Nonprofit Executive Compensation
Rules and Best Practices

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Who Cares About Executive Compensation?

- Executive compensation is a hot topic, in Knoxville and across the country.
  
  - Donors and public perception
  
  - Internal Revenue Service

- Goal: To help nonprofits and tax-exempt entities understand the importance of following a documented procedure for setting executive compensation (not to suggest nonprofit executive aren’t entitled to fair compensation).
Who Cares About Executive Compensation?

- Public perception
  - Salaries of nonprofit executives are often the subject of intense media, public, and legislative scrutiny and can lead to public outrage.
  - *Knoxville News Sentinel* publishes an annual list of nonprofit executive compensation numbers.
  - Public charities that rely on donations from the public should be especially concerned with their donors’ perception of how the nonprofit is compensating its executives.
  - Example: Jessica Day, President and CEO of local nonprofit Pleasantville History Foundation, earned $505,000 in salary and bonus payments in 2014. In a series of articles, local media reported that Day earned more than 3 times the compensation of executives of similar organizations in other cities in the state. Day, PHF, and the PHF Board come under intense scrutiny. Donors, upset by these revelations, pull support for the nonprofit.
Who Cares About Executive Compensation? Cont’d

Internal Revenue Service

- In 2013, the IRS's Exempt Organization (EO) group's Work Plan called for a focus on the transparency of executive compensation and the disclosures in Form 990.
- Responsible for enforcing the Federal Private Inurement Prohibition, which forbids exempt organizations' board members, officers, and key employees from receiving unreasonable salary and benefits.
- Executive compensation is the most common violation of the prohibition and can lead to hefty fines against those involved.
Employee remuneration must be reasonable under the circumstances. See Mabee Petroleum Corp v. U.S., 203 F.2d 872 (5th Cir. 1953).

Treas. Reg. § 1.162-7(b)(3) defines “reasonable compensation” as the amount that would ordinarily be paid for like services by like organizations in like circumstances.
The IRS has identified two prongs under the “reasonable compensation” definition:

(1) An “amount” test, focusing on the reasonableness of the total amount paid; and

(2) A “purpose” test, examining the services for which the compensation is paid. Both issues are important in determining whether, under the circumstances, compensation is reasonable.
The IRS focuses on the following factors in determining whether compensation is “reasonable” as to an individual employee:

- Whether there were arm’s length negotiations;
- The level of control by the founder or founder’s family over the organization;
- Availability of comparable services from a third party (i.e., at a lower cost);
- Nature of the employee’s duties (responsibilities, roles, etc.);
- The employee’s background and experience;
- The employee’s salary history (whether there is a sharp increase in compensation with little or no rationale behind the decision);
- The employee’s contribution to the organization’s success;
- Time devoted to the job
Reasonableness

Example 1:
President and Founder of 501(c)(3) tax-exempt entity receives $50,000 per year of annual salary from the foundation. There was no arm’s length bargaining to determine the salary. He works approximately 40 hours each week, and has extensive administrative and managerial duties. Additionally, the President is primarily responsible for raising over half of the foundation’s donations, which total more than $800,000. All of these facts are part of an analysis of whether the amount paid and the purpose for which it is paid are reasonable under the circumstances.

Under these circumstances the compensation is likely reasonable.

Best Practice Tip: Although compensation appears reasonable on its face, it is important for an independent Board or Committee to review, approve, and document President and Founder’s compensation package.
What is Included in Compensation?

- Compensation includes essentially all items of value received by the executive, including salary or wages, pension, profit sharing plans, unpaid deferred compensation, payment of personal expenses, rents, royalties, and personal use of an organization’s property or facilities. *See 1990 CPE Article, IRS, at 171.*
Tax-Exempt Entities and Special Benefits

- There are special benefits that nonprofit, tax-exempt entities may offer its employees, including executives, under sections 403(b) (tax-sheltered annuities), 457(b) (qualified deferred compensation plans), and 457(f) (nonqualified deferred compensation plans) of the Internal Revenue Code.

- However, there are special tax rules governing these benefits under sections 403(b), 457, and 409A that are not the same as private employer rules and can have very significant tax consequences.

