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Recommended Citation

Terri L. Helge & David M. Rosenberg, *Nonprofit Executive Compensation*, 38 Tex. Tax Law. 36 [1] (2011).
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The Texas Tax Lawyer

Spring 2011
Vol. 38, No. 3
www.texastaxsection.org

State Bar of Texas

2011

Created in 1939

NONPROFIT EXECUTIVE COMPENSATION

By: *Terri Lynn Helge and David M. Rosenberg*[1]

I. **Introduction.** Excessive compensation paid to nonprofit executives and board members is one of the key issues concerning charitable organizations that garner the attention of the general public and Congress. Charitable organizations may pay reasonable compensation to their directors, executive officers and employees for their services without violating applicable federal tax law or state law. The determination of reasonable compensation depends on several factors – the budget of the organization being the most significant factor. Other factors include the number of employees of the organization, the particular sector of the charitable community served by the organization, the geographic location of the organization, the focus of the organization as being national or local, the length of the employee's service and external market forces.

Even if executive compensation is considered reasonable in light of the foregoing factors, the perception that a charitable organization is paying excessive compensation can be damaging to the organization's reputation. Some nonprofit executive salaries have reached seven figures, particularly in the larger health care systems and higher education.[2] In some cases, the highest paid employee of a charitable organization is not its chief executive officer, but instead may be a senior administrator or key physician of a large urban medical center, a key athletic coach at a Division I university, or a chief investment officer of a university or foundation with a large endowment. Reports of high nonprofit executive compensation have lead the Internal Revenue Service to conduct an Executive Compensation Compliance Initiative in 2004 (with its findings published in March 2007, discussed below), and the Internal Revenue Service continues to scrutinize nonprofit executive compensation. In addition, because nonprofit executive compensation must be reported annually on the organization's Form 990, the general public, the media, and charity watchdog organizations also scrutinize nonprofit executive compensation. Therefore, it is important for charitable organizations not only to understand the federal tax law governing the payment of reasonable compensation to their directors, officers and key employees, but also to understand their reporting obligations and best practices with respect to executive compensation to avoid undue scrutiny.

II. **Prohibition on Private Inurement.** Section 501(c)(3) of the Code[3] provides that no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual. The Internal Revenue Service takes the position that any element of private inurement can cause an organization to lose or be deprived of tax exemption, and that there is no de minimus exception.[4] The private inurement prohibition contemplates a transaction between a charitable organization and an individual in the nature of an "insider," who is able to cause application of the organization's assets for private purposes because of his or her position.[5] In general, an organization's directors, officers, members, founders and substantial contributors are insiders. The meaning of the term "net earnings" in the private inurement context has been largely framed by the courts. Most decisions reflect a pragmatic approach, rather than a literal construction of the phrase "net earnings."[6] Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental

prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) purchases of assets for more than fair market value; and (v) certain joint ventures with commercial entities.

A. Public Charities. In general, a charitable organization is presumed to be a private foundation unless it can establish that it qualifies as a public charity under Sections 509(a)(1)–(3) of the Code. Types of public charities described under Section 509(a)(1) of the Code include churches, schools, hospitals, government entities and university endowment funds.[7] In addition, an organization which normally receives more than one-third of its total support from contributions from the general public is considered a public charity under Section 509(a)(1) of the Code.[8] An organization which receives more than one-third of its total support from exempt function revenues, such as admission fees to a museum or patient revenues for a hospital, is considered a public charity under Section 509(a)(2) of the Code, provided the organization does not normally receive more than one-third of its support from gross investment income. An organization which does not meet either of these tests may still qualify as a public charity under Section 509(a)(3) of the Code as a "supporting organization" of another public charity by virtue of the relationship between the first organization and the second public charity.

B. Excess Benefit Transactions. Section 4958 of the Code imposes an excise tax on disqualified persons who engage in excess benefit transactions with public charities.[9] An "excess benefit transaction" is any transaction in which an economic benefit is provided by the public charity directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for such benefit.[10] The term "transaction" is used very generally and includes a disqualified person's use of a charitable organization's property and services provided to a disqualified person without adequate payment. Prototypical examples of excess benefit transactions include paying excessive compensation to a director or officer or overpaying a director or officer for property the director or officer sells to the charitable organization. However, any direct or indirect benefit to a disqualified person may result in a violation of Section 4958 if the disqualified person does not provide adequate consideration for the benefit.

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person.[11] A tax of 10% of the excess benefit is imposed on any organization manager, i.e., any officer, director, or trustee of the organization, who knowingly participates in the transaction.[12] The initial excise tax on organization managers is capped at $20,000.[13] If a disqualified person engages in an excess benefit transaction with a public charity, corrective action must be taken to essentially undo the excess benefit to the extent possible and to take any additional measures to put the public charity in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[14]

C. Disqualified Persons. The term "disqualified person" includes any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization.[15] Some persons, including (but not limited to) board members, the president or chief executive officer, the treasurer or chief financial officer, family members of such individuals, and entities in which such individuals own 35% of the interests, are automatically considered "disqualified."[16]

Where a person is not automatically disqualified, all of the facts and circumstances will generally be considered to determine if the person has substantial influence over the affairs of the organization.[17] Factors tending to show that an individual exercises substantial influence include:

i. the individual is a founder of the organization;

ii. the individual is a substantial contributor to the organization;

iii. the individual's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the individual controls;

iv. the individual has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;

v. the individual manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

vi. the individual owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.[18]

Factors tending to show that an individual does not exercise substantial influence include:

i. the individual has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;

ii. the individual is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the individual will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);

iii. the direct supervisor of the individual is not a disqualified person;

iv. the individual does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

v. any preferential treatment the individual receives based on the size of that individual's contribution is also offered to all other donors making a comparable

contribution as part of a solicitation intended to attract a substantial number of contributions.[19]

1. Exception for Non-Highly Compensated Employees. Nonetheless, an employee who does not receive economic benefits from the organization in excess of the indexed amount for being considered a highly compensated employee ($110,000 in 2011),[20] is not a disqualified person even if the above factors indicate that the individual may have substantial influence over the affairs of the organization.[21] This exception does not apply to employees who are automatically considered disqualified or who are substantial contributors to the organization.[22]

2. Initial Contract Exception. The theory behind the initial contract exception is that an individual who negotiates an employment agreement in good faith before the individual is in a position to exercise substantial influence over the organization should not be subject to sanctions even if the compensation under the employment agreement turns out to be excessive. Accordingly, Section 4958 does not apply to any fixed payment made to an individual with respect to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit.[23] An "initial contract" is a binding written agreement between the charitable organization and an individual who was not a disqualified person immediately before entering into the agreement.[24] A "fixed payment" an amount of cash or other property specified in the agreement, or determined by a specified objective fixed formula, which is to be paid or transferred in exchange for the provision of specified services or property.[25] A fixed formula may incorporate an amount that depends on future specified events or contingencies (such as the amount of revenues generated by one or more activities of the organization), provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment.[26] If an initial contract provides for both fixed and non-fixed payments, the fixed payments will not be subject to Section 4958 while the non-fixed payments will be evaluated under an excess benefit transaction analysis, taking into account the individual's entire compensation package.[27]

