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The dollars and sense of executive compensation

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This article discusses current and proposed legal parameters applicable to executive compensation packages generally, as well as current key focus areas for legislation and regulatory oversight of executive compensation and recommendations for strengthening the defensibility of executive compensation programs. Our concern here is with the appropriate process for establishing executive compensation and challenges to the total value of compensation packages. It is not our intent to outline the technical requirements for particular elements of a compensation package, such as the strict limitations that may apply to various deferred compensation arrangements, limits on deductibility of executive compensation, or the detailed record keeping necessary to support certain expense reimbursements for federal tax purposes. Our discussion focuses on the nonprofit, tax-exempt health care sector, because it is the largest segment of the health care industry and generally subject to more extensive regulation of their contracts and transactions with insiders.[1]

Fiduciary duties

Directors and officers of nonprofit corporations have at least three commonly recognized fiduciary duties – the duty of care, the duty of loyalty, and the duty of obedience (though some would argue for a higher fiduciary standard for charitable organizations). The duty of care relates to the director or officer's competence in performing those functions and requires that the director or officer carry out those duties with the same degree of diligence, care, and skill as an ordinarily prudent person would exhibit in like circumstances, and that they act in a manner that they believe to be in the best interests of the corporation. The duty of loyalty dictates that the director or officer act in faithful pursuit of the interests of the corporation rather than their own financial or other interests or those of any other person or entity. Finally, the duty of obedience obligates a director or officer to act with fidelity to the mission and purposes of the corporation within the bounds of the law generally.

Directors and officers are also generally required to act in good faith in discharging their duties.[2] Any unjust enrichment or fraud on the corporation may violate the good faith requirement and the duty of loyalty to the corporation. Where a director or officer engages in self-dealing to gain approval of his or her own compensation without disclosure of relevant potential conflicts, such action is arguably inconsistent with these fiduciary duties. In one illustrative case, a federal appellate court found that a health care CEO breached his fiduciary duty by setting his own salary without disclosing substantial outside income from another organization or the use of corporate funds to purchase a $6 million life insurance policy. He also bifurcated the presentation of a severance plan, allegedly to mislead the board as to the magnitude of severance benefits he would receive.[3]

Such cases highlight the importance of transparency and full disclosure of potential conflicts in any compensation arrangement review, as well as the need to insist on appropriate documentation of reasonableness. As indicated in Section 8.30(b) of the Model Act and in many state statues, directors and officers are entitled to rely on "information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by … legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence."

Failure to obtain evidence of fair market value, and failure to exercise appropriate oversight of the executive compensation process, arguably would be a breach of fiduciary duty by whoever presented or approved the compensation package. Documentation of fair market value is also key to compliance with the tax rules applicable to exempt organizations and their executives. The IRS, however, has also shown concern with organizations that lack appropriate board oversight in compensation matters, including one audit where the board "had actual knowledge of…improper payments" to the president and took no action to recover those payments and instead approved additional payments.[4] Concerns over whether the fiduciary duties described above are being met also has resulted in increasing activism in the executive compensation area at both the state and federal levels.

Recent inquiries

One of the first rules in the playbook for any attack on a corporation is to "follow the money." More precisely, follow how much money goes to whoever is responsible for making the decisions, or exercising the oversight, over the actions being challenged. In some cases (such as union-sponsored corporate campaigns or class action lawsuits), it may be a distraction or a tactic to weaken resolve in other areas. At other times, it is a prelude to possible legislative efforts, administrative rule makings, or negotiated settlements. Finally, in an increasing number of instances, it is the path followed to prove serious allegations of excess benefit, breach of fiduciary duty, kickbacks, or securities fraud.

Congressional Inquiries. In the last Congress, nonprofit health care came under attack before several committees. Whether those attacks gain traction in the new Democratic Congress may be an open question as this article is written. It seems clear, however, that the focus on executive compensation will continue in some key forum, whether state or federal, whether regulatory, legislative, or judicial.

On the federal level, the Senate Finance Committee staff released a proposal in June 2004 that included significant compensation reforms.[5] The proposal would have imposed a number of reforms on the nonprofit executive compensation process, with potential new excise taxes for noncompliance. The detailed process proposed for approval of compensation included: (a) annual advance approval by the board for all management positions for any increase beyond an inflation adjustment; (b) independence standards for compensation consultants, who would have to be hired by and report directly to the board; (c) mandatory public disclosure of compensation arrangements, including an explanation that would be understandable by someone with a "basic business background."

Following up on executive compensation concerns, in May 2005, Senator Grassley, then Chair of the Senate Finance Committee, took up the banner by peppering ten major hospital systems with 46 detailed questions, many of them with multiple subparts, and setting a 45-day deadline to reply.[6] The last question on that list asked for a detailed breakdown of travel expenses for the five top salaried employees for the past three years, all salaries, and benefits (singling out country club dues in particular) they received from their employer and related organizations during the same period.

Federal legislation. The Pension Protection Act of 2006 (PPA) included limited reforms relevant to executive compensation, including increasing the maximum tax on organization managers to $20,000 per transaction for approving non-fair market–value packages [PPA, § 1212(a)(3)]. The PPA also makes it a per se excess benefit for any supporting organization (which includes many health care holding companies and foundations) to provide a loan to any disqualified person, with the full amount of the loan being an excess benefit [PPA, § 1242(b)]. Perhaps most significantly though, the PPA also increased the range of permitted disclosures to state charity officials, including allowing the IRS to disclose proposed revocations and closing agreements (PPA, § 1224).

