ROCKY MOUNTAIN TAX SEMINAR
FOR PRIVATE FOUNDATIONS

CURRENT AND DEFERRED COMPENSATION FOR DIRECTORS AND OFFICERS: THE RED FLAGS

September 11, 2013

Celia Roady, Esq.
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
202-739-5279
croady@morganlewis.com

CURRENT AND DEFERRED COMPENSATION FOR DIRECTORS AND OFFICERS: THE RED FLAGS

Celia Roady
Morgan, Lewis & Bockius LLP
Washington, DC

I. Introduction

A. Director and officer compensation is coming under scrutiny on many fronts: Congress, state charity regulators, the Internal Revenue Service, and the media. Private foundations are no exception, and this scrutiny on compensation requires all private foundations to review their compensation procedures and ensure compliance with current law, as well as to monitor closely current developments on this issue.

B. At the Congressional level, the option of limiting executive compensation by tax-exempt organizations is included on the list of possible tax reform options for consideration on the Senate Finance Committee Staff's paper of June 13, 2013.

C. At the state level, the State Attorney General in Massachusetts has been a vocal opponent of director compensation in nonprofit organizations and legislation has been introduced to require prior approval to pay compensation to non-employee officers, directors and trustees of public charities.

D. The IRS issued the final report on its audit project of colleges and universities, and the findings noted deficiencies in how compensation decisions were made by some organizations.

E. Private foundations need to review their compensation policies and practices in light of these developments in order to ensure that they are consistent with the applicable legal standards under Sections 4941 (self-dealing) and 4945 (taxable expenditures).

II. Definition of Disqualified Persons

A. Section 4941 imposes an excise tax penalty on "disqualified persons" ("DPs") who engage in "acts of self-dealing" with private foundations. The definition of an act of self-dealing includes the payment of compensation, subject to a narrow exception allowing the payment of reasonable compensation for personal services under certain circumstances, as described below.

B. Section 4946 lists specific categories of persons who are considered to be DPs with respect to a private foundation –

1. "Substantial contributors," meaning persons who have contributed more than $5,000 to the foundation, if the amount is more than 2% of all the contributions received by the foundation since its inception.

2. "Foundation managers," including directors, officers, trustees, persons with similar powers or responsibilities and employees who had authority or responsibility with respect to the act of self-dealing.

3. Owners of more than a 20% interest in a substantial contributor, meaning persons who own more than 20% of the profit interests of a partnership, the beneficial interests of a trust or the total combined voting power of a corporation if such entity is a "substantial contributor" to the foundation.

4. Family members of individuals described in (1), (2) or (3), meaning a DP's spouse and ancestors, as well as children, grandchildren, great-grandchildren and their spouses, but not a DP's brothers and sisters.

5. A corporation, partnership, trust or estate in which persons described in (1), (2), (3) or (4) hold more than 35% of the voting power or interests.[1]

III. <u>Payment of Reasonable Compensation as an Exception to Self-Dealing Rules</u>

A. Section 4941(d)(1)(D) provides that, as a general rule, the payment of compensation or reimbursement of expenses to a DP by a private foundation is an act of self-dealing. A DP who engages in an act of self-dealing is subject to an excise tax penalty (discussed below), as is a foundation manager who knowingly approves an act of self-dealing.

B. Section 4941(d)(2)(E) provides an exception for the payment by a private foundation of reasonable compensation to a DP for certain "personal services" that are necessary to carry out the foundation's exempt purposes.

1. The term "personal services" includes personal services rendered by a DP for serving as an officer or trustee of the foundation.

2. Treas. Reg. 53.4941(d)-3(c)(1) provides that the term "personal services" also includes the services of a broker serving as the agent for the private foundation. In addition, based on examples contained in the regulations, the term includes legal, investment management and banking services. The term does not include the services of a dealer who buys from the foundation and resells to a third party.

(a) In recent years, the IRS has interpreted the scope of the personal services exception very narrowly, and foundations should be

---

[1] Certain government officials are also considered to be DPs. Government officials are not discussed in this outline because private foundations are not permitted to pay compensation to DPs who are government officials.

cautious in applying the provision in contexts that go beyond the categories set forth in the regulations.

