Compensation for Private Foundations: Strategies & Compliance

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The Often Asked Question:
Can I use my private foundation as a way to support my brother/friend/descendants per stirpes?

Keep in Mind:

- We are not in Kansas anymore.

- It is no longer “your money”.

To compensate or not to compensate, that is the question.

- Long tradition of voluntary service on charitable boards
- Some charities compensate directors, others do not
- Responsible board service is time consuming, requires certain skills, creates the potential for liability and involves certain legal complexities
- Private Foundations come down on both sides of this issue.

Where do we start?

- Read the governing documents to see if compensation is permissible.
- For a PF set up as a TRUST, this would be a trust agreement or a Will.
- For a PF set up as a Nonprofit Corporation, this would be the Articles of Incorporation (or Certificate of Formation), Bylaws and any compensation-related Board policy.

Uh, the trust agreement/bylaws are silent?

- Look to state law:
  - Texas Trust Code: Unless the terms of the trust provide otherwise and except in the case of a trustee committing a breach of trust, the trustee is entitled to reasonable compensation from the trust for acting as trustee.
  - Texas Business Organizations Code: A nonprofit corporation may pay compensation in a reasonable amount to the members, directors, or officers of the corporation for services provided.
  - There are a few other vehicles for creation of a nonprofit entity, but nonprofit corporations and purely charitable trusts are by far the most common.

What about the IRS?

- Section 4941 imposes severe penalties for both direct and indirect self-dealing between a disqualified person and a private foundation.
- The intention is to discourage a PF and its Disqualified Persons from entering into most business related transactions.
- For compensation purposes it is important to be aware that "disqualified persons" includes:
  - Certain "foundation managers" – which includes an officer, director or trustee of a PF, or any individual having similar powers or responsibilities.
  - Can also include an employee of a foundation having authority or responsibility with respect to particular actions.
  - Members of the family of certain foundation managers - spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren, and great-grandchildren

What are the penalties for self-dealing?

- Penalty for Self-Dealing:
  - 10% of the amount involved to be paid by the disqualified person
  - Any Foundation Manager who knowingly and willfully participates will be subject to a tax of 5% of the amount involved
  - If not corrected within certain time frames, a tax of 200% will be imposed on the disqualified person and a tax of 50% will be imposed on the Foundation manager.
- Keep in mind: it doesn't matter if it is a "good deal" for the PF. Self-dealing, even if resulting in a bargain transaction for the PF, is subject to penalties unless an exception applies.

Where does compensation fit within the self-dealing rules?

- For Foundation Managers: they are disqualified persons providing a service to the PF.
- The payment of compensation (and reimbursement of expenses) by a PF to a disqualified person for personal services that are reasonable and necessary to carry out the exempt purposes of the private foundation is not an act of self-dealing if the compensation is not excessive.

PLRs on Director Compensation

- Private Letter Rulings issued by the IRS, which cannot be relied upon by any other taxpayer as precedent, give some guidance in this area:
  - PLR 200007039
  - Be careful of irregular payments: may suggest tie between compensation and financial needs of director, and self-dealing
  - One ruling holds that payment of a pension to a foundation director for past personal services where total compensation including the pension is not excessive does not constitute self-dealing.
  - Many rulings will find that compensation for a particular set of tasks is a reasonable and necessary personal service to the PF, but not get into details on whether the actual compensation involved is excessive
  - TAM 9008001

More IRS concerns:

- 4945, dealing with taxable expenditures, could include any expenditures for **unreasonable** administrative expenses, including compensation, consultant fees, and other fees for services rendered unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence.
- The determination of whether an expenditure is unreasonable shall depend on the facts and circumstances of the particular case.

Taxable Expenditures continued

- Taxable expenditures under 4945 give rise to a first tier excise tax of 20% of each expenditure, payable by the PF.
- There can be an additional first-tier excise tax of 5% of the amount of the expenditure imposed upon the "agreement" of any foundation manager to the making of the expenditure under certain circumstances.
- Second-tier excise taxes equal to 100% of the amount of the expenditure are imposed if the expenditure is not corrected within an applicable time period, and a 50% excise tax on the amount of the expenditure is also imposed on any foundation manager who refuses to agree to any part of the correction.