The Sarbanes-Oxley Act of 2002 (SOX) includes a giveback rule for executive compensation arguably designed to deprive executives of the benefits of intentional or negligent misstatement of financial results. In the event of an accounting restatement due to material noncompliance with securities laws financial reporting requirements as a result of misconduct, the CEO and CFO must repay any bonus, incentive, and equity-based compensation received for 12 months following the noncompliant filing, and any profits realized from sale of the issuer's securities in that same 12-month period.[7] Although this portion of SOX only applies to public companies and not nonprofit organizations, it is indicative of potential legislative reforms to deal with perceived abuses in the nonprofit sector as well, and may reflect what Congress considers best practices for executive compensation programs. Stories of nonprofit executives benefiting in similar circumstances are likely to increase calls for similar reforms in the nonprofit sector, such as the CFO of a Michigan hospital who allegedly falsified journal entries by overstating asset values and operating income and understating liabilities. This resulted in a misstatement of the hospital's financial statements in an aggregate amount of $117 million over approximately five years and inflated his bonuses by over $144,000, which he agreed to repay.[8]

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Encouragement for best practices. The Nonprofit Panel of the Independent Sector (the Panel), in its June 2005 report to the Senate Finance Committee, followed a central theme that more responsibility for executive compensation should be focused at the board level to the extent that can be accomplished without conflicts of interest. The Panel recommended, among other things, that CEO compensation be approved by the full board annually, in advance, unless the CEO is under a multi-year contract with no more than an inflation factor or cost-of-living adjustment. For compensation of other executives, the Panel recommended regular reporting to and oversight by the board.[9] A number of these concerns have been echoed by the bond rating agencies in their call for transparency and more performance-based compensation.

Rating agencies have also focused on executive compensation, and their judgments about the executive compensation and review process can affect an organization's bond rating and, thus, the organization's access to the public capital markets. For example, in June 2005, Moody's Investor Services issued a "Special Comment" dealing with the extent to which good (or bad) corporate governance practices impact the credit rating of nonprofit health care organizations. In discussing the criteria considered in the credit rating process, the Special Comment noted that the board's handling of the "level of management compensation" for CEOs and other top management personnel in the nonprofit health care sector is "drawing increasing attention," and this increased attention requires a hands-on involvement by the board in the process of establishing executive compensation and in monitoring executive performance to ensure that the organization gets the performance it has paid for. In this regard, the Moody's Special Comment notes that nonprofit health care organizations today face a number of conflicting pressures regarding executive compensation. On the one hand, large health care organizations are complicated, sophisticated business operations that require capable, experienced management, and the organizations must compete for that talent with other comparable organizations, including for-profit companies. This competition for talent results in an increased pressure to pay more to attract and retain the kinds of individuals needed to run a successful operation. On the other hand, as the Moody's Special Comment notes, the "appropriate" level of compensation for these executives is "difficult to gauge," and "attempts to increase executive compensation can generate negative press attention and the discontent of major constituencies."

One recent IRS ruling also highlights many of these same emerging best practices in executive compensation. Private Letter Ruling 200601030 (Jan. 6, 2006) involved a long-term incentive compensation plan aimed at retention of important personnel. The procedures followed in this ruling were a model of transparency, including multiple procedural safeguards and review by an independent board; each layer of management making recommendations up the ladder and no one approving their own compensation; and no bonuses paid until organization recovers capital investment in the related technology company.

State Legislation. Some state statutes already regulate conflicts of interest in compensation and other matters. For example, in Florida, any director or officer of a nonprofit corporation who improperly benefits, directly or indirectly, from a conflict-of-interest transaction may be required to disgorge those profits in an action by the attorney general.[10]

One of the more drastic legislative proposals at the state level surfaced in Michigan just over two years ago. House Bill 6365 (introduced 12/02/04) aimed to regulate compensation of all executive and administrative employees of licensed hospitals. That legislation would have capped executive pay at 1200% of federal poverty guidelines for a household of the same size. That cap would have equated to the following amounts in 2005: $114,840 for a single executive, and $232,200 for an executive with a family of four.[11]

State regulatory oversight. Irrespective of legislative action or inaction, state attorneys general and other state regulators have and likely will continue to exercise their oversight responsibilities over perceived abuses in the nonprofit sector, including poorly designed, poorly documented, and poorly implemented executive compensation plans. Those investigations are examples, though not an exhaustive list, of arrangements that are likely to draw close scrutiny. In one example, the Kansas attorney general leveled civil conspiracy allegations related to a golden parachute for Health Midwest's president as part of a proposed hospital sale. Minnesota's attorney general audited executive compensation and other arrangements at three major health systems, and in Maryland, the insurance regulators blocked the conversion of a health care plan, criticizing executive bonuses.

In another example, in late June of 2006, the Ohio attorney general proposed (and subsequently withdrew) a far-reaching set of proposed rules governing the operation of charitable organizations in Ohio. As part of these proposals, the Ohio attorney general suggested a Model Compensation and Expense Reimbursement Policy. Part of this Model

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Policy established a presumption that payment of compensation paid to a Covered Person (which would have included any employee of a charitable organization) in excess of 30 times the minimum wage ($321,600), was, "as a rule," "generally not deemed to be in furtherance of the charitable purposes" of the organization.[12] The proposed Model Policy further provided that, if more than $321,600 is paid, there must be "procedural safeguards," which "at a minimum, shall include approval by a supermajority of the full board, . . . with the full knowledge of the total Covered Compensation paid to the Cover Person by the charitable organization and such other Related Third Parties as may be compensating the Covered Person."[13]

Executive compensation initiative. IRS enforcement activities have increased significantly in recent years despite overall staffing declines in the exempt organization sector. Although full scale audits are still conducted, the IRS has shifted significant resources to more focused, limited-scope exams through what have been dubbed "soft contact letters." In that vein, in the first half of 2005, the IRS launched its executive compensation initiative, contacting over 1,800 exempt organizations with questions about their executive compensation. That initiative was followed in early 2006 with nearly 600 soft contact letters asking about both community benefit activities and executive compensation.