(b) See Madden v. Commissioner, 74 T.C.M. 440 (1997), in which the Tax Court held that the "personal services" exception is intended to cover services that are "essentially professional and managerial in nature."

3. The determination of whether compensation is reasonable is made based on the standards set forth under Section 162, which provides generally that reasonable compensation is the amount that would ordinarily be paid for comparable services by similarly situated employers under similar circumstances. (Treas. Reg. 1.162-7)

4. In addition to allowing the payment of reasonable compensation for personal services, the regulations provide that a foundation manager or employee may receive reasonable cash advances for and reimbursements of expenses incurred on behalf of the foundation, generally up to $500 (Treas. Reg. 53.4941(d)-3(c)(1)).

5. Note that the reasonable compensation exception does not override other self-dealing prohibitions, such as the making of a loan to a DP. For example, in Private Letter Ruling 9530032, a private foundation offered a below-market rate home mortgage loan to a person it sought to hire as a foundation manager. The loan was part of a compensation package extended to induce him to accept the job offer, which required him to move to an area with higher housing costs. Although the loan was part of a compensation package, the IRS held that it constituted an act of self-dealing because Section 4941(d)(1)(B) prohibits any loan from a private foundation to a DP.

6. <u>Examples of Rulings Involving Exception for Reasonable Compensation</u>

(a) In Private Letter Ruling 200007039, the children and grandchildren of a private foundation's founder served on the foundation's board. The board members managed all aspects of the foundation's operations, which had no paid staff. The IRS approved the foundation's request to pay compensation to the individual board members under the personal service exception, provided that the compensation would be reasonable and not excessive.

(b) In Revenue Ruling 74-591, the IRS permitted a private foundation to provide a pension to one of its directors in recognition of past services. The amount of the pension was reasonable, and the DP's services were necessary in carrying out the foundation's exempt purposes.

C. Procedure for Setting Compensation – Analogy to Intermediate Sanctions Rules

1. In 1996, Congress enacted Section 4958, which is modeled on the self-dealing rules under Section 4941 and imposes an excise tax penalty on insiders who engage in "excess benefit transactions" (including the receipt of unreasonable compensation) with public charities. The regulations under Section 4958 set forth certain procedures that, if followed by public charities in setting compensation for DPs, will provide a "presumption of reasonableness."

2. Under Treas. Reg. 53.4958-6(b), the presumption of reasonableness shifts the burden of proof from the taxpayer to the IRS in the event of a challenge to the reasonableness of a particular transaction. This means that in such a dispute, there will be a presumption that the compensation is reasonable, which the IRS may rebut only by providing sufficient evidence challenging the probative value of the comparability data used by the foundation.

3. Although the regulations under Section 4941 do not contain a comparable "presumption of reasonableness," the IRS has indicated that it is considering adopting such a provision. (Announcement 2002-47 (April 23, 2002)) Accordingly, private foundations should be aware of the procedures set forth under Section 4958 and may be well-advised to follow them to the extent possible.

4. Under Treas. Reg. 53.4958-6, an organization is entitled to a "rebuttable presumption" that payments under a compensation arrangement are reasonable if the following three requirements are met:

   (a) The compensation is set and approved in advance by the board of directors or by a board committee and none of the board or committee members have a "conflict of interest" with respect to the compensation arrangement. An individual is deemed not to have a conflict of interest provided that he or she –

      (i) is not a DP participating in or economically benefiting from the compensation arrangement and is not a family member (as defined under Treas. Reg. 53.4958-6(c)(1)(iii)(A)) of any such DP;

      (ii) is not in an employment relationship subject to the direction or control of any DP participating in or economically benefiting from the compensation arrangement;

      (iii) does not receive compensation or other payments subject to approval by any DP participating in or economically benefiting from the compensation arrangement;

(iv) has no material financial interest affected by the compensation arrangement; and

(v) does not approve a transaction providing economic benefits to any DP participating in the compensation arrangement who in turn has approved or will approve a transaction providing economic benefits to the member.

