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## Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?

### Cover Page Footnote

Professor Jill S. Manny, New York University School of Law; Executive Director, National Center on Philanthropy and the Law. Thanks to Roger Colinvax and Linda Sugin for making me write this essay, to Elizabeth Boris for her comments, and to Aric Hansen, Alex Roberts, and Elisabeth Lerner for their invaluable research assistance. Thanks also to Professor Stephen Schwarz for his insightful comments and to Marion Fremont-Smith for providing us with so many wonderful resources that it makes writing much easier and more tempting. And thanks to Professor Harvey Dale for his many years of guidance and friendship.

# NONPROFIT PAYMENTS TO INSIDERS AND OUTSIDERS: IS THE SKY THE LIMIT?

*Jill S. Manny\**

## INTRODUCTION

A quick peek at *The Chronicle of Philanthropy* salary survey indicates that salaries of nonprofit organization executives have increased dramatically over the past decade.<sup>1</sup> Newspaper coverage of this topic suggests that some of these salary increases have not been well considered or properly approved.<sup>2</sup>

Over the past few decades, the law has struggled, somewhat unsuccessfully, to control these salary increases. In the summer of 1996, Congress enacted legislation as part of the Taxpayer Bill of Rights II in an attempt to curtail excessive payments to nonprofit executives.<sup>3</sup> The legislation, which was codified as § 4958 of the Internal Revenue Code,<sup>4</sup> imposes penalty excise taxes as a sanction on public charities and social welfare organizations that engage in “excess benefit transactions.”<sup>5</sup>

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\* Professor Jill S. Manny, New York University School of Law; Executive Director, National Center on Philanthropy and the Law. Thanks to Roger Colinvax and Linda Sugin for making me write this essay, to Elizabeth Boris for her comments, and to Aric Hansen, Alex Roberts, and Elisabeth Lerner for their invaluable research assistance. Thanks also to Professor Stephen Schwarz for his insightful comments and to Marion Fremont-Smith for providing us with so many wonderful resources that it makes writing much easier and more tempting. And thanks to Professor Harvey Dale for his many years of guidance and friendship.

1. See Noelle Barton et al., *Top Nonprofit Executives See Healthy Pay Raises*, Chron. of Philanthropy, Sept. 28, 2006, at 39; Noelle Barton & Peter Panepento, *Executive Pay Rises 4.6%*, Chron. of Philanthropy, Sept. 20, 2007, at 34.

2. See Michael W. Peregrine & Robert C. Louthian, *American University: Significant Implications for Nonprofits*, 50 Exempt Org. Tax Rev. 337 (2005); Beth Healy et al., *Charity Money Funding Perks*, Boston Globe, Nov. 9, 2003, at A1; Beth Healy et al., *Some Officers of Charities Steer Assets to Selves*, Boston Globe, Oct. 9, 2003, at A1; Michael Rezendes, *AG's Charities Chief to Review Salaries at 2 Foundations*, Boston Globe, Dec. 23, 2003, at A1.

3. Pub. L. 104-168, 110 Stat. 1475 (1996) (codified as amended at I.R.C. § 4958 (2000)). The Treasury issued proposed Regulations under this provision in the summer of 1998, issued temporary Regulations in January 2001, and issued final Regulations in January 2002. Treas. Reg. § 53.4958 (2006).

4. All section references, unless otherwise indicated, refer to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

5. I.R.C. § 4958(a)(1). The statute defines “excess benefit transaction” as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of

These rules are not meant to penalize public charities. Rather, they are viewed positively, as an intermediate sanction which allows the Internal Revenue Service (IRS) to discipline a charitable organization without revoking its tax-exempt status if the organization crosses over into an inurement situation<sup>6</sup> but still generally operates for the benefit of the public.

The statute and regulations also are favorable to charities because they dictate a procedure that charities can follow in order to avoid wasting charitable assets while compensating executives. They create a safe harbor process for organizations to follow in setting certain salaries,<sup>7</sup> under the theory that organizations that follow this process are more apt to set reasonable, or at least market rate, salaries than organizations that set salaries outside the process.<sup>8</sup> Ultimately, the intermediate sanctions provisions are all about process, not substance.

There is evidence, however, that § 4958 and its process have not been effective in reducing or even maintaining salary levels in the nonprofit sector. In fact, since 1996, salaries paid to organizational insiders have skyrocketed.<sup>9</sup> There is some indication that stratospheric compensatory payments made by public charities are not limited to payments made to “disqualified persons.”<sup>10</sup> Several cases, as well as newspaper articles,

the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.” *Id.* § 4958(c)(1)(A).

6. Loosely translated, the inurement proscription is generally considered to prohibit the flow of assets of a charity away from the charity for non-charitable purposes to someone with substantial influence over the charity. *See supra* Part II.A. The intermediate sanctions imposed under § 4958 are not intended to extend the definition of “inurement.” *See* Harvey P. Dale, *The Crux of Charity: Inurement, Private Benefit, and Excess Benefit Transactions* (Oct. 28, 2004) (unpublished manuscript on file with N.Y. Univ. Sch. of Law), available at [http://www.law.nyu.edu/nepi/library/publications/Conf2004\\_Dale\\_DRAFT.pdf](http://www.law.nyu.edu/nepi/library/publications/Conf2004_Dale_DRAFT.pdf). Professor Dale’s article contains an excellent discussion of the inurement concept and of the history of the enactment of I.R.C. § 4958.

7. Section 4958 only covers payments by public charities to executives with “substantial influence over the affairs” of the organization. The organizational insiders are referred to as “disqualified persons.” I.R.C. § 4958(f)(1)(A); Treas. Reg. § 53.4958-3(a); *see also* I.R.C. § 4958(c), (f)(1); Treas. Reg. § 53.4958-3(a).

8. *See infra* notes 46–47 and accompanying text.

9. Pablo Eisenberg, *Skyrocketing CEO Pay Raises Questions for Charities*, *Chron. of Philanthropy*, Feb. 8, 2007, at 37; Elizabeth Schwinn & Ian Wilhelm, *Nonprofit CEOs See Salaries Rise*, *Chron. of Philanthropy*, Oct. 2, 2003, at 27.

Compensation for the leaders of the nation’s largest nonprofit organizations rose at more than twice the rate of inflation last year . . . .

The chief executives at the nation’s biggest charities and foundations received a median pay increase of 4.6 percent in 2006, a year in which the inflation rate was 2 percent.

....

The results reflect a decade-long trend in which compensation growth for executives of large nonprofit groups outpaced inflation.

Barton & Panepento, *supra* note 1, at 34.

10. I.R.C. § 4958(f)(1); Treas. Reg. § 53.4958-3(a). In the statute and the Treasury Regulation, “disqualified persons” are defined generally as those with “substantial influence over the affairs of the organization.” I.R.C. § 4958(f)(1); Treas. Reg. § 53.4958-3(a); *see also* *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1175–76 (7th Cir. 1999).

highlight substantial compensatory payments made to persons and entities without “substantial influence” who provide services to public charities.<sup>11</sup> A review of the annual disclosure returns filed by various hospitals and universities reflects high salaries paid to physicians, football coaches, and money managers, often topping the amounts paid to the hospital’s or the university’s chief executive.<sup>12</sup> In many instances, these payments are subject to neither the process nor the sanctions imposed under § 4958 because the recipients of the payments are not disqualified persons.<sup>13</sup>

This essay examines whether § 4958 or a similar regime should be applied to private benefit transactions that do not involve insiders or disqualified persons. Part I of the essay presents a discussion of current standards of “reasonableness” in both the for-profit and the nonprofit sectors. Part II of the essay examines the current regime of restrictions and sanctions in the nonprofit sector that seeks to limit salaries to “reasonable” amounts. It examines excess benefit transactions, as well as the interrelated concepts of private inurement and private benefit, from both a policy and a technical perspective, in order to determine whether any of the available restrictions and sanctions are effective in limiting what many consider to be excessive salaries.

Part III of the essay examines the problem of increasing salaries of non-insiders in the nonprofit sector. Part IV discusses the policy considerations behind the enactment of § 4958 and argues that while § 4958 is effective as to process, it does not succeed in limiting or reining in executive salaries in the nonprofit sector. The purpose of § 4958 is not to rein in executive salaries, but rather, its purpose is to ensure that executive salaries in the nonprofit sector reflect market rates. For these purposes, a “reasonable” salary is a salary that reflects the market for similar positions in the same or similar locations. Organizations that follow the process clearly are more likely to set market rate salaries than those that ignore the process. For this and other reasons, § 4958 or some similar process and sanctions should be compelled in private benefit, non-inurement situations where the compensated individual does not have substantial influence over the affairs of the organization. Part V addresses the advisability of applying § 4958 in non-inurement private benefit situations. Part V concludes by suggesting some alternative mechanisms and modifications to current law that, if implemented, may deter payments of excessive compensation both to insiders and to outsiders.

### I. STANDARDS OF REASONABLENESS

The concept of reasonableness “defies simple interpretation by tax experts in the same manner that the hypothetical reasonable man escapes

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11. Barton & Panepento, *supra* note 1, at 34; Stephanie Strom, *I.R.S. Finds Errors in Reports of Nonprofits*, N.Y. Times, Mar. 1, 2007, at A15.

