised individually by each fundraiser; *Nat’l Found., Inc. v. United States*, 13 Cl. Ct. 486 (1987) (approving a contingent fee of up to 6 percent of each donation to the organization’s fundraisers who were independent contractors; noting that the result would have been the same had the fundraisers been employees).

2. **Service’s Administrative Guidance**

a. **Overview**

i. The Service has addressed the question of whether incentive compensation jeopardizes the exempt status of section 501(c)(3) organizations in numerous instances and, over the course of forty years, has developed a clear set of factors that it evaluates in determining whether an incentive compensation plan results in private benefit or private inurement.

ii. The Service’s rulings and other guidance on incentive compensation indicate that in every case it will give consideration to factors that indicate whether (i) an employee’s total compensation package is reasonable in light of the circumstances and (ii) the compensation arrangement furthers the organization’s exempt purposes.

iii. In evaluating these two issues, the Service considers a number of factors that are discussed below. These factors are so well established that the Service recently summarized them in the context of healthcare organizations in IRS General Information Letter 2002-21. Information Letters are issued by the National Office of the Service to set forth “well-established interpretation or principle of tax law . . . without applying it to a specific set of facts.” *See Rev. Proc. 2006-1, 2006-1 I.R.B. 1, § 2.04*. The Service has also used this list of factors in internal training materials. *See CPE Text 1998.*
b. Factors in General Information Letter 2002-21

i. Reasonableness of Total Compensation

Reasonableness of incentive compensation is determined on the basis of the total compensation package, including base compensation, incentive compensation and any other economic benefits provided by the organization to the employee in connection with his or her services. See IRS General Information Letter 2002-21 (Jan. 9, 2002).

ii. Arms’ Length Bargaining

(a) The Service consistently looks to whether the incentive compensation plan is the result of arms’ length bargaining. In Revenue Ruling 69-383, 1969-2 C.B. 113, the leading published ruling on incentive compensation, in determining that an arrangement to pay a radiologist a percentage of billings was permissible, the Service relied on the fact that the arrangement was negotiated on an arms’ length basis and that the radiologist had no control over, or management authority with respect to, the hospital. Similarly, in GCM 32453 (Nov. 30, 1962), the Service ruled favorably on a contingent compensation arrangement between an HMO and medical groups providing services for a fixed fee plus 50 percent of certain specified revenue less specified expenses. In reaching its decision, the Service noted that there was no relationship between the HMO and the medical groups and that the medical groups did not participate in management of the HMO.

(b) While arms’ length bargaining is a factor that indicates compensation is reasonable, the lack of arms’ length bargaining does not establish that the organization’s net proceeds inured to the insider’s benefit if the authorized compensation was indeed reasonable. Brian Ruud Int’l v. United States, 733 F. Supp. 396 (D.D.C. 1989). In Ruud, the employee was in control of the organization and, thus, had substantial authority over setting the amount of his own compensation. Nevertheless, the total amount of compensation paid to the employee (including food and automobile allowances and various expense reimbursements) was reasonable. Accordingly, the court held that the prohibitions against private inurement and impermissible private benefit were not violated.

iii. Independent Governing Body

(a) A compensation arrangement will be considered to be arms’ length if it is established by an independent compensation committee or board of the organization.

(b) In GCM 39674 (Oct. 23, 1987), a hospital established an incentive compensation plan for all management and non-management employees of the hospital. Some of the managers were also members of the board of directors. However, the employee directors were prohibited from voting on any matter that affected the plan, including decisions on the amount that would be set aside to pay bonuses.

(c) In PLR 8808070 (Dec. 27, 1987), an exempt organization established an Incentive Compensation Plan (the “Plan”) for executive employees selected and approved by the Executive Compensation Committee of the Board of Directors.
The organization represented that the purpose of the Plan was to advance the organization’s interests by strengthening its ability to attract, motivate and retain executive employees upon whose judgment, initiative and efforts the organization relied for its success. All of the members of the organization’s board of directors were independent community representatives. No member of the Executive Compensation Committee was eligible to receive an incentive compensation award under the Plan. Individual performance awards under the Plan were based on the organization’s net revenues. The Service ruled that the adoption of the Plan and the payment of incentive compensation thereunder would not constitute private inurement and would not result in the revocation of the organization’s tax-exempt status under section 501(c)(3). See also GCM 38905 (Oct. 6, 1982); IRS General Information Letter 2002-21, supra.

iv. Comparables

(a) As with all types of compensation, amounts paid under incentive compensation arrangements must reflect the value of the employee’s services to the organization and must not be based on the employee’s personal needs. See Rev. Rul. 69-383, 1969-2 C.B. 113 (ruling that the amount paid a hospital radiologist was reasonable because it was commensurate with his responsibilities and activities). Cf. Mabee Petroleum, 203 F.2d 872; GCM 39862 (Nov. 22, 1991).