The IRS letters asked a series of questions focused on the compensation review process, conflicts of interest, and reasonableness of total compensation, including who made compensation decisions, what were the duties and responsibilities of the executives, does the organization follow the procedures for establishing a rebuttable presumption of reasonableness, what sources of comparable data were used, whether hospitals used both for-profit and nonprofit comparables in setting compensation, and whether actual compensation was set within the range of comparable data. Consistent with prior guidance, the questionnaires reflect a focus on total compensation and benefits.

Prior to issuance of the formal report on this project, comments from various IRS officials highlighted several red flags that may suggest a defective compensation process (and potential inurement or excess benefit issues):

- Insufficient governing board oversight of compensation decisions
- Failure to follow the rebuttable presumption procedure as a "best practice" may be a cause for concern
- Compensation not clearly tied to actual duties
- Using comparables that include only for-profit companies
- Underreporting of compensation on Form 990
- Compensation paid by multiple entities
- Loans to directors, officers, or other insiders (Note: IRS sent 200 follow-up letters)
- Use of property for non-business purposes (e.g., cell phones, lap tops, spousal travel, auto allowance, country club dues, other perquisites)

The formal IRS (Internal Revenue Services) report on the executive compensation initiative was released on March 1, 2007.[14] The report highlights a significant rate of errors (more than 30%) in reporting compensation on Form 990. Levels of adherence to the rebuttable presumption review process were relatively modest (51%), and only slightly more organizations had documented the market value of compensation packages (54%). In addition to the reporting problems, the IRS found excessive compensation in 25 examinations and assessed excise taxes under Section 4958 in excess of $21 million against 40 disqualified persons and organization managers. The report also notes that in addition to the 200 compliance check letters for loan deals (see above), the IRS has opened 50 examinations of potentially suspect insider loans made at below market rates and loans that were not repaid.

Whistleblowers. For years, whistleblowers have been key players in the enforcement of fraud and abuse laws. The opportunity to prosecute cases directly under the False Claims Act may be a part of the reason; however, many such claims result in government intervention. Although the False Claims Act does not allow private parties to enforce the tax laws, there is a little used (in health care) provision in the Tax Code that provides for rewards for whistleblowers who alert the government to violations of the tax law. Under Section 7623 and the related regulations (Treas. Reg. § 301.7623-1), whistleblowers can recover up to 30% in such cases, with the recovery funded from the taxes collected. It is the government, however, who prosecutes these cases; there is no private right of action (though one was proposed in the last Congress). On February 2, 2007, the IRS set up a dedicated Whistleblower Office to receive and follow up on tips of alleged tax law violations that involve amounts greater than $2 million. (When this article went to press, legislation was pending in Congress that would lower that threshold to $20,000.)

GAO survey. At the request of the Chair of the House Committee on Ways & Means, in 2006 the General Accounting Office (GAO) distributed a "voluntary" survey to the largest health care systems in the country. Survey questions focused on the CEO and four other top-paid executives at the system level. GAO's questions reflect an interest in the rebuttable presumption process, handling of conflicts of interest, reliance on independent professional advice in setting compensation, use of internal and external self-audits, and the enforcement of performance bonus criteria for executives. Like the IRS questionnaires, the GAO survey focused on all forms of compensation, including cash compensation, retirement benefits, and perquisites (including loans, travel and entertainment expenses, and payments to/for spouses and family members).

Of the 100 surveys distributed, GAO received 65 replies. The replies show a significant level of sophistication in executive compensation matters. GAO noted that the hospital systems commonly reported that their board or executive committee were primarily responsible for approving executive compensation, the system had a conflict-of-interest policy that applied to the board or committee members and compensation consultants, and they relied on comparable market data in making compensation decisions. Senator Grassley, however, focused on the negative, noting his disappointment that 35% of the hospitals surveyed did not respond, that one-third of those responding had no written criteria for selecting members of the compensation review body, and that in 17% of the cases, the CEO was a voting member of that body. He also noted that "critical audits of personal entertainment expenses, spousal travel, automobile expenses, and social club dues are not being performed on a regular basis."[15]

Federal compensation standards for nonprofits

The legal standards related to executive compensation for tax-exempt organizations are not overly complex on their face, yet their application to particular facts can prove challenging, particularly for higher-end compensation packages. Although they lack the same purported bright lines that apply to deductibility under Section 162(m) in the for-profit sector, the rules for exempt organizations rely heavily on process. Following those procedural protections, including taking the steps to establish a rebuttable presumption of reasonableness, can protect both the organization and its executives.

Inurement and private benefit. Among other requirements for tax-exempt status as a Section 501(c)(3) organization, no part of the organization's net earnings may inure to the benefit of insiders,[16] and the organization may not benefit any private party more than as an incidental part of its broader, primarily charitable activities.[17] Violation of either the private inurement or private benefit rules can jeopardize tax-exempt status. Section 501(c)(3) organizations, however, may pay reasonable compensation for services actually provided without violating these proscriptions.[18]

Defining reasonable compensation. Reasonableness for this purpose is based on comparables—like-pay for like-services, by like organizations, in like circumstances.[19] Whether an organization is "comparable," however, means more than just being in the same line of business.[20] It is also important to consider the size of the organizations (in both revenues and scope of activities) and their financial performance. Defining the comparables that go into a compensation analysis can, in practice, have a more significant outcome on the final result than what percentile is selected.

Fair market value generally is a range rather than a specific amount.[21] The same can be said for reasonable compensation. Compensation consultants, however, are unlikely to provide unqualified opinions on reasonableness if compensation is above the 90th percentile in appropriate surveys for comparable positions with comparable organizations (because higher percentiles tend to be extrapolations or have insufficient data points for the same reliability), or if more than half of the comparables are for-profit companies.

The regulations define "reasonable compensation" as: "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances."[22] A cap on compensation is relevant to reasonableness under Section 4958 and under the inurement rules generally.[23] Although the IRS encourages reasonable caps on total compensation, there is no hard dollar cap required by current federal law at any specific amount.