(b) Prior to making its determination, the board or committee obtains and relies upon "appropriate data as to comparability" of the compensation, meaning sufficient information to determine whether the compensation arrangement is reasonable, given the knowledge and expertise of the board or committee. Treas. Reg. 53.4958-4(b) describes rules for determining reasonable compensation, the most notable of which establish that:

(i) the reasonableness standards of Section 162 apply here;

(ii) the fact that a compensation arrangement is subject to a cap is relevant to determining reasonableness; and

(iii) all sources of compensation must be considered in evaluating compensation, including benefits, regardless of whether included in the DP's gross income for income tax purposes. Relevant comparability data includes, but is not limited to:

- compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
- the availability of similar services in the geographic area of the applicable tax-exempt organization;
- current compensation surveys compiled by independent firms; and
- actual written offers from similar institutions competing for the DP's services.

(c) The board or committee adequately and concurrently documents the basis for its determination. Documentation is considered to be contemporaneous if the records are prepared before the later of the next board or committee meeting or sixty days after the final action of the board or committee is taken. The records must subsequently be reviewed and approved by the board or committee as reasonable, accurate and complete within a reasonable time period.

"Adequate documentation" means that the written or electronic records must note:

(i) that the terms of the transaction were approved and the date of such approval;

(ii) the board or committee members present during debate on the compensation arrangement and who voted on it;

(iii) the comparability data obtained and relied upon, and how such data was obtained;

(iv) any action taken with respect to consideration of the transaction by any board or committee members having a conflict of interest; and

(v) if reasonable compensation is higher or lower than the range of comparability data obtained, the basis for the board or committee's determination.

5. The intermediate sanctions regulations further provide that for purposes of determining whether an organization manager may be liable for knowingly approving an excess compensation arrangement, the manager may rely on the reasoned written opinion of an appropriate professional with respect to elements of a transaction within the professional's expertise made following full disclosure of the factual situation.

6. Sources of comparable compensation data may include the Council on Foundations' annual compensation study,[2] the Chronicle of Philanthropy's annual study[3] and information obtained from the IRS Form 990-PFs of comparable foundations. In some cases, it may be appropriate to engage an independent compensation consultant to provide data and an opinion as to reasonableness.

IV. <u>Treatment of Indemnification and Insurance Provided to Foundation Managers</u>

A. Treas. Reg. 53.4941(d)-2(f) outlines the treatment of indemnification and insurance under the self-dealing rules. The regulations contain different rules for applying the self-dealing prohibition to "compensatory" and "noncompensatory" indemnification and insurance.

1. <u>Compensatory Indemnification and Insurance:</u>

(a) Compensatory indemnification is defined as the indemnification of a foundation manager for expenses owed by the manager relating

---

2 See www.cof.org.

3 See <philanthropy.com>

to (i) any private foundation excise taxes, penalties or expenses of correction owed by the manager, (ii) any expense resulting from an act (or failure to act) with respect to which the manager has acted willfully and without reasonable cause and (iii) any other expense not reasonably incurred in connection with the defense of a civil administrative or civil judicial proceeding arising out of the manager's performance of services for the foundation.

(b) Compensatory indemnification will be considered self-dealing unless the indemnification amount, when added to the manager's other compensation, is reasonable and not excessive.

(c) In addition, the purchase of directors' and officers' insurance coverage attributable to the provision of compensatory indemnification constitutes self-dealing, unless the allocable cost of such insurance, when added to other compensation, is considered reasonable for purposes of Section 4941.

2. <u>Noncompensatory Indemnification and Insurance</u>

(a) The regulations permit a foundation to indemnify its managers for expenses involved in a civil judicial or administrative proceeding arising out of the manager's performance of services for the foundation (other than amounts that fall within the definition of compensatory indemnification as described above), provided that the DP's expenses are reasonably incurred and that the DP has not acted willfully and without reasonable cause with respect to the act (or failure to act) that led to the judicial or administrative proceeding.

(b) The regulations also permit a foundation to obtain insurance in connection with such indemnification. The cost of such insurance coverage need not be considered compensation for purposes of establishing the reasonableness of compensation under Section 4941.

V. <u>Matching Gift Programs</u>

A. Like many employers, some private foundations offer matching gift programs under which the foundation will match charitable contributions made by its employees to Section 501(c)(3) public charities.

