A 'REASONABLE' INVESTMENT—COMPENSATING EXECUTIVES WITHIN LEGAL BOUNDS

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When setting executive compensation, staff, nonprofit boards, and other decision-makers should make sure that the benefit the organization receives in return is proportionate, in order to comply with the various legal standards.

You are advising a foundation that is ready to make an offer of employment to its choice candidate for the chief investment officer (CIO) position. The organization is excited to bring in talent from industry to manage its investments and asks you to help structure a competitive compensation package to entice the candidate.

The private sector pays substantially more than nonprofits and has other compensation elements that are not as prevalent among nonprofits—for example, bonuses tied exclusively to financial performance or carried interest. There are various legal standards limiting pay that govern nonprofit compensation generally, and these would also apply to the chief investment position. How competitive of a package can the foundation offer while still steering clear of any IRS sanctions?

In this article, the authors offer a high-level overview of the various legal standards that apply to nonprofit compensation and the safeguards available to nonprofits. We use investment positions as a practical case study since they are among the trickiest positions for which to structure compensation packages. Investment positions are typically highly-paid[1] and get significant external scrutiny, yet it may be unclear whether certain legal standards apply to them. In addition, nonprofit investment positions—unlike many other nonprofit executive positions—tend to have a significant overlap in the for-profit marketplace, both in terms of talent pool and pay practices, that can make setting compensation that is competitive yet compliant a challenge. We conclude with a brief discussion of recent proposed legislation concerning nonprofit compensation at both the federal and state level as a lens into potential future scrutiny.

Overview—legal standards that apply to nonprofit compensation

In this section, we briefly outline the legal standards.[2] There are primarily three legal standards that apply to nonprofit compensation: (1) the intermediate sanctions ("I.S.") regulations, (2) the private inurement ("P.I.") doctrine, and (3) the rules against self-dealing. Depending on organization type, one or more of these standards may apply to a particular nonprofit. While the stan-

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dards differ in certain respects that we will touch on briefly, they overlap to a large extent. The main takeaway is that they all aim to ensure that compensation paid to a nonprofit employee is proportionate to the benefit the organization receives from that individual, and is therefore "reasonable."

Applicability of the legal standards. Almost all nonprofits fall under the purview of at least one of these three IRS legal standards. The broadest of the standards in terms of applicability is the P.I. doctrine, which applies to virtually all nonprofits, including Section 501(c)(6) trade associations (to which the other two doctrines do not apply).[3] The I.S. regulations apply to a subset of nonprofits—Section 501(c)(3) public charities and Section 501(c)(4) social welfare organizations (in addition to the P.I. doctrine). The rules against self-dealing apply to private foundations (in addition to the P.I. doctrine).[4] For a graphic illustration of the applicability of the legal standards, see Exhibit 1 on page 32, below.

Private inurement doctrine and rules against self-dealing. The P.I. doctrine penalizes "insiders" (those in a position to divert nonprofit assets or income to their own benefit) who receive some sort of financial gain from the nonprofit for which the nonprofit does not receive comparable benefit in return.[5] It of course does not prohibit the compensation of nonprofit employees; rather, it prohibits *excessive* compensation. The penalties for violating this doctrine can be severe—potentially the revocation of the organization's tax-exempt status.[6]

In establishing procedures for setting compensation internally, the doctrine has three main implications for nonprofits. First, compensation should be clearly tied to performance. Second, compensation should be reasonable and not excessive. Third, a board or committee approving compensation should be cautious with any arrangement that may appear to be a distribution of profits.

The rules against self-dealing, which apply only to private foundations, penalize self-dealing, which occurs when someone in a fiduciary relationship with an organization acquires or uses property belonging to a foundation for his or her own benefit.[7] Again, compensation is not prohibited—as long as compensation is "reasonable and necessary to carry out the exempt purpose" of the foundation and is not excessive.[8] The penalties are in the form of excise taxes.

Intermediate sanctions regulations. The I.S. regulations penalize "disqualified persons" who receive excessive compensation from a 501(c)(3) public charity or 501(c)(4) social welfare organization. Although a violation of the I.S. regulations will not result in the nonprofit's losing its favorable tax status, the IRS may hold disqualified persons and individuals who knowingly approve an excess benefit transaction personally liable.[9] The three-part test for whether a transaction violates the I.S. regulations is: (1) the regulations must apply to the organization involved (i.e., organization must be a 501(c)(3) public charity or 501(c)(4) social welfare organization); (2) the transaction must involve a disqualified person; and (3) there must have been an excess benefit transaction between the organization and the disqualified person.

"Disqualified person." A "disqualified person" is someone who is "in a position to exercise substantial influence over [the organization's] affairs over the past five years."[10] Presidents, chief executives, chief operating officers, chief financial officers, treasurers, and board members are automatically considered "disqualified."[11] For other individuals (such as investment staff), whether an employee "exercises substantial influence over the affairs" of the organization and therefore may be considered disqualified "depends upon all relevant facts and circumstances," including whether the employee's "compensation is primarily based on revenues derived from activ-

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[1] Although the highest-paid position is typically the CEO, a chief investment officer at a foundation may be paid more. At colleges and universities, athletic coaches—as well as chief investment officers—may earn more than the president. See the section on "Compensation of investment staff," below, for further discussion.