All items of value are included in assessing reasonableness, with limited exclusions [i.e., de minimis and working condition fringe benefits, expenses reimbursed pursuant to an accountable plan under Reg. 1.62-2(c)]. Although the Section 4958 regulations are silent on the role of community benefit and community need in an analysis of reasonableness, given the IRS' focus on community benefit activities generally in the model conflict-of-interest policy (included with the instructions to Form 1023), and in the recent compliance check letters mailed to 600 hospitals, it is difficult to imagine the IRS arguing that nonprofits cannot assign some value to specific community benefit goals in an executive bonus program.

Use of surveys and consultants. Although using an off-the-shelf survey is less expensive and may be adequate for many typical executive positions and performers, its reliability and utility depend, in part, on the degree of expertise in compensation matters of board or committee members who rely on the surveys.[24] Off-the-shelf surveys tend to

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include a wide range of companies that may end up overstating, or understating, the actual market rate for comparable positions.

A customized survey, though more expensive, can be more precise and produce a dramatically different range through the selection of comparator companies that are more closely comparable to the organization. A number of public companies have been taken to task in the press for selecting peer groups to benchmark themselves against for compensation purposes that are in unrelated industries, are not of a similar size, or are not performing as well financially, are not giving due consideration to where the companies actually recruit for executive talent, and are paying all executives at the 75th percentile or above.[25] Compensation also can exceed the range of comparables in special cases with an explanation.[26] However, a case-by-case review is necessary to assure that there are appropriate reasons for the excess (e.g., documented recruitment and retention difficulties or exceptional performance). Exceeding ranges increases the risk that compensation would be found to be unreasonable.

Finally, whether using published or custom surveys, the data generally must be fresh to be reliable. Compensation consultants typically update a prior year's survey results by an inflation factor to adjust for the normal time lag between data gathering and publication. Although there is no bright-line time as to when a survey or other valuation is too old to use, and much may depend on local market conditions, the IRS has found a five-year-old compensation survey to be outdated and unreliable (Tech. Advice Memo. 200244028), and in another case, an 18-month-old valuation was considered unreliable (Anclote, *supra*).

Excess benefit transactions. Compensation above reasonable levels is a taxable excess benefit for "disqualified persons" (which includes all voting board members, CEO, COO, CFO, treasurer, key department heads, and others with significant influence over the organization, as well as their family members).[27] The amount of compensation in excess of what is determined to be reasonable is referred to as the excess benefit. Section 4958 imposes a two-tier tax on that excess, first at the rate of 25% and then, if it is not repaid with interest, an additional tax at the rate of 200%. In willful or flagrant cases or repeat violations, those taxes can be doubled under Section 6684. Organization managers who approve excessive compensation packages are also subject to tax at the rate of 10% of the excess benefit, subject to a per transaction cap (formerly $10,000, now $20,000). Moreover, if the excess benefit transactions are substantial or pervasive enough to demonstrate that, as a whole, the organization is no longer operated exclusively for charitable purposes, exemption may be revoked.[28]

Automatic excess benefit transactions. Payments to disqualified persons will not be treated as payment for services, unless that intent is contemporaneously substantiated (or the payments are expense reimbursements under an accountable plan). Without that substantiation, the payments would be viewed as automatic or per se excess benefits, regardless of the value of any services provided. Appropriate substantiation includes properly reporting the payments on Forms W-2, 1099, 990, or 1040 before the IRS opens an audit of the taxpayers. If there is reasonable cause for failure to report (i.e., mitigating factors or events beyond the exempt organization's control), and that failure is promptly corrected, the per se rule would not apply. In addition, an exempt organization may produce other documentation to show that it followed its normal approval process for compensation (e.g., approved written contract signed before payment is made).[29]

Compensation compliance protection for various executive levels

Various exceptions may apply to protect compensation paid to different employees, depending on their prior relationships with the organization, the total value of their annual pay package, and the process followed by the organization to approve executive compensation.

New and newly promoted executives. One of the most useful exceptions in the regulations allows organizations to negotiate compensation payments for new executives and those promoted from the ranks without subjecting the contract to the Section 4958 excess benefit rules. Similarly, a new executive with no prior relationship with the organization is not likely to be an insider triggering the private inurement rules.[30]

Although the Section 4958 exception is frequently referred to as the "initial contract" exception, it can be used for the same executive multiple times as long as he or she is not already a disqualified person when the contract is signed (e.g., a finance executive being promoted to CFO may not be a disqualified person before his new agreement takes effect). The exception, however, is limited to fixed payments – which would include specific dollar amounts and amounts that can be objectively determined pursuant to a fixed formula set forth in the contract. Specific awards for specific targets will be considered objective, but discretionary judgments about performance will not (i.e., the discretionary portion would be subject to the excess benefit rules).

Only binding written contracts can qualify for this exception. The agreement need not be overly formal or detailed, as long as it has the basic terms and compensation spelled out with sufficient specificity to

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be enforceable under state law. If at any time the executive does not substantially perform his or her obligations under the contract, the exception is lost. Likewise, if the contract is terminable by the exempt organization without cause and without substantial penalty (e.g., at will employment), the contract is treated as a new contract as of the first date that such termination could be effective (even if it is not terminated). In addition, if the parties make any material change in the contract, such as extending or renewing its term or making a "more than incidental change to any amount payable under the contract," the contract is also treated as a new contract as of the date of the change. In these last two cases, the deemed "new contract" still may qualify for the initial contract exception, if the executive is not yet a disqualified person.[31]