12. Barton & Panepento, *supra* note 1, at 34

13. I.R.C. § 4958(a), (c), (f)(1); Treas. Reg. § 4958-3.

precise definition by negligence lawyers and the concept of reasonable doubt remains an elusive factor in the criminal law.”<sup>14</sup> Thus, it seems impossible to formulate an objective standard of reasonableness to moderate executive salaries in either the for-profit or the nonprofit sector. The IRS and the courts are left with a subjective facts and circumstances test to measure reasonableness.

#### A. For-Profit Standards and Penalties

In enacting § 4958 in 1996, Congress indicated that relevant nonprofit sector salaries should be set using comparables and that those comparables could include salaries paid by similarly situated for-profit entities as well as nonprofit organizations.<sup>15</sup> It makes sense, therefore, to first examine briefly the policy, standards, process, and penalties used to set for-profit compensation.

Section 162 of the Internal Revenue Code allows for-profit entities a tax deduction for a “reasonable allowance for salaries or other compensation for personal services actually rendered.”<sup>16</sup> According to the Treasury Regulations accompanying § 162, the “test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.”<sup>17</sup> The Regulations further provide that “reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances” on “the date when the contract for services was made, not those existing at the date when the contract is questioned.”<sup>18</sup>

This language clearly anticipates a facts and circumstances test, which, by definition, establishes a subjective and nonmeasurable standard for reasonableness of compensation in the for-profit sector. Its focus on market comparables suggests that any market rate salary will qualify as reasonable. The goal, then, of the “reasonableness” restriction under § 162 is to achieve salaries at market rates. Code § 4958’s reliance on § 162 standards suggests a similar market rate target in the charity realm.

Neither the Internal Revenue Code nor the Treasury Regulations specify an objective test for determining reasonable compensation. In the for-profit realm, the IRS and the courts generally have sought to identify various facts and circumstances that might help them to arrive at an estimate of reasonableness in a particular situation. The determination of what constitutes reasonable compensation is “a question of fact, to be determined

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14. Gerald A. Kafka, *Reasonable Compensation*, 390-3d Tax Mgmt. Portfolio (BNA), at A-3 (2001).

15. Staff of J. Comm. on Taxation, 104th Cong., General Explanation of Tax Legislation Enacted in the 104th Congress 57-58 (Comm. Print 1996), available at <http://www.house.gov/jct/s-12-96.pdf>; see also Treas. Reg. § 53.4958-6(c)(2).

16. I.R.C. § 162(a)(1).

17. Treas. Reg. § 1.162-7(a).

18. Treas. Reg. § 1.162-7(b)(3). Similar language is repeated in the Treasury Regulations accompanying I.R.C. § 4958. See Treas. Reg. § 53.4958-4(b)(1)(ii).

by the peculiar facts and circumstances in each particular case.”<sup>19</sup> There is no single determinative factor and the IRS does not issue letter rulings or technical advice on the issue of whether the “compensation is reasonable in amount.”<sup>20</sup> Without precedential IRS rulings or statutory guidance, the determination of reasonable compensation is, as the U.S. Court of Appeals for the Sixth Circuit concluded in *Kennedy v. Commissioner*,<sup>21</sup> “more nearly an art than a science.”<sup>22</sup>

Although no codified or regulatory method exists for determining the reasonableness of compensation, the IRS and the courts loosely apply a multifactor test. When determining the reasonableness of a salary, “[t]he situation must be considered as a whole, with no single factor being decisive.”<sup>23</sup> The Internal Revenue Manual lists eight factors for determining the reasonableness of compensation.<sup>24</sup> The courts have focused on various several groups of factors, but there is no single definitive list.

The U.S. Tax Court and appellate courts have built several multifactor tests in an attempt to standardize the criteria used for making these determinations. The Sixth Circuit developed a list of nine factors in *Mayson Manufacturing Co. v. Commissioner*.<sup>25</sup> Another court divided the factors into five broad categories that essentially cover every aspect of the compensation arrangement<sup>26</sup> and other courts have devised similar facts and circumstances tests,<sup>27</sup> many with factors that overlap the *Mayson* test.<sup>28</sup> However, none of these tests is sufficiently objective to create a measurable or objective standard of reasonableness.<sup>29</sup> It appears then, that we are left

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19. *Miller Mfg. Co. v. Comm’r*, 149 F.2d 421, 423 (4th Cir. 1945) (citing *H. Levine & Bros. v. Comm’r*, 101 F.2d 391 (7th Cir. 1939)).

20. Rev. Proc. 2005-3, § 3.01(16), 2005-1 C.B. 118, 119.

21. 671 F.2d 167 (6th Cir. 1982).

22. *Id.* at 173.

23. *Pepsi-Cola Bottling Co. of Salina v. Comm’r*, 528 F.2d 176, 179 (10th Cir. 1975).

24. See IRS, Internal Revenue Manual: Audit Techniques for Business Returns (May 5, 2006), <http://www.irs.gov/irm/part4/ch33s02.html#d0e460533>.

25. 178 F.2d 115, 119 (6th Cir. 1949) (“Such factors include the employee’s qualifications; the nature, extent and scope of the employee’s work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.”).

26. *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1245 (9th Cir. 1983) (citing factors including (1) role in company, (2) external comparison, (3) character and condition of the company, (4) conflict of interest, and (5) internal consistency).

27. See, e.g., *Rutter v. Comm’r*, 853 F.2d 1267, 1271 (5th Cir. 1988); *Pepsi-Cola Bottling*, 528 F.2d at 179; *Trucks, Inc. v. United States*, 588 F. Supp. 638, 642–43 (D. Neb. 1984).

28. Still other courts have used an independent investor standard. See *Elliotts*, 716 F. 2d at 1245.

29. The existing § 162 standard of reasonableness has been interpreted to make it malleable to the individual circumstances of the case. This is reflected in the variety of

with a standard of comparables and market rates. Tying reasonableness to market comparables, however, assumes that the comparables are reasonable, which may not be the case. If inflated comparables can be found and utilized, inflated compensatory arrangements may result. If this process is repeated, the inflated compensatory arrangements become market rate, and salaries continue to soar. But it is significant to keep in mind that, to the extent that a particular salary is comparable to salaries for similar positions (i.e., reflects market rates), it should qualify as reasonable for these purposes.<sup>30</sup>

Process in the for-profit sector authorizes boards of directors of for-profit corporations to set compensation and, in the absence of waste or malfeasance, the decisions of boards generally are upheld under the "business judgment rule."<sup>31</sup> Corporate fiduciaries are held to a duty of care and a duty of loyalty. The business judgment rule shields directors from liability for decisions made in the ordinary course of business. When self-dealing is charged in a for-profit context, courts are more likely than not to sustain executive compensation where the interested executive made a full disclosure of the plan, the plan was approved by either a committee of disinterested directors or shareholders, and the plan was fair to the corporation.<sup>32</sup> In these instances, the court generally will use the business judgment rule to determine if the directors have complied with the duties of loyalty and care.<sup>33</sup>

Courts can challenge the compensation set by boards in the for-profit sector, but such challenges are rare. Courts generally are unwilling to

factors that different courts consider in determining whether or not compensation may be defined as reasonable for the purposes of § 162. While different courts have added and subtracted a great variety of factors, there is no "definitive list." *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001) (illustrating the lack of a definitive list by documenting the different number of factors used by five other courts).

30. This is not intended to provide a complete discussion of the standards of reasonableness under § 162. For a detailed discussion of that issue, see Michael Q. Eagan, Note, *Reasonable Compensation and the Close Corporation: McCandless, the Automatic Dividend Rule, and the Dual Level Test*, 26 Stan. L. Rev. 441 (1974).

31. *Heller v. Boylan*, 29 N.Y.S.2d 653, 667-72 (Sup. Ct. 1941) (illustrating that courts are reluctant to interfere and that the business judgment rule applies to executive compensation decisions), *aff'd*, 32 N.Y.S.2d 131 (App. Div. 1941); see also Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. Corp. L. 631 (1998).

32. According to the American Law Institute,

A director or officer who makes a business judgment in good faith fulfills his duty [of care] if:

- (1) he is not interested in the subject of his business judgment;
- (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
- (3) he rationally believes that his business judgment is in the best interests of the corporation.

Principles of Corporate Governance: Analysis and Recommendations § 4.01(c) (Tentative Draft No. 11, 1991) (citation omitted).

33. See *supra* note 32 and accompanying text.



intervene in decisions made by boards of directors and therefore tend not to second-guess boards' compensation plans. For example, in *Heller v. Boylan*, the court felt that it was "ill-equipped to solve or even to grapple with [this] entangled economic problem[]."34 The court stated that shareholders are best able to determine "what is reasonable compensation for [the corporation's] officers."35 In an unusual case, the U.S. Supreme Court did challenge a compensation arrangement and found that the compensation plan in question violated the corporate waste doctrine even though it had been ratified by the company's shareholders.36 Courts rarely deem compensation schemes unreasonable because of the dearth of guidelines available to determine whether compensation is sufficiently excessive to result in corporate waste. The absence of any objective standard of reasonableness and the wide range of comparables available in the market give directors significant leeway and protection in setting executive compensation in the for-profit arena.