D. What Constitutes Compensation? A disqualified person's entire compensation package must be evaluated to determine whether on the whole, the compensation received by the individual is reasonable for the services provided. Accordingly, if the organization is relying on the rebuttable presumption of reasonableness (discussed below), the organization's board of directors must consider and approve the disqualified person's entire compensation package, not merely salary and bonuses. The compensation package includes all forms of cash and noncash compensation, all forms of deferred compensation if earned and vested, most fringe benefits whether or not taxable, employer-paid premiums for liability insurance coverage,[28] expense allowances and reimbursements, and other economic benefits received by the disqualified person from the organization in exchange for the performance of services.[29] However, the following benefits may be disregarded in evaluating the compensation package under Section 4958: (i) employee fringe benefits that are excluded from gross income under Section 132; (ii) expense reimbursements paid pursuant to an accountable plan; (iii) economic benefits provided to a disqualified person solely as a member of or volunteer for the organization if the same benefit is available to the general public in exchange for a membership fee of no more than $75 per year;

and (iv) economic benefits provided to a disqualified person solely as a member of a charitable class that the organization is organized to serve.[30]

1. Determination of Reasonable Compensation. In general, the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under Treasury Regulation Section 53.4958-4(a)(4)) provided to a person and the rate at which any deferred compensation accrues.[31] The factors generally considered for purposes of Section 162 include (i) the employee's qualifications, (ii) the nature, extent and scope of the employee's work, (iii) the size and complexities of the employer's business, (iv) the prevailing economic conditions, (v) the prevailing rates of compensation for comparable positions in comparable employers, and (vi) the employer's salary policy that applies to all employees.[32] The fact that bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a state or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of Section 4958.[33]

Normally, the facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment are those existing on the date the parties enter into the agreement pursuant to which the payment is made.[34] However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under an agreement, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment.[35]

2. Substantiation of Economic Benefit Treated as Compensation. To monitor disguised compensation, the Treasury Regulations require a charitable organization to clearly indicate its intent to treat an economic benefit as compensation when it is paid. This rule is intended to prevent a charitable organization from later claiming that an excess benefit transaction, such as a below-market loan or personal expense allowance, was actually compensation and that the overall compensation package of the disqualified person was reasonable.[36] To establish its intent, the organization must provide contemporaneous written substantiation of the economic benefit intended to be compensation for services.[37] Contemporaneous written substantiation can be accomplished through the inclusion of the economic benefit on the individual's Form W-2 or Form 1099, through a written employment agreement, or through the written contemporaneous documentation of the approved compensation package under the rebuttable presumption of reasonableness.[38] However, the organization is not required to provide written substantiation of its intent to include nontaxable economic benefits, such as employer-provided medical insurance or employer contributions to a qualified retirement plan, as part of the individual's compensation.[39] As a result, even though contributions to qualified retirement plans and other nontaxable benefits are required to be taken into account in evaluating whether the overall compensation package is reasonable, they are not subject to the contemporaneous written substantiation requirement.

3. Revenue-sharing Compensation Arrangements. Revenue-sharing arrangements between a charitable organization and a disqualified person may be treated as an excess benefit transaction if the transaction results in prohibited private inurement.[40] The scope of this rule is uncertain and is not addressed in the final regulations. However, the implications of this rule may be significant for performance-based compensation arrangements and more complex arrangements to share revenue from intellectual property or other income-producing activities.

After the enactment of Section 4958, proposed regulations were issued that addressed the application of the excess benefit transaction rules to revenue-sharing compensation arrangements. These rules were not incorporated into the final regulations, and the Internal Revenue Service may later issue guidance in this area. In the meantime, revenue-sharing compensation arrangements are evaluated under the general rules governing reasonableness of compensation paid to a disqualified person, leaving a fog of uncertainty about whether these arrangements are in fact reasonable.

Since the old proposed regulations provide the only guidance on this issue, they are discussed herein for informational purposes, although they have no precedential value. In general, whether a revenue-sharing arrangement constitutes an excess benefit transaction depends on all relevant facts and circumstances. The arrangement may result in excess benefit if it permits a disqualified person to receive additional compensation without providing proportional benefits for the charitable organization. Relevant factors include the relationship between the size of the benefit provided and the quality and quantity of the services provided, and the ability of the disqualified person to control the activities generating the revenues.[41] The proposed regulations provided three examples illustrating the principles for determining whether a revenue-sharing transaction resulted in an excess benefit:[42]

i. In the first example, the disqualified person was an in-house investment manager for the charitable organization. In addition to the individual's regular salary and benefits, the individual was entitled to a bonus equal to a percentage of any increase in the net value of the portfolio. The bonus was considered an incentive to maximize benefits and minimize expenses to the organization. Thus, even though the individual had a measure of control over the portfolio performance, the bonus produced a proportional benefit for the organization. Therefore, the revenue-sharing arrangement was not considered an excess benefit transaction.

ii. In the second example, the disqualified person was a third-party management company managing the charitable organization's charitable gaming activities. The management company controlled all of the activities generating revenues and paid the charitable organization a percentage of the net profits from these activities. Since the management company provided all the personnel and equipment for the activities, the management company controlled all the costs charged to revenues and net revenues. This structure did not provide the management company with an appropriate incentive to maximize benefits and minimize costs to the charitable organizations because the management company benefitted whether the net revenues were low because expenses were high or net revenues were high because expenses

were low. In contrast, the charitable organization only benefitted if the net revenues were high. As a result, the entire transaction was considered an excess benefit transaction.

iii. In the third example, the disqualified person was a university professor who was the principal investigator in charge of certain scientific research. In addition to the professor's regular salary and benefits, the professor was entitled to a specified percentage of any patent royalties on inventions produced by the professor's research. This arrangement provided an incentive for the professor to produce especially high quality work and no incentive to act contrary to the university's interest. Moreover, the university shared proportionately with the professor. Lastly, the university owned and controlled the patent and the professor had no control over the revenues generated from the patent. This arrangement was not considered an excess benefit transaction. Many research institutions have invention and research policies similar to this example.

E. Rebuttable Presumption of Reasonableness. The Treasury Regulations provide for a procedure, which if followed, creates a rebuttable presumption that a transaction between a public charity and a disqualified person will not constitute an excess benefit transaction within the meaning of Section 4958 of the Code. These procedures apply to fixed payments and, with minor additional requirements, to non-fixed payments subject to a cap.[43] Legislative history indicates that compensation arrangement or other financial transactions will be presumed to be reasonable if the transaction arrangement was approved in advance by an independent board (or an independent committee of the board) that was composed entirely of individuals unrelated to and not subject to the control of the disqualified person, obtained and relied upon appropriate data as to comparability, and adequately documented the basis for its determination.[44] The Treasury Regulations read into the legislative history three distinct requirements: (1) approval by an authorized body, (2) the appropriate data as to comparability, and (3) the documentation.[45]

1. Approval by an Authorized Body. The authorized body may be the Board of Directors or a committee duly authorized under state law to act on behalf of the Board of Directors.[46] A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.[47] No person voting on the matter may have a conflict of interest with respect to the transaction.[48] A member of the authorized body does not have a conflict of interest if the member:

i. is not the disqualified person or related to any disqualified person who benefits from the transaction;

ii. is not employed by or controlled by any disqualified person benefiting from the transaction;

iii. is not receiving compensation or other payments from a disqualified person benefiting from the transaction;

iv. has no material financial interest affected by the compensation arrangement or transaction; and

v. does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[49]

2. Appropriate Data as to Comparability. The authorized body must have sufficient information to determine whether a compensation arrangement or other transaction will result in the payment of reasonable compensation or a transaction for fair value. Relevant information includes, but is not limited to:

i. compensation levels paid by other similarly-situated organizations (taxable or tax-exempt);

ii. availability of similar services in the applicable geographic area;

iii. independent compensation surveys;

iv. written offers from similar institutions competing for the services of the person;

v. independent appraisals of all property to be transferred; or

vi. offers for property received as part of an open and competitive bidding process.[50]