What are the rules on compensation for directors?

- Private Foundations can pay REASONABLE COMPENSATION to DIRECTORS
- For NECESSARY SERVICES ACTUALLY RENDERED
- On BEHALF OF FOUNDATION

The inherent complication with director compensation:

- Directors are those charged with making the final decisions about the management of the PF (same for Trustees).
- This includes compensation for officers, employees and directors.
- When placed in the role of choosing one's own compensation (or compensation for a small group) there is an inherent conflict of interest.
- Due to this, it is advisable to be diligent, cautious and conservative in setting director compensation.

Reasonable Compensation

- Keep in mind that compensation comes in several forms:
  - Salary (annual, per meeting, some combination)
  - Benefits (health insurance for full time employees for example)
  - Reimbursement for Travel (ok to reimburse for reasonable expenses incurred directly in connection with personal services rendered)
    - Be careful with reimbursement for directors' family members: allowable under certain circumstances but has to be treated as compensation and compensation still has to be reasonable
  - Extra Benefits
    - Expenses of directors
    - Expenses of employees
    - Careful! (e.g. direct payment of costs could be self-dealing)

Reasonable Compensation cont'd

- Payment to professionals for professional services (outside of serving as a director) while also serving as director or Trustee (banks and trust companies, law firms, accountants)
  - These are a bit outside of the topic of director compensation, but should be carefully reviewed to confirm payments fit within the personal services exception (to be discussed later) and are not excessive
  - Consider whether non-disqualified person third-party service provides may be a good way to avoid these issues, and how best to document
- Also keep in mind that institutions serving as a trustee (e.g. a bank or trust company) will consistently have higher compensation than an individual director, as the institution typically takes on more responsibility for investments, tax return preparation, grant administration, etc.

Reasonable Compensation cont'd

- Unfortunately there is no one size fits all answer on what constitutes reasonable compensation.
- Factors affecting compensation include:
  - Complexity of PF operations (grant-making only or operating?)
  - Asset size of PF (and related sophistication of investments)
  - Complexity of programs (robust scholarship program?)
  - Time demands of directors
  - Geographic area

Reasonable Compensation cont'd

- Factors to consider:
  - What functions are required of and actually performed by the directors or trustees?
  - What is the realistic time commitment for all tasks (preparing for meetings, reviewing statements/programs, attending meetings)?
  - What level of skill is required for the director to adequately perform his or her duties?
  - What are similar foundations (similar in size, complexity, requirements and location) paying their directors?

Reasonable Compensation cont'd

- After understanding the "job description", the next step in the process is:
  - Review comparable compensation data:
    - Salary surveys compiled by independent firms (for example, Council on Foundations and Exponent Philanthropy)
    - Local Resources (Philanthropy Southwest)
    - Forms 990-PF for other private foundations (their websites and Guidestar)
    - Compensation Experts with access to more data

Reasonable Compensation cont'd

- What if the board cannot/does not want to make the decision?
  - Outside Compensation Consultant/Expert
  - Independent Compensation Committee
- But keep in mind: any consultant or independent committee not consisting of directors is not authorized to actually act on behalf of the PF with respect to a compensation decision. The committee would RECOMMEND, but the board must adopt and approve.

Then pause for a reality check:

HOW DOES THIS BREAK DOWN ON AN HOURLY RATE BASIS?

WOULD AN UNRELATED, THIRD PARTY BE PAID THAT AMOUNT?

For Reasonable and Necessary Services Actually Rendered

- This seems like common sense, but:
  - Training younger generations who are not currently serving on PF?
  - Does the Private Foundation have paid staff carrying out most of the time-consuming duties?
  - Where is the PF in its life cycle? A new private foundation developing programs may have more time involved than an established foundation and program. Reasonable and necessary services can vary at different points in time.

On Behalf of the Private Foundation

- Again, seems like common sense, but the services need to be important to carrying out the Foundation's exempt purposes.
- Regularly attending galas is probably not time spent carrying out Foundation's exempt purposes.

Document the Process.