- We will talk about these benefits and the rules governing them in the fall. We will also discuss some of the common pitfalls tax-exempt employers encounter in maintaining and administering these plans.
Example 2:
The president of ABC Corp., a nonprofit 501(c)(3) tax-exempt entity, makes $42,000 per year in salary for her services. The average salary for presidents of similar-sized organizations is around $50,000. ABC Corp. president is also provided with an apartment leased by ABC Corp. at no cost to the president. The fair market value of the apartment is $6,000 per year. She accrues deferred compensation equal to $5,000 per year.

- Both the value of the apartment and the deferred compensation constitute “compensation” for reasonableness purposes.
- Total compensation = $53,000
Best Practice Tip

- IRS has not established a standard formula for determining fair and reasonable compensation.
- Determine appropriate salary and benefits package based on the market rate/range.
- Consider what someone in a similar position would earn at an organization of a similar size with a similar mission or field of activity.
- Can look at for-profit compensation when determining market rate, so long as the job, organization size, and organization purpose/mission are comparable.
Aside from public perception and mistrust, there are consequences with the IRS of failing to pay fair and reasonable compensation:

- Private Inurement
- Excess benefit
- Unlawful distributions
- Diversion of assets
Inurement of Net Income

- **Inurement:** Code § 501(c)(3) prohibits inurement of the net income of any organization to any private shareholder or individual. Treas. Reg. § 1.501(c)(3)-1(c)(2) states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private individuals.

- The regulations provide that the terms “private shareholder” or “individual” include any persons having a personal and private interest in the activities of the organization.
Inurement is most likely to arise when an “insider” relationship exists between the person who benefits and the organization.

“Insiders” generally include an organization’s officers, directors, founders, and their families. See 1993 CPE Article, IRS, at Section 3.A.2

Courts have regularly found inurement where compensation to a tax-exempt entity’s executives is excessive and unreasonable.
Inurement Test

- The IRS has created a three-prong test for determining when private inurement exists.
  - In G.C.M. 39670, the IRS identified the following prongs:
    - (1) whether the total compensation package is merely a device to distribute profits to principals or transform the organization’s activities into a for-profit joint venture;
    - (2) whether the compensation package is the result of arm’s length bargaining; and
    - (3) whether the compensation constitutes reasonable compensation under the circumstances (see prior factors).
  - Each of the prongs must be satisfied to avoid inurement issues.
Inurement Example

Example 3:
A public college pays compensation to employees according to a ratable distribution based on stock ownership. The college does not base compensation on what is customary and reasonable for the services rendered. A court found that this arrangement resulted in inurement because (1) the compensation scheme is a device to transfer the profits of the college to private persons; (2) there were no arm’s length negotiations; and (3) the compensation is not based on the services the employees actually provide, the time devoted to the job, or the employees’ contribution to the college’s success.

See Birmingham Business College v. Commissioner, 276 F.2d 476 (5th Cir. 1960).
Inurement Example

Example 4:
A nonprofit hospital rents office space to an association of doctors at below fair market value. The doctors treat >90% of all patients at the hospital. Less than 10% of the patients are treated on a charitable basis. A court found that under these circumstances, the hospital’s activities resulted in substantial inurement of benefits to private individuals because the hospital’s operations were akin to a for-profit joint venture where the profits of the hospital inured to the benefit of the association of doctors. *Harding Hospital, Inc. v. U.S.*, 505 F.2d 1068 (6th Cir. 1974).
In *Founding Church of Scientology v. U.S.*, the Court of Claims stated that if a loan or “other payment in addition to salary is a disguised distribution or other benefit [derived] from net earnings” then it does not matter if the payment would otherwise result in reasonable compensation under the circumstances because the compensation would fail the first prong of the inurement test. 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. den.* 397 U.S. 1009 (1970).
“Private benefit” has been held to be a separate, albeit overlapping, issue from inurement that tax-exempt entities must be careful to avoid. See People of God Community v. Commissioner, 75 T.C. 127, 131 (1980).

The prohibition on Private Benefit is found in Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii)
Private Benefit

- Private benefit is generally found in situations where the entire benefit structure of *an organization* provides for excessive and unreasonable compensation.