3. Documentation. For the decision to be adequately documented, the records of the authorized body must note:

i. the terms of the transaction and the date it was approved;

ii. the members of the authorized body who were present during the debate on the transaction or arrangement and those who voted on it;

iii. the comparability data obtained and relied upon and how the data was obtained;

iv. the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and

v. the basis for any deviation from the range of comparable data obtained.[51]

Moreover, such records must be prepared by the next meeting of the authorized body (or within 60 days after the final action of the authorized body, if later than the next

meeting) and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter.[52]

III. Best Practices for Executive Compensation.

A. Internal Revenue Service Executive Compensation Compliance Initiative. The Internal Revenue Service has devoted substantial time and attention to executive compensation paid by nonprofit organizations. In August 2004, the Internal Revenue Service announced that it would conduct a Compensation Compliance Initiative aimed at identifying and stopping abuses by nonprofit organizations that pay excessive compensation to their directors, officers and key employees. The Compensation Compliance Initiative involved Internal Revenue Service contact of over 1,800 public charities and private foundations, seeking information about their compensation practices and procedures. In March 2007, the Internal Revenue Service issued a report summarizing the results of its Compensation Compliance Initiative.[53] In its report, the Internal Revenue Service made the following points:

1. There were significant reporting issues with respect to executive compensation. Over thirty percent of the organizations had to amend their Form 990 and approximately fifteen percent of the organizations were selected for examination.

2. Examinations primarily showed problems with reporting, rather than other concerns. However, the Internal Revenue Service cautioned that this was not a statistical sample, so no definitive statement could be made about the level of compliance in the area of executive compensation. The Internal Revenue Service will conduct continued work with respect to executive compensation.

3. Where problems were discovered, the Internal Revenue Service made large assessments of excise taxes with respect to excess compensation – 25 examinations of 40 disqualified persons or organizations managers have resulted in proposed excise tax assessments in excess of $21 million.

4. While high compensation amounts were found in many cases, they generally were substantiated with appropriate comparability data.

Prior to the release of the final report on the Compensation Compliance Initiative, the Internal Revenue Service conducted an Executive Compensation Phone Forum in May 2006 to discuss the issues which emerged from the Compensation Compliance Initiative.[54] The Phone Forum provided an interesting view of the Internal Revenue Service's thoughts on nonprofit executive compensation. In particular, Internal Revenue Service representatives suggested that nonprofit organizations should focus their attention on the following best practices:

1. Legal Protection. According to the Internal Revenue Service representatives "every board should consider meeting the requirements of the rebuttable presumption of reasonableness."

2. Timely Reporting and Disclosure. All economic benefits to directors, officers and key employees should be reported timely on the organization's Form 990. If an organization does not clearly indicate its intent to treat an economic benefit provided to an officer, director or key employee as compensation for services, it will automatically be treated as an excess benefit transaction. Accordingly, organizations that fail to report "fringe benefit perks" like personal use of an automobile of reimbursement of personal expenses will subject the disqualified person to an automatic 25% excise tax on the amount of the fringe benefit as an automatic excess benefit transaction.

3. Transparency. While many charitable organizations have compensation committees that are given the authority to evaluate and approve executive compensation, the full board still has the ultimate responsibility over executive compensation matters. Therefore, to the extent appropriate, executive compensation matters decided by a committee of the board should be reported to the full board. The level of oversight by the full board may vary depending on the type and size of the organization, but there should be a system in place to ensure that the full board is aware of the most important compensation matters within the organization. The Internal Revenue Service representatives on the Phone Forum indicated there are specific problem areas that "frequently fall through the cracks." In particular, personal components of business travel, personal use of employer-owned property, gifts and gift certificates, tax gross-ups, expense reimbursements outside corporate travel policies, spouse travel expenses, non-accountable expense allowances, and club memberships, are additional perks that some nonprofit executive receive and should be considered as part of the overall compensation package. However, these items may not be disclosed to the board or the committee of the board making compensation determinations.

B. Panel on the Nonprofit Sector Recommendations. Over the past several years, the Senate Finance Committee has scrutinized the compensation practices of charitable organizations. While no legislation affecting compensation of nonprofit executives has been proposed, the staff of the Senate Finance Committee released a discussion draft on proposed reforms and best practices in the charitable community in June 2004 that may still be considered for future proposed legislation.[55] At the prompting of the Senate Finance Committee, an independent nonprofit organization, the Independent Sector, convened the Panel on the Nonprofit Sector (the "Panel") to study the proposals in the discussion draft and make recommendations with respect to the reforms needed in the charitable community. The result was the issuance of the Panel's final report "Strengthening Transparency Governance Accountability of Charitable Organizations" in June 2005.[56] Most recently, the Panel issued a draft "Principles for Effective Practice," which are a series of voluntary best practices standards for effective governance of charitable organizations.[57]

1. Compensation of Individuals Serving the Organization in a Dual Capacity. Under current law, there is no prohibition on directors of a charitable organization receiving compensation from the organization for their services to the organization in some other capacity. However, the Senate Finance Committee staff discussion draft contained proposals that would limit the ability of a director of a charitable organization to receive compensation from the organization in some other capacity. In particular, the proposals would allow only one member of the board to receive compensation from the organization, and such individual could not serve

as chair or treasurer of the organization. Similarly, in its recommended "Principles for Effective Practice," the Panel advocates separation of the paid chief executive officer and the treasurer and the chair of the charitable organization as an essential good governance practice. The Panel's rationale for this principle is as follows:

> Concentrating authority for the organization's governance and management practices in one or two individuals removes valuable checks and balances that help ensure that conflicts of interest and other personal concerns do not take precedence over the best interests of the organization. Both the board chair and the treasurer should be independent of the chief staff executive to provide appropriate oversight of the executive's performance and to make fair and impartial judgments about the appropriate compensation of the executive. When the board deems it is in the best interests of the charitable organization to have the chief executive officer/executive director serve as the board chair, the board should appoint another board member (sometimes referred to as the "lead director") to handle issues that require a separation of duties. For example, the lead director would serve as chair for deliberations involving the responsibilities, performance or compensation of the chief executive officer/executive director.

In addition, the Panel advocates that a "substantial majority" of the directors of a charitable organization not be compensated for their services to the organization in any capacity other than as directors of the organization. The Panel reasons "[w]hen a majority of the board members are free of the conflicts of interest that can arise from having a personal interest in the financial transactions of the charity, the board as a whole may be more likely to exercise its responsibility to review and take action on materials and information independent of the staff management." Accordingly, if a director of the charitable organization receives compensation for services to the organization in some other capacity, it is essential that the composition of the board be large enough so that the compensated individual does not unduly influence the board's decisions.

2. <u>Compensation of the Chief Executive Officer</u>. The Panel advocates that the board annually evaluate the performance of the chief executive officer prior to any change in that officer's compensation, unless there is a multi-year contract in force or the change consists solely of routine cost of living adjustments. The Panel considers the selection, evaluation and determination of compensation of the chief executive officer of the organization as one of the most important responsibilities of the board. Accordingly, the Panel recommends that the full board approve the compensation of the chief executive officer annually. Although delegation of chief executive officer compensation decisions to a compensation committee of the board is not recommended, the Panel provides that "[i]f the board designates a separate committee to review the compensation and performance of the CEO, that committee should be required to report its findings and recommendations to the full board for approval and should provide any board member with details, upon request. The board should then document the basis for its decision and be prepared to answer questions about it." Therefore, even though the rebuttable presumption of reasonableness would allow approval of the chief executive officer's compensation by a duly authorized committee of the board, the Panel does not recommend that the final approval rest with a committee. Even if a charitable organization does leave the approval of the chief executive officer's compensation to a duly authorized compensation

committee, the committee should report the basis for its approval to the full board in a timely manner.