(b) Comparability data is very useful in establishing that an incentive compensation arrangement is reasonable. For example, in PLR 9112006 (Dec. 20, 1990), the Service relied on comparability data generated by independent auditors engaged by the organization to conclude that compensation paid under the organization’s incentive compensation plan was reasonable. See also IRS General Information Letter 2002-21, supra (providing that reliable compensation survey data for the type of employee and the geographic locale are helpful in establishing reasonableness).

v. Ceiling or Cap on Amount of Compensation

(a) Another important indicator of reasonableness is a cap or a ceiling on the total amount of compensation that can be paid to an employee under an incentive compensation arrangement. In one of the earliest GCMs on incentive compensation, the Service required the organization to add to the incentive compensation plan a ceiling or reasonable maximum, which in that case was stated as a percentage of salary. See GCM 32453 (Nov. 30, 1962). See also GCM 39674; PLR 8808070; PLR 9316052 (Jan. 29, 1993); IRS General Information Letter 2002-21, supra.

(b) In the Service’s view, the presence of a cap prevents “a windfall benefit to the [employee] based upon factors bearing no direct relationship to the level of service provided.” GCM 32453.

(c) The Service may accept a compensation arrangement without a cap if the arrangement was the result of arms’ length bargaining. See Rev. Rul. 69-383 1969-2 C.B. 113.
vi. Furthering Exempt Purposes

(a) In the case of an incentive compensation plan, it is not sufficient for the amount of the compensation to be reasonable. As the Service said in GCM 36918 (Nov. 11, 1976), “[p]roof that a given class of payments to or for the benefit of employees can never exceed reasonable compensation will not . . . provide adequate assurance of compatibility with the exclusive pursuit of exempt purposes for any given method of determining the amounts of a given class of compensation payments.” Even when reasonableness is assured, the Service emphasized that there is a continuing concern with

“any plan or arrangement essentially conditioning payments of supplemental compensation upon the attainment of any prescribed combination of income production and expenditure limitation or on the achievement of any other specified relationship between income and outgo that may create a significant conflict between serving the personal interests of the employees and maximizing the extent to which ongoing activities may otherwise effectively serve the exempt purposes of the organization in question.” Id.

(b) In addition to being reasonable in amount, payments under incentive compensation arrangements must take into account employees’ performance factors that are relevant to the organization’s exempt purposes. See GCM 39862 (“The proper starting point for our analysis of the net revenue stream arrangements is to ask what the [exempt organization] gets in return for the benefit conferred on the [participating employees].”); Roderick Darling & Marvin Friedlander, Intellectual Property in IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1999, at 37 (1999) (“All [incentive] compensation arrangements must be based on services performed for the exempt organization in activities that further its exempt purposes”).

(c) Thus, in order to pay incentive compensation, the organization must be able to show that the services either contributed to the increase in the organization’s revenues or generated cost savings having an impact on the organization’s bottom line or contributed to the organization’s exempt purposes in some other tangible way.

(d) In PLR 9316052 (Jan. 29, 1993), a section 501(c)(3) organization engaged in biotechnology research for the purpose of creating and facilitating useful processes and products to be used for economic development and job creation in the state of M. The primary aim of the organization was to create commercial products, attract industry and encourage the development of existing industry to contribute to the economy of the state of M. This was accomplished by developing intellectual property and transferring it to the private sector for commercialization through licenses and the creating of new businesses. The organization’s federal research agreements required the organization to share with inventors royalties derived from intellectual property arising from such agreements. The inventors received one-third of royalties from such intellectual property. Royalties received from licensing intellectual property that was donated to the organization were also shared with employees. Fees received by employees for consulting were shared with the organization. In accordance with the organization’s bonus policy, managers and senior scientists received a bonus based on overall
performance and computed as a percentage of base compensation up to 20 percent. Factors considered in determining bonuses were: amounts contributed to gross receipts from consulting, scientific achievement, economic development assistance, and special project performance. The Service held that the incentive compensation arrangement did not result in private inurement.

(e) There are numerous other examples. In GCM 32453, the requisite connection between the amount of the incentive compensation and the organization’s revenues was established because the amount of the compensation at issue was dependent on the accomplishment of the organization’s cost-saving objectives. Likewise, in Rev. Rul. 69-383, the requisite connection was established because the physician’s compensation was based directly on the physician’s contribution to the revenues of the hospital. See GCM 39862 (clarifying the fact pattern in Rev. Rul. 69-383 and explaining that, because the hospital in Rev. Rul. 69-383 was acting as the billing and collection component for the physician’s services performed at the hospital, the ruling’s reference to the percentage of the adjusted gross revenues from the radiology department meant a percentage of the physician’s own billings and not a percentage of the revenues of the hospital’s entire radiology department). See also GCM 32453 (approving an incentive compensation arrangement based on a percentage of net revenues where the compensation was not dependent principally upon incoming revenue of the exempt organization, but was dependent upon the accomplishment of the objectives of the compensatory contract, such as keeping actual expenses within the limits of projected expenses upon which the ultimate prices of charitable services are based).