- The IRS focuses on the following factors in determining whether compensation is “reasonable” as to an organization as a whole:
  - The size of the organization;
  - The salary scale of others in the same line of business;
  - Salary scale for employees of the organization generally;
  - The amount of the organization’s income that is devoted to compensation;
Private Benefit Example

Example 5:
In Senior Citizens of Missouri, Inc. v. Commissioner, 56 T.C.M. (CCH) 480 (1988), the Tax Court found that where an organization paid over 30% of its gross receipts in advances to employees and contractors for work that was never shown to have been performed, there was a private benefit violation. This was especially true in light of the fact that the organization only devoted 8% of its gross receipts to fund activities that furthered exempt purposes.
Consequences of Inurement or Substantial Private Benefit

- If either inurement or private benefit are found to exist, an entity’s tax-exempt status could be revoked. *Kermit Fischer Foundation et al. v. Commissioners*, T.C. Memo 1990-300.

- Where there is inurement to an outsider, the IRS has found that revocation is not always necessary. Rev. Rul. 69-383, 1969-2 C.B. 113.

- However, where the inurement is to an insider such as a board member, founder, or officer, the IRS is more likely to revoke tax-exempt status.

- Private benefit will result in revocation where the benefit to private interest is substantial. *See Senior Citizens of Missouri* (holding that where >30% of the entity’s gross income benefited private interests, revocation of tax-exempt status was warranted).
Consequences of Inurement or Substantial Private Benefit

- In the case of private inurement with a “disqualified person” such as an insider or another person who exercised substantial influence over the affairs of the organization (whether such influence is formal or informal), the disqualified person can be subjected to a penalty equal to 25% of the portion of the compensation that is unreasonable and excessive. Internal Revenue Code § 4958(a). If the disqualified person does not correct any portion of the excess benefit (i.e. return it) within the taxable period, the person will be liable for a 200% tax imposed on the uncorrected portion of the excess benefit.

- A 10% penalty may be levied on any organizational manager (such as executives, directors, and the like) who participates in the transaction and is found to have acted willfully, unreasonably, and with knowledge that the transaction provided for excessive and unreasonable benefits. This penalty is capped at $20,000.
Number of Charitable Organization Returns with Revocations and the Reasons, Fiscal Years 2011-2013

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<th>Fiscal Year</th>
<th>Not operating for tax-exempt purposes</th>
<th>Failed to file tax returns, render statements, or maintain records</th>
<th>Inurement or private benefits</th>
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<td>2011</td>
<td>115</td>
<td>20</td>
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<td>2012</td>
<td>123</td>
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<td>2013</td>
<td>72</td>
<td>34</td>
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Source: GAO analysis of data provided by IRS officials. | GAO-15-164

Note: These revocations are from examinations and do not include automatic revocations based on failure to file for three consecutive years.
Tennessee Compensation Rules - Distributions

- Nonprofit corporations are prohibited from making distributions to its members, directors, or officers under state law. See Tenn. Code Ann. § 48-63-101.

- A “distribution” is any direct or indirect transfer of assets or any part of the income or profit of a corporation to its members, directors, or officers. Tenn. Code Ann. § 48-51-201(13)
  - However, “distribution” does not include payment of compensation in a reasonable amount and the reimbursement of reasonable expenses to its members or directors.
  - What is “reasonable” under the current Nonprofit Corporation Act has not been specifically defined by statute or case law in Tennessee.
Reasonableness

In interpreting a statute related to exemption from property taxation for charitable nonprofit organizations, the Tennessee Court of Appeals found that where an organization complied with the federal standards for tax-exempt organizations in establishing compensation and the compensation is reasonable in light of the work performed, then such compensation will be considered reasonable under Tennessee law. *Club Systems of Tennessee, Inc. v. YMCA of Middle Tennessee*, M2004-01966-COA-R3CV, 2005 WL 3479628, at *14 (Tenn. App. Dec. 19, 2005)

Thus, it may be prudent to look to the federal reasonableness factors when assessing the reasonableness of employee compensation under Tennessee law.
Liability For Unlawful Distributions

- Directors are liable for the amount of any distribution that is unlawful - i.e., the unreasonable or excessive portion of any compensation paid to officers and employees. Tenn. Code Ann. § 48-58-302(a).

- Any person receiving an unlawful distribution is liable to the extent such distribution is unlawful. *Id.* at (b).
Unlawful Distributions Example

Pleasantville Museum of Art held a rather successful fundraising event where they raised $10,000 more than they needed to fund their regular operations. Directors Ann and Sara decide that they’ve done such a great job that they’re going to distribute that excess money to the Directors and Executive Director Mark for their contributions to the fundraising success. Director John votes against the distribution and refuses to take any of the money. The others happily take the money and quickly spend the funds.