3. Compensation of Other Officers and Key Employees. As for the compensation of other officers and key employees, the determination of the amount of compensation is normally delegated to the chief executive officer. However, the Panel recommends that the board approve "the compensation range of other persons in a position to exercise substantial control of the organization's resources. It is the responsibility of the CEO to hire and set the compensation of other staff, consistent with reasonable compensation guidelines set by the board. If the CEO finds it necessary to offer compensation that equals or surpasses his or her own, in order to attract and retain certain highly qualified and experienced staff, the board should review the compensation package to ascertain that it does not provide an excess benefit."

IV. Special Rules Applicable to Supporting Organizations and Donor Advised Funds.

A. Supporting Organizations. Organizations that support a public charity are allowed public charity status if they meet certain requirements. These "supporting organizations" are grouped into three types: (i) those that are "operated, supervised, or controlled by" the public charity they support (Type I); (ii) those that are "supervised or controlled in connection with" the public charity they support (Type II); and (iii) those that are "operated in connection with" the public charity they support (Type III).[58] Type III supporting organizations are further divided into functionally integrated Type III supporting organizations and other Type III supporting organizations. A functionally integrated Type III supporting organization[59] is defined as a Type III supporting organization that is not required to make payments to the supported organizations due to the supporting organization's activities being related to performing the functions of, or carrying out the purposes of, such supported organizations.[60]

Enacted on August 17, 2006, the Pension Protection Act of 2006[61] (the "PPA") contains many reforms for supporting organizations and donor advised funds (discussed below). In particular, if an individual or entity is a disqualified person with respect to a supporting organization, such individual or entity is automatically a disqualified person with respect to the supported organization(s) as well.[62] Accordingly, transactions between such individual or entity and the supported organization must be analyzed under the excess benefit transaction rules of Section 4958 of the Code. In addition, all types of supporting organizations are prohibited from making grants, loans, compensation or similar payments[63] to a substantial contributor of the supporting organization or a person related to a substantial contributor.[64] Similarly, all loans to disqualified persons of the supporting organization are prohibited.[65] The prohibitions do not apply if the substantial contributor or disqualified person is a public charity (other than another supporting organization). If a prohibited payment is made, the substantial contributor is treated as a disqualified person and the entire amount of the payment is treated as an excess benefit transaction under Section 4958(c) of the Code.

B. Donor Advised Funds. Donor advised funds are generally funds owned by a public charity in which a donor is able to make non-binding recommendations as to their management and investment. The charity remains in control over the use of the funds and is free

to disregard the advice of the donor. Because the donor is able to influence how the funds are used, there is concern that donor advised funds are being abused in various ways. The PPA adds Sections 4966 and 4967 to the Code which is designed to improve the accountability of donor advised funds.

1. Definitions. Section 4966(d) of the Code contains four important definitions, including a statutory definition of donor advised funds:

a. Sponsoring Organization: A Sponsoring Organization is any charitable organization that is not a private foundation and that maintains one or more Donor Advised Funds.[66]

b. Donor Advised Fund: The term "donor advised fund" means a fund or account: (1) that is separately identified by reference to contributions of a donor or donors;[67] (2) that is owned and controlled by a Sponsoring Organization; and (3) with respect to which a donor, or the donor's designee has, or reasonably expects to have, advisory privileges[68] regarding the distribution or investment of any amounts held in the fund.[69] However, the term "donor advised fund" does not include a fund or account from which grants to individuals for travel, study or similar purposes are made as long as (a) the donor's advisory privileges are performed exclusively by such donor in his capacity as a member of a committee appointed by the Sponsoring Organization, (b) no combination of a donor and persons related to or appointed by such donor control such committee, and (c) all grants from such funds satisfy the requirements applicable to private foundations under Section 4945(g) with respect to grants made for travel, study or similar purposes.[70] In addition, a fund which benefits a single identified organization or governmental entity is exempted from treatment as a Donor Advised Fund.[71] Furthermore, the Secretary of the Treasury (the "Secretary") may exempt from treatment as a Donor Advised Fund a fund which is advised by a committee not controlled by a donor, donor advisor or related persons or which is designed to benefit a single identified charitable purpose. In Notice 2006-109, the Internal Revenue Service determined that employer-sponsored disaster relief funds are excluded from treatment as Donor Advised Funds, provided certain requirements are met.[72]

c. Fund Manager: A Fund Manager is any officer, trustee, or director of a Sponsoring Organization and, with respect to a specific act or failure to act, the employees of the Sponsoring Organization having authority or responsibility with respect to such act or failure to act.[73]

d. Disqualified Supporting Organization: A Disqualified Supporting Organization is (1) any Type III supporting organization that is not a functionally integrated Type III supporting organization, (2) any Type I, Type II or functionally integrated Type III supporting organization over which a donor or donor appointee who advises regarding distributions from a Donor Advised Fund to such organization has direct or indirect control, or (3) any other supporting organization that the Secretary determines by regulation to be a Disqualified Supporting Organization.[74]

2. Inappropriate Donor Benefits. In order to combat abuses where donors are inappropriately benefiting from Donor Advised Fund assets, the PPA imposes several reforms. First, Section 4966 of the Code prohibits distributions from a Donor Advised Fund to individuals. Second, donors, donor advisors, and investment advisors to Donor Advised Funds are automatically treated as disqualified persons with respect to the Sponsoring Organization for purposes of Section 4958(f) of the Code.[75] Accordingly, transactions between these persons and the Sponsoring Organization are subject to the excess benefit transaction rules contained in Section 4958 of the Code. In addition, the definition of "excess benefit transaction" is amended to include any grant, loan, compensation or similar payment[76] from a Donor Advised Fund to a person who is a donor, donor advisor, or related person.[77] The entire amount of any such grant, loan, compensation or similar payment is treated as an "excess benefit" subject to the tax, regardless of whether the terms of the payment are reasonable. Finally, if a donor, donor advisor, or related person receives, directly or indirectly, a benefit as a result of a distribution from a Donor Advised Fund, and such benefit is more than incidental, Section 4967 of the Code would impose excise taxes of 125% of the more than incidental benefit[78] on the donor or donor advisor who recommended the distribution and on the recipient of the benefit.[79] An excise tax of 10% of the more than incidental benefit is also imposed on Fund Managers who approved the distribution.[80] There is no exception for Fund Managers acting not willfully and due to reasonable cause. No tax will be imposed under Code Section 4967 if a tax has been imposed under Code Section 4958 with respect to the distribution.[81]

V. Reporting Compensation on Form 990

A. Key Thresholds and Definitions. Thresholds vary for purposes of reporting names and compensation on Form 990 as follows:

1. Director or Trustee. All voting directors and trustees of a charitable organization are reported on Form 990 without regard to compensation.

2. Officer. All officers of a charitable organization are reported without regard to compensation.

3. Key Employee. A key employee is reported on Form 990 only if the employee's compensation exceeds $150,000 and the employee (a) has responsibilities, powers or influence over the organization similar to those of officers, directors or trustees, (b) manages a discrete segment or activity of the organization that represents at least 10% of the assets, income or expenses of the organization, or (c) has or shares authority to control or determine at least 10% of the organization's capital expenditures, operating budget or employee compensation.