The sanctions for excessive salaries in the for-profit sector are distinct from those available in the nonprofit sector. Aside from the potential loss of a tax deduction under § 162 at the corporate level, shareholder derivative suits and shareholder proxy actions with respect to elections of directors or changes in bylaws may be utilized to keep for-profit salaries in check. None of these sanctions would be particularly relevant in the nonprofit sector because it is a non-shareholder realm.

### B. *Nonprofit Standards and Sanctions*

In enacting § 4958 in 1996, Congress made clear that, for purposes of the new statute, the standards of reasonableness set forth in § 162 of the Internal Revenue Code and its accompanying regulations would apply.37 Like the for-profit sector, reasonableness in the nonprofit sector is based on market comparables. Charities are permitted to pay reasonable compensation for services rendered. Reasonable salaries are defined as "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances. . . . Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits . . . provided to a person and the rate at which any deferred compensation accrues."38

As mentioned above, reasonableness is determined more by process than through objective criteria.39 The final Treasury Regulations promulgated under § 4958 create a rebuttable presumption of reasonableness that sets

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34. *Heller*, 29 N.Y.S.2d at 680.

35. *Id.*

36. *See* *Rogers v. Hill*, 289 U.S. 582 (1933).

37. H.R. Rep. No. 104-506, at 56 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1124, 1179 ("Existing tax-law standards (see sec. 162) apply in determining reasonableness of compensation and fair market value.").

38. Treas. Reg. § 53.4958-4(b)(1)(ii) (2006).

39. *See supra* Introduction.

forth a process to be followed in setting salaries.<sup>40</sup> Following the process creates a safe harbor for the cooperative organization, which shifts the burden of proof of reasonableness to the IRS.<sup>41</sup> Once the burden shifts, the IRS will be required to present “sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction” in order to prove an excess benefit transaction.<sup>42</sup>

The process for establishing a rebuttable presumption of reasonableness under § 4958 is threefold. First, compensation decisions must be approved by a board or committee of the board composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement being considered.<sup>43</sup> Second, the authorizing body must properly base its decision on comparables, as discussed below.<sup>44</sup> And third, the authorizing body must properly document the basis for its determination.<sup>45</sup> These procedures are not required, and an organization failing to follow this process will not automatically be subject to sanctions as a result of such failure, but adhering to this process will provide the organization with a safe harbor by giving rise to the aforementioned rebuttable presumption of reasonableness that shifts the burden of proof of reasonableness to the Service.<sup>46</sup> The policy behind the grant of this presumption must be that it is more likely that organizations following the procedure to produce this presumption will set salaries at market rates than those that do not adhere to the procedure. There is some merit to this suggestion.<sup>47</sup>

The Treasury Regulations promulgated under § 4958 attempt to define the types of data necessary to prove reasonableness of compensation, including (1) “compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions”; (2) “the availability of similar services in the geographic area of the applicable tax-exempt organization”; (3) “current compensation surveys compiled by independent firms”; and (4) “actual written offers from similar institutions competing for the services of the disqualified person.”<sup>48</sup> Data that satisfies these requirements will fulfill the second prong of the process for securing the rebuttable presumption of reasonableness.

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40. See Treas. Reg. § 53.4958-6.

41. See *id.*

42. H.R. Rep. No. 104-506, at 56 (1996), reprinted in 1996 U.S.C.C.A.N. 1124, 1179; Treas. Reg. § 53.4958-6(c).

43. Treas. Reg. § 53.4958-6(c).

44. *Id.*

45. *Id.*

46. See *id.* § 53.4958-6(e). Note that these procedures do not apply to setting compensation for non-disqualified persons. The process also does not apply to individuals hired under initial contracts. See *id.* § 53.4958-3(a).

47. A.L. (Lorry) Spitzer, *Executive Compensation in Nonprofit Health Care Organizations: Who's in Charge?*, 15 Health Matrix 67, 73 (2005).

48. Treas. Reg. § 53.4958-6(c)(2)(i).

The process for setting compensation, while helpful in that it requires attention to and affirmative action in salary setting, does nothing to establish an objective standard of reasonableness. Nor would it make sense for the IRS to police the actual salaries paid by hundreds of thousands of public charities. The compensation arrangements arrived at through the process are likely to be, more or less, reflective of market rates for similar services in the nonprofit and for-profit sectors in the same or similar geographic location. But as those market rates rise, compensation may exceed what the public would perceive as reasonable. In effect, if an organization sets a salary based on another salary or collection of salaries that is excessive, the second salary may be deemed “reasonable” for purposes of establishing a rebuttable presumption of reasonableness, although it may in fact, by many standards, not be reasonable at all. Again, inflated comparables are likely to protect an organization but still give rise to inflated compensatory arrangements. In a short period of time, the process can lead those inflated compensation arrangements to set the market rate standard.

Although the standards in the charitable sector mirror the standards in the for-profit sector, the sanctions do not. Sanctions in the nonprofit sector are primarily government imposed, namely, intermediate sanctions under § 4958 and the ultimate sanction of loss of exemption available under § 501(c)(3).<sup>49</sup> Arguably, the public can sanction a charity for excessively compensating its executives through withholding of charitable contributions and refusal to purchase the charity’s goods and services, but this public impact requires disclosure and transparency that currently are difficult to detect in the nonprofit realm.<sup>50</sup>

### C. *The End Result*

In sum, measuring reasonableness for purposes of § 4958 by reference to the reasonableness standards used to measure compensation in the for-profit sector gives rise to several inevitable flaws in outcome. First, the standard articulated under § 162 does not delineate a particularly concise and measurable standard of reasonableness. It is difficult, perhaps impossible, to determine with any certainty what the limits of reasonableness are with respect to the salary for any particular executive position in a for-profit corporation or a nonprofit organization. Second, although the process and sanctions for establishing reasonableness in the for-profit sector may appear to be more robust than the process and sanctions available to charities, the standards are equally subjective and the resulting salaries in the for-profit sector may be even more inflated.<sup>51</sup> Third, the sin of exorbitant salaries in the charitable sector seems somehow greater because of the availability of

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49. *See infra* Part II.B–C.

50. *See infra* Part V.C.7.

51. Gretchen Morgenson, *Outside Advice on Boss’s Pay May Not Be So Independent*, N.Y. Times, Apr. 10, 2006, at A1.

the charitable contribution deduction.<sup>52</sup> In other words, funding extravagant salaries with deductible contributions from the public is more offensive than funding enormous salaries with for-profit corporate earnings. And fourth, in any sector, determining compensation through comparables that may be excessive because of the absence of an objective standard of reasonableness is likely to result in compensation arrangements that meet market standards but not the public perception of reasonableness. Perhaps the lack of precision in determining reasonableness of salaries is not sector specific. In other words, setting and measuring reasonable salaries may simply be impossible. The best that we can hope for and achieve is salaries that comply with market rates. That seems to have been the goal of Congress in enacting § 4958 of the Internal Revenue Code.

## II. THE CURRENT REGIME

Compensatory payments made by charities<sup>53</sup> are subject to a three-part regulatory regime. Three interrelated concepts—*inurement*, *private benefit*, and *excess benefit transactions*<sup>54</sup>—create a regime that aims to limit executive salaries paid by charities to “reasonable” amounts. All of these concepts police the same boundary aimed at ensuring that charities operate for public, rather than private, benefit.<sup>55</sup>

### A. *Private Inurement*

The *inurement* concept derives from the language of the Internal Revenue Code, which states in § 501(c)(3), that an organization will qualify for exemption under that provision only if “no part of [its] net earnings . . . inures to the benefit of any private shareholder or individual.”<sup>56</sup> This restriction applies to all organizations exempt under § 501(c)(3).

The *inurement* proscription is drafted somewhat incomprehensibly. Although it is not specifically defined in the Internal Revenue Code or the Treasury Regulations, the doctrine of *private inurement* is generally considered to prevent income and assets of a tax-exempt organization from flowing away from the organization to one or more persons with control over the organization for nonexempt, non-charitable purposes. The essence

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52. I.R.C. § 170 (2000).

53. Such payments refer to all organizations exempt under § 501(a) and described in § 501(c)(3), comprising both public charities and private foundations.

54. A similar, albeit more wide-reaching set of restrictions, is applied in the private foundation universe to prohibit transactions between private foundations and disqualified persons with respect to those foundations. I.R.C. § 4941.