[2] For more detail on the legal standards and nonprofit compensation, see Vogel and Quatt, *Nonprofit Executive Compensation: Planning, Performance, and Pay* (BoardSource, 2014). The material that immediately follows describes the intermediate sanctions regulations (hereinafter the "I.S. regulations"), the private inurement doctrine, the rules against self-dealing, and the safeguards offered under the I.S. regulations—notably the rebuttable presumption of reasonableness and the reasoned written opinion from a professional. The reader who already is familiar with these rules may feel free to jump ahead to the sections on "Meeting the standard of reasonableness for intermediate sanctions purposes" and "Compensation of investment staff," which focus on best practices and the practical aspects of ensuring compliance with the I.S. regulations and on investment position compensation.

[3] The doctrine stems from Section 501(c)(3), which instructs tax-exempt organizations to be organized and operated so that no part of their net earnings "inure ... to the benefit of any private shareholder or individual."

[4] Reg. 53.4941(d)-1.

[5] Hopkins, *The Law of Tax-Exempt Organizations*, (Wiley, 2011) page 507.

[6] *Id.*, page 508.

[7] Reg. 53.4941(d)-1.

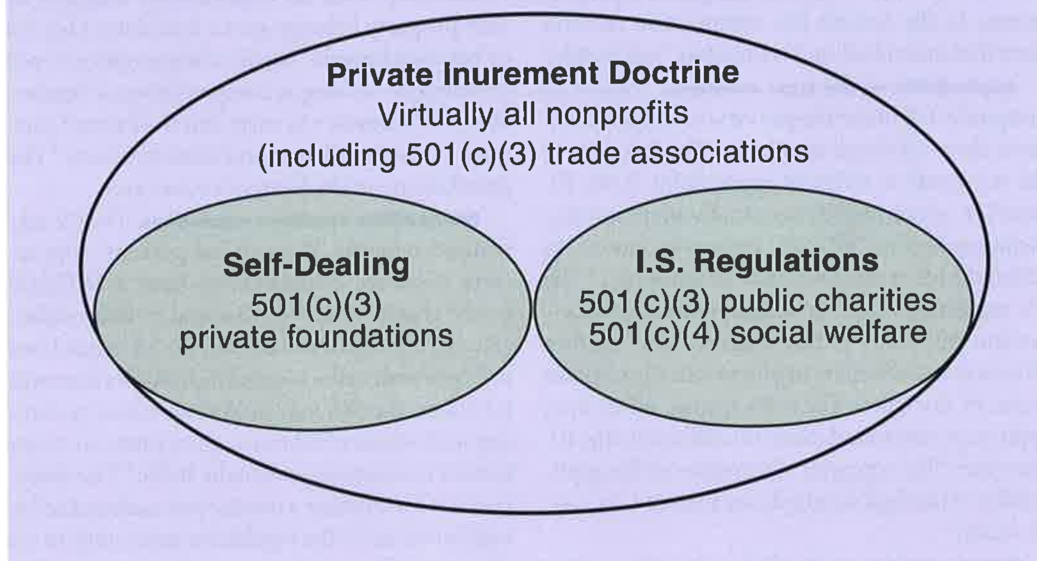
[8] Reg. 53.4941(d)-3.

[9] For detail on the penalties, see Reg. 53.4958-1.

[10] Reg. 53.4958-3(a)(1).

[11] Reg. 53.4958-3(c)(2)-(3).

EXHIBIT 1
The Overlapping Applicability of the Legal Standards.



ities of the organization, or of a particular department or function of the organization, that the person controls"; "has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees"; or "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," among other factors.[12]

"Excess benefit transaction." An "excess benefit transaction" is a transaction in which the benefit the disqualified person receives from the nonprofit is not proportionate to the benefit the nonprofit receives in return.[13] To determine whether compensation is excessive, the IRS uses a "reasonableness" standard, with "reasonableness" defined as the value "that would ordinarily be paid for like services by like enterprises ... under like circumstances."[14]

Whether compensation is "reasonable" is a case-by-case, fact-based determination based on several factors. Unfortunately there is no bright-line set of factors that is always applied; rather, the particular combination of factors varies by jurisdiction.[15] There are, however, a number of factors that provide valuable guidance with respect to the meaning of "reasonableness." These are derived from the legislative history of Section 4958 (the Code section under which the I.S. regulations were issued), case law, and other commentary.[16]

In summary, the factors seek to capture various attributes of both the organization (size, the need for an executive's services, compensation of other staff) as well as the executive in question (qualifications, performance, compensation history) in order to capture what constitutes an appropriate marketplace for compensation comparison purposes. For examples of these factors, see Exhibit 2 on page 33. A more detailed discussion of meeting the standard of reasonableness appears in the section on "Meeting the standard of reasonableness for intermediate sanctions purposes," below.

Intermediate sanctions regulations as model for compliance. Of the three standards, the I.S. regulations are the firmest and best-articulated. Because the doctrines overlap in their regulation of compensation (for example, an "excess benefit transaction" under the I.S. regu-

[12] Reg. 53.4958-3(e).

[13] Reg. 53.4958-1(b).

[14] Reg. 53.4958-4(b)(1)(ii).

[15] Hopkins, *supra* note 5, pages 514-15.

[16] *Id.*

[17] Although many nonprofit investment positions are at 501(c)(3) private foundations, the I.S. regulations do not apply to these nonprofits. However, following the guidelines for complying with these regulations can help foundations comply with other legal standards that do apply to them.

[18] Reg. 53.4958-6.

EXHIBIT 2
Summary of I.S. Tests, Safeguards, and Reasonableness Factors.