4. Highest Compensated Employees. An organization's highest compensated employees include its other employees whose compensation exceeds $100,000. Only the top five highest compensated employees are reported on Form 990.

5. ODTKEs. ODTKEs include officers, directors, trustees and key employees.

6. Family Member / Family Relationship. For purposes of Form 990 reporting, a family member includes an individual's spouse, ancestors, siblings (whole or half), children (natural or adopted), grandchildren, great-grandchildren, and spouses of siblings, children, grandchildren, and great-grandchildren.

B. Part VI – Line 15; Rebuttable Presumption of Reasonableness. Line 15 of Part VI asks "[d]id the process for determining compensation of the CEO/Executive Director/top management official and other officers or key employees of the organization include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?" Essentially, the organization is asked to describe if and how it establishes a rebuttable presumption of reasonableness for compensation paid to the listed individuals. Schedule O must include a description sufficient to evidence that the organization takes appropriate steps to avoid the payment of "excess benefits" that could be taxable to the recipient and managers under Section 4958 of the Code. A clue to the desired elements of the compensation determination process is found in Schedule J, Part 1, Line 3, which lists the following components: compensation committee, independent compensation consultant, Form 990s of other organizations, written employment contracts, compensation surveys, and approval by the governing board or compensation committee.

C. Part VII – ODTKEs and Highest Compensated Employees. All compensation paid to ODTKEs and highly compensated employees must be reported in Part VII. For purposes of Part VII, a person with any voting power at any time during the year, whether compensated or not, is considered a director or trustee and must be listed. If the membership of the board changes during the year, there will be more directors listed than the number that served at any one time, and all of them will be listed as "current" members of the board per the Form 990 instructions. Officers include anyone with top administrative and financial duties without regard to designation or title.

One objective of the Form 990 redesign with respect to compensation reporting was to gain the ability to compare similar organizations with different tax years. Thus, compensation for all organizations is reported on a calendar year basis as reflected on Forms W-2 or 1099. The following compensation must be reported for the individuals required to be listed in Part VII regardless of amount: (i) salaries and bonuses; (ii) employer contributions to defined benefit retirement plans; (iii) tax deferred employer and employee contributions to qualified defined contribution retirement plans; (iv) increase in the actuarial value of a qualified or nonqualified defined benefit plan, whether or not the plan is funded, vested or subject to a substantial risk of forfeiture; (v) increase in the value of a deferred compensation plan, whether or not vested or paid to the employee; and (vi) the value of health benefits provided by the employer that are not reported as part of reportable compensation, such as health insurance premiums, medical reimbursement, flexible spending plan contributions, and the value of health coverage provided by an employer's self-insured or self-funded health plan. Other compensation, such as compensation from a related organization and other reportable employee benefits (e.g., automobile allowances, life insurance, tuition assistance, dependent care assistance, disability insurance and club dues), must be reported if it exceeds $10,000 per item.[82]

Reporting difficulties with Part VII stem primarily from payments made by affiliated organizations, outside management companies, and common paymasters, including how to obtain the proper information and what to report. For example, Organization A serves as common paymaster for itself and Organization B, a related entity. Officer M works 75% of her time for A and 25% for B. One hundred percent of M's compensation is reported on the returns for both organizations. Thus, a person reading both organizations' Forms 990 may conclude that Officer M received more compensation than was actually paid due to the requirement to report the same compensation on both returns. The organizations can alleviate this misperception of excessive compensation by including a statement on Schedule O of both returns that describes the allocation of Officer M's compensation between the two organizations and that explains the same compensation is required to be reported on both returns.

D. Schedule J – Compensation Information for Certain ODTKEs and Highest Compensated Employees. Schedule J requires an organization to report additional detailed information regarding the compensation paid to certain ODTKEs and highest compensated employees. An organization is required to complete Schedule J if it meets any of the following requirements: (i) the organization is required to list any former ODTKE or highest compensated employees in Part VII; (ii) the sum of reportable compensation and other compensation paid to any individual listed in Part VII exceeds $150,000; or (iii) the organization participated in an arrangement in which an unrelated organization paid compensation to one of its ODTKEs or highest compensated employees for services performed for the filing organization. If an organization is required to file Schedule J, the organization only needs to report on Schedule J the individuals that satisfy one of the three threshold requirements; other ODTKEs and highest compensated employees are not required to be reported on Schedule J.

Part I contains questions regarding the organization's executive compensation practices and policies. Line 3 asks about the method for determining compensation for the organization's chief executive officer. Like line 15 in Part VI of the core form, the question seeks to determine if the organization is following the rebuttable presumption of reasonableness procedures in determining the CEO's compensation. All other questions in Part I relate to the organization's compensation practices and policies with respect to all of its ODTKEs and highest compensated employees reported in Part VII, even if the details of the compensation paid to some of those individuals are not required to be reported on Schedule J. Line 4 asks whether any of the reported individuals received a severance or change of control payment, participated in a supplemental nonqualified retirement plan, or participated in an equity-based compensation arrangement. If so, the details of the arrangement must be described in Part III of Schedule J. In particular, the Internal Revenue Service is likely to scrutinize severance payments and equity-based compensation arrangements for potential excess benefit. The Internal Revenue Service is suspicious of any compensation that does not have a fixed amount or value. Therefore, lines 5, 6, and 7 ask whether the organization has paid any non-fixed payments to or participates in revenue-sharing arrangements with its ODTKEs and highest compensated employees. If so, the details of the arrangement must be reported in Part III of Schedule J.

E. Schedule L – Relationships. This schedule should be considered hand-in hand with responses provided in the governance portion of Part VI of Form 990. The completion of

Schedule L is made more complicated by the fact that the four separate parts each have a different definition of the term "interested person."

Part I requires disclosure of impermissible excess benefits with disqualified persons, which are subject to the intermediate sanctions penalties under Section 4958 of the Code and required to be reported on Form 4720. Coordination of the information provided in Line 15 of Part VI and Lines 1-8 of Schedule J, Part I (relating to compensation), is prudent.

Part II reports loans to or from interested persons that are outstanding at the end of the year, regardless of whether the loans constitute excess benefit transactions under Section 4958. Loans for this purpose include salary and other advances and receivables. Interested persons include current and former ODTKEs listed in Part VII, Section A, highest compensated employees, and disqualified persons as defined in Section 4958 of the Code. Even though loans to or from interested persons may be permissible, the Internal Revenue Service, the Panel on the Nonprofit Sector and charity watchdog groups all view interested person loans with great skepticism.

Part III reports grants or assistance benefiting interested persons. Interested persons for this purpose include current and former ODTKEs listed in Part VII, Section A, substantial contributors, and family members and 35% controlled entities of any of the foregoing. The INTERNAL REVENUE SERVICE has stipulated that grants paid to an interested person who is a member of the charitable class which the grant is intended to benefit in furtherance of the organization's exempt purpose, such as disaster relief or trauma counseling, need not be reported. Grants to enhance one's literary, artistic or other skills are reportable. The names of interested person grantees receiving funding for study or travel or for achievement awards must be included. Schools that award scholarships are not required to identify interested persons who receive grants.