(f) Similarly, in World Family Corp. v. Comm’r, 81 T.C. 958 (1983), the court found that commissions were directly contingent on success in securing funds and thus tied to services rendered. The court distinguished Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969) and People of God Cmty. v. Comm’r, 75 T.C. 127 (1980) on the grounds that in those cases the employees received a percentage of the organizations’ revenue or profits without regard to any connection between the services performed and the amount of the payment.

(g) The Service has also approved incentive compensation arrangements when the incentive payment is funded by an affiliate. In PLR 200225046 (Mar. 28, 2002), the Service ruled that the issuance by a tax-exempt parent of options for stock in a wholly-owned for-profit subsidiary to employees of the tax-exempt parent would not adversely affect the parent’s tax-exempt status. Although the Service did not expressly address the issue, PLR 200225046 suggests by its favorable ruling that providing incentive compensation to employees of a tax-exempt parent based on the profitability of a for-profit subsidiary can be compatible with the parent's exempt purposes.

(h) PLR 8808070 is another situation where the Service approved an incentive compensation arrangement, even though the source of the funds was not directly linked to the employee's incentives. In that ruling, the board of directors established a “performance gain pool” based on a percentage of the corporation’s actual performance compared to budget. Each executive had performance objectives based on standards for improving the quality of care and services, which were established by the president and reviewed and approved by the board. Distributions were made at the discretion of the board based on achievement of goals and budget for the executives’ area of responsibility.
vii. Real and Discernible Business Purpose

(a) In order for an incentive compensation plan to further an organization’s exempt purposes, it must also serve a real and discernible business purpose.

(b) In GCM 32453, the Service found that cost control was an issue for hospitals and that physicians have a substantial impact on cost control. Therefore, it made sense to provide an incentive to physicians to operate in a cost efficient manner.

(c) In GCM 38905 (Oct. 6, 1982), the Service found that a plan that paid a real estate investment advisor based on financial performance served a real and discernable business purpose because it was customary and prevalent in the real estate industry to pay investment advisors based on performance and it was “almost impossible to secure the services of an investment manager” without an incentive compensation arrangement. *Id.* (citation omitted).

(d) In PLR 8808070, the Service approved an incentive compensation plan the purpose of which was to advance the exempt organization’s interests by strengthening its ability to “attract, motivate and retain executive employees whose judgment, initiative and efforts” were essential to the organization’s success.

(e) In contrast, in GCM 39862 (Nov. 22, 1991), a hospital formed a joint venture with physicians and sold the revenue stream of the hospital to the joint venture. The Service characterized the transaction as a sale of a profits interest, not a compensation arrangement, and found that it did not further the hospital’s exempt purposes at all.

viii. Compensation Must Reward Based on Performance

(a) The payment of compensation to individual employees under plans that are contingent upon the organization’s revenue or profits must depend upon the employee’s performance and not solely upon the organization’s revenue. Otherwise, the plan will be viewed as transforming the principal activity of the organization into a joint venture between itself and the participating employees (in other words, an incentive compensation arrangement must not give the participating employees a proprietary stake in the organization’s revenues).

(b) Thus, as noted above, an arrangement that permitted physicians to share in the revenue stream of the hospital without regard to the services performed by the physicians was found to result in private inurement and impermissible private benefit. *See* GCM 39862.

(c) In contrast, in Rev. Rul. 69-383, the radiologist’s payment was dependent upon the amount that he billed for his services and the compensation arrangement was approved by the Service.
Similarly, in GCM 32453, where payments were contingent upon economies of operation, the arrangement was found to be permissible.

In GCM 38905, payments contingent upon the value of the assets under management were permissible.

Similarly, in GCM 39674, payments that were dependent upon the accomplishment of goals for quality and efficiency were acceptable.

ix. Arrangement Must Not Be a Joint Venture

(a) An arrangement may be treated as a joint venture (or a partnership) if each party to the arrangement has a proprietary stake therein. See Comm’r v. Culbertson, 337 U.S. 733 (1949).

(b) The main difference between a joint venture and an employer/employee relationship is that, in a joint venture, the parties’ return is based, principally, on the parties’ investment (or “interest”) in the venture, while in an employer/employee relationship, the employee’s compensation is based solely or principally on the value of the services provided by the employee. See I.R.C. §§ 702(a) (defining income and credits of a partner), 3401(a) (defining “wages” from employment).

(c) In a joint venture, a party is generally entitled to a percentage of the total profit (or loss) of the venture, in proportion to the party’s proprietary stake in the venture, based on all the factors that have contributed to the venture’s yield, and not just based on the party’s own contribution to the venture. See I.R.C. §§ 702(a), 704(b). Cf. Birmingham Business College, Inc. v. Comm’r, 276 F.2d 476 (5th Cir. 1960) (holding that a tax-exempt school that compensated its three employee-shareholders in proportion to their stock ownership was not entitled to exemption).