55. For an excellent discussion of the history of these three concepts, see Dale, *supra* note 6, at 11–32.

56. I.R.C. § 501(c)(3).

of the concept is to ensure that an exempt organization subject to this provision will serve a public interest rather than a private interest.<sup>57</sup>

The private inurement doctrine represents the substantive dividing line between nonprofits and for-profits because it mandates the non-distributional constraint. For the most part, the characteristics of nonprofits and for-profits are identical—both entities must be created in some legal form (e.g., trust, fund, corporation), pay compensation to employees, incur similar expenses, may make investments, are able to receive a profit, and produce and sell goods or provide services.<sup>58</sup> But, a nonprofit, unlike a for-profit, cannot distribute its profits to those who control it, other than as reasonable compensation.<sup>59</sup> This restraint is intended to insure that the assets of a tax-exempt organization inure to public, rather than private, benefit. The non-distribution restraint is the primary distinction between nonprofits and for-profits.<sup>60</sup>

Under § 501(c)(3), the private inurement proscription is an absolute proscription, the violation of which should cause an organization to fail the operational test and to lose its tax-exempt status. In other words, the proscription has a hair trigger—one dollar of inurement is enough. There is no *de minimis* exception to the inurement prohibition.<sup>61</sup> Because revocation of exemption seemed like a rather severe penalty, and perhaps because it had the effect of penalizing a charity and its beneficiaries rather than the perpetrator in certain cases, the penalty often was not imposed, at least in cases of minor inurement.<sup>62</sup> This means that no sanction was imposed at all, even though some public money went to serve a private purpose.

### B. *Private Benefit*

A concept that is similar to and overlaps at some points with the private inurement proscription is the private benefit limitation. The two concepts are distinct and separate requirements for exemption.<sup>63</sup> The private benefit

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57. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2006); I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991). See generally John D. Colombo, *In Search of Private Benefit*, 58 Fla. L. Rev. 1063 (2006).

58. See *Camps Newfoundland/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 585 (1997); James J. Fishman & Stephen Schwarz, *Cases and Materials: Nonprofit Organizations* 476 (3d ed. 2006); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497, 501–04 (1981) [hereinafter Hansmann, *Reforming Nonprofit Corporation Law*]; Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835, 838 (1980).

59. Subcomm. on Oversight of H. Comm. on Ways and Means, 103d Cong., Report on Reforms to Improve the Tax Rules Governing Public Charities 14–15 (1994).

60. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 58, at 501–02.

61. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

62. *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179–80 (7th Cir. 1999); *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1068 (1989); I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

63. *Am. Campaign Acad.*, 92 T.C. at 1068; see also H.R. Rep. No. 104-506, at 53 n.2 (1996), reprinted in 1996 U.S.C.C.A.N. 1124, 1176 n.2.

restrictions apply to insiders as well as to third parties, and prohibit anything more than the receipt of incidental private benefits by a person. Unlike private inurement, then, the test for private benefit is both qualitative and quantitative—private benefit must be both qualitatively and quantitatively incidental.<sup>64</sup> Also unlike private inurement, private benefit is not subject to a hair trigger.

The private benefit proscription is not found in the Internal Revenue Code; it is expressed only through the regulations, case law, and IRS rulings. It derives, perhaps loosely, from § 1.501(c)(3)-1(d)(1)(ii) of the Treasury Regulations, which provides that an organization will not qualify for exemption under § 501(c)(3) “unless it serves a public rather than private interest.”<sup>65</sup> Thus, “it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”<sup>66</sup>

The doctrine of private benefit then differs from private inurement in three significant respects. First, the private benefit proscription applies to payments to insiders as well as to payments to “disinterested persons” while the inurement proscription applies only to payments to organizational insiders.<sup>67</sup> Second, private benefit will only result in a sanction if it is qualitatively and quantitatively more than incidental, while private inurement is not subject to a de minimis threshold.<sup>68</sup> And third, the only available sanction for private benefit is the ultimate sanction of loss of exemption, while the most likely sanction for most forms of private inurement in a public charity is an excise tax under § 4958. As stated by Professor Harvey Dale, “[T]he inurement rules require the finding of an ‘insider’ and are then trigger happy; the private benefit rules apply to any recipient of a private benefit but require a balancing of benefits to the public against the benefits to the recipient.”<sup>69</sup>

### C. Excess Benefit Transactions

The third concept in the border patrol regime safeguarding charitable assets from private interests is the proscription against “excess benefit

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64. As the U.S. Tax Court concluded in *American Campaign Academy*, “[N]onincidental benefits conferred on disinterested persons may serve private interests.” 92 T.C. at 1069. See also *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179–80 (7th Cir. 1999).

65. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2006).

66. *Id.*

67. See *Am. Campaign Acad.*, 92 T.C. 1053; Fishman & Schwarz, *supra* note 58, at 485–86.

68. I.R.S. Announcement 92-83, 1992-22 I.R.B. 59; I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

69. Dale, *supra* note 6, at 14; see also Colombo, *supra* note 57, at 1067–69.

transactions” imposed by § 4958. This provision is a relative newcomer to the regime, having been enacted in 1996.<sup>70</sup>

Section 4958 imposes penalty excise taxes as an intermediate sanction on § 501(c)(3) public charities and on § 501(c)(4) organizations that engage in “excess benefit transaction[s].”<sup>71</sup> “Excess benefit transaction” is defined in § 4958(c)(1) as “any transaction in which an economic benefit is provided . . . directly or indirectly to or for the use of any disqualified person” if “the value of the economic benefit provided [to the disqualified person] exceeds the value of the consideration (including performance of services) received by the organization for providing such benefit.”<sup>72</sup> This definition refers primarily to two kinds of transactions: (a) excess compensation paid to a disqualified person by a public charity or social welfare organization and (b) transactions between a disqualified person and a public charity or social welfare organization (e.g., lease, loan, sale, royalty arrangement) that unduly favor the disqualified person.<sup>73</sup>

### III. THE PROBLEM

Many charities pay substantial salaries to persons who do not fall within the definition of disqualified persons for purposes of § 4958. Even if those salaries are excessive, no sanctions are likely to be imposed. For example, it has been reported that, for the fiscal year ending in 2006, New York University (NYU) President John Sexton was not the most highly paid employee at NYU.<sup>74</sup> That honor went to James Grifo, M.D., a professor of obstetrics and gynecology at the university’s medical school, who earned \$2,823,406 for the same period.<sup>75</sup> In fact, the five most highly paid individuals at the university all are on the NYU School of Medicine faculty, all have the same office address as Dr. Grifo, and all earned in excess of \$2,000,000 for that period.<sup>76</sup> More significantly for the purposes of this essay, while President Sexton is undoubtedly an insider for purposes of the inurement proscription<sup>77</sup> and a disqualified person for purposes of the excess benefit transaction provisions, Dr. Grifo and his colleagues arguably

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70. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311(a), 110 Stat. 1452, 1475–79 (1996) (codified at I.R.C. § 4958 (2000)).

71. Dale, *supra* note 6, at 29–30.

72. I.R.C. § 4958(c)(1). Note that § 4958(c)(4) extends the definition to include certain revenue sharing transactions, where the benefit provided to the disqualified person is determined in whole or in part by the revenues of one or more activities of the organization, but only to the extent provided in the Treasury Regulations. As no such Regulations have been promulgated to date and it is unlikely that the Treasury will promulgate Regulations on this point in the near future, this essay will not focus on this portion of the definition of “excess benefit transaction.” The Pension Protection Act of 2006 also expanded the definition of “excess benefit transaction” by adding § 4958(c)(2)–(3) to the Internal Revenue Code. These provisions are not discussed in this essay.

73. See I.R.C. § 4958(c)(1); Treas. Reg. § 53.4958-4(a)(1)–(2) (2006).

74. Cf. Barton & Panepento, *supra* note 1.

75. *Id.*

76. *Id.*

77. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

do not wield substantial influence over the affairs of the university or even over 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,”<sup>78</sup> and therefore may not be subject to the inurement proscription or the excess benefit transaction sanctions.<sup>79</sup> If these salaries are excessive, the only penalty available is loss of exemption for the university under the private benefit doctrine. It is unlikely that the penalty will be imposed unless the university in question no longer seems to be operated primarily for its exempt public purposes. Accordingly, no sanction is likely to be imposed in this situation even if some assets of the university may flow to the private benefit of university employees for nonexempt purposes.

Similarly, much ink has been spilled in the press regarding the salaries of the Harvard Management Company (HMC) money management gurus led by Jack Meyer, who recently left Harvard to form his own fund largely because of the publicity.<sup>80</sup> The salaries of certain HMC employees exceeded \$35 million in 2003, while Mr. Meyer himself earned a mere \$6.9 million that year for managing an endowment in excess of \$19.3 billion dollars.<sup>81</sup> While Mr. Meyer arguably was a disqualified person subject to § 4958, many of the other highly compensated money managers undoubtedly did not have substantial influence over the affairs of Harvard or the HMC. Accordingly, they were not subject to § 4958’s compensation-setting process or sanctions. If comparables had been applied to determine the reasonableness of their salaries, the outcome of the reasonableness test would hinge largely on whether or not the comparables were derived from the for-profit or the nonprofit sector. During the same time period, University of Texas money manager Bob L. Boldt received \$743,316 for managing the second-largest university endowment, while David F. Swenson received \$1,027,685 for managing the third-largest university endowment at Yale University.<sup>82</sup> If comparables are to be drawn from other similarly situated universities in the nonprofit sector, the salaries of Mr. Meyer and his colleagues may appear excessive.<sup>83</sup> But if salaries of for-profit money managers are added to the compensatory pool, the HMC

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78. Treas. Reg. § 53.4958-3(e)(2)(v).

79. Even if it could be argued that Dr. James Grifo is a disqualified person as director of New York University’s fertility program, it would be hard to argue that the four physicians who work with him wield similar influence.