Long-term executives. Some longer serving executives still may qualify for another exception, including the exception for binding written contracts in effect continuously since before September 14, 1995.[32] If at any point the exempt organization has the right to terminate the contract without consent and without substantial penalty, the exception ends as of the first date that such termination could be effective (whether or not it is actually terminated). Likewise, any material change in the contract results in loss of the exception. After this exception ends, the normal reasonableness analysis would apply (unless the executive fits another exception). In the course of one audit, the IRS determined that a consulting agreement for a retired health care system CEO and his spouse had been materially changed (and thus no longer qualified for this exception). The changes included extending the term, decreasing the minimum hours of service required, restructuring annual payments to include payment for an existing noncompete, adding a survivor's benefit to pay the surviving spouse, and adding a deemed insecure clause to allow the couple to accelerate payments if they became concerned about the system's financial condition following a sale of substantially all system assets.[33]

Junior/Mid-level executives. Executives at relatively more modest pay levels also may qualify for a blanket exception from the Section 4958 excess benefit rules. Under IRS regulations, all non-highly compensated employees [as defined in Section 414(q)(1)(B)(i)] will be deemed not to be disqualified persons if they are not voting board members, are not certain high-ranking officers or family members of disqualified persons, and they are not substantial contributors to the organization under Section 507(d)(2)(A) (gifts of at least $5,000 and more than 2% of total donations).[34] For 2006 and again for 2007, the dollar amount threshold for being highly compensated was $100,000.[35]

Other executives. For other executives, as well as for boards and organization management approving their compensation, the best protection available is often following the procedure outlined in the regulations for establishing a rebuttable presumption of reasonableness for the compensation package.[36] Following an appropriate process (described below) creates a rebuttable presumption of reasonableness and shifts the burden to the IRS to prove compensation is too high. As we have seen in recent tax litigation (i.e., the *Caracci* case, *supra*), who has the burden of proof can have a significant impact on the outcome. To establish the presumption and shift the burden of proof to the IRS, three basic requirements must be met.

First, the compensation arrangement must be approved in advance by an authorized body (which can include the board, a committee, or individuals authorized under state law to act on behalf of the board) comprised of independent members. In this context, independence means that the member and his or her family have no conflict as to the arrangement being approved and no vote swapping occurs (i.e., trading an approving vote on one transaction for a conflicted member's approving vote on another transaction). A conflict may be present if:

- the arrangement involves the member's own compensation or that of his or her family,
- the member or any of his or her family members is an employee reporting to the person whose compensation is being approved (e.g., a CEO's direct report voting on the CEO's compensation),
- the member receives other payments that are approved by the person whose compensation is being approved, or
- the member has any other material financial interest affected by the compensation arrangement.

Consistent with the IRS model conflict-of-interest policy, anyone who has a conflict should be excused from the meeting before any deliberation or vote on the compensation package, though they may make a statement and respond to questions.

Second, the authorized body must determine that the transaction is consistent with fair market value based on a review of adequate comparability data. As noted above, the level of detail required in the comparability data depends on the expertise of the authorized body in compensation matters. Under Section 53.4958-6(c)(2) of the regulations, adequate comparability data may include market data for "functionally comparable positions," information on the availability of similar services in the geographic area, "[c]urrent compensation surveys compiled by independent firms," and actual binding written offers from similar organizations.

The standards for independence of a compensation consultant under the Section 4958 regulations are not well defined. The auditor independence standards of Section 201 of SOX [15 U.S.C. § 78j-1(g) & (h)] require prior audit committee approval (or a special exception from the Public Company Accounting Oversight Board) for an auditor of a public company to provide certain non-audit services, including "appraisal or valuation services, fairness opinions, or contribution-in-kind reports." A growing number of nonprofit organizations have voluntarily adopted this and other requirements of SOX, which may lead to questions as to whether valuation experts who are part of a professional services firm that renders accounting services to the organization can be independent for purposes of Section 4958.

The final regulations are silent on that point, however, the preamble to the temporary regulations provides some guidance on the meaning of "independence" for compensation consultants and other valuation experts. There, the IRS stated that "[t]he requirements for appropriate valuation experts are modeled after the section 170 regulations that define qualified appraisers for charitable deduction purposes."[37] Those regulations provide that a qualified appraiser, among other things, does not include an employee of the taxpayer, corporations owned more than 50% by the taxpayer or part of the same control group, or an appraiser who is both regularly used by the taxpayer and does not provide a majority of his/her/its appraisals for unrelated persons during the tax year.[38] The final Section 4958 regulations do not reference these rules, leaving the meaning of "independence" somewhat up in the air. Although Section 1219 of the Pension Protection Act, passed last year, amended the statutory definition of "qualified appraiser" for purposes of Section 170, it continued the authority for additional regulatory criteria, and the IRS has confirmed that the above independence standard still applies.[39]

In light of the recent indication that the IRS is examining corporate responsibility issues in the tax-exempt sector, it remains to be seen whether the independence issue will be addressed specifically in the future.[40] One IRS official, however, commented that the IRS does not believe that exempt organizations should follow any more lenient practice for auditor conflicts of interest than that applicable to public companies under SOX, and "extra scrutiny will be given to any compensation report or property valuation that is performed by the organization's regular accounting firm." The official went on to note that the IRS is particularly concerned about the business relationship that typically exists between top officers and the organization's regular accounting firm, and that the IRS (presumably to be convinced of independence) would require that the consultant should be selected by, and the engagement terms (including compensation) should be approved by, the board of the exempt organization and not by the executives whose compensation is being evaluated.[41]

Internally generated surveys of at least three comparable organizations are specifically recognized in the regulations as an acceptable alternative for organizations with gross receipts under $1 million, though such surveys may raise antitrust concerns. The regulations do not require customized opinions from independent compensation consultants, but it is often prudent to seek that advice for higher-end compensation arrangements.

Third, the approval must be adequately and concurrently documented. The required documentation amounts to the four W's of compensation: Who is paid? What are they paid? Why are they paid that? When is it documented? The minutes of the meeting must include:

- the details specified in the regulations, including the terms of the compensation arrangement being approved
- the identity of the members present and voting
- the comparability data they relied on and
- any actions related to the compensation arrangement that were taken by conflicted members of the authorized body.