Summary—Test of Whether Transaction Violates I.S. Regulations:

(1) Must involve a 501(c)(3) or (c)(4) nonprofit.
(2) Must involve a disqualified person.
(3) Transaction is an excess benefit.

Summary—Safeguards Against Legal Sanctions:

A. Rebuttable presumption of reasonableness:
   (1) Approval by independent body.
   (2) Reliance on appropriate data.
   (3) Adequate documentation.
B. Reasoned written opinion from a professional:

Examples of Factors for Determining Reasonableness:*

Organization-Specific Factors:

- Scope of organization – revenues, expenses, number of employees; overall complexity of organization.
- Location.
- Organization's need for the services of individual in question.
- How individual's compensation compares to that of other staff in the organization.

Individual-Specific Factors:

- Overall background - education, training, experience.
- Current responsibilities and performance history.
- Amount of time spent in position.
- Compensation history, including presence of any sharp increases year to year.
- Written offers from similar organizations for individual's services.

Other Factors:

- Compensation paid by similar organizations, especially in same geographic area, for similar positions.
- Whether there was arm's-length bargaining.

* Hopkins, *The Law of Tax-Exempt Organizations* (Wiley, 2011), page 514;.
26 C.F.R. § 53.4958-4, available at https://www.law.cornell.edu/cfr/text/26/53.4958-6.

lations is a form of private inurement under the P.I. doctrine and will also often be considered self-dealing for private foundations), and because most of the guidance provided by the IRS with respect to best practices for ensuring that compensation is reasonable has been issued with regard to the I.S. regulations, the I.S. regulations often serve as a model for compliance, regardless of the particular legal standard(s) applicable.

As discussed in the following section, the procedures for complying with the I.S. regulations are generally aimed at making sure compensation decisions are fully informed, deliberate and well-reasoned, and appropriately documented. These are general best practices. Therefore, if an organization can meet the bar set by the I.S. regulations, it is likely following best practices to ensure compliance with the other standards as well.[17]

Safeguards against legal sanctions

In enacting the legislation introducing the I.S. regulations, Congress wanted to encourage boards to follow sound procedures in setting compensation, and for this reason it established various guidelines to help those making compensation decisions. Organizations adhering to these guidelines are rewarded with a "rebuttable presumption of reasonableness," which shifts the burden of proof of showing that an excess benefit transaction has taken place to the IRS.[18] Nonprofits to which the I.S. regulations apply also have a second protec-

tion from personal liability if they rely on "a reasoned written opinion" from a professional regarding the compensation in question.[19]

Rebuttable presumption of reasonableness. The rebuttable presumption of reasonableness offers considerable protection to the board members and executives of nonprofits to which the I.S. regulations apply in return for following best practices in approving compensation that is reasonable for disqualified persons. To receive the benefit of the rebuttable presumption with respect to a particular compensation arrangement, the organization must make sure that the following tests are met:

1. *Approval by independent body.* Compensation must be "approved in advance by an authorized body" (such as the board of directors) of the tax-exempt organization.[20] None of the members of the body can have a "conflict of interest ... with respect to the compensation arrangement."[21] It is important to note that while the body is said to determine whether compensation is reasonable, it really needs to be basing its determination on what *the IRS* would deem reasonable and therefore should take a conservative approach to evaluating compensation.
2. *Reliance on appropriate data.* Before making a determination of the reasonableness of compensation, the authorized body must obtain and rely on data that, "given the knowledge and expertise of its members," gives the authorized body "information sufficient to determine whether ... the compensation arrangement in its entirety is reasonable."[22] Such data is described in more detail in the section on "Meeting the standard of reasonableness for intermediate sanctions purposes," below.
3. *Adequate documentation.* The authorized body must "adequately document ... the basis for its determination concurrently with making that determination."[23]

Best practice note—Governance and approval of compensation. As a general matter of governance, a nonprofit board has both a legal and a fiduciary duty to review the compensation of the CEO as well as senior staff below the CEO. "To the extent permitted by state law, other parties authorized by the governing body," such as the CEO, can act on the board's behalf to approve compensation arrangements for positions below the CEO, and it is standard practice for the CEO to set the compensation for his or her staff so long as it meets the legal standards.[24] But because the board is ultimately responsible for ensuring that all compensation provided by the organization is reasonable, it is a best and nearly universal practice for the board or a committee of the board to review the compensation decisions and methodology for determining compensation for top executives who might be regarded by the IRS as disqualified persons.

Best practice note—Documentation. We strongly recommend that organizations follow a formal process for setting and reviewing compensation to help ensure that they are meeting the requirement for adequate and current documentation.

The regulations note that if the compensation the authorized body determined as reasonable is "higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination."[25] We would add that it is good practice to have reasoned documentation of the basis for setting compensation in all cases, even if approved compensation falls within the range of the comparability data, so that the organization has a complete record of all compensation decisions. Regular recordkeeping can be particularly useful if the organization has high board or executive turnover.

Reasoned written opinion from a professional. In addition to the rebuttable presumption of reasonableness, a nonprofit to which the I.S. regulations apply can obtain a second protection from personal liability for disqualified persons and those approving compensation—a reasoned written opinion from a professional. Such an opinion provides protection because in order to be held personally liable, an individual must *knowingly* participate in an excess benefit transaction, and reliance on an expert's opinion helps negate this knowledge element.[26] Although not an absolute protection, the professional's opinion will also help support the rebuttable presumption of reasonableness.

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19 Reg. 53.4958-1(d)(4).