80. See generally Riva D. Atlas & Stephanie Strom, *Doesn't Anyone Want to Manage Harvard's Money?*, N.Y. Times, Aug. 5, 2005, at C1.

81. Charles Stein, *Harvard's \$12 Billion Man: Despite Outpacing His Peers, the Strong-Willed Endowment Chief Is Under Attack for Paying Millions to His Money Managers*, Boston Globe, Oct. 17, 2004, at D1; Stephanie Strom, *Harvard Money Managers' Pay Criticized*, N.Y. Times, Jun. 4, 2004, at A18.

82. See Strom, *supra* note 81.

83. See *id.* It would be important to take performance into account in that analysis. Harvard Management Corporation’s managers produced a total return of 12.5% after fees and expenses, David F. Swenson’s return at Yale was 8.8%, while the University of Texas saw a 12.8% return but earned on a smaller pool of funds. *Id.*



salaries will pale in comparison.<sup>84</sup> In any event, given the negative press and the outcry from the public and Harvard alumni, it seems that while the salaries of Mr. Meyer and his money managers are “reasonable” based on the market-based approach dictated by § 4958 and the Treasury Regulations, they do not comport with public perceptions of reasonable salaries. It also seems likely that even if the salaries of the money managers are inflated when compared to market comparables, Harvard will not lose its exempt status and no penalties will be imposed.

The problem posed by the examples described above is that the salaries flowing to Dr. Grifo and his colleagues and to the HMC money managers, particularly if they do not wield substantial control over the affairs of the universities or a discrete segment of the universities that employ them, are not likely to be excessive when measured under the standards of § 4958, § 162, or any other imaginable standard. The precise reason for this is that these highly compensated employees do not have the control to force their employers to pay them unreasonable amounts. It may be unfair to penalize someone who negotiates a lucrative arrangement in good faith and at arm’s length just for getting a good deal. To the extent that § 4958 is about process, the arm’s-length arrangement should sanitize the negotiation and result in market rate salaries without forcing the § 4958 process on the negotiations. In other words, with respect to non-insiders, perhaps the market should police the process, making the additional statutory procedure unnecessary. Ultimately, though, the market might not adequately perform this function.

It is worthwhile to consider the extent of the problem. In fact, although evidence is slim, the evidence that does exist suggests that most compensation paid in the nonprofit sector is not excessive. As Elizabeth Boris of the Urban Institute points out, “The factual basis for asserting that there is widespread excessive compensation in the nonprofit sector is weak—but the *perception* is undoubtedly true.”<sup>85</sup> A recent IRS report similarly concludes that “[e]xaminations completed to date do not evidence widespread concerns [about executive compensation] other than reporting.”<sup>86</sup> But both the statistics put forth by Boris and the IRS report confirm that the problem is not nonexistent and that where excess compensation is paid by nonprofits the numbers may be high. In other words, public funds are being expended for non-charitable purposes. If these payments can be curtailed without too much cost in terms of time or

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84. Stein, *supra* note 81; Strom, *supra* note 81.

85. Elizabeth T. Boris, Address at Nat’l Tax Ass’n’s 36th Annual Spring Symposium and State-Local Tax Program I (May 18, 2006) (transcript on file with author) (commenting on an earlier draft of this essay).

86. IRS, Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II, at 1 (2007), available at [http://www.irs.gov/pub/irs-tege/exec\\_comp\\_final.pdf](http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf). The report also states that since “this was not a statistical sample, no definitive statement can yet be made concerning the compliance level in this area.” *Id.*

money to the charities, it is a worthwhile pursuit, even if the problem is small.

The ultimate question is, Should the § 4958 regime be imposed in non-inurement private benefit situations? Before reaching a conclusion on that question, it is worthwhile to examine some of the policy questions surrounding the enactment of § 4958.

#### IV. POLICIES SURROUNDING THE ENACTMENT OF § 4958

Before contemplating an expansion of the application of § 4958 to non-inurement private benefit situations, it is prudent to examine Congress's impetus for its enactment of the intermediate sanctions regime. Three significant points are worth noting: First, the intermediate sanctions were endorsed by the IRS to provide additional but less draconian sanctions for violations of the inurement proscription. Second, the intermediate sanctions regime imposed by § 4958 was propelled largely by efforts of the nonprofit sector on which it was to be imposed.<sup>87</sup> And third, the point of the legislation was to enforce the standard of reasonable compensation through a process meant to produce market rate salaries for certain employees of charities.<sup>88</sup> There is no evidence that the legislation was intended to rein in or limit salaries other than to market rates.

When § 4958 was enacted in 1996, it was intended to provide an intermediate sanction, short of the ultimate sanction of loss of exemption, when the inurement proscription was violated but where the organization nevertheless seemed to be operating primarily for the exempt purposes for which it was formed. The inurement proscription is breached only in situations involving a charity and someone with substantial control over the charity or a segment of the charity (i.e., an insider or disqualified person).<sup>89</sup> The legislative history behind § 4958 quite clearly indicates that the provision is not intended to expand the reach of the inurement proscription.<sup>90</sup> The application of § 4958 in non-inurement private benefit situations would greatly expand the reach of the inurement proscription.

The primary reason for enacting the intermediate sanctions under § 4958 was not to penalize charities.<sup>91</sup> Rather, the availability of the intermediate sanction was intended to benefit charities in that it provided a penalty short of the ultimate penalty for charitable organizations that engaged in some, perhaps *de minimis*, amount of inurement.<sup>92</sup> As discussed earlier, the inurement proscription does not require a minimum amount of inurement in order to elicit the ultimate sanction.<sup>93</sup> One dollar of inurement technically

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87. For an excellent discussion and analysis of the legislative history supporting these conclusions, see Dale, *supra* note 6, at 21–22.

88. See Spitzer, *supra* note 47.

89. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

90. H.R. Rep. No. 104-506, at 56 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1124, 1179.

91. See Dale, *supra* note 6, at 19.

92. *Id.*

93. See I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

violates the language of § 501(c)(3) of the Internal Revenue Code.<sup>94</sup> Inurement, therefore, is subject to a hair trigger, so that indisputably charitable organizations could, in theory if not in practice, suffer the ultimate sanction for a de minimis instance of inurement.

Prior to the enactment of § 4958 in 1996, the only sanction available for excessive payments to insiders in a public charity was revocation of exemption.<sup>95</sup> The policy behind the enactment of the § 4958 intermediate sanctions seems to be that if an organization is not operating primarily for charitable purposes it should not be exempt as a charity, whether because of too much inurement to insiders or because of too much private benefit to third parties. In that case, the exemption should be revoked. But in some instances the overly generous organization continues to operate primarily for charitable purposes in spite of some private inurement flowing to someone with substantial influence over the organization. In these cases, the disqualified person should be punished (along with those entrusted with protecting the assets of the organization), rather than the entire organization and all of its donors and potential beneficiaries.<sup>96</sup> But § 501(c)(3), if read literally, has a hair trigger—any inurement will cost the organization its exemption. This is what § 4958 is meant to address—it protects otherwise charitable organizations from this hair trigger.<sup>97</sup>

The hair trigger in the inurement proscription has caused considerable enforcement issues for the IRS. In testimony at a congressional hearing in 1993, then-Commissioner of Internal Revenue Margaret Richardson said, in part,

The lack of a sanction short of revocation of exemption in cases in which an organization violates the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue. For example, assume that an examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to that

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94. *See id.*

95. *See* I.R.C. § 501(c)(3) (2000).

96. In situations involving inurement, excess benefit transactions, and self-dealing, the person receiving excessive payments from the charity is, by definition, an “insider” or “disqualified person” with respect to the charity. In other words, the inurement, excess benefit, and self-dealing regimes apply only to those with a special relationship to the charity that is likely to yield substantial influence over the organization to the overpaid individual. In the private benefit situation, sanctions may be applied to a charity for excessive payments to those without substantial influence over the charity making the payment, but the private benefit must be both qualitatively and quantitatively substantial, and the sanction is imposed on the organization and not on the overpaid individual. As a result, sanctions generally are not imposed in isolated instances of excessive salary or other compensation paid to non-disqualified persons as long as the charity is deemed primarily to be operated for charitable, exempt public purposes in spite of these instances of private benefit.

97. *See supra* Part II.C for a more detailed discussion of excess benefit transactions and § 4958.

paid to presidents of comparable universities. Alternatively, the university may have provided the president with a substantial interest-free loan. It may have paid for costly and luxurious amenities in the president's official residence. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community—employees, students, and area residents. Moreover, even if the organization's exemption were revoked, the president would be able to retain the benefits inappropriately received from the university. In short, the Service may be faced with the difficult choice of revoking an organization's exemption or taking no enforcement action as long as the compensation in question has been reported accurately on the individual's income tax return.<sup>98</sup>

The problem is clear. As Professor Dale comments, "Revocation would punish the innocent, disrupting many important relationships and expectations. It would have little or no impact on the recipient of the inurement."<sup>99</sup> This problem, which the intermediate sanctions regime sought to resolve, is caused by the hair trigger. The lack of a hair trigger in the private benefit situation makes the policy for applying the intermediate sanctions in non-inurement private benefit situations less vivid.