(d) A venture’s investment return may be enhanced by the value of the services provided to the venture but it is not limited to the value of such services and may include items such as depreciation, fees, capital gains, etc. For example, a partner in a real estate partnership will receive its proportionate share of the appreciation of the real estate owned by the partnership when such real estate is sold (and will be liable for any losses in the value of such real estate) regardless of whether the partner contributed any services to the partnership. See I.R.C. § 702(a).

(e) In an employer/employee relationship (excluding relationships that involve employee co-ownership), the employee may be entitled to a portion of the employer’s revenues, in addition to a fixed salary, but only based on the employee’s own contribution to the increase in the employer’s revenues and without a concomitant liability for a portion of the employer’s losses. For example, an employee-inventor may be entitled to a percentage of royalties generated by his invention but will not bear any financial risk of loss if the invention fails to generate any revenues. See, e.g., PLR 9316052; see also Bayh-Dole Act, 35 U.S.C. § 202(c)(7)(B) (2000) (requiring nonprofit entities that retain title to inventions made with federal assistance to share royalties with inventors). Cf. GCM 39862 (ruling that an arrangement that permitted physicians to share in the revenue stream of the hospital without
regard to the services performed by the physicians transformed the principal activity of the hospital into a joint venture and resulted in private inurement).

(f) Accordingly, an employee who receives a portion of the employer’s revenues will not be treated as a co-venturer with his employer if the portion received by the employee is measured strictly by the value of the employee’s services and the employee is not entitled to share in the employer’s profits without regard to the value of his services.

x. Arrangement Must Not Be a Device to Distribute All or a Portion of the Profits to Persons in Control of the Organization

(a) The term “net earnings” in the private inurement provision of section 501(c)(3) of the Code has been construed to permit an organization to incur ordinary and necessary expenditures. By analogy to the tax treatment of taxable businesses, compensation is an ordinary and necessary expenditure if it is reasonable. See Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969); St. Germain Found. v. Commissioner, 26 T.C. 648 (1956), acq., 1956-2 C.B. 8; A. A. Allen Revivals, Inc. v. Comm’r, 22 T.C.M. (CCH) 1435 (1963). Thus, as long as the compensation is reasonable and adequately tied to the value of the services provided, it is an ordinary and necessary expense of conducting the organization’s exempt activities and, as such, does not give rise to prohibited private inurement.

(b) Where a compensation arrangement is not tied to the value of the services performed, it may be characterized as a device to distribute the organization’s profits to the employees under the guise of compensation.

(c) For example, where a physician transfers his private practice to a tax-exempt organization, becomes an employee of the organization and arranges to receive from the organization a salary and benefits approximating the amount he could receive if he remained in private practice, the primary function of the organization is to serve the private interest of the physician. See Rev. Rul. 69-266, 1969-1 C.B. 151. Cf. GCM 39498 (Apr. 24, 1986) (ruling that guaranteed minimum salary for physicians that was measured by the amount they could earn in private practice was private inurement).

(d) Similarly, where a large stockholder of a for-profit corporation donates the stock of such corporation to a nonprofit corporation and the nonprofit corporation assumed the for-profit corporation’s obligation to pay a very generous salary to the stockholder, the assumption of the salary obligation by the nonprofit corporation is a device to distribute the nonprofit corporation’s earnings to the stockholder. See Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953). See also Hancock Academy of Savannah, Inc. v. Comm’r, 69 T.C. 488 (1977) (holding that the assumption by the organization of certain debt of a for-profit corporation which was controlled by the organization’s insiders was a device to distribute the organization’s earnings to the insiders).
Arrangement Must Not Have the Potential to Reduce the Charitable Services or Benefits that the Organization Would Otherwise Provide

(a) Where the compensation accurately reflects the value of the services provided, the compensation comes out of the value added by the services provided and does not diminish the baseline value committed to the organization’s charitable services or benefits. For example, the payment to an employee of a fixed percentage of each donation raised by that employee does not reduce the organization’s charitable services or benefits, even though it reduces the net amount of the donation received by the organization, because, in the absence of the employee’s efforts, the organization would not have received that donation. See, e.g., World Family Corp., 81 T.C. 958. See also Rev. Rul. 69-393, 196-2 C.B. 206, as explained by GCM 39862 (ruling that an arrangement to pay a radiologist a percentage of his own billings was permissible).