20 Reg. 53.4958-6(a)(1).

21 Reg. 53.4958-6(a)(1).

22 Regs. 53.4958-6(a)(2), -6(c)(2)(1).

23 Reg. 53.4958-6(a)(3). Documentation must include the terms of the transaction, the members present and those voting, the data on which the body relied, and any actions by those with a conflict of interest.

24 Reg. 53.4958-6(c)(1)(i)(C).

25 Reg. 53.4958-6(c)(3)(ii).

26 Reg. 53.4958-1(d)(4).

27 Reg. 53.4958-1(d)(4)(i).

28 Reg. 53.4958-1(d)(4)(iii).

29 *Id.*

30 *Id.*

31 See the subsection on "I.S. regulations as model for compliance," above.

32 See the discussion of "Disqualified person," above.

Acting "knowingly." To act knowingly, the individual must (1) have "actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction": (2) be "aware that such a transaction under these circumstances may violate the provisions of federal tax law governing excess benefit transactions"; and (3) "negligently fail ... to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction."[27]

Requirements to receive protection. If those assessing the reasonableness of compensation "relie[d] on a reasoned written opinion" from "an appropriate professional ... with respect to elements of the transaction within the professional's expertise," they are held not to be knowing participants "even [if] the transaction is subsequently held to be an excess benefit transaction."[28] In order to receive this protection, managers must fully disclose the factual situation to the professional, and the opinion must recite both the facts and the applicable standards.[29]

"Appropriate professional." On compensation issues in particular, professionals are "independent valuation experts who (1) [h]old themselves out to the public as appraisers or compensation consultants; (2) [p]erform the relevant valuations on a regular basis; (3) [a]re qualified to make valuations of the type of property or services involved; and (4) [i]nclude in the written opinion a certification" that the foregoing three requirements have been met.[30]

Practical note on working with experts. From a practical standpoint, we add that the outside expert should have expertise on compensation practices in the nonprofit market and preferably in the organization's nonprofit sector. The expert should also be familiar with the relevant legal standards at both the state and federal level. If the same expert has been engaged for multiple years in a row, the board should regularly reflect on the quality of the expert's work and whether the expert maintains expertise in relevant areas. Also, the consultant should report to the board rather than to the staff, since the board is ultimately responsible for approving the compensation of executives. Nonetheless, the consultant should have access to staff for compensation information and to understand staff views on compensation and the review process.

Meeting the standard of reasonableness for intermediate sanctions purposes

In this section, we discuss the IRS requirements and guidelines for ensuring that compensation is reasonable for all disqualified persons under the I.S. regulations. The next section will expand on this discussion, focusing in particular on the unique aspects of investment staff compensation.

As previously mentioned,[31] "reasonableness" is a case-by-case determination with some—but not comprehensive—guidance provided by the IRS. Therefore, this section incorporates both our understanding of the Service's guidance and our practical experience working with nonprofits to ensure that the compensation they approve for disqualified persons is reasonable.

"Like enterprises under like circumstances." For organizations subject to the I.S. regulations, the compensation provided to disqualified persons should be comparable to what would be paid by similar organizations to similar executives performing similar services in order to meet the regulations' standard of reasonableness. To obtain a sense of what level of compensation this may be, it is important to define the marketplace for the organization and for the particular executives under consideration through the following steps:

1. Identify disqualified persons.
2. Define the marketplace.
3. Understand the nature of position.
4. Identify appropriate data; if applicable, determine the appropriate cuts of survey data.
5. Determine a market value.

The board can then determine an appropriate range in which to set compensation for each position using this market information and also considering other factors, such as whether compensation is internally equitable, whether it conforms with the organization's compensation philosophy, and whether it will pass public scrutiny.

Identifying disqualified persons. An organization should identify which of its positions would be considered "disqualified" under the I.S. regulations and therefore subject to higher scrutiny with respect to compensation. While the regulations explicitly name CEOs or CFOs as "disqualified persons," the regulations also apply to employees who "exercise substantial influence over the affairs" of the organization.[32] The organization should also consider including in its formal compensation analysis and approval process other top-paid executives such as CIOs, who may come under greater external scrutiny.

Defining the marketplace. In our experience, the most important factors to consider when defining the marketplace are organization mission and type (tax status, corporate/individual membership organization, etc.), the size and complexity of the organization (revenues/expenses, staff size, international offices, etc.), the pay practices in the organization's region or locality, and the duties of the employee (departmental oversight, full-time/part-time, etc.). See also our earlier discussion[33] and Exhibit 2 for more detail on the factors the IRS has provided as guidance.

It can be useful to consider what organizations share or compete for the same talent pool or may serve as a recruitment source for the particular position, since those are organizations looking for individuals with similar skill sets to perform comparable services. We note that it may also be appropriate to understand aspects of the for-profit marketplace for the organization or specific position, since some nonprofits may compete for talent with the for-profit sector. However, for purposes of passing both IRS and public scrutiny, we recommend relying primarily on nonprofit data, especially for the CEO position.

Understanding the position. It is critical not only to understand which organizations are similar, but to also understand each position being benchmarked. Since the purpose of benchmarking is to determine the compensation range for executives providing "similar services," it is key to focus on organizations whose executives for a particular position have a similar scope of responsibility. Likewise, when looking for survey data, it is important to ensure that the scope of responsibility for the survey position is comparable to that of the internal position being benchmarked. It is also important to understand each position because there are many executive positions that are unique to an organization or less common among similar organizations, so matching them to similar positions may require a more subtle or nuanced approach.