B. The participation of DPs, such as foundation directors and officers, in matching gift programs does not violate the self-dealing laws, because any benefits received from participating in a matching gift program are considered incidental or tenuous.

C. In Private Letter Ruling 9630026, a private foundation proposed taking over a matching gifts program offered to employees and board members of a company that was a disqualified person with respect to the foundation. The IRS determined that no self-dealing was involved. The economic benefit the company received from turning over this program was deemed "incidental or tenuous," as the company was under no obligation to conduct its matching gift program. Likewise, the benefits received by the individuals participating in the program who were disqualified persons were also deemed to be incidental or tenuous.

D. In Private Letter Ruling 8004086, a private foundation offered to provide funding to public charities for which eligible employees of a company had provided at least one year of volunteer service. The grant funds could be used to purchase equipment or materials and to sponsor specific programs related to the employee's volunteer activities. The IRS determined that the intangible benefits received by the employees participating in this program as well as the public recognition, goodwill and increased employee satisfaction received by the company were incidental or tenuous benefits. Because no DP received benefits other than incidental or tenuous benefits, this matching gift program did not constitute self-dealing.

VI. Penalties for Violations of Self-Dealing Rules

A. Section 4941 imposes an excise tax on each act of self-dealing between a private foundation and a disqualified person. Section 4941 provides two tiers of excise taxes: an initial tax and a second-tier tax if the improper transaction is not "corrected."

B. Initial Tax

1. Tax on the Self-Dealer: This tax is 10% of the amount involved with respect to each act of self-dealing for each year during the taxable period involved. This tax is imposed even if the DP was unaware that the act constituted self-dealing.

2. Tax on the Foundation Manager: This tax is 5% of the amount involved, capped at $20,000, and is imposed on a foundation manager who participated in the act, but only if the manager was aware that the act constituted self-dealing and the manager's participation was willful and not due to reasonable cause.

3. Note that if the foundation manager is the same person as the self-dealer, he or she may be subject to both sets of taxes.

C. Second-Tier Tax: Where an initial tax is imposed and the self-dealing act is not "corrected" in the proper time period, an additional tax is imposed.

1. The second-tier tax on the self-dealer is 200% of the amount involved.

2. The second-tier tax on the foundation manager is 50% of the amount involved, up to $20,000, and is imposed on a foundation manager who refuses to agree to all or part of the correction of the self-dealing act.

D. Definition of "Correction": Correction of a self-dealing transaction means undoing the transaction to the extent possible in a manner ensuring that the foundation's financial position is no worse off than if the DP had met the highest fiduciary standards.

E. Imposition of Tax on Foundation. Unlike other private foundation penalty taxes, there is no tax on the foundation itself under Section 4941. Note, however, that where there is a finding of self-dealing, the IRS may seek to impose an excise tax on the foundation (and possibly foundation managers) under Section 4945(d)(5), which penalizes foundations for making expenditures for non-charitable purposes. This category of taxable expenditure includes expenditures made for "unreasonable administrative expenses," such as "compensation, consultant fees, and other fees for services rendered," under Treas. Reg. 53.4945-6(b)(2). An exception is made if the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and consistent with ordinary business care and prudence.

VII. Potential Application of Private Inurement and Private Benefit Doctrines

A. Private Inurement:

1. The payment of excessive compensation to a DP may result in private inurement, meaning the receipt of improper benefits by a private foundation insider, which would jeopardize a foundation's continued entitlement to federal income tax exemption under Section 501(c)(3).

B. Private Benefit:

1. Private foundations that engage in unreasonable transactions with persons who are not disqualified persons but nevertheless have a special relationship need to be mindful of the prohibition against excessive private benefit. Foundations that engage in transactions resulting in excessive private benefit may jeopardize their tax-exempt status under Section 501(c)(3).

2. Private Letter Ruling 200114040 addressed the request of a great-niece of a private foundation's founder to review the foundation's collection of original documents, in connection with a book she was writing about her great-grandfather. The foundation had withheld public access to the materials while they were undergoing a conservation process. The author held positions on the foundation's advisory committees, but did not have voting power. The foundation had neither requested nor authorized the book, which was a wholly commercial venture initiated by the author. There was no plan to compensate the foundation for the author's use of the

foundation's collection. The IRS determined that there was no self-dealing because the author was not a DP, but that the transaction would result in excessive private benefit to the author.