## V. SHOULD § 4958 APPLY TO PRIVATE BENEFIT SITUATIONS?

### A. Policy Considerations

For several reasons, requiring the process and imposing the penalties of § 4958 to compensatory arrangements involving non-disqualified persons seems wrong. First, as discussed above, if the regime does not effectively moderate salaries paid to those subject to its reach, why extend its reach? If the goal is to regulate salaries paid by charities and evidence is that the result will not reflect that goal, an extension of § 4958 to a much wider range of employees will simply increase the charity's administrative costs. In other words, the salaries will not decrease, and the costs of paying a salary consultant will reduce the funds that a charity has available to spend on programs. The result is a loss of funds for public purposes, a result not to be encouraged.

Second, it is difficult to justify penalizing someone without substantial influence over the affairs of a charity for negotiating a lucrative arrangement in good faith and at arm's length. If excessive compensation is the result of such negotiations, it is fallacious to assign blame to the skillful negotiator. If any fault is to be found, it should be with those responsible

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98. *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the Comm. on Ways and Means*, 103d Cong. 18-19 (1993) (prepared statement of Hon. Margaret Milner Richardson, Comm'r of Internal Revenue).

99. Dale, *supra* note 6, at 19.

for negotiating and approving the contract on behalf of the charity. As Judge Richard Posner pointed out in *United Cancer Council v. Commissioner*, “[The outside fund-raiser] did not, by reason of being able to drive a hard bargain, become an insider of UCC.”<sup>100</sup> In other words, an excessive salary negotiated in good faith and at arm’s length by a non-insider might not be a good deal for the charity, but it is not inurement. The directors may have violated state corporate fiduciary duties of care. If this is the case, the penalty should be borne by the directors and imposed under state not-for-profit corporate law. Imposing sanctions on the overcompensated and the organization places the penalty on the skilled and the innocent rather than on the careless.

A third rationale dictating against the expansion of § 4958 to non-inurement private benefit transactions is more practical. If true standards of reasonableness do not exist either in the for-profit or the nonprofit realm, it becomes impossible to identify a salary that is unreasonable. In other words, in the absence of an ascertainable standard, delineating between reasonable and unreasonable payments is unfeasible except in extreme circumstances.<sup>101</sup> Unless a viable method for determining what constitutes an excess benefit transaction can be formulated, applying a set of rules that lacks an ascertainable standard to a new set of service providers will not meet the objective of moderating the amounts paid to the new group.

On the other hand, a strong policy does exist for policing salaries in pure private benefit situations. The fundamental tenet of the charitable sector is to ensure that the assets held by charities are used exclusively for public, charitable purposes rather than for private purposes. The goal of avoiding diversions of charitable assets for private purposes by prohibiting waste in the form of excessive compensation is paramount to the proper functioning of the nonprofit sector. After all, private benefit to non-insiders is and should be prohibited. To permit charitable assets to flow away from a charity for nonexempt purposes would be to violate the non-distribution constraint and to eradicate the fundamental distinction between the charity and General Motors. The argument would follow that, while § 4958 has not proved an effective tool in reducing or even stabilizing salaries, it is useful in directing charities to set salaries using a more rigorous process.<sup>102</sup> Perhaps, then, in spite of policies to the contrary, this policy should win out in an attempt to preserve charitable assets for charitable purposes.

#### B. *Applying the § 4958 Process to Payments to Non-disqualified Persons*

Section 4958 could be expanded to cover compensatory payments to some non-disqualified persons through a new regime crafted to apply only

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100. *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1178 (7th Cir. 1999).

101. For an example of an extreme circumstance where an excess benefit transaction was readily identifiable, see *Caracci v. Commissioner*, 118 T.C. 379 (2002).

102. See Spitzer, *supra* note 47, at 82.

to these non-inurement situations. It would be more efficient, however, to apply the current § 4958 regime to these situations because the regime is already in place and both charities and regulators are, slowly but surely, becoming familiar with the process that it compels. It would be wise to modify the process required by § 4958 for setting salaries for highly compensated non-disqualified persons because the policies for the extension of § 4958 to non-insider transactions is different and the lower policy threshold might not justify as formidable of a financial or administrative burden.

The first necessary modification to the current § 4958 standards would require expanding the definition of disqualified persons under § 4958 to include some portion of the persons most highly compensated by the charity, perhaps including some independent contractors. For example, a new category of disqualified person could include the top ten percent of all persons compensated by the charity, including both currently defined disqualified persons and a new group of non-influential but highly compensated disqualified persons.<sup>103</sup>

Second, because the lower policy threshold for subjecting non-inurement payments to § 4958's process and sanctions does not justify the same financial and administrative burden required for excess benefit transactions as currently defined, a modified and less cumbersome process should be implemented for the new set of transactions. The "do it yourself" process available to small organizations<sup>104</sup> could be modified to suit this purpose. It might suffice, for example, for a public charity using the § 4958 process to set a salary for a non-influential disqualified person to examine comparability data from perhaps five similarly situated organizations in the same location for similar positions. Required comparability data would be easily obtainable from GuideStar and other Internet sources without charge and with minimal effort. This "do it yourself" process would reduce the cost of compliance with § 4958, both in terms of dollars and time, in non-inurement private benefit compensation situations where the likelihood of salaries exceeding market rates is lower than in the traditional excess benefit transaction situation.

### C. *Strengthening the Process Dictated by § 4958*

One of the arguments against applying a § 4958-like regime to compensation arrangements for non-disqualified persons is that § 4958 has done little to maintain or rein in salaries for disqualified persons.<sup>105</sup> If the extension of § 4958 to a much wider range of employees will simply

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103. The new category would contain provisions similar to Treas. Reg. § 53.4958-3(e)(3)(ii) (2006) to exclude attorneys, accountants, and investment advisors, where appropriate.

104. Treas. Reg. § 53.4958-6(c)(2)(ii). Thanks to Professor Stephen Schwarz for coining that phrase.

105. See *supra* Part V.A.

increase the charity's administrative costs and do nothing to regulate salaries, perhaps such an extension cannot be justified. But if § 4958 is ineffective in stemming the rising salaries in the nonprofit sector, perhaps it could be modified to make it more effective in protecting charitable assets.<sup>106</sup>

### 1. Alter the Process

One possible solution for the problem of escalating salaries in the public charity sector would be to alter the process for setting salaries to one which might produce less inflated salaries. This change in process might include eliminating for-profit salaries from the list of permitted comparables for setting nonprofit salaries, setting a higher standard, including requiring a greater number of more closely linked comparables for setting salaries for disqualified persons, and imposing more stringent sanctions for failure to comply with the new and more stringent process.<sup>107</sup> It might also include mandating a required percentage of independent directors on a board for an organization wishing to take advantage of the process.<sup>108</sup>

The change in process might also eliminate the safe harbor aspect of the rebuttable presumption of reasonableness and make the procedure dictated by § 4958 a threshold for avoiding penalties under that provision. If, as seems clear, the best that § 4958 can offer is process, not substantive limitations on salaries, imposing that process on charities is sensible. The process merely compels charities to do what they should be doing anyway as "best practices." Following the requirements of the process will force the board to determine comparable market rates and to make some effort to reflect those rates in setting salaries. Operating under the assumption that nonprofit managers want to set salaries that do not exceed market rates,

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106. Similar suggestions have been discussed elsewhere. See Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (2004) [hereinafter Fremont-Smith, *Governing Nonprofit Organizations*]; Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (2005) [hereinafter Panel, *Final Report*], available at [http://www.nonprofitpanel.org/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf); Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Supplement to the Final Report to Congress and the Nonprofit Sector* (2006), available at [http://www.nonprofitpanel.org/supplement/Panel\\_Supplement\\_Final.pdf](http://www.nonprofitpanel.org/supplement/Panel_Supplement_Final.pdf); Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 *Fordham L. Rev.* 609 (2007).

107. If it proves to be more competent in restraining rising salaries in the private foundation universe than § 4958 is in the public charity arena, it might make sense to import the § 4941 self-dealing regime to public charities as a replacement for § 4958, although the author is somewhat skeptical of imposing that more stringent regime on public charities at this point, particularly in light of the lack of data indicating that it is, in fact, more effective in setting market rate salaries. For an interesting discussion on this topic, see Marion R. Fremont-Smith, *Is It Time to Treat Private Foundations and Public Charities Alike?*, 52 *Exempt Org. Tax Rev.* 257 (2006).

108. See Charles M. Elson, *Executive Compensation—A Board-Based Solution*, 34 *B.C. L. Rev.* 937, 942–43 (1993).

requiring these managers to consider and document comparable market rates would help them to achieve the goal of setting fair salaries. The downside to this suggestion, in many cases, is the expense of paying a salary consultant to provide the required data. Ultimately, one would hope that this data would become more readily available at reduced or no cost. In any event, excessive salaries inevitably cost the sector more than the cost of obtaining data. The conversion of the safe harbor into a threshold requirement should be accompanied by an expansion of the organizations and the positions for which a less costly “do it yourself” process could be implemented.