(b) Where the compensation, however, does not accurately reflect the value of the services provided, the excess of the compensation over the value of such services diminishes the organization’s resources that could be used for other purposes. For example, the payment to a minister of a fixed percentage of tithes and collections collected by a church, not only reduces the net amount of the tithes and collections received by the church, but also transfers to the minister a potential windfall of high collections that are due to factors other than the value of his services and that could have been used by the church for other purposes. See, e.g., People of God Cmty, 75 T.C. 127. See also GCM 32453 (emphasizing that, to be reasonable, a compensation arrangement must be designed to prevent “a windfall benefit to the [employee] based upon factors bearing no direct relationship to the level of service provided”).

(c) Thus, the potential for reducing the organization’s charitable services or benefits arises where the compensation is out of proportion to the value of the services provided, but does not arise where the amount of the compensation is limited to the value added by the services provided.

In Actual Operation, the Plan Must Not Result in Abuse or Unwarranted Benefits

(a) Although reasonableness is generally determined at the time the contract for services is made, the Service may look to the actual operation of the incentive compensation plan to make sure that it does not result in any abuse or unwarranted benefits to employees. See GCM 38905; IRS General Information Letter 2002-21, supra.

(b) For example, if the contract for services contemplates a 40-hour workweek, but the employee does not actually work the requisite number of hours each week, the compensation that would have been reasonable based on a 40-hour workweek may be deemed unreasonable under the actual circumstances of the employee’s performance. See Mabee Petroleum, 203 F.2d 872 (holding that a $100,000 per year salary for part-time work was excessive).
(c)  If a portion of the compensation is based on the difference between subscription revenues and operating costs and the compensation is determined to be reasonable at the time the contract for services is made but the actual operation of the arrangement reveals excessive subscription rates, the compensation arrangement will not be treated as reasonable. See Information Letter 2002-21, supra, at 7 (in discussing incentive compensation of physicians, noting the need to have “effective controls to avoid increases in compensation predicated on increases in fees charged to patients”). Cf. GCM 32453 (holding that physician compensation based, in part, on a percentage of net health plan revenues was reasonable and did not result in inurement because, inter alia, “[t]he subscription rates and operating costs of the [organization] compare[d] favorably with all other major health plans” and thus were not excessive).

VI. Filing Requirements

A. Current Form 990

1. Part V-A of Form 990 requires an exempt organization to list the current officers, directors, trustees, and key employees of the organization and provide the following information for each person:
   a. Title and average hours per week devoted to position
   b. Compensation
   c. Contributions to employee benefit plans and deferred compensation plans
   d. Expense account and other allowances

2. Part V-B of Form requires similar information for former officers, directors, trustees, and key employees of the organization.

3. Part VI, Line 89b requires an exempt organization to state whether it engaged in any excess benefit transactions under section 4958 and if so, to attach a statement explaining each transaction.

B. Redesigned Form 990

1. On December 20, 2007, the IRS released a new Form 990 to be used for the 2008 tax year (forms filed in 2009). The IRS had two goals in revising the form: 1) to ensure that the core form appropriately collects information for the various types and sizes of exempt organizations required to complete the form, and 2) to address the concerns expressed in public comments regarding the Draft’s burden minimization, transparency and tax compliance objectives.

2. Part IV, Line 25a requires an exempt organization to state whether it engaged in an excess benefit transaction with a disqualified person during the year. Part IV, Line 25b requires an exempt organization to state whether the organization became aware that it had
engaged in an excess benefit transaction with a disqualified person from a prior year. If an organization answer “yes” to either question it must complete Schedule L, Part I explaining each transaction.

3. The new Schedule L consolidated the reporting of most relationships and transactions involving insiders, including loans to and from interested persons, in a single schedule.

4. Part VI, Governance, Management, and Disclosure, asks exempt organizations questions about its board composition and independence, governance and management structure and policies, and whether (and if so, how) the organization promotes transparency and accountability to its constituents or beneficiaries. The IRS believes that the existence of an independent governing body and well-defined governance and management policies and practices increases the likelihood that an organization is operating in compliance with federal tax law.

5. The revised Form 990 consolidated the compensation question in Part VII and requires exempt organization to list:

   a. All of the organization’s current officers, directors, trustees (whether individuals or organizations) and key employees regardless of amount of compensation.

   b. The organization’s five current highest compensated employees (other than an officer, director, trustee or key employee) who received reportable compensation of more than $100,000 from the organization and any related organizations.

   c. All of the organization’s former officers, key employees, or highest compensated employees who received more than $100,000 of reportable compensation from the organization and any related organizations.

   d. All of the organization’s former directors or trustees that received, in the capacity as a former director or trustee of the organization, more than $10,000 of reportable compensation from the organization and any related organizations.

6. Part VII also requires an exempt organization to provide the following information for each of the persons described above:

   a. Title

   b. Average hours per week

   c. Position

   d. Reportable compensation from the organization

   e. Reportable compensation from related organizations
f. Estimated amount of other compensation from the organization and related organizations

7. The new Schedule J requires exempt organizations to report detailed compensation information for those individuals whose compensation exceeded certain thresholds including information about first class or charter travel, travel for companions, tax indemnification and gross up payments, discretionary spending accounts, housing allowances and payments for business use of a personal residence, health or social club dues or fees, and personal services (maid, chauffeur, chef).