- Concurrent documentation is best.
- Document in the minutes:
  - Basis for determination
  - Discussion among board members
  - Resources consulted
  - Why comparable data is applicable to this PF
  - Abstentions in voting (if applicable)
  - Result of vote (unanimous or majority approval)

Policies Are Your Friend.

- Well defined policies applied across the board can help if allegations if improper compensation are made.
- Consider:
  - Expense Reimbursement Policies
  - Travel Reimbursement Policies
  - Spouse Travel Reimbursement Policies (including that spouse travel will not be reimbursed if the result is excessive compensation for the director)
  - Compensation Policies (find a good procedure and document how it should operate annually)

Why Does it Matter?

- IRS – Self-dealing and Taxable Expenditure concerns described earlier.
- Controversy – Not all publicity is good publicity, and coverage could cast shadow on good works and impair ability to fundraise (if applicable), recruit highly qualified board members, and carry out charitable intent.
- An investigation by your state regulator (Attorney General) could be initiated.

Role of State Attorney General in Charitable Oversight

- The Attorney General of the State of Texas is charged with the duty of protecting the public interest in charity.
- Structurally, there is a Charitable Trusts Section within the Financial and Tax Litigation of the Texas Attorney General's office.

Some General Areas of Interest to State Regulators:

- One person selecting/choosing the board and thereby effectively setting compensation alone (even worse if the board is inactive)
- Lack of financial policies and procedures
- Exotic meeting locations for Board, with all expenses charged to the Foundation
- Loosey-goosey PF credit card usage
- Exorbitant salaries and benefits paid to outside professionals, employees, officers or directors.

What can happen with a state investigation?

- Texas AG has authority to examine PF books and records and investigate PF
- Often looking for breach of fiduciary duties, violation of the DTPA, negligence and misapplication of charitable assets and fraud
- Huge amount of information may be requested
- Significant expense for Foundation in defense may be necessary
- Delay in carrying out objectives, progressing with new programs and management selection
- Investigation can result in settlement which may involve removal of directors and attorney general involvement in selection of new board and executive director

When is a state investigation likely to “come up”?

- Form 990-PF shows excessive compensation or non-charitable expenses
- Anonymous Complaints
  - Former employees
  - Angry neighbors
  - “dissatisfied” heirs
  - Rejected scholarship recipients
- News stories originating from a variety of sources can take on a life of their own…

What are the rules on compensation for employees?

- PF can pay REASONABLE COMPENSATION to employees for services ACTUALLY RENDERED ON BEHALF OF THE FOUNDATION
- PFs can have charitable operating and administrative expenses for carrying out their mission
- The process and issues are similar to those of director compensation:
  - What is the time commitment for the employee?
  - What is the skill set required to perform the tasks?
  - How sophisticated is the program?
  - What are comparable charities paying similarly qualified employees in similar roles?

Strategies to Ensure Employee Compensation is Reasonable

- Salary Tables
- 990-PF for similarly situated foundations (Guidestar)
- Local resources
- Compensation Consultants
- While the inherent conflict of interest present in the director setting is gone, the need to document all decisions, criteria and other factors that go into setting reasonable compensation is still present.

Strategies to Ensure Executive Director Compensation is Reasonable:

- Because some Executive Directors serve on the Board, it is important to follow a Conflict of Interest Policy with respect to setting compensation for serving in this capacity.
- Executive Director and any relatives should not participate in the discussion.
- Consider having a committee with some directors and some independent third-party persons familiar with compensation review Executive Director Compensation.
- Ensure that Executive Director is not present for discussions and abstains from voting on items related to his or her compensation.

Compensation to Disqualified Persons for Personal Services (other than board service)

- This falls under self-dealing, but for discussion purposes it is grouped with employee compensation rather than director compensation because it can be independent of board status. It can be an issue with directors who also provide personal services, as discussed earlier.
- The payment of compensation (and reimbursement of expenses) by a PF to a disqualified person for **personal services** that are reasonable and necessary to carry out the exempt purposes of the private foundation is not an act of self-dealing if the compensation is not excessive.
- In addition to being cognizant of the reasonableness of the compensation, it is important to be aware of limitations on "personal services".