Data sources and use of data. Again, there is relatively limited guidance regarding which factors the IRS considers most relevant for defining a marketplace. However, in the case of colleges and universities, the IRS recently issued a report regarding the use of data in market analyses, and this can serve as guidance for other nonprofits as well.[34] In particular, the IRS indicated in the report a strong preference for using specific comparable organizations (as opposed to summary statistics from generic surveys) and noted the importance of documenting the reasons for choosing the particular comparable organizations.[35] It also mentioned, as important factors for colleges and universities, the type of university (private/public, research, etc.), size (enrollment, faculty, endowment), and location, among others. These factors can be generalized to other nonprofits as well.[36]

Given the Service's preference for specific comparators, we recommend that organizations develop a group of similar organizations based on the aforementioned key factors, then obtain compensation data for executives at those organizations from proprietary or public sources. Such a comparator group (or groups, if some positions have slightly different marketplaces) is the strongest marketplace for an organization/position.

Typically, it is best to select a group of at least ten organizations, but a group of closer to 20 will better ensure that the group is stable (less susceptible to outliers).[37] We note that there is a tradeoff between the size of the group and how closely the group is tailored to the organization; more organizations should not be added to the group if they are not truly comparable to the organization in question. Also, it is best prac-

[33] See the subsection on "I.S. regulations as model for compliance," above.

[34] Internal Revenue Service, "IRS Exempt Organizations—Colleges and Universities Compliance Project Final Report" (2013), available at www.irs.gov/Charities-&-Non-Profits/Colleges-and-Universities-Compliance-Project.

[35] *Id.*

[36] *Id.*

[37] We note that the IRS permits organizations with annual gross receipts of less than $1 million to look at compensation data "paid by three comparable organizations in the same or similar communities for similar services." Reg. 53.4958-6(c)(2)(ii).

[38] The Sherman Antitrust Act of 1890, amended through the Clayton Act in 1914, prohibits price fixing, where "[t]he term 'prices' also includes the costs of compensation, including salaries, wages ... and benefits." Cardinal and Florin, *Handbook for Conducting Compensation & Benefits Surveys 101* (WorldatWork Press, 2012). Hence, organizations' directly sharing compensation information can potentially be an antitrust violation.

[39] By working with a third party such, as a compensation consultant, to sponsor a survey, a nonprofit can ensure its survey does not run afoul of the Sherman Act. In particular, according to guidelines provided by the U.S. Department of Justice and the Federal Trade Commission, a salary survey is in the "safety zone" if: (1) "[t]he survey is managed by a third party"; (2) "[t]he information provided by survey participants is based on data more than three months old"; and (3) "[t]here are at least five providers reporting data" for each aggregate statistic, "no individual provider's data represents more than 25 percent on a weighted basis of that statistic," and the data is not identifiable to particular survey participants. Cardinal and Florin, *supra* note 38.

[40] Organizations can include comments on the Form 990 to explain, for example, deferred compensation or bonus payouts, but the comments are often not comprehensive.

tice to regularly review the group of comparable organizations since organizations that are comparable one year might not be the most comparable a few years later (for example, if the organization increased or decreased significantly in size).

Proprietary data. Proprietary data can offer the most recent, accurate, and detailed compensation data. However, it may be difficult for an organization to obtain because other organizations may not be willing to share such information. Even if they were willing, access to this data may put a nonprofit in danger of an antitrust violation.[38] An organization can, however, obtain aggregated proprietary data through a compensation consultant, a compensation study, or a custom survey it sponsors.[39]

Form 990s. Nonprofits are legally required to publicly disclose compensation information for certain top positions in their Form 990s. Although freely and readily available, Form 990 data is typically less desirable than proprietary data because it may be difficult to derive an accurate value for the amount of compensation the executive earned in a single year. For example, it may not be clear from the Form 990 whether the organization reported only the deferred compensation accrued in one year, or if the amount listed is a payout of multiple years' accruals. Likewise, it may be unclear if a bonus payout reflects only what is earned in one year, since an organization would include on the 990 the aggregate of all bonuses earned in different years if they were paid out in the same calendar year.[40]

Nonetheless, the compensation data on the Form 990s is typically broken down sufficiently for market comparison purposes. We note that this is not the case on Form 990-PF, the form filed by private foundations. For private foundations, proprietary sources or survey data may be particularly valuable. In addition, an organization may not be required to disclose compensation for certain positions, especially if they are paid below a threshold amount, which may make direct comparison difficult.

Aggregate survey data. While not as strongly preferred, aggregated survey data/summary statistics are also a useful source of compensation data, especially if they are closely tailored to the organization (based on, for example, sector, revenues/expenses, or staff size) or to the position (for example, revenues/expenses are relevant for survey cuts for the CFO position, whereas staff size is more relevant for the top human resources position, to capture the scope of each position's responsibilities).

Determining a market value. A market value for the position may then be derived from the most relevant data sources. Sometimes, the market value is derived from only one source. When data is available for a stable comparator group, we believe it is appropriate to rely on this single source since the comparator group reflects the position's closest marketplace. Where multiple sources of data are determined to be the most relevant for defining the marketplace, the data may be blended for an overall market value.

It is most useful to calculate overall market values for the position at various percentiles, including the 25th, 50th (median), and 75th percentiles. These are the most common statistics provided in compensation surveys. While the average may also be calculated and is often provided in surveys, we do not recommend relying on it when benchmarking compensation. The average can be highly susceptible to outliers; the median (the level above which half of the organizations fall) is a truer representation of the "middle" of the data.