## 2. Increase Responsibility of and Sanctions on Salary Setters

Another avenue to pursue in the quest for “reasonable” salaries is the role and responsibility of salary setters. Increasing both the fiduciary responsibilities and the penalties for directors and trustees could be a step toward restraining salaries to levels perceived as reasonable.<sup>109</sup> After all, salaries do not set themselves. The current “knowing,” “willful” standard<sup>110</sup> permits extensive escape routes for those charged with setting and reviewing salaries. It seems to penalize directors and officers only if they willfully approve a transaction knowing that the transaction violates the law. Harvard Hauser Center scholar Marion Fremont-Smith quite correctly calls this a “serious flaw” in the excise tax provisions.<sup>111</sup> Combined with the limits on liability for the sanctions imposed under § 4958 and the shifting of the burden of proof to the IRS to prove knowing participation,<sup>112</sup> these escape routes logically result in a less active role for directors and trustees than one might hope for. As Harvey Goldschmid points out, “[T]he roles of directors of nonprofit institutions are more demanding and complex than those of their for-profit peers, but almost all evidence suggests that nonprofit directors provide less oversight, less effective participation in decision-making, and in general, less effective governance than their peers in comparable for-profit corporations.”<sup>113</sup> The increase in penalties on organization managers enacted in the Pension Protection Act of 2006<sup>114</sup> was a step in the right direction, but more steps are needed to bring the law to its proper destination.

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109. This suggestion was included in the Panel on the Nonprofit Sector’s report *Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*. Panel, Final Report, *supra* note 106, at 88–89.

110. Treas. Reg. § 53.4958-1(d)(3)–(6).

111. Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 106, at 261.

112. Treas. Reg. § 53.4958-1(d)(7)–(9).

113. Goldschmid, *supra* note 31, at 632; *see also* Michael Klausner & Jonathan Small, *Failing to Govern? The Disconnect Between Theory and Reality in Nonprofit Boards and How to Fix It*, Stan. Soc. Innovation Rev., Spring 2005, at 42.

114. Pub. L. No. 109-280, 120 Stat. 780 (2006) (codified in scattered sections of the I.R.C.).



Increasing the pressure on managers to properly set salaries by providing fewer escape hatches and increasing penalties could result in more input from directors and trustees based on their own notions of reasonableness. To the extent that the boards of charities are composed to reflect the community in which the charity operates, these notions of reasonableness should conform to and reflect that community's notion of reasonableness. Although this change in standards and penalties would do nothing to elucidate the meaning of "reasonableness" in the charitable arena, the additional pressure on managers might, as a practical matter, rein in excessive salaries based on excessive comparables.

The argument against increasing the responsibilities and potential liability of directors who generally serve charities without compensation is that this added pressure and the consequences of failure to act might deter some candidates from serving as charitable fiduciaries. Eliminating escape routes and increasing penalties would inevitably dissuade inattentive directors from joining nonprofit boards. Deterring individuals not interested in exercising their duty of care and loyalty to the organization, however, should be viewed as a positive result of higher standards and increased sanctions for directors and trustees. As a society, we should not encourage inattentiveness among individuals selected to safeguard public funds by not requiring those individuals to pay attention.

### 3. Increased Scrutiny and Enforcement

Another possible solution to the problem of escalating compensation in the nonprofit sector is increased federal and state enforcement of the preservation of charitable assets for public purposes and the expansion of the pool of persons eligible to enforce. As Fremont-Smith elucidated in her testimony before Congress, "It is not the Code provisions that are inadequate; rather it has been the inability of the Service to adequately police the sector."<sup>115</sup> Specifically, if state attorneys general and the IRS were to increase scrutiny and enforcement over the use of assets by charities, or if others were anointed through grants of standing to perform this role, nonprofits would be less likely to waste charitable assets in the form of excessive compensation. This scrutiny and enforcement should be coupled with an improved Form 990.<sup>116</sup>

Sadly, although an improved Form 990 is in the works, increased scrutiny, at least at the federal level, will require additional funding for the exempt organizations function at the IRS, and additional funding is not

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115. Letter from Marion R. Fremont-Smith, Senior Research Fellow, Hauser Ctr. for Nonprofit Orgs., Harvard Univ., to Sen. Chuck Grassley, Chairman, S. Comm. on Fin., & Max Baucus, Ranking Member, S. Comm. on Fin. 1-2 (July 13, 2004) (on file with author); see also Stephanie Strom, *New Equation for Charities: More Money, Less Oversight*, N.Y. Times, Nov. 17, 2003, at F1; J. Christine Harris, *Grassley: GAO Report on 9/11 Charities Shows Need for Oversight*, 38 Exempt Org. Tax Rev. 17 (2002).

116. See Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 Tax Law. 571 (1998).

likely to be forthcoming. Accordingly, while increased state and federal enforcement inevitably would have an impact on salaries paid in the nonprofit sector, insufficient funding and human power suggest that is not a viable solution to the problem at this juncture.

State enforcement of fiduciary duties of officers and directors, particularly with respect to salary setting, is lax and demands significant attention and augmentation. Under state law, there is a perception that there are more significant issues for attorneys general to police.<sup>117</sup> Furthermore, since attorneys general often are elected, suing the directors of a charity is not always politically expedient. Also, state charities officials suffer from lack of information because the IRS is limited in the amount of information that it can share with state officials.<sup>118</sup> Finally, attorneys general offices, like the IRS, generally are understaffed in the charities area.<sup>119</sup> In rare cases where attorneys general do take action, the focus seems to be on issues of fundraising and charitable solicitation rather than on breaches of board fiduciary duties.

In sum, federal and state oversight of charities with respect to the non-distribution constraint is lax and inadequate. In order to maximize the impact of insufficient resources and attention, a unified standard and compliance regime should be set as a regulatory goal. Accordingly, the states should be encouraged to enact legislation which parallels the provisions of § 4958. Setting a single standard for charity compliance will both reduce costs of compliance and increase familiarity and compliance with those standards.<sup>120</sup>

#### 4. Expanding Standing to Sue Charities

Generally, under common law, the attorney general has exclusive standing to sue to enforce charitable purposes.<sup>121</sup> The policy for this exclusive authority is somewhat obvious—it is intended to avoid frivolous lawsuits that would cause charities to waste charitable assets to defend

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117. See Harvey P. Dale, *Tax-Exempt Organizations: The Winds of Change*, Norman A. Sugarman Memorial Lecture at Case Western Reserve University 4 (Mar. 20, 1991), available at <http://archive.nyu.edu/bitstream/2451/23385/2/HPD.TEO.CaseWest.91.pdf>; see also Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 106, at 443.

118. Increasing the flow of information from the Internal Revenue Service to the state attorneys general would certainly aid in the enforcement lapses. The Pension Protection Act of 2006 took a step in the right direction, but further legislative action will be required to permit much needed information sharing. Pub. L. No. 109-280, 120 Stat. 780 (codified in scattered sections of the I.R.C. and 29 U.S.C.).

119. See Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. Rev. 37, 41 (1993).

120. See generally Panel on the Nonprofit Sector, *Interim Report Presented to the Senate Finance Committee* (2005), available at <http://www.nonprofitpanel.org/interim/PanelReport.pdf>.

121. Blasko et al., *supra* note 119, at 40–41; see also Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 Ind. L.J. 937 (2004).

themselves.<sup>122</sup> However, since attorneys general frequently fail to enforce state laws against charities for reasons discussed above,<sup>123</sup> and since few others generally have standing to sue,<sup>124</sup> enforcement tends to be lax. There is an argument to be made, therefore, that expanding the number of parties with standing to sue charities to enforce charitable purposes would cut down on diversions of charitable assets for non-charitable purposes, including excessive compensation. The policy against permitting frivolous law suits, however, should trump the claims for expanding standing to sue charities. In the wrong hands, this right is simply too dangerous and might cause charities to expend more charitable assets defending baseless lawsuits than society would preserve through a few meaningful legal challenges to excessive compensation.

### 5. Capping Revenue Based Compensation

Capping revenue based compensation is another mechanism that would encourage a reduction in compensation paid by charities to insiders and outsiders. In the absence of regulations specifically addressing revenue based compensation, mandating a fixed amount cap might be sensible, but it is not required except in the case of discretionary (“non-fixed”) payments poised to take advantage of the rebuttable presumption of reasonableness.<sup>125</sup> A cap is not required to take advantage of the rebuttable presumption of reasonableness or the initial contract exception with regard to fixed payments, but the regulations do say that a cap is “a relevant factor in determining the reasonableness of compensation.”<sup>126</sup> On the other hand, with respect to discretionary payments, a cap will convert the payment into a fixed payment at the capped amount, at least for purposes of the rebuttable presumption of reasonableness,<sup>127</sup> so the cap is particularly relevant in that situation.

The result in the fixed payment situation where no cap is required is problematic in an attempt to restrict compensatory payments made by charities. Reasonableness of compensation to be paid under a revenue-

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122. Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information Be Utilized Effectively?*, 40 New Eng. L. Rev. 447 (2006); see also Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 106.

123. See *supra* Part V.C.2.

124. For excellent discussions of standing to sue charities, see Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. Corp. L. 655 (1998); Harvey P. Dale, *Standing to Challenge Tax-Exempt Status*, 307 PLI/Tax 491 (1990); see also Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 106, at 448–49.