Good Examples of Personal Services Exception for Non-Director Compensation:

- Need to be reasonable and necessary to carrying out PF's exempt purpose
- Generally will be professional or managerial in nature
- Examples from rulings:
  - Investment partnership that functions like a brokerage account
  - Legal services
  - Investment counseling services
  - Real Estate brokerage services
  - Art coordination services, which were considered personal services and were reasonable and necessary for museum functions
  - Expert technical services for conservation of museum exhibit artifacts

Bad Examples of Personal Services Exception for Non-Director Compensation:

- Certain property maintenance expenses do constitute self-dealing because not professional or managerial in nature
- Company, which was a disqualified person, providing a product (the microscope example from the regulations)
- Company, which was a disqualified person, provided construction work in connection with interior renovation of tenant space. Company effectively acted as a general contractor. Ruling held that:
  - Personal service exception to be strictly enforced
  - These services are provided in a business context and not engaged in directly to carry out the exempt purposes, and as such they are not "personal" services

Case Study #1: The Unemployed College Grad

- Bobby recently graduated from the University of Texas with a business degree. However, due to the state of the economy (and possibly his thorough documentation of his college years on Facebook and Instagram) he is struggling to find a paying job.
- He is back at home with mom and dad, and they decide to hire him as the Executive Director of the family private foundation, which has an asset base of $2.5M and engages only in grant making.

Case Study #1: The Unemployed College Grad (continued)

- Mom, Dad and Uncle John (the 3 directors) ask around and hear that an Executive Director for a private foundation can be paid up to $250,000. Thinking its wise to err on the conservative side, they settle on $100,000 per year for Bobby. Bobby works 3-4 hours per week, mostly opening mail.
- So elated at the good news, Bobby snaps a copy of his first paycheck and posts it on Instagram. One of his 450 followers works at a newspaper in the community, and finds this fascinating.
- Moral of the Story: USE THE SALARY TABLES AND APPLY THEM CAREFULLY. PAY ATTENTION TO THE BREAKDOWN IN HOURS WORKED, REGION and ASSET BASE. Remember TAM 9008001

Case Study #2: Very Active Directors

- Allen and Bert are named as the two Co-Trustees for a private operating foundation upon founder's death.
- The activities of the foundation are extensive, and the Co-Trustees wish to serve both as Co-Trustees and as employees of the foundation.
- They quit their "day jobs" and hire themselves as Co-Executive Directors, estimating that they will each be working for the foundation 45+ hours per week.

Case Study #2: Very Active Directors (continued)

- They agree on a trustee fee and salaries for themselves, taking into account the amount of work involved and their extensive professional experience.
- Doug, Allen's next door neighbor who is envious of Allen's new BMW, initiates a complaint with the attorney general's office.
- INVESTIGATION ENSUES.
- MORAL OF THE STORY: It is hard to avoid self-interest issues and allegations of self-dealing in setting your own compensation, particularly if the PF role will be the full time job. Seek outside consultants and/or compensation committee, and document the process. Consider whether additional non-employee trustees/directors may be appropriate.

Case Study #3: The Director Who is Long in Tooth

- Freddy Founder's right hand man, Edward, worked for him for many years preceding his death.
- Freddy's Will creates a significant private foundation, naming Edward as one of several Co-Trustees of the foundation.
- Edward tells anyone who can listen that Freddy PROMISED Edward that he could work as the Executive Director of the foundation for life.
- Edward is a fantastic employee for many years, has the most insight on Freddy's wishes, and is instrumental in expanding the reach and operations of the foundation. During these years, he receives fair and reasonable compensation.

Case Study #3: The Director Who is Long in Tooth (continued)

- Edward is now 85, slowing down in his role as Executive Director, and does more “work from home”. The remaining Trustees are confident that Edward is earning his compensation, but are concerned that others might assume he is continuing to be paid but no longer doing the work.
- The remaining Co-Trustees wish to protect themselves and the Foundation from allegations that Edward is over-compensated.
- MORAL OF THE STORY: DOCUMENT, DOCUMENT, DOCUMENT and enforce abstention and recusal policies in place.