C. Section 6033 Return Filing Requirement

1. “Except as provided in paragraph (2), every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe; except that, in the discretion of the Secretary, any organization described in section 401(a) may be relieved from stating in its return any information which is reported in returns filed by the employer which established such organization.” Section 6033(a)(1).

2. The penalty with respect to an exempt organization for failure to file a return under section 6033 or for filing incorrect information on a return is located in section 6652(c)(1)(A).

   a. Exempt organization having gross receipts of $1,000,000 or less for any year--$20 for each day during which such failure continues with a maximum penalty of the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year.

   b. Exempt organization having gross receipts exceeding $1,000,000 for any year--$100 for each day during which such failure continues with a maximum penalty of the lesser of $50,000 or 5 percent of the gross receipts of the organization for the year.

VII. Deferred Compensation Issues Overview

A. Overview

A detailed discussion of section 457(b), section 409A, and section 83 is beyond the scope of this outline. However, it is important to keep these potential deferred compensation issues in mind when structuring and valuing compensation.

B. Section 457(b)

1. Section 457 of the Code provides rules for the deferral of compensation by an individual participating in an eligible deferred compensation plan. Section 457(a)(1)(B) of the Code provides that in the case of a participant in an eligible deferred compensation plan of a tax- exempt employer, any amounts of compensation deferred under the plan and any income
attributable to the amounts so deferred shall be includible in gross income only for the taxable year in which such compensation or other income is paid or otherwise made available to the participant or beneficiary.

2. The definition of “eligible deferred compensation plan” is described in section 457(b).

   a. An eligible plan is a written plan established and maintained by an eligible employer (i.e., a government or tax-exempt entity) that is maintained, in both form and operation, in accordance with certain requirements. Only individuals who perform service for the employer may be participants in the plan. See I.R.C. § 457(b)(1) The amount of compensation that an individual may elect to defer under the plan must not exceed certain maximum deferrals. Certain distribution requirements must be satisfied. See I.R.C. §§ 457(b)(5) and 457(d).

   b. The plan must provide that (i) all amounts of compensation deferred under the plan, (ii) all property and rights purchased with such amounts, and (iii) all income attributable to such amounts, property, or rights must remain (until made available to the participant or other beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the employer's general creditors. See I.R.C. § 457(b)(6).

   c. The plan must have distributions requirements providing that under the plan amounts will not be made available to participants or beneficiaries earlier than i) the calendar year in which participant attains 70-1/2, ii) the calendar year when the participant has a severance from employment with the employer, or iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. See I.R.C. § 457(d)(1)(A)

C. Section 409A

1. Section 409A was added by the American Jobs Creation Act of 2004, Pub. Law No. 108-357, and provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met.

2. Section 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under section 409A may nevertheless be required to be included in income under section 451, the constructive receipt doctrine, the cash equivalency doctrine, section 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

3. Because of numerous comments regarding the difficulty of implementing section 409A and/or amending deferred compensation plans in light of section 409A, the IRS issued two notices at the end of 2007 providing transitional relief.
a. In late October 2007, the IRS issued Notice 2007-86, which generally extended the transitional period for compliance with the final IRS regulations under IRC § 409A to December 31, 2008. Those regulations provide guidance regarding the requirements for deferral elections and payment timing under section 409A.

b. In late December 2007, the IRS issued Notice 2007-100, which provides transition relief and guidance on the correction of certain failures of a nonqualified deferred compensation plan to comply with section 409A(a) in operation (an operational failure).

4. See Notice 2005-1, 2005-1 CB 274

D. Section 83

1. Amounts includable in taxable income under section 83 should be considered in determining the total amount of compensation for purposes of determining whether such compensation is reasonable.

2. Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred to such person and become substantially vested in such person.

3. Under section 83, the excess of the fair market value of such property (determined without regard to any lapse restriction) at the time that the property becomes substantially vested, over the amount (if any) paid for such property shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested.

4. Until such property becomes substantially vested, the transferor is regarded as the owner of such property. Accordingly, any income from such property received by the employee or independent contractor before such property becomes substantially vested constitutes additional compensation and must be included in the gross income of such employee in the year the income is received. For example, assume an employee receives restricted stock subject to section 83 in Year 1, a dividend with respect to the stock in Year 2, and the stock becomes substantially vested in Year 3. Under section 83, the dividend is treated as compensation to the employee and included in taxable income of the employee in Year 2 (even though the amount includable in income under section 83 with respect to the stock itself is not includable in income until the stock vests in Year 3). The employer also receives a corresponding deduction for compensation paid as a result of the dividend in Year 2. After the stock becomes substantially vested in Year 3, any future dividends are simply treated as dividends to the employee as the owner of the stock.
VIII. Corporate Governance Issues

A. Sources of Guidance

1. Overview

There is a considerable body of law and literature relating to corporate governance which can be separated into two categories: (1) legal requirements with which nonprofit corporations must comply; and (2) laws that do not directly apply to nonprofit corporations and nonbinding guidance that may affect interpretations of applicable law or notions of “best practices.”