The minutes must be prepared no later than the date of the next meeting of the authorized body or 60 days after the approval, and the authorized body must then approve the minutes within a reasonable time.

Protections for management. The regulations include two specific safe harbors for board members and other organization managers that will "ordinarily" protect them from liability for the 10% organization manager tax for approving transactions that result in an excess benefit. The first safe harbor, and one followed frequently in practice, is to follow the steps outlined in the regulations for establishing the rebuttable presumption of reasonableness.[42]

The second safe harbor available to organization managers is reliance on a favorable, reasoned opinion of an attorney (including in-house counsel), appraiser, or compensation consultant, following full disclosure of all material facts, and including a full analysis of the transaction (both the facts and the applicable standards), not just a statement of conclusions. For organization managers to be able to rely on the

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opinion of experts other than attorneys or CPAs, such experts must (1) hold themselves out to the public as compensation consultants, (2) perform the relevant valuations on a regular basis, (3) be qualified to make valuations of the type of services at issue, and (4) include in the written opinion a certification that they meet requirements 1–3.[43]

Non-traditional compensation models

Although granting stock or the equivalent in a Section 501(c)(3) organization likely violates the inurement prohibition and jeopardizes exemption, similar structures involving taxable affiliates may pass muster. Two recent IRS rulings highlight that even in the tax-exempt sector, it may be possible to structure appropriate compensation arrangements that go beyond a typical base-salary-and-bonus arrangement where the executives' efforts are contributing to the growth of other aspects of the overall enterprise. Where these other activities are in the commercial sector, they may also strengthen the case for more significant reliance on compensation plans of for-profit companies in that sector, particularly if there is a history or tangible risk of losing executives to other employers in that sector. Like OIG advisory opinions, private letter rulings are only binding as to the particular parties and transactions involved; however, they are often indicative of the agency's views of particular issues absent more authoritative guidance.

In Private Letter Rulings 200602039, 200602040, and 200602041 (Jan. 13, 2006), various Section 501(c)(3) organizations formed a taxable corporation to develop and exploit intellectual property. Stock or options in the new entity would be used by the related exempt organizations as compensation for services provided by employees or contractors. The IRS concluded that this arrangement would not adversely affect the organizations' exempt status as long as total compensation is reasonable.

In Private Letter Ruling 200225046, a Section 501(c)(3) education and research organization (M) established a taxable subsidiary (N), provided all of the initial capitalization in exchange for 100% of N's stock, and licensed certain intellectual property to N for a 10- to 20- year period for minimum annual payments and a split of gross revenues from the commercialization of the intellectual property. A majority of the directors of the subsidiary were not directors or officers of the tax-exempt parent, and the two entities maintained separate space, records, bank accounts, and employees. The parent also intended to grant stock or options in the subsidiary to the parent's employees as part of a reasonable compensation package (apparently with support from a compensation consultant). The IRS concluded that the proposed arrangement would not jeopardize the parent's exempt status.

Form 990 reporting

The IRS released a revised version of Form 990 on February 1, 2006 that significantly expanded the required reporting of compensation for directors, officers, key employees, and independent contractors. The changes, detailed below, reflect an expanded view of what may constitute a conflict of interest and also sound a theme of increased transparency and better tracking of compensation from related entities. It is likely that the IRS intends to use this additional data in developing a risk modeling program to improve audit focus, and the list of revisions may, in effect, be a checklist of potential areas of abuse that will receive close scrutiny in future audits:

- **Question 50 of the Form 990** now requires reporting of all loans to current or former directors, officers, or key employees, including payment terms, interest, security, and purpose of the loan. This reporting requirement also includes any salary advances or "other advances for the personal use and benefit of the recipient" and any receivables that are subject to "special terms" or arise from "non-typical transactions." A separate entry on the schedule is required for each such item, even if made to the same person or on the same terms.
- **Question 51.b.** requires reporting of other receivables not acquired as investments, including a description of the relationship of the borrower to any director, officer, key employee, or substantial contributor.
- **Question 75.b.** adopts a broad view of what may constitute a conflict of interest by asking for an explanation of any family or business relationships among directors, officers, key employees, the five highest paid other employees reported on Schedule A, the five highest paid professionals, and the five highest paid other independent contractors reported on Schedule A (referred to collectively below as the "Inside Group").
- **Question 75.c.** requires reporting of payments by any related organizations (under common supervision or control) or management companies to any of the Inside Group, including a schedule identifying each related organization and, depending on the relationship, also the amount of compensation it paid. Organizations are also required to attach a description of the relationship with the other organizations. The Instructions to Form 990, however, provide significant clarifying detail explaining the scope of what constitutes related organizations and establishing two levels of disclosure, depending on the nature of the relationship.

Rather than including additional detail on the Form itself, the Instructions call for an attachment to provide various levels of detail on compensation from organizations that are related to the taxpayer.

The scope of what needs to be reported depends on the nature of the relationship from among the eight different types of relationship identified in the Instructions. Those potential relationships between the organizations are:

(1) ownership or control
(2) common control
(3) supporting and supported organization as described in Section 509(a)(3)
(4) use of a common paymaster
(5) one organization pays a portion of the compensation that the other organization is contractually obligated to pay
(6) partners in a partnership, members in an LLC or joint ventures
(7) entities that conduct joint programs or share facilities or employees
(8) one or more persons exercise substantial influence over the affairs of both organizations (the same test as for determining who is a disqualified person under Section 4958)

For Relationships 1-6, the required attachment must include compensation paid by the related organization as well as identifying the overlapping directors and officers, the Employer Identification Number (EIN) of the related organization, and a description of the relationship. For Relationship 2, compensation from the related organization must be reported unless the new volunteer exception applies. For Relationships 7 and 8, compensation from the related organization does not need to be reported (if those are the only relationships). For Relationship 8, the only reporting required on the Form 990 is the name of the individual, the name and EIN of related organization, and a description of the relationship between the organizations.