Part IV identifies reportable business transactions for which payments were made between the organization and an interested person during the tax year. The definition of interested person is broad and includes current and former ODTKEs listed on Part VII, Section A, family members or 35% controlled entities of any ODTKEs, or an entity (other than an exempt organization described in Section 501(c) of the Code or a governmental unit or instrumentality) of which a current or former ODTKE listed in Form 990, Part VII, Section A was serving at the time of the transaction as (1) an officer, (2) a director, (3) a trustee, (4) a key employee, (5) a partner or member with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is treated as a partnership, or (6) a shareholder with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is a professional corporation. Business transactions include contracts of sale, lease, license, and performance of services and also joint ventures in which the interest of the organization and of the interested person each exceeds 10%. Business transactions with interested persons are reportable if: (1) all payments during the tax year between the organization and interested person exceeded $100,000, (2) all payments from a single transaction between the organization and interested person exceeded the greater of $10,000 or 1% of the organization's total revenues, (3) compensation payments by the organization to a family member of certain persons exceeded $10,000, or (4) in the case of a joint venture with an interested person, the organization has invested $10,000 or more.

VI. **Texas Law Related to Nonprofit Executive Compensation.** Texas law is similar to federal tax law regarding compensation of officers and directors of a nonprofit organization. The Texas Nonprofit Corporation Law (TNCL) allows nonprofit corporations to "pay compensation in a reasonable amount to its . . . directors and officers for services rendered."[83]

A. Role of the Board of Directors. Typically, Texas nonprofit corporations are managed by a board of directors (sometimes called the board of trustees). Texas law requires a minimum of three directors of a nonprofit corporation.[84] The board of directors is ultimately responsible for the oversight of the nonprofit corporation. The board of directors elects the officers of the nonprofit corporation who are responsible for the day to day management of the corporation.[85]

B. Fiduciary Duties of Nonprofit Directors. The fiduciary standards applicable to charitable directors include the duty of care, the duty of loyalty, and the duty of obedience.

1. Duty of Care. All nonprofit directors are subject to a duty of care. The duty of care requires a nonprofit director to discharge his responsibilities in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes is in the best interests of the organization.[86] The degree of skill required is that of the ordinary prudent person, that is, the basic directorial attributes of common sense, practical wisdom, and informed judgment. If a director has special expertise, such as accounting, legal or investment expertise, then that director must exercise the degree of skill that a prudent person with similar expertise would exercise in the same or similar circumstances. The duty of care also requires that directors make decisions they reasonably believe to be in the best interests of the corporation.[87]

A director can fail to discharge the duty of care in two ways: by failing to supervise or by failing to make an informed decision. Adequate supervision means that the director actively participates in the charity's governance, such as by regularly attending board meetings, reviewing minutes and other materials disseminated to board members, meeting periodically with senior management, periodically reviewing the charity's financial statements and annual information returns (IRS Form 990), and asking questions of outside experts such as consultants, accountants and attorneys when appropriate. To make an informed decision, a director must be adequately informed about the material aspects of a proposed transaction before approving it. In discharging the duty of care, a director may rely in good faith on information, opinions, reports or statements concerning the corporation that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or outside professional advisors to the corporation (e.g., auditors, legal advisors, and investment advisors).[88] Thus, directors should be aware of the compensation paid to the organization's officers and the method used to determine the officers' compensation. If the director is serving on a compensation committee (or if approval of officer compensation is done by the entire board), then the director should review all relevant materials related to the compensation decision prior to the meeting and ask relevant questions of any compensation consultant retained by the organization.

The business judgment rule protects nonprofit directors by providing that directors will not be liable for harm to the corporation for the exercise of their judgment so long as they exercised care in the decision making process. Thus more than simple negligence on the part of the director is required to hold the director liable for a breach of the duty of care. The business judgment rule applies only in the absence of fraud, illegality or a disabling conflict of interest. In summary, the duty of care relates to the decision-making process. If a nonprofit director acts in good faith and satisfies the requisite standard of care, a court generally will not review the action, even if it proves disastrous to the charity. Accordingly, compliance with the duty of care protects a nonprofit director from liability for decisions that, with the benefit of hindsight, turn out to be wrong.

2. Duty of Loyalty. To satisfy the duty of loyalty, a nonprofit director must act in the best interests of the corporation, but does not need to avoid personal gain at all costs. In the nonprofit corporate setting, a conflict-of-interest or self-dealing transaction is not flatly prohibited, but should be carefully scrutinized. The only exception is a blanket prohibition on loans to directors of a nonprofit corporation; any director who votes for or assents to the making of the loan is jointly liable for the amount of the loan until it is repaid.[89] Before engaging in a self-dealing or conflict-of-interest transaction with a charitable organization (including payment of compensation to the director in the director's capacity as an officer of the organization), the director should disclose all material facts relating to his personal interest in the transaction to the board of directors or a committee of the board comprised of disinterested directors, and a majority of disinterested directors or committee members should approve the transaction only after concluding that it is fair and reasonable to the charity.[90] If this procedure is followed, then the transaction is not void or voidable solely because of the director's interest in the transaction. If the transaction occurred prior to obtaining approval from a majority of disinterested directors, then the transaction may be ratified by a majority of disinterested directors or a committee of the board comprised of disinterested directors provided the transaction is fair to the nonprofit corporation. A breach of the duty of loyalty not only gives rise to a tort claim under state law, but may also implicate penalties under federal tax law as an excess benefit transaction.

3. Duty of Obedience. The duty of obedience requires a director to adhere to the governing documents of the organization and to faithfully adhere to its mission, and to follow restrictions imposed by donors on contributions of charitable funds. Essentially, the duty of obedience requires directors and trustees to refrain from transactions and activities that are ultra vires. Thus, a director must carefully review the governing documents of the organization and adhere to any provisions in the governing documents addressing the compensation of the organization's directors and officers.

4. Limitation of Liability. Texas law allows for a nonprofit corporation to limit the liability of its directors to the organization or its members for monetary damages for an act or omission by the director in the person's capacity as a director by including appropriate provisions in its certificate of formation.[91] However, the elimination or limitation of the liability of a director is not allowed to the extent the person is found liable under applicable law for: (1) a breach of the director's duty of loyalty; (2) an act or omission not in good faith that: (A) constitutes a breach of duty of the director to the organization; or (B) involves intentional misconduct or a knowing violation of law; (3) a transaction from which the director received an

improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the director's duties; or (4) an act or omission for which the liability of a director is expressly provided by an applicable statute.[92]

C. Enforcement by the Texas Attorney General. Officers and directors who breach their fiduciary duties to the nonprofit corporation may be held liable to the nonprofit corporation for the resulting damages to the corporation. Generally, the Texas Attorney General is vested with the authority to investigate and enforce potential breaches of fiduciary duties by nonprofit officers and directors. While the enforcement of excessive compensation paid to nonprofit directors and officers in Texas by the Texas Attorney General is not common, it has been successfully done.

Most recently, the Texas Attorney General brought suit against several directors of the Carl B. and Florence E. King Foundation seeking to recover excessive compensation paid to the officers.[93] The King Foundation was established in 1966 by oilman Carl B. King and his wife, Florence E. King. The primary defendant in the case, Carl L. Yeckel, is the Kings' grandson. Yeckel was elected to the King Foundation's board of directors in 1971. At the time, Florence King was the board's president. Thereafter, in 1975, Yeckel accepted full-time employment with the King Foundation for an annual salary of $24,000. Yeckel was elected president of the King Foundation in 1993, after the death of both his grandparents. On October 6, 1994, during his first year as Foundation president, Yeckel sent a memorandum to the board proposing raises for himself and the King Foundation's two other employees, Thomas Vett, the corporate secretary and accountant, and office staffer Carolyn Mott. In the memo, Yeckel advised the board that his annual salary as of that date was $220,800, that Vett's salary was $120,700, and that Mott's salary was $75,500. Yeckel proposed a four percent fixed salary increase for each employee plus "a possible merit scale of 0 - 4%," effective as of June 1, 1994. Yeckel further stated that the King Foundation's practice had been to increase or adjust salaries each April 1, and justified the raises he proposed as necessary to correct a "twenty month oversight" in making those annual adjustments. Yeckel's memo prompted at least one of the King Foundation's board members to raise concerns that the salary levels were high compared to comparable foundations--between seventeen and sixty-five percent higher, the board member claimed--and could create problems with the Internal Revenue Service. Similar concerns were raised by the accountant who prepared the King Foundation's tax returns.