2. Directly Applicable Law

a. State Law. The rights and duties of directors and the procedures by which directors take action are found in the law of the state in which the corporation is created and in the corporation’s governing documents, including its Articles of Incorporation and its Code of Regulations or Bylaws. One of the basic responsibilities of the board of directors of a corporation is to hire and oversee the work of the CEO. Virtually all state laws impose on directors a duty of care and a duty of loyalty. However, state laws generally do not provide detailed requirements or guidance for setting compensation.

b. Federal Tax Law. As discussed above, section 4958 includes procedures for creating a rebuttable presumption that compensation is reasonable.

3. Nonbinding Guidance

There are numerous sources of nonbinding guidance for governance of nonprofit corporations. Two sources of particular note for compensation issues are the listing rules of stock exchanges and guidelines recently issued by the Panel on the Nonprofit Sector convened by Independent Sector. These are discussed below. Other sources include watch dog groups such as the BBB/Wise Giving Alliance, trade associations of nonprofits such as National Association of College and University Business Officers (NACUBO), bond rating services such as Fitch ratings, and Board Source.

B. Stock Exchange Listing Rules

1. Following the enactment of the Sarbanes-Oxley Act in 2002, the New York Stock Exchange and other exchanges adopted governance requirements that went beyond the requirements of Sarbanes-Oxley. Although the stock exchange rules apply only to corporations whose securities are listed on the exchange, the listing rules may be viewed as “best practices.” The requirements of the NYSE regarding compensation committees are described below. Requirements of other exchanges are similar. Organizations that are exempt under section 501(c)(3) or (c)(4) should follow the rules under Section 4958 and refer to nonbinding rules for additional guidance. Organizations that are not subject to Section 4958 (e.g., organizations exempt under Section 501(c)(6) should look to Section 4958 and the NYSE listing rules as sources of “best practices” for good governance.
2. The NYSE Listed Company Manual, §303A.05 Compensation Committee, requires listed companies to have compensation committee that meet the requirements described below. Whether an exempt organization has a compensation committee or the full board operates as the compensation committee, the requirements of the NYSE listing rules provide helpful guidance.

   a. The compensation committee must be composed entirely of independent directors.

   b. The compensation committee must have and publish a written charter that addresses the committee's purpose and responsibilities.

   c. The compensation committee’s responsibilities must include:

      i. Review and approval of corporate goals and objectives relevant to CEO compensation

      ii. Evaluation of the CEO's performance

      iii. Determination and approval of the CEO's compensation level based on this evaluation

      iv. Making recommendations to the board concerning:

         (a) Non-CEO compensation

         (b) Incentive-compensation plans

3. Under the NYSE rules, a director is considered independent if he or she does not have a material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company). No director qualifies as “independent” unless the board of directors affirmatively determines the director’s independence. If the board determines that a relationship is immaterial, the basis for the determination must be disclosed in the annual meeting proxy statement. The listed company is required to disclose any standards adopted by the board to assist it in making determinations of independence and any specific independence determinations made for a director who does not meet those standards. Under the NYSE rules, the following types of employment, affiliation, or compensation will preclude a director from being “independent” for purposes of board membership (including during a three-year look-back period):

   a. a director who is an employee, or whose immediate family member is an executive officer, of the company;

   b. a director who, or whose immediate family member, receives more than $100,000 per year in direct compensation (excluding fees for service as a director or committee members and pension or other deferred compensation payments for prior service) from the company;
c. a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed by, a present or former internal or external auditor of the listed company;

d. a director who has been, or whose immediate family member has been, employed as an executive officer of another company where any of the listed company’s present executives serves on the compensation committee; or

e. a director who is an executive officer or employee of, or whose immediate family member is an executive officer of, another company that makes payments to or receives payments from the listed company for property or services in an amount that in any single fiscal years exceeds the greater of $1 million or two percent of the other company’s consolidated gross revenues.

C. Panel on the Nonprofit Sector’s Principles for Good Governance and Ethical Practice

1. In October 2007, the Panel on the Nonprofit Sector convened by Independent Sector published Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations, which contains 33 principles for good governance and ethical practice to guide the boards and leaders of charitable organizations. Several of these principles involve compensation and are summarized below.

