What Constitutes "Reasonable" Compensation For Private Foundation Insiders?

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Private foundations are created as independent legal entities for solely charitable purposes, and many are run by unpaid family members and other volunteers. But what happens when a private foundation wishes to pay officers, directors or trustees, who are also family members of the individual funding, the foundation?

Because private foundations are "private" as opposed to public charities, there are strict rules around paying family members. Specifically, Section 4941 of the Internal Revenue Code prohibits any financial transaction between a private foundation and a "disqualified person" or an "insider,"[i] – generally the donor and the donor's family – as it may constitute "self-dealing," which is deemed a misuse of charitable assets. Family compensation would seem to fall directly under this restriction. However, there is one notable exception to this rule: compensation paid for "personal services" to carry out foundation affairs is permissible, provided that the services rendered are "reasonable and necessary" to carry out the exempt purposes of the foundation, and the compensation is "not excessive." What constitutes "reasonable" and "not excessive" compensation may vary widely, depending on underlying facts and circumstances.

The services provided to the foundation must be "necessary" for the foundation to carry out its tax-exempt purpose and "personal" in nature. Although the IRS has not specifically defined "personal services," the regulations cite examples such as investment management, legal and banking services. And, they include professional and managerial services rendered by an insider in his or her capacity as an officer, director, trustee or executive director of the foundation.

The services provided to the foundation must also be "reasonable." Public charities can more easily determine whether compensation paid to an insider is "reasonable" because there are specific IRS regulations that define unreasonable compensation for public charities called "excess benefit transactions." Private foundations, however, do not have clear-cut guidelines but will often defer to the regulations that public charities follow. The standards set forth in the regulations require that compensation should be what "would ordinarily be paid for like services by like enterprises under like circumstances." This depends on the individual's job title and description, the skill or knowledge required to perform the duties, the amount of time needed to fulfill the functions required, and the salaries paid for comparable positions. In practice, many foundations compare their proposed compensation amounts to what other for-profit and non-profit companies and organizations pay to similarly qualified individuals with comparable levels of responsibility.

Some factors to be considered:

(i) the size of the organization;

(ii) the employment history of the candidate and any special qualifications (e.g., licenses and certifications);

(iii) the geographic location of the foundation (some regional markets pay more than others);

(iv) the specific job responsibilities and duties;

(v) the time commitment; and

(vi) the total value of the compensation package, including benefits.

It is highly recommended that the compensation of foundation insiders meet the following requirements:

(i) the compensation is approved in advance by an authorized body of disinterested individuals such as the independent board members;

(ii) the authorized body obtains appropriate comparable data prior to making its determination as to reasonableness; and

(iii) the authorized body concurrently makes its determination and adequately documents the basis for that determination, all without the participation of the individuals whose compensation is being set.

Conflicts of interest frequently arise when setting compensation or benefits for officers, directors or trustees of private foundations. As such, the IRS requires that private foundations adopt a conflict of interest policy to help ensure that when actual or potential conflicts of interest arise, the organization has a process in place to resolve the conflict and assure that the affected individual will advise the governing body about all of the relevant facts concerning the situation. A conflict of interest policy is also intended to establish procedures under which individuals who have a conflict will be excused from voting on such matters.

States also have rules around conflicts of interest. In New York, a conflict of interest policy for private foundations became mandatory after the passage of the New York Non-Profit Revitalization Act of 2013.[ii]

A private foundation’s conflict of interest policy, among other things, must include the following:

(i) a definition of the circumstances that constitute a conflict of interest;

(ii) procedures for disclosing a conflict to the board;

(iii) a requirement that the person with the conflict not be present to vote on matters giving rise to such conflict;

(iv) a requirement that existence and resolution of a conflict be properly documented;

(v) procedures for disclosing, addressing and documenting related party transaction; and

(vi) a requirement that each officer, director and key employee submit to the secretary of the foundation prior to initial election of the board, and annually thereafter, a written statement identifying possible conflicts of interest.

The penalties for disregarding the compensation rules are severe. If foundation insiders fail to meet the “personal services” and “reasonable and necessary” requirements, the foundation will be subject to substantial fines. The foundation is assessed a penalty equal to 20% of the portion of compensation that is considered unreasonable. And each foundation manager who agrees to pay the unreasonable compensation could be personally liable for a penalty equal to 5% of the unreasonable compensation. On top of these penalties, the violation must be corrected, which could require returning the portion of the compensation deemed unreasonable to the foundation, along with interest. If all of this is not corrected in a timely manner, the IRS may impose additional taxes on the foundation, currently 100% of the amount of the unreasonable compensation. Similarly, an additional tax of 50% may be imposed on any foundation manager who refuses to correct the violation.

The good news is that a private foundation may pay its insiders for their foundation work as long as it follows the rules and takes all necessary steps to remain in compliance.

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[i] A “disqualified person” or “insider” is any of the following: (1) foundation managers (officers, directors, trustees or persons with similar powers); (2) substantial contributors and individuals or entities with a 20% or greater interest in an entity that is a substantial contributor; (3) the family members of all such individuals; (4) certain entities partially or wholly owned, directly or indirectly, by disqualified persons; and (5) certain government officials.

[ii] The Non-Profit Revitalization Act of 2013 was signed into law by Governor Andrew M. Cuomo on December 18, 2013, and became effective on July 1, 2014.

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