This would be an unlawful distribution, and Ann and Sara would be personally liable for the total amount distributed and would have the right to seek contribution from Mark. John would not be liable.
Unlawful Distributions
Wasting Corporate Assets

- Directors of Tennessee nonprofit public benefit corporations have a duty to assure that the assets of the corporation are not being misapplied or wasted.

- Making unlawful distributions by providing unreasonable and excessive compensation on a regular basis could be considered wasting or misapplying corporate assets. Under Tenn. Code Ann. § 48-64-301(1)(E), misapplying or wasting assets is grounds for dissolving a corporation.
Diversion of Assets

- Property held by a nonprofit corporation may not be diverted from its charitable purposes. Tenn. Code Ann. § 48-60-206(a).

- A person who is a member or otherwise affiliated with a public benefit corporation may not receive direct or indirect financial benefit from the corporation unless the person is (a) a public benefit corporation itself or (b) an unincorporated entity with a charitable purpose.

  - Receipt of reasonable compensation for services rendered is exempted from this general prohibition.
Best Practice Tip

- Nonprofit boards can protect themselves and the organizations' executives from sanctions and revocation of tax-exempt status by establishing and following procedures for approving executive compensation.

- Doing so establishes a "rebuttable presumption" of reasonableness of compensation that the IRS must then refute.
IRS-Recommended Procedure

- Approval by independent board or committee.
- Consider and approve executive compensation in advance of the executive's compensation being set.
- Ensure no one who participates in the decision has a conflict of interest.
- Base decision on comparability data obtained before the compensation is approved.
- Document the decision-making process at the time the compensation is approved.
Best Practice Tip

- IRS guidance on documenting the decision:
  - Terms of the transaction (e.g., salary and benefits agreed upon)
  - Date of approval
  - Members of authorized body present during discussion and vote
  - Comparability data obtained and relied upon
  - Actions of board members with conflicts of interest
  - Basis for the determination
Best Practice Tip

- Comparability data must be for "compensation levels paid by similarly situated organizations for functionally comparable positions."
- Smaller organizations can rely on the annual returns their peers file with the IRS.
- Larger organizations can look to external compensation studies or surveys.
Reporting Compensation to the IRS (and to the Public)

- Almost all tax-exempt organizations are required to file a Form 990.
- Must include information on compensation paid to directors, trustees, officers, and key employees (employees who earn more than $100,000 per year).
- Form 990 is a public document that can be obtained by anyone from the nonprofit, the IRS, and other sources such as GuideStar.
Information on the Firm

Kennerly Montgomery is a general practice law firm that has provided legal advice to clients for almost 100 years. KM attorneys practice in a variety of areas, representing public, private, and municipal clients, including nonprofit and tax-exempt entities, public and private employers, local governments, agencies and public utilities.

Bill Mason, Brittany Brent Smith, and Zack Gardner practice extensively in the firm’s corporate law practice area, representing numerous nonprofit and tax-exempt entities. The attorneys practicing in this area routinely guide nonprofit and tax-exempt entities through various issues concerning formation, operations, governance, employment, and financing under various applicable federal, state, and local laws.
A Little About Your Presenters


Brittany Brent Smith is an associate with Kennerly Montgomery focusing in the areas of corporate law and tech transfer and commercialization. Brittany assists business and corporate clients with a range of business planning and operations services, such as establishing, organizing, and maintaining their entities. She routinely assists non-profit and tax-exempt entities with forming their organizations and obtaining and maintaining their non-profit and tax-exempt statuses. Brittany counsels public entities and private companies, senior management, boards of directors, and board committees on a broad range of corporate governance and compliance matters, including governance structure and documentation, conflicts of interest, and general functioning. Brittany is the membership and social chair for the Knoxville Bar Association Corporate Counsel Section and a member of the Knoxville Association of Women Executives. She also serves as a member of the Board of Trust of the Appalachian Ballet Company.

Zack Gardner joined Kennerly Montgomery as an associate in July of 2014. He works primarily in the firm’s business & corporate law practices. He graduated cum laude from the University of Tennessee with a Concentration in Business Transactions in 2013 and also earned a Bachelor of Arts in Political Science and History, summa cum laude, from the University of Tennessee in 2010. He also serves on the Knox Bar Association’s Minorities Opportunities Committee and is Co-Chair of the KBA Barristers Diversity Committee.