Determining where to target compensation relative to the market. Once the market value has been determined, it can be used to inform compensation decisions. Again, the overarching consideration from a legal perspective is that compensation should be "reasonable" from the Service's point of view—comparable to what other organizations pay for similar services. Those approving compensation should tread cautiously in raising compensation significantly year to year. A significant increase year to year is one of the factors listed in Exhibit 2 that the IRS considers in assessing the reasonableness of compensation. If the basis for such an increase is an increase in market data, those approving compensation should be sure that the increase is not due to chance, but reflects actual trends over several years.

The organization should also keep the following secondary considerations in mind:

- Compensation decisions should be in line with the organization's compensation philosophy. A compensation philosophy documents the organization's overall approach to setting compensation relative to the market.
- The level of compensation should recognize the executive's performance and other key attributes. While the organization's overall compensation philosophy may be to target the market median, compensation for a particular position may be set above or below that level

based on the particular incumbent's demonstrated performance, tenure with the organization, unusual skills or background, or other factors.

- Compensation should pass the test of public and stakeholder scrutiny. Although a certain level of compensation may be reasonable for IRS purposes, it may make the headlines or may elicit a negative reaction from a nonprofit's donors or members, which can hurt the nonprofit irreparably.

Again, we underscore that regardless of the organization's compensation philosophy or the executive's performance and skills, pay must be reasonable from the Service's point of view. Therefore, organizations should take a conservative approach to evaluating compensation with respect to the market and should be particularly careful when positions fall high relative to the market, especially near or above the 75th percentile. As previously noted,[41] we recommend documenting compensation decisions for each position, especially if compensation is high relative to the market or the position is among the organization's most highly compensated.

Compensation of investment staff

In this section, we expand on our more general discussion in the previous section of ensuring reasonableness of compensation, with particular attention to the unique aspects of investment staff compensation that may draw the attention of the IRS. Investment staff compliance can be tricky because such positions are highly paid (a CIO may sometimes be the highest-paid executive) and therefore often come under greater external scrutiny, but it may be unclear whether they are formally included under the I.S. regulations or not. In addition, the nonprofit investment market has a significant overlap with the for-profit marketplace in terms of pay practices and sources of talent, which may make defining a marketplace and setting pay more difficult. For these reasons, compensation for these positions may require extra diligence and a more conservative approach in order to ensure reasonableness.

Background—Investment position as highest paid. Although typically an organization's president or CEO is the highest paid executive, this is not always the case. For example, investment positions are generally highly-paid, and sometimes an organization's top investment officer may be paid more than the CEO. While the CEO may have a higher base salary, the CIO may have a much higher bonus opportunity, making the overall compensation of the CIO higher than that of the CEO.

Among nonprofits, this is most common at large foundations and at universities. For instance, Harvard University's endowment chief earned nearly $5 million in the 2012 calendar year (and several portfolio managers earned even more), compared to the Harvard president's compensation of approximately $1 million.[42] We note that a parallel example among universities' athletic departments, where some coaches may be paid more than the president.

Applicability of intermediate sanctions. Many nonprofit investment positions are at private foundations, to which the I.S. regulations do not apply. However, as mentioned above,[43] even for organizations falling outside of the I.S. regulations' purview, the I.S. guidelines for governance and setting compensation can serve as a model to help ensure compliance with other legal standards that do apply to the organization with respect to compensation.

Even if the investment position is at an applicable 501(c)(3) public charity or 501(c)(4) social welfare organization, it may be unclear whether CIOs would be considered "disqualified persons" under the regulations because, while they are not per se "disqualified" like

[41] See the "Best practice note" on documentation, above.

[42] "Harvard Executives' Compensation Reported," Harvard Magazine (5/16/14), available at http://harvardmagazine.com/2014/05/harvard-endowment-managers-executives-compensation.

[43] See the subsection on "I.S. regulations as model for compliance," above.

[44] In fact, there has been proposed legislation to formally do so by including CIOs (and football coaches) automatically as "disqualified persons" alongside CEOs, COOs, and CFOs (see the "Looking forward" section, below, for more detail). By treating CIOs as disqualified persons, an organization can better defend its pay practices to the IRS and public, and anticipate possible future legislation.

[45] Reg. 53.4958-3(e)(3)(ii).

[46] The requirement is for the organization's five current highest compensated employees receiving over $100,000 from the organization to be reported on the IRS Form 990; for the Form 990-PF, the threshold amount is $50,000. See IRS Form 990, "Return of Organization Exempt From Income Tax."

[47] See, for example, the Investment Management Consultants Association, "IMCA Code of Professional Responsibility (7/1/09), available at ttp://www.imca.org/sites/default/files/Code.pdf.

[48] See the discussion of "Reliance on appropriate data," above.

[49] See the discussion of "Defining the marketplace," above.

CEOs or CFOs, they are highly-paid and may have a significant amount of influence in the organization. When an investment position is one of the highest-paid, we generally recommend that the organization treat it as if the CIO were a disqualified person, since such highest-paid employees typically get the most external scrutiny from the IRS, the public, and other stakeholders. It is best to act conservatively and treat these positions as if they were disqualified, holding them to the highest standard when setting compensation.[44]

In addition, even if a particular investment position is not formally subject to the I.S. regulations, it may nonetheless be subject to the P.I. doctrine and/or the rules against self-dealing. Following the same procedures as for compliance with the I.S. regulations can help ensure that the organization meets those legal standards.