3. As an additional example of potential excessive private benefit, consider a foundation that hires the brother of the foundation's founder to perform services to the foundation, and pays him an inappropriately high fee. Assuming the brother is not a DP, there would be no act of self-dealing. However, the payment of excessive compensation could be a violation of Section 4945(d)(5) and Treas. Reg. 53.4945-6(b)(2), discussed above, resulting in an excise tax penalty on the foundation. In addition, the arrangement could result in excessive private benefit to the brother, thereby jeopardizing the foundation's continued entitlement to exemption.

VIII. Deferred Compensation Issues for Private Foundations

A. Introduction

Section 457 governs nonqualified deferred compensation paid by state and local governmental and tax-exempt employers to employees and independent contractors. There are two primary types of plans subject to Section 457:

1. "Eligible" plans established by a state or local government employer or any other tax-exempt entity under Section 457(b) and

2. "Ineligible" nonqualified deferred compensation plans established by state or local government employers or any other tax-exempt entity, which are subject to Section 457(f).

Section 457(b) limits the amount of compensation that can be deferred under an eligible Section 457(b) plan, so many tax-exempt employers provide additional deferred compensation to their executives through an ineligible Section 457(f) plan. In addition, if a plan sponsored by a tax-exempt employer fails to satisfy one or more of the requirements of Section 457(b), it is treated as an ineligible plan subject to Section 457(f). The advantage of a Section 457(f) plan is that there is no limit under the Code on amounts that can be deferred under such plans and it is not subject to the other requirements of Section 457(b). The downside, however, is that unlike Section 457(b) plans, amounts deferred under Section 457(f) plans are taxable to the participant when such amounts are no longer subject to a substantial risk of forfeiture. Once the substantial risk of forfeiture lapses, deferred amounts are includible in the participant's income, whether or not such amounts are actually received by the participant.

B. Section 457(b) Plans

1. Background

Section 457(b) plans are popular retirement programs for tax-exempt employers because the plans allow for the deferral of compensation without requiring such amounts to be subject to a substantial risk of forfeiture. If certain requirements are met, participants are taxed on amounts deferred under a Section 457(b) plan in the taxable year in which such compensation is paid or otherwise made available to the participant, even if such amounts are not distributed to the participant. Another advantage of Section 457(b) plans is that they are not subject to the strict requirements imposed under Section 409A for nonqualified deferred compensation.

2. Overview of Requirements of Section 457(b) Plan

To qualify as a Section 457(b) plan, the plan must meet certain requirements, which include:

(a) Employers must generally limit the amount that can be deferred for a participant each year to the lesser of (a) 100% of the participant's taxable compensation or (b) a specified amount as set forth in Section 457 ($17,500 in 2013).

(b) Participation must be limited to a select group of management or highly compensated employees, also known as a "top hat" group.

(c) A plan must be unfunded (although an employer may set aside assets to fund its obligation under the Section 457(b)).

3. IRS's Compliance Check Questionnaire Program

On June 3, the IRS announced the creation of its Section 457(b) Plan Compliance Check Questionnaire Program for tax-exempt entities. The IRS will use the data gathered from the questionnaire initiative to gain a better understanding of Section 457(b) plans and the plans' overall compliance with Section 457(b) of the Code. Through the compliance check program, the IRS seeks to learn more about the operation of Section 457(b) plans of tax-exempt employers, verify whether the plans comply with the requirements of the Code, identify noncompliance issues, and develop recommendations to remove barriers to compliance.

A copy of the IRS questionnaire is attached as Exhibit 1.