The Instructions also include three reporting exceptions: (1) The volunteer exception (referenced above) applies only to Relationship 2 and takes the relationship out of the full disclosure with compensation, and into the more limited disclosure approach of names, EIN, and relationship. This exception only applies where Relationship 2 is the only relationship with the related organization, and it only applies to a person serving on the taxpayer's board "as a volunteer without compensation." It is not clear from the Instructions whether reimbursement of expenses would be treated as compensation for this purpose, but even non-taxable compensation, such as working condition fringe benefits, is required to be reported in Part V. On the other hand, it is not unusual for state statutes to ignore reimbursement of expenses in classifying directors as volunteers.[44]

For the second exception, organizations related through a bank or financial institution trustee, neither the relationship nor the compensation would need to be reported. Likewise, with the third exception (for certain independent contractors), neither the relationship nor the compensation would need to be reported if the recipient of the compensation is merely a common independent contractor without substantial influence over either the taxpayer or the related organization. The independent contractor exception, however, does not apply to management companies that perform CEO, COO, CFO/Treasurer or similar services for the taxpayer. Of the five examples included in the Instructions, Examples 3 and 4 are the most useful in illustrating the interplay between Relationships 2 and 8.

- **Question 75.d.** also asks whether the organization has in place a written conflict-of-interest policy. The Form 990, however, does not yet require organizations to attach a copy of their conflict-of-interest policies. The current Form 1023 (required for new Section 501(c)(3) organizations), however, does require copies of those policies (Part V, Question 5.a. and Schedule C, Question 14).
- Part V-B now requires organizations to report payments to former directors, officers, and key employees, regardless of how long they have been out of office, retired, or otherwise out of the organization. Instructions require organizations to attach a schedule showing a breakdown of the type and amount of compensation, and given the inherent double counting for retirement benefits, the reporting period could be extensive. Although for purposes of Section 4958 there is a five-year limit on the look-back period for disqualified person status, there is no limit on look-back periods for who is an insider subject to the inurement prohibition. Moreover, if there was no disclosure of an excess benefit transaction on the Form 990, the statute of limitations on any excess benefit transaction still may be open beyond the five-year look-back period for disqualified person status.
- **Schedule A,** before the recent revisions, only required reporting of payments to independent contractors for professional services. Schedule A now has been revised to require reporting payments to independent contractors other than for professional services. This would include services such as construction, catering, maintenance, landscaping, etc. (Connecting the dots, the IRS, in theory, could identify arrangements that may involve indirect excess benefit or vote swapping with members of the board or committee approving executive compensation.)

Form 1023 reporting

The IRS has also revised the Form 1023 exemption application to significantly expand the required compensation disclosures for new organizations with respect to directors, officers, key employees, and

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independent contractors, including much of the same information requested on Form 990. Part V of Form 1023 also outlines what the IRS considers to be "recommended" practices for establishing compensation (though not necessarily required for obtaining exemption):
(a) whether the organization follows a conflict-of-interest policy;
(b) whether compensation arrangements are approved in advance of paying the compensation;
(c) whether the organization documents in writing the date and terms of approved compensation arrangements;
(d) whether the organization records the vote of every individual who decided or voted on the compensation arrangements;
(e) whether compensation arrangements are approved based on evidence of compensation paid by similarly situated taxable and exempt organizations, current compensation surveys compiled by independent firms, or actual written offers from similarly situated organizations;
(f) whether the information on which the compensation decisions are based and their source are recorded in writing; and
(g) if the organization does not follow all of these practices, that it describes how it establishes compensation that is reasonable for its Inside Group.

Form 1023 does note that adopting a conflict-of-interest policy is not a prerequisite for exemption, though in practice it can be difficult to obtain exemption without one. If the organization has not adopted a conflict-of-interest policy, it is asked in the next question (Part V, Question 5) to describe what procedures the organization will follow to assure that no one with a conflict of interest will have influence over the organization's setting of his or her compensation.

Following up on the theme of concern with insider transactions, and likely because of the IRS' perception of a potential for conflict between personal financial gain and the mission of the exempt organization, Part V, Question 6 asks about discretionary bonuses and revenue-based compensation for the Inside Group. Organizations that have or intend to implement such programs are required to describe how the amounts are determined, who is eligible to participate, whether there is a cap on total compensation, and how the organization will determine that it pays no more than reasonable compensation for their services.

Strengthening executive compensation programs

The flood of recent challenges and guidance in the area of executive compensation can seem like a complex, never-ending maze, albeit one with blurred edges rather than sharp corners. Nevertheless, a few beacons emerge to guide the way in developing best practices for a nonprofit organization's compensation program:

1. Follow the rebuttable presumption procedure when establishing compensation for anyone who may be a disqualified person. To the extent approvals are delegated by the board to a committee or individuals, regular reports should be provided to the board for exercise of appropriate oversight.
2. Critically examine the comparable data to assure that the organizations and positions included are truly comparable to your organization in size, financial performance, duties and responsibilities, and other relevant circumstances.
3. Develop a compensation philosophy that is focused on the specific market circumstances of your organization and where it is likely to turn when recruiting talent. Also include a description, updated annually, of employees recruited by other organizations, including as many details as are available about the compensation arrangements offered by those other organizations.
4. Review and update comparability data for all executive compensation programs on an annual basis, at least for anyone who may be a disqualified person.
5. Tie compensation amounts and pay ranges to specific goals that are set in advance and objectively measurable, and document performance of those goals, such as through annual evaluations.
6. Include a mix of both financial and mission-driven goals in the executive compensation program.
7. Create incentives for better performance and avoid the risk of overpaying for underperformance by putting more compensation at risk at a more modest percentile base compensation.
8. Assure independence of the approving body through adoption and monitoring of a substantive conflict-of-interest policy based on the IRS model policy and any more-stringent requirements of state law, including annual or more frequent conflict disclosure requirements. (Some organizations begin each board meeting with a standing question about any previously undisclosed potential conflicts.)
9. Obtain independent compensation consultant opinions for executive compensation packages (total compensation) above a certain percentile (e.g., 60th, 75th, or 90th, depending on risk tolerance).
10. Avoid lightning rod perquisites like automobile allowances, country club dues, and spousal travel. For other common perquisites (e.g., cell phone, laptop), either discontinue the program, insist on documentation of business use, or treat the entire amount as income on Form W-2.
11. Follow the four W's in preparing minutes of compensation meetings: Who, What, Why, When.
12. Keep all documentation of compensation decisions, contracts, evaluations, and resolution of potential conflicts of interest on file for at least six years. ■