Note about I.S. applicability to contractors. The I.S. regulations are unlikely to apply to investment managers or advisors who are contractors to a nonprofit and receive normal fees for their services, as long as they only provide professional advice to the organization and do not have decision-making authority.[45] We note, however, that even if the individual in question is a contractor, this compensation does not go without scrutiny. First, the Form 990 requires that the nonprofit report the compensation it provided for the five highest compensated independent contractors, along with a description of services, so the information is still publicly disclosed.[46] Second, external staff may also have standards for compensation imposed by their own professions.[47] Third, even if the I.S. regulations do not apply, the P.I. doctrine—and, if the organization is a foundation, the rules against self-dealing—may. Therefore, compensation for these individuals cannot be excessive. Thus, it is best practice to review compensation for both in-house and external staff with the same standards in mind.

Appropriate data for investment staff. As discussed generally above,[48] it is important for the authorized body to obtain and rely on appropriate data in order to obtain the rebuttable presumption of reasonableness.

Overlap of nonprofit investment positions with the for-profit marketplace. Defining a marketplace for purposes of obtaining appropriate data for nonprofit investment staff is complicated by the fact that the nonprofit investment sector has significant overlap with the for-profit marketplace, which is a common recruitment source—more so than for other nonprofit positions.

As noted above,[49] the most important step in establishing a reasonable range for compensation for a position is defining the marketplace. Even though there may be frequent recruitment for investment managers from the for-profit sector, there is a robust not-for-profit marketplace for such positions, and using this well-defined, discrete marketplace for compensation comparison purposes is the prudent and more defensible approach.

Potential separate comparator group. While a group of comparable organizations may appropriately reflect the marketplace for most if not all of the organization's executives, it may be more appropriate, or even necessary, to develop a different group of organizations for the CIO, which may have a different marketplace. The CIO's comparator group should reflect organizations with a similar scope of investment activities for their top investment positions. For such positions, relevant factors may include the size and scope of responsibility of in-house investment staff, reliance on external investment managers, and the amount of funds managed.

Investment positions are among the trickiest positions for which to structure compensation packages.

It may sometimes be particularly difficult to find enough truly similar organizations with respect to investment activity, requiring a more nuanced approach to defining the marketplace. For example, for social equity fund clients, we have sometimes compared investment staff to positions at universities with comparable investment operations. In these cases, it is particularly important for the organization to justify in writing its rationale for the particular marketplace used to benchmark investment positions.

Data sources and use of data. For investment positions in particular, it may be especially useful when reviewing the compensation of comparable organizations to have a separate breakdown of base salary, the most recent bonus award, and other elements of compensation (benefits, retirement, and any perquisites). While we typically provide our clients and their boards with such detail and consider it a best practice, it is particularly important for investment positions, given the potential variability of the bonus award both by organization and year.

In addition, we also would advise looking at compensation for each organization over a five-year (or longer) period to have a fuller un-

derstanding of that organization's typical compensation practices. This approach helps to address any anomalies in compensation in a single year. Boards should be wary when one year's compensation analysis is notably higher than the prior year's, since this could be due to unusual or chance variations. When in doubt, we recommend removing any outliers or averaging compensation over several years to provide a more consistent and conservative estimate of compensation.

Setting compensation for investment staff—Reasonableness. When setting compensation for investment staff,[50] the authorized body should consider whether the dollar value of all compensation (including any revenue-sharing) paid to the individual will be reasonable from the Service's perspective. If the investment officer has the opportunity to receive a variable bonus award, it is a best practice to cap the bonus amount, and the maximum award amount (regardless of the award percentage) should be considered when reviewing the reasonableness of the overall package.

Background—Nonprofit investment staff and profit sharing. More so than for other nonprofit executives, investment staff bonuses are more likely to have a "revenue sharing" aspect (i.e., compensation determined by reference to the exempt organization's revenues), such as when bonus payments are pegged to investment portfolio performance. For some nonprofit CIOs, a large portion of the cash they take home consists of such a bonus award, with the amount awarded sometimes exceeding the base salary amount. For example, the base salary of Yale University's CIO "has stayed fairly constant at $770,000" since 2008, while his bonuses "have fluctuated between $2.9 million and $1.5 million."[51]

Unlike other nonprofit executive positions, the CIO's performance metrics may rely heavily—or almost exclusively—on such financial metrics (for top executives managing Harvard University's endowment, "more than 90 percent of the pay [is] tied to returns" and "bonuses often reflected several years of gains and losses relative to a benchmark").[52] Putting such a large portion of the CIO's compensation at risk is intended to align the CIO's goals with that of the organization—to incentivize the CIO to drive strong performance of the investment portfolio he/she is managing. However, although not per se a violation of the I.S. regulations, such arrangements may be a red flag for the IRS, especially if they have the potential for an unexpectedly large payout.

I.S. regulations—Reasonableness of total remuneration including "revenue sharing." As with other executive positions, total remuneration for top investment personnel must to be reasonable in order to comply with the I.S. regulations. The I.S. regulations apply even when there is an existing contract setting forth an executive's compensation, even if it might stipulate a bonus based on a formula that might provide a potentially high payout, such as from certain equity investments.