125. Treas. Reg. § 53.4958-6(d)(2) (2006).

126. *Id.* § 53.4958-4(b)(1)(ii)(A). Note that revenue based compensation that is nondiscretionary is considered “fixed” for purposes of that provision.

127. The Regulations do not specifically provide that capping a discretionary payment will convert it into a fixed payment for purposes of the initial contract exception, but if the payment does not qualify for the initial contract exception because it is not fixed, it should flow into the general rules where capping it will protect it under the rebuttable presumption of reasonableness. Treas. Reg. § 53.4958-6(d)(2); *id.* § 53.4958-4(a)(3).

sharing arrangement can be determined at the time of entering into the contract. If the amount likely to be paid at that time (based on a proper calculation and projected valuation) is reasonable, it is likely that there will not be an excess benefit transaction later when the amount payable under the agreement is actually paid, even if the recipient ends up with a windfall based on revenues actually generated. If the mandated process is followed and the payment qualifies as "reasonable," the payment will be protected by the rebuttable presumption of reasonableness, and should not constitute an excess benefit when paid.<sup>128</sup> Actually requiring a cap on revenue based compensation will protect organizations from paying out a windfall to anyone subject to § 4958 or any similar regime. Even in situations where the disqualified person can only benefit proportionately to the benefit bestowed on the organization by the disqualified person, a cap on revenue based compensation will result in more funds for the charity.

### 6. Capping Salaries

Another potential avenue of resolution for the problem of escalating payments in the nonprofit sector is a cap on overall salaries (or perhaps only on compensation paid to disqualified persons, as that term may be redefined) expressed as a percentage of gross annual revenue or through some other objective measurement. For example, salaries for a public charity for any year might be capped at fifteen percent of the organization's "normal" gross revenues. The sanction for failure to comply with this requirement might be loss of exemption under § 501(c)(3). Alternatively, the sanction might be correction plus an excise tax on managers, perhaps with no escape routes. The benefits to this solution are threefold: First, it puts more pressure to bear on managers to set reasonable salaries. Second, compensation paid by a charity will bear a relationship to the size of the charity. And third, it gives the charity a choice as to how it spends its capped amount. It could choose to hire fewer highly compensated employees or more employees who are paid less. The charity could determine which method is the most efficient for its purposes. The negative result is that charities may lose out to for-profit entities (or even to larger charities) in hiring the best candidates. Congress was clearly aware of this negative when it enacted § 4958, as reflected in the legislative history to that provision.<sup>129</sup>

### 7. Disclosure

A final solution to the problem of escalating payments in the nonprofit sector to insiders and non-insiders is increased transparency through

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128. It is the projected amount that must be reasonable based on comparables, not the formula used to determine the amount.

129. H.R. Rep. No. 104-506, at 56-60 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1124, 1179-83.

increased disclosure. “Sunshine” has always been the most effective deterrent for both malfeasance and nonfeasance in this realm.<sup>130</sup> Disclosure more similar to that required for private foundations could be required for public charities. This might increase public policing of charities, since the IRS and the states seem to be short staffed.<sup>131</sup>

Disclosure and transparency should be increased to permit more public oversight of public charities. Congress concluded in the 1960s that the stringent regulation applied to private foundations was not necessary in the public charity universe because public charities were more publicly accountable.<sup>132</sup> Public charities rely on the public for donations and for purchases of goods and services. If a public charity runs amok, the public will cease to support it. In effect, the marketplace monitors public charities. No similar public controls can be imposed on private foundations because private foundations are not dependent on the public. In other words, while the public bears some of the burden for policing public charities, the government must police private charities in a more rigorous manner. Accordingly, increased disclosure for public charities would enhance the tools that the public could utilize to more effectively fulfill its oversight role in the charitable sector. With increased transparency marketplace supervision will become informed supervision.

Ultimately, in order to increase transparency, disclosure should be targeted to those most likely to impact the bottom line of the charity—donors. Although much of the relevant salary information is available to donors on GuideStar and directly from the charities, it is unlikely that many potential donors seek out the information prior to making a contribution, particularly when the contribution is destined for an established charity such as a university, museum, or hospital. This forced transparency could be implemented simply by adding a provision to § 170(f)(8) that would require that the contemporaneous written acknowledgement delivered to donors must include a copy of the donee organization’s Form 990, parts V-A and V-B,<sup>133</sup> or better yet, must include a list of total amounts paid to all disqualified persons in the prior taxable year of the organization, as the term “disqualified person” would be expanded to include the new category of non-influential but highly compensated persons.<sup>134</sup> This will almost surely have an impact on escalating compensatory payments in the nonprofit sector.

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130. Chester, *supra* note 122; *see also* Goldschmid, *supra* note 31.

131. *See* Dale, *supra* note 117, at 4; *see also* Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 106, at 443–448.

132. Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings*, 27 *Exempt Org. Tax Rev.* 52 (2000).

133. This portion of the Form 990 reveals compensation paid to current and former officers, directors, trustees, and key employees.

134. This suggestion will not be popular with charities because of its potential impact on charitable giving, but it is worth considering in light of the impact it would have on compensation in the nonprofit sector.

## CONCLUSION

In conclusion, it is clear that § 4958 is helpful to public charities in that it provides a lesser sanction for charities that engage in an inurement transaction but otherwise operate primarily for charitable purposes. Furthermore, it penalizes the proper culprits. The statute and regulations are all about process, not substance. They create a safe harbor process for organizations to follow in setting salaries for disqualified persons under the theory that organizations that follow this process are more likely to set reasonable salaries. It seems probable that organizations that follow this process are more likely to set salaries at market rates. Section 4958, however, has done nothing to limit the escalation in compensation paid to disqualified persons in public charities. In effect, if an organization sets a salary based on another salary or collection of salaries that is excessive, the second salary arguably will reflect market rates and be deemed "reasonable" for purposes of establishing a rebuttable presumption of reasonableness, although it may in fact, by many standards, not be at all reasonable. Again, inflated comparables are likely to protect an organization (or at least to shift the burden of proof to the IRS) but still give rise to inflated compensation arrangements.

It is clear from legislative history, though, that § 4958 was not intended to rein in, reduce, or even stabilize salaries paid to nonprofit executives. It was intended only to ensure that these salaries reflect market rate compensation for similar positions. Although the process can be abused, charitable fiduciaries determined to set fair salaries are more likely to accomplish this goal using the process compelled by § 4958.

In spite of excellent reasons not to extend § 4958 to non-inurement private benefit transactions, if excessive salaries are being paid to non-insiders, those salaries should be subject to regulation and penalties in order to avoid wasting charitable assets. Under current law, insubstantial excessive payments to non-disqualified persons will not result in either the ultimate or an intermediate sanction. Accordingly, charitable funds will be used for non-charitable, private purposes without repercussion. Creating repercussions might be accomplished through a new regime to apply only to non-inurement private benefit transactions, but it would be much more efficient to apply § 4958 in these situations because the regime is already in place and both charities and regulators are familiar with the process that it compels. It would be essential to modify the process required by § 4958 for setting salaries for highly compensated non-insiders, because the policies for the extension of § 4958 to non-insider transactions are different.

In order to expand the reach of § 4958 to non-insider arrangements, the definition of disqualified persons should be modified to include some portion (perhaps ten percent) of the persons most highly compensated by the charity, including currently defined disqualified persons and certain independent contractors. A modified process similar to the "do it yourself" process available to small organizations should be available for determining comparables for the new category of non-influential but highly

compensated disqualified persons. Perhaps in a situation where the board is setting the salary of a non-disqualified person, the board could satisfy the rebuttable presumption of reasonableness using self-obtained data from five similarly situated organizations for similar positions. That would eliminate concerns of wasting charitable assets to pay salary consultants in the pure private benefit, non-inurement situation where abuse is likely to occur.

In order to make the recommended expansion of § 4958 to non-influential highly paid service providers more meaningful, § 4958 must be made more robust and effective in all of its applications. To accomplish this goal, the standards and penalties for managers should be increased. The penalty increases enacted in the Pension Protection Act of 2006<sup>135</sup> may be sufficient to deter lackadaisical salary setting by boards if the standards that apply to board members are made more stringent (i.e., if escape hatches were reduced). In addition, the process compelled by § 4958 should be declared as a threshold for avoiding penalties under § 4958 rather than as an optional method of securing protection. Requiring caps on revenue based compensation should be considered, as should capping the overall amount of salary paid to disqualified persons (using the modified definition of that term).

Finally, an increase in disclosure and transparency should be mandated. This can best be accomplished by adding a provision to § 170(f)(8) that would require that the requisite contemporaneous written approval must include a copy of the organization's Form 990, part V, or better yet, a list of total amounts paid to all disqualified persons in the prior taxable year of the organization (as the term "disqualified person" would be defined as suggested above). In other words, supply the marketplace with tools to enhance the efficacy of its supervision. In combination with the suggested changes to process, this increase in transparency would inevitably affect escalating compensatory payments to insiders and non-insiders in the nonprofit sector. Until these steps are taken, the sky may be the only effective limitation on compensation paid by charities.

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135. Pub. L. No. 109-280, 120 Stat. 780 (2006) (codified in scattered sections of the I.R.C. and 29 U.S.C.).

*Notes & Observations*