In the years that followed, Yeckel did not again disclose employee salaries to the King Foundation's board, although this information was included in the Foundation's annual tax returns. Yeckel was able to set his own compensation and that of Vett and Mott, without board approval. He steadily increased his compensation during each year of his presidency between twenty and twenty-six percent each year from 1996 through 2000, while awarding Vett annual increases of between nineteen and twenty-two percent. By 2002, Yeckel's annual salary was $974,978, Vett's was $451,937, and Mott's was $141,622, not counting benefits. In addition, a separate bank account was established from which the salaries of Yeckel and Vett were paid, and no one other than Yeckel and Vett saw the checks written on that account. Board members were unaware of the continued increases in Yeckel's compensation after 1994 and of various benefits that Yeckel provided to himself using Foundation funds, including use of vehicles, private club

memberships, payment of all unreimbursed health expenses for himself and his family, and use of Foundation credit cards for personal charges that were not required to be reimbursed.

In August 2002, after receiving a complaint from Yeckel's sister, the Texas Attorney General sued the King Foundation, Yeckel, Vett, and other directors to protect the public interest in the administration of charitable assets held by the King Foundation. The suit asserted claims against Yeckel, Vett and other officers and directors of the King Foundation for breach of fiduciary duty, conversion, conspiracy to commit fraud, and violation of the Texas Non-Profit Corporation Act. Subsequently, Yeckel resigned from the King Foundation, each of the other members of the five-member board either resigned or was removed, and Vett was terminated. With a new board of directors in control, the Texas Attorney General dropped its suit against the King Foundation, and the King Foundation asserted its own claims against Yeckel, the other former directors, and Vett, and was realigned as a co-plaintiff with the Texas Attorney General. Ultimately, settlements were reached with most of the other directors and a trial on the claims against Yeckel and Vett ensued. The jury found Yeckel and Vett breached their fiduciary duties to the King Foundation and received excessive compensation for their services. Yeckel was ordered to reimburse the King Foundation $5,286,946.76 and Vett was ordered to reimburse the King Foundation $2,304,629.49. Additional punitive damages of $14 million awarded by the jury were not upheld on appeal.[94] The King Foundation case is representative of situations in which the failure of board members to properly exercise their duty of care by staying informed and properly supervising creates an environment ripe for abuse by self-interested officers and directors.

D. Proposed Legislation. The Texas Legislature is currently considering legislation that would increase the enforcement power of the Texas Attorney General with respect to charitable organizations. House Bill 2921[95] would amend the Texas Business Organizations Code to provide:

> If the attorney general has reason to believe that a nonprofit entity with a charitable purpose is engaging in, has engaged in, or is about to engage in an unlawful act or practice or that it would be in the public interest to conduct an investigation to ascertain whether the entity is engaging in, has engaged in, or is about to engage in an unlawful act or practice, the attorney general may:
>
> (1) require an employee or agent of the entity to file on forms prescribed by the attorney general a statement or report in writing, under oath or otherwise, as to all the facts and circumstances concerning the alleged unlawful act or practice and other data and information the attorney general considers necessary; and
>
> (2) examine under oath any person in connection with the alleged unlawful act or practice.[96]

A similar amendment is proposed for the Texas Trust Code relating to charitable trusts.[97] House Bill 2921 was recently reported favorably out of the State Affairs Committee on April 19, 2011 and may now be considered by the Texas House of Representatives. A similar Senate Bill 342[98] is currently pending for Senate committee action.

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[2] *See, e.g.,* Chronicle of Philanthropy 2010 Executive Compensation Survey, available at http://philanthropy.com (the Chronicle of Philanthropy's annual survey lists the compensation and benefits paid to top executives of some the nation's largest charitable organizations and is not a representative sample of nonprofit executive compensation generally); The Chronicle of Higher Education 2010 Executive Compensation Survey, available at http://chronicle.com (The Chronicle of Higher Education's annual survey lists the compensation and benefits of the chief executive officers at hundreds of public and private institutions).

[3] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[4] Gen. Couns. Mem. 35855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[5] *See* Treas. Reg. § 1.501(a)-1(c); *see, e.g,* South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

[6] *See, e.g.,* Texas Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); Tech. Adv. Mem. 9130002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

[7] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

[8] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(2).

[9] Private foundations are subject to a different excise tax regime on transactions with disqualified persons. *See* I.R.C. § 4941. Section 4941 of the Code prohibits direct or indirect acts of "self dealing" between a private foundation and those individuals or entities who are "disqualified persons" with respect to the foundation. Typically, in considering whether a transaction between a private foundation and a disqualified person is an act of self-dealing, it is immaterial whether the transaction results in a benefit or detriment to the foundation. Treas. Reg. § 53.4941(d)-1(a). However, a private foundation generally may pay reasonable compensation to a disqualified person, including its officers and directors, without creating a prohibited act of self-dealing. The payment of compensation to a disqualified person for services unrelated to carrying out the foundation' s exempt purposes and the payment of excessive compensation (or payment or reimbursement of excessive expenses) by a private foundation to a disqualified person are prohibited acts of self-dealing. I.R.C.§ 4941(d)(2)(E).

[10] I.R.C. § 4958(c)(1).

[11] I.R.C. § 4958(f)(1).

[12] I.R.C. § 4958(a)(2).

[13] I.R.C. § 4958 (d)(2).

[14] I.R.C. § 4958(f)(6). The Treasury Regulations contain specific procedures to correct certain excess benefit transactions between a public charity and a disqualified person. *See* Treas. Reg. § 53.4958-7.

[15] I.R.C. § 4958(f)(1).

[16] Treas. Reg. § 53.4958-3(c).

[17] Treas. Reg. § 53.4958-3(e).

[18] Treas. Reg. § 53.4958-3(e)(2).

[19] Treas. Reg. § 53.4958-3(e)(3).

[20] Notice 2010-78, 2010-49 I.R.B. 808 (Oct. 28, 2010). Note that this is a different standard than the one used to determine which individuals are "highly-compensated employees" for Form 990 reporting purposes.

[21] Treas. Reg. § 53.4958-3(d)(3).

[22] *Id*.

[23] Treas. Reg. § 53.4958-4(a)(3)(i).

[24] Treas. Reg. § 53.4958-4(a)(3)(iii).

[25] Treas. Reg. § 53.4958-4(a)(3)(ii).