1 All section numbers refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
2 See Revised Model Nonprofit Corporation Act, § 8.30(a)(1) (1987) (the "Model Act").
3 Boston Children's Heart Foundation, Inc. v Nadal-Ginard, 73 F.2d 429, 434 & 437-38 (1st Cir. 1996).
4 Tech. Advice Memo. 200243057 (July 2, 2002).
5 The report is online at: http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.
6 The list of questions and a summary of all replies can be found on the Senate Finance Committee Web site (http://finance.senate.gov/) on the Press Releases page for Sen. Grassley.
7 SOX § 304, 15 U.S.C. § 7243.
8 See SEC Litigation Release No. 19455 (Nov. 2, 2005).
9 The Panel's final and supplemental reports are available online at http://www.independentsector.org/panel/main.htm.
10 See Fla. Stat. 617.2003.
11 70 Fed. Reg. 8373.
12 Prop. Ohio Admin. Code § 109:1-1-11(A)(6)(a).
13 Id.
14 The final report is available on the IRS web site at http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.
15 See Press Release, "GAO Survey on Nonprofit Hospitals' Executive Compensation" (July 28, 2006), http://finance.gov.
16 Treas. Reg. § 1.501 (c)(3)-1(c)(2).
17 St. David's Health Care System v. United States, 349 F.3d 232, 236-237 (5th Cir. 2003); American Campaign Academy v. Commissioner, 92 T. C. 1053, 1065-66 (1989); Gen. Couns. Memo. 37789 (Dec. 18, 1978); Treas. Reg. § 1.501(c)(3)-1(c)(1).
18 See, e.g., United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173, 1176 (7th Cir. 1999); Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958); Sonora Community Hosp. v. Commissioner, 46 T.C. 519, 525-26 (1966), aff'd per curiam, 397 F.2d 814 (9th Cir. 1968).
19 See Treas. Reg. § 1.162-7(b)(3). See also Founding Church of Scientology v. United States, 188 Ct. Cl. 490, 412 F.2d 1197, 1200 (1969); B.H.W. Anesthesia Foundation v. Commissioner, 72 T.C. 681, 686 (1979).
20 See Caracci v. Commissioner, 456 F.3d 444 (5th Cir. 2006).
21 See Caracci, 456 F.3d at 449 (noting with approval the assignment of a fair market value range to assets involved in the conversion of a tax-exempt health care provider to a taxable corporation); see also Anclote Psychiatric Ctr. v. Commissioner, 1998 T.C. Memo 273 (stating, "We see our task as one of determining whether the sale price was within a reasonable range of what could be considered fair market values"), aff'd, 190 F.3d 541 (11th Cir. 1999).
22 Treas. Reg. § 53.4958-4(b)(1)(ii).
23 See Treas. Reg. § 53.4958-6(d)(2)(ii); Gen. Couns. Memo. 38322 (March 24, 1980).
24 Treas. Reg. 53.4958-6(c)(2)(i) & (c)(2)(iv), Example 1.
25 See G. Morgenson, "Peer Pressure: Inflating Executive Pay," New York Times (Nov. 26, 2006).
26 Treas. Reg. § 53.4958-6(c)(3)(ii).
27 Treas. Reg. § 53.4958-3(c) & (e).
28 70 Fed. Reg. 53599-53604 (Sept. 9, 2005) (proposed regulations); Caracci v. Commissioner, 118 T.C. 379 (2002), rev'd on other grounds, 456 F.3d 444 (5th Cir. 2006).
29 Treas. Reg. § 53.4958-4(c).
30 United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173, 1176 (7th Cir. 1999).
31 Treas. Reg. § 53.4958-4(a)(3).
32 Treas. Reg. § 53.4958-1(f)(2).
33 Tech. Advice Memo. 200244028 (June 21, 2002).
34 Treas. Reg. § 53.4958-3(d)(3).
35 IR-2006-162 (Oct. 18, 2006).
36 Treas. Reg. § 53.4958-6.
37 66 Fed. Reg. at 2146 (emphasis in original).
38 See 26 C.F.R. § 1.170A-13(c)(5) & 26 U.S.C. § 267(b). For this purpose, "taxpayer" likely should be read as referring to both the applicable tax-exempt organization and the disqualified person.
39 IRS Notice 2006-96, I.R.B. 2006-46 (Nov. 13, 2006).
40 See Announcement 2002-87, 2002-39 I.R.B. 1 (Sept. 4, 2002).
41 "Remarks of Leonard J. Henzke Jr., IRS Exempt Organizations Reviewer, Before the ALI-ABA Conference on Tax-exempt Organizations," Tax Notes Today, 2004 TNT 25-25 (Feb. 6, 2004).
42 Treas. Reg. § 53.4958-1(d)(4)(iv).
43 Treas. Reg. § 53.4958-1(d)(4)(iii).
44 See, e.g., Mich. Comp. Laws § 450.2110(2) (defines a volunteer director as "a director who does not receive anything of more than nominal value from the corporation for serving as a director other than reasonable per diem compensation and reimbursement for actual, reasonable, and necessary expenses incurred by a director in his or her capacity as a director").