C. Section 457(f) Plans

Deferred amounts are taxable under Section 457(f) when no longer subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists if the participant's right to such compensation is conditioned upon the future performance of substantial services. The most common form of risk of forfeiture is to subject the deferred compensation to vesting over a period of years. If the participant voluntarily terminates or is terminated for cause prior to vesting, and he or she forfeits the benefit, a substantial risk of forfeiture will exist even though the plan provides that a participant vests upon an involuntary termination of employment without cause, disability, death, or upon a change in control. Other forms of substantial risk of forfeiture include:

1. <u>Noncompetition restrictions</u>: A participant's adherence to a non-competition agreement may be considered a substantial risk of forfeiture if the participant can demonstrate that under the facts and circumstances there is a real likelihood that the participant will be required to actually refrain from performing substantial services. The burden is on the participant, though, to prove the validity of the non-compete to a very skeptical IRS.

2. <u>Post-termination consulting agreement</u>: A substantial risk of forfeiture can include the participant's performance of substantial consulting services after termination of employment. Whether services are substantial depends on the regularity of the performance of the services as well as the time spent in performing such services. Compensation paid to a retiring participant subject to the sole requirement that it be returned if the participant fails to render consulting services upon the request of his or her former employer will not be considered subject to a substantial risk of forfeiture unless the participant is in fact expected to perform substantial services.

D. <u>Overview Of Section 409A</u>

The American Jobs Creation Act of 2004 added Section 409A, a provision governing nonqualified deferred compensation, to the Code. Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture unless the plan meets specified restrictions set forth in Section 409A. Failure to comply with the requirements of Section 409A results in (a) automatic inclusion of all amounts deferred under the plan to the extent not subject to a substantial risk of forfeiture and not already included in income, (b) a 20% penalty on amounts includible in income, and (c) an interest charge at the underpayment rate plus 1% on amounts previously deferred and not included in income.

A plan or arrangement generally provides "deferred compensation" under Section 409A if an employee has a legally binding right to compensation in one taxable year that is or may be paid to the employee in a later year. Section 409A does not apply to certain qualified plans, including qualified plans under Section 401(a), cash or deferral arrangements under Section 401(k), annuity contracts under Section 403(b), annuity plans under Section 403(a), or eligible deferred compensation plans under Section 457(b). Section 409A, however, does cover a wide range of plans and arrangements, including salary and bonus arrangements, severance arrangements, reimbursement arrangements, relocation policies, etc.

E. Potential Red Flags In The Deferred Compensation Area

1. Section 409A and Section 457(f) Plans

Since Section 409A applies to ineligible Section 457(f) plans, such plans will be subject to the requirements of both Section 457(f) and Section 409A. Section 409A issues that are particular to Section 457(f) plans include:

(a) Certain events that constitute a substantial risk of forfeiture under Section 457(f), such as a non-compete, are disregarded in determining whether a substantial risk of forfeiture exists under Section 409A.

(b) Section 457 does not apply to "bona fide severance pay" whereas Section 409A does not have such an exception, although its regulations provide a limited safe harbor exception.

The IRS is expected to release guidance that attempts to reconcile these issues.

Section 457(f) plans that distribute benefits to a participant upon vesting will typically not be subject to Section 409A due to an exception in the regulations known as the short-term deferral rule. Plans qualifying for the "short term deferral" exception and the exemption for certain severance that is payable on an involuntary termination must be carefully drafted to ensure that (a) the exception is not jeopardized; and (b) in the event the exception is jeopardized, the arrangement complies with Section 409A. In light of the harsh penalties for failure to comply with Section 409A, it is important to conduct a comprehensive review of all plans and arrangements that could be subject to Section 409A before they are finalized.

2. Limiting Participation in a Section 457(b) plan to the "Top Hat" Group

Top hat plans are exempt from most requirements of ERISA, including vesting, funding, and fiduciary requirements. If an employer fails to limit participation in a top hat plan to a "select group of management or highly compensated employees" as required by section 401 of ERISA, then the plan will lose its top hat status and be subject to ERISA's vesting, funding, and fiduciary requirements.

3. Expected Release of New Proposed Regulations under Section 457(f)

In Notice 2007-62, the Treasury Department and the IRS announced their intent to issue guidance regarding the definition of "substantial risk of forfeiture" under Section 457(f) and the definition of a bona fide severance pay plan under Section 457(e)(11). Although Notice 2007-62 provides that any future guidance will be prospective, such guidance could significantly change the design of some Section 457(f) plans because events previously considered to trigger a substantial risk of forfeiture would no longer be considered as such.