[26] *Id.*

[27] Treas. Reg. § 53.4958-4(a)(3)(vi).
[28] A charitable organization's payment of premiums for liability insurance covering Section 4958 excise taxes or indemnification of such taxes will not be an excess benefit if the premium or indemnification is included in the disqualified person's compensation when paid and the disqualified person's total compensation is reasonable. Treas. Reg. § 53.4958-4(b)(1)(B)(2).
[29] Treas. Reg. § 53.4958-4(b)(1)(B).
[30] Treas. Reg. § 53.4958-4(a)(4).
[31] Treas. Reg. § 53.4958-4(b)(1)(ii).
[32] Mayson Mfg. Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949).
[33] Treas. Reg. § 53.4958-4(b)(1)(ii).
[34] These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the agreement providing for the transfer of the property. Treas. Reg. § 53.4958-4(b)(2)(i).
[35] Treas. Reg. § 53.4958-4(b)(2)(i).
[36] *See, e.g.,* Treas. Reg. § 53.4958-4(c)(4) Example 2.
[37] Treas. Reg. § 53.4958-4(c)(1).
[38] Treas. Reg. § 53.4958-4(c)(3).
[39] Treas. Reg. § 53.4958-4(c)(2).
[40] I.R.C. § 4958(c)(4).
[41] Prop. Treas. Reg. § 53.4958-5(a) (withdrawn).
[42] Prop. Treas. Reg. § 53.4958-5(d) (withdrawn).
[43] Non-fixed payments to a disqualified person not subject to a cap are generally not advisable. The Internal Revenue Service will not presume any non-fixed payments to be reasonable until the amounts are determined. Treas. Reg. § 53.4958-6(d). Therefore uncapped non-fixed payments are highly vulnerable to challenges as excess benefit transactions or private inurement.
[44] H.R. Rep. No. 104-506, at 56-57.
[45] Treas. Reg. § 53.4958-6(a)(1)-(3).
[46] Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).
[47] Treas. Reg. § 53.4958-6(c)(1)(ii).
[48] Treas. Reg. § 53.4958-6(a)(1).
[49] Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).
[50] Treas. Reg. § 53.4958-6(c)(2)(i). For organizations with annual gross receipts of less than $1 million, the authorized body will be considered to have appropriate data as to comparability if it has compensation data of three comparable organizations in the same or similar communities for similar services. Treas. Reg. § 53.4958-6(c)(2)(ii).
[51] Treas. Reg. § 53.4958-6(c)(3)(i)(A)-(D), (ii).
[52] Treas. Reg. § 53.4958-6(c)(3)(ii).
[53] Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II (March 2007), available at http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf.
[54] The 18-page script from the Phone Forum is available at http://www.irs.gov/pub/irs-tege/may_17_final_script_exec_comp_phone_forum.pdf.
[55] In fact, many of the proposed reforms contained in the discussion draft found their way into the Pension Protection Act of 2006 (the "PPA"), which was enacted in August 2006. While compensation reforms were not contained in the PPA, then-serving Senate Finance Committee Chairman Grassley indicated that the PPA was only the first of proposed legislative reforms for the charitable community and that more should be expected.
[56] Available at http://www.nonprofitpanel.org/Report/final/Index.html.
[57] Available at http://www.nonprofitpanel.org/Report/principles/Principles_Guide.pdf.
[58] I.R.C. § 509(a)(3).
[59] Proposed regulations issued on September 24, 2009 provide an integral part test to determine whether a Type III supporting organization qualifies as a functionally integrated Type III supporting organization. *See* Prop. Treas. Reg. § 1.509(a)-4(i)(4). A Type III supporting organization satisfies this integral part test if it either (1) serves as the parent of each of its supported organizations or (2) engages in activities (i) substantially all of which directly further the exempt purposes of its supported organizations, by performing the functions of, or carrying out the purposes of,

such supported organizations, and (ii) that, but for the involvement of the supporting organization, would normally be engaged in by its supported organizations. *Id*.

[60] I.R.C. § 4943(f)(5)(B). As the Joint Committee on Taxation explains:

> The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii). Under Treasury regulation section 1.509(a)-4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a payout requirement on any or all organizations not currently required to pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 360, n. 571.

[61] Pub. L. No. 109-280 (2006).

[62] I.R.C. § 4958(f)(1)(D).

[63] The term "other similar payment" is not intended to include a payment pursuant to a bona fide sale or lease of property. Such payments are instead subject to the general rules of Section 4958 if the substantial contributor meets the definition of a "disqualified person." Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 358.

[64] I.R.C. § 4958(c)(3).

[65] *Id.*

[66] I.R.C. § 4966(d)(1).

[67] A fund or account of a Sponsoring Organization which pools contributions of multiple donors generally will not meet the first prong of the definition of "donor advised fund" unless the contributions of specific donors are in some way tracked and accounted for within the fund. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 342-43.

[68] This requirement is satisfied only if the expectation of advisory privileges is by reason of the donor's status as donor, and not solely by reason of the donor's service to the Sponsoring Organization, such as by reason of the donor's position as an officer, employee or director of the Sponsoring Organization. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 344.

[69] I.R.C. § 4966(d)(2).

[70] I.R.C. § 4966(d)(2)(B)(ii).

[71] I.R.C. § 4966(d)(2)(B)(i).

[72] Notice 2006-109, 2006-51 I.R.B. 1121.

[73] I.R.C. § 4966(d)(3).

[74] I.R.C. § 4966(d)(4).

[75] I.R.C. § 4958(f)(1)(D) and (E).

[76] The term "other similar payment" is not intended to include a payment pursuant to a bona fide sale or lease of property. Such payments are instead subject to the general rules of Section 4958. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 347.

[77] I.R.C. § 4958(c)(2).

[78] Although there is no statutory definition of "incidental benefit," the Joint Committee on Taxation's interpretation of this provision states that there is only an incidental benefit if, as a result of a distribution from a Donor Advised Fund, a donor, donor advisor or related person, receives a benefit that would have reduced a charitable contribution deduction if the benefit was received as part of the contribution to the Sponsoring Organization. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 350.

[79] I.R.C. § 4967(a)(1).

[80] I.R.C. § 4967(a)(2).

[81] I.R.C. § 4967(b).

[82] The $10,000 reporting threshold for other employee benefits and compensation paid by related organizations applies only to compensation reported in Part VII. These items are also required to be reported on Schedule J, regardless of amount. Accordingly, the amounts reported on Schedule J may exceed the amount of compensation reported in Part VII for the same person.

[83] Tex. Bus. Org. Code § 22.054.

[84] Tex. Bus. Org. Code § 22.204(a).

[85] *See* Tex. Bus. Org. Code § 22.232(b).

[86] *See* Tex. Bus. Org. Code § 22.221(a).

[87] *See* Tex. Bus. Org. Code § 22.221.

[88] *See* Tex. Bus. Org. Code § 3.102.

[89] *See* Tex. Bus. Org. Code § 22.225. In addition, loans to officers of a nonprofit corporation are prohibited unless the loan is "(1) made for the purposes of financing the officer's principal residence; or (2) set in an original principal amount that does not exceed: (A) 100 percent of the officer's annual salary, if the loan is made before the first anniversary of the officer's employment; or (B) 50 percent of the officer's annual salary, if the loan is made in any subsequent year." Tex. Bus. Org. Code § 22.055(b).

[90] *See* Tex. Bus. Org. Code § 22.230. Note that the procedure under Texas law for interested director transactions is not as stringent at the rebuttable presumption of reasonableness procedure for transactions with disqualified persons under Section 4958 of the Code.

[91] *See* Tex. Bus. Org. Code § 7.001(b).

[92] *See* Tex. Bus. Org. Code §7.001(c).

[93] *See* Yeckel v. Abbott, No. 03-04-00713-CV, 2009 Tex. App. LEXIS 3881 (Tex. App. – Austin June 4, 2009, pet. denied) (mem. op.).

[94] *Id.*

[95] Tex. H.B. 2921, 82nd Leg., R.S. (2011).

[96] *Id.*

[97] *Id.*

[98] Tex. S.B. 342, 82nd Leg., R.S. (2011).