2. Principle #13 – The Chief Executive Officer

a. The full board should annually evaluate the performance and approve the compensation of the organization’s CEO.

b. Compensation committees should report their findings and recommendations to the full board for approval.

c. The board should consist of independent members to insure that those individuals making compensation recommendations are free from any conflicts-of-interest.

d. The board should examine the compensation paid by similarly situated organizations to their CEOs.

e. The organization should ensure that the compensation consultants do not have any conflicts-of-interest with the CEO.

f. The CEO should hire and set the staff’s compensation which should be reviewed by the board.

3. Principle #20 – Board Member Compensation

a. Board members are generally expected to serve without compensation, other than reimbursement for expenses related to board work.
b. If a board member is compensated, the organization should be prepared to show that the amount is reasonable and supports the performance of the organization’s exempt function.

c. Board members’ compensation should reflect the compensation received by individual with similar responsibilities in similar organizations.

4. Principle #23 – Loans

a. Organizations should not provide loans to directors, officers, or trustees.

b. Organizations may make loans to employees in limited circumstances (i.e., helping an employee relocate to a location nearer to the organization).

c. The terms of the loan should be clear and approved by the board.

5. Principles #25 and #26 – Expenses

a. Organizations should have simple and unambiguous policies for paying the reasonable expenditures of those individuals conducting business or traveling on behalf of the organization.

b. Travel policies should ensure that business is carried out in a cost-effective manner (i.e., avoid first class travel in most circumstances).

c. Organization should not pay a spouse’s travel expenses, unless the spouse is conducting business for the organization.

IX. Employment Agreements

A. Value in Tax Compliance and Governance

Well-drafted employment agreements can assist executives and finance staff in complying with federal tax laws and requirements. Detailed employment agreements also help to ensure that compensation consultants and are aware of all compensation when they render their opinions of reasonableness and that the board of directors is aware of all sources of compensation. Tax counsel should be sure that the compensation consultant has a copy of the agreement.

B. Provisions That Assist with Compliance

1. Duties

The description of duties should be detailed enough to support the level of compensation and to establish a link between the executive’s duties and any performance based pay.
2. Outside Activities and Obligations

One of the bases for valuing services is the amount of time that the executive devotes to the job. Thus, outside activities that take time away from the executive’s work for the exempt organization should be agreed. This provision is also useful for non-tax purposes as the organization will want an executive’s outside activities to be consistent with the organization’s mission and reputation, and will want to be sure that outside activities do not take an inordinate amount of time from the executive’s duties for the organization.

3. Compensation

An employment agreement will be a useful tool for tax compliance if it is drafted in a manner that reflects federal tax law requirements. Thus, the agreement should describe total compensation in detail, reflect whether payments are taxable income, and provide procedures for certain payments such as incentive compensation and reimbursements. Elements of compensation may include the following:

- Base Salary
- Signing Bonus
- Annual Performance Awards
- Long Term Incentive Compensation
- Retirement and Deferred Compensation
- Health and Welfare Benefit Plans
- Fringe Benefits
- Reimbursement of Expenses
- Payments Upon Termination, Disability or Death

4. Benefits

The agreement should include a description of all benefits such as fringe benefits, loans with below market interest, and perquisites such as cars. The description of fringe benefits and perquisites should be detailed and should distinguish between taxable benefits (e.g., club dues) and benefits that are excluded under section 132 (e.g., certain parking and moving expenses) because the latter are not considered part of compensation under 4958. The value of below market loans is considered part of total compensation and the value of automobiles is included in taxable income except to the extent that contemporaneous records of business use are maintained. Additionally, making this distinction in the employment agreement will also help avoid failure to report taxable income and, thus avoid automatic excess benefit transactions.
5. Reimbursement of Expenses

a. To avoid inclusion of expense reimbursements in total compensation for 4958 purposes, the agreement should require the executive to substantiate business expenses and return excess reimbursements. Further, because generous expense reimbursements have been the subject of recent media and Congressional attention, the agreement should provide that the board will review expenses on an annual basis and may require the executive to reimburse any that are deemed extravagant. Such a provision will take the burden off the finance staff and insure that the board is aware of the executive’s expenditures.

b. If the organization reimburses expenses for the executive’s spouse, the agreement should state whether expenses will be considered part of executive’s taxable income. As noted above, in most instances, it will be taxable income. Since family members of disqualified persons are also disqualified persons, if the contract is not clear, payment of the spouse’s expenses could be treated as an excess benefit to the spouse.

c. If the spouse is receiving separate compensation, he or she should have a separate employment agreement that describes the spouse’s duties, and a compensation consultant should be retained to provide an opinion of reasonableness.

d. The agreement should also include a provision reflecting reimbursement or payment of insurance premiums and note whether the reimbursement is taxable.

C. Use of a “Score Card”

Some elements of income, particularly those determined with reference to salary and length of service increase in value over time. Although it need not be included in the employment agreement, for purposes of board review, a “score card” should be prepared that shows each element of compensation and its current value. A “score card” or tally sheet will fully inform the board of the value of the executive’s total compensation.