Although the IRS has yet to issue regulations providing concrete guidance on revenue-sharing transactions, such arrangements are not excessive or unreasonable per se. Rather, the general standard applies for compensation that includes revenue sharing—the overall compensation arrangement must be reasonable. Nonetheless, the IRS raises an eyebrow at such arrangements because they look like a distribution of profits and, by definition, a nonprofit's main purpose is not profit-generation. In addition, revenue sharing "may be considered to be an excess benefit transaction even when the proportional amount of revenue shared does not exceed the fair market value of the services provided"—"if, at any point, the arrangement permits a person to receive additional compensation without providing reciprocal benefits to the organization."[53] Such a determination is based on the facts of the case; here, too, there are no bright-line rules, so organizations are ad-

[50] For our prior discussion on setting compensation for executives generally, see "Determining where to target compensation relative to the market," above.

[51] Rodrigues, "Yale's Top Earners Defended," Yale Daily News, 2/6/14, available at http://yaledailynews.com/blog/2014/02/06/yales-top-earners-defended.

[52] McDonald and Streib, "Harvard Endowment Compensation Sparks Letter From Alumni," Bloomberg Business, 8/27/14, available at www.bloomberg.com/news/articles/2014-08-27/harvard-endowment-compensation-sparks-letter-from-alumni.

[53] Tenenbaum, *Association Tax Compliance Guide 101* (Association Management Press, 2013).

[54] Reg. 53.4958-4(b)(1)(ii)(A).

[55] See the "Best practice note" on governance and approval of compensation, above.

[56] "Dave Camp Drops a Tax Reform Bill on his Way out the Door," The Washington Post, 12/24/14, available at www.washingtonpost.com/business/economy/dave-camp-drops-a-tax-reform-bill-on-his-way-out-the-door/2014/12/23/ec9cb998-863a-11e4-b9b7-b8632ae73d25_story.html.

[57] Kalick, "Draft Tax Reform Act of 2014 Proposes Profound Impact on Tax-Exempt Organizations," Nonprofit Quarterly, 3/18/14, available at https://nonprofitquarterly.org/policysocial-context/23858-draft-tax-reform-act-of-2014-proposes-profound-impact-on-tax-exempt-organizations.html.

vised to take a conservative approach.

Best practice—capping bonuses. If the organization nonetheless wants to incorporate revenue sharing into an executive's compensation package, we strongly recommend capping bonuses to ensure that total remuneration, including any revenue sharing, is reasonable. Despite the overall scarcity of its guidance with respect to revenue sharing, the IRS does note that "[t]he fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation."[54]

Capping a bonus is particularly important where a bonus award is tied to a formula that has the potential of a large payout, even if such a payout unlikely due to the uncertainty of the underlying event. Such an uncertain event may be the performance of an investment portfolio.

The predictability of the actual award is important because it is otherwise difficult to evaluate the reasonableness of the actual total remuneration amount that the individual will receive. By setting a cap, the entity or individuals approving a compensation package can more easily ensure that the total package, assuming the highest possible bonus award, will still be reasonable. They can also more easily justify compensation to the public and external stakeholders, and can manage the employee's expectations with respect to the bonus award (since they will not have to cut the bonus award in the future in order to keep total remuneration reasonable).

Note on setting performance goals. We note that, in general, it is a best practice to set executive performance goals based on metrics that are tied to the fulfillment of the organization's mission, with financial goals as only one of several objectives for assessing an executive's performance, and to tie the bonus award to the executive's meeting those goals. Compensation tied to financial metrics may elicit negative reactions from the public and key stakeholders, such as donors. For this reason, nonprofits typically set mission-based objectives, since nonprofits' primary objectives are not financial but rather mission-oriented. However, it is common for investment positions for performance (and thereby the bonus award) to be tied primarily through financial objectives.

Best practice—Approving compensation. As a matter of governance, we would recommend that the board take particular care in reviewing the compensation of any executive, such as a CIO, who is paid more than the CEO. Although a board may delegate primary responsibility for reviewing the compensation of other executives to the CEO,[55] compensation at the highest levels receives great external scrutiny and ultimately *the board* is responsible for ensuring that all approved compensation meets the applicable legal standards.

Investment staff and external scrutiny. In addition to the other considerations discussed earlier in this section that should be kept in mind when setting compensation for investment staff, decision-makers should be particularly mindful of the public perception of investment staff compensation. Investment staff compensation may be subject to particularly strong external scrutiny given the high levels of compensation overall, and especially because of the high bonus awards, which often make headlines. Such publicity could adversely affect the reputation of a well-known foundation even if the compensation it pays to its investment staff is legally reasonable.

Looking forward—Current and potential future changes

Although the I.S. regulations were issued almost 20 years ago, there is still a fair amount of uncertainty around certain aspects of the regulations. Because the Service's interpretations and guidance are still evolving, it is important when setting nonprofit compensation not only to ensure that compensation is reasonable given the current guidelines, but to also be aware that there may be greater scrutiny of and restrictions on nonprofit compensation, both at the state and federal levels, on the horizon.

At the federal level, the most recent notable legislation was the Tax Reform Act of 2014. Although not ultimately enacted,[56] it contained several significant provisions with respect to nonprofit compensation, including (1) a 25% excise tax on compensation over $1 million to an organization's five highest-paid employees, (2) extending the I.S. regulations to Section 501(c)(5) unions and Section 501(c)(6) trade associations and chambers of commerce, (3) including investment advisors and athletic coaches specifically in the definition of "disqualified persons," (4) imposing penalties not only on those approving compensation but on the organization itself as well, and (5) eliminating the rebuttable presumption of reasonableness and the additional protection from relying on expert opinions.[57]

At the state level, some states have enacted tighter rules regarding nonprofit compensation, and several state attorneys general have actively pursued nonprofits appearing to overcompensate their executives. For example, Massachusetts' Attorney General has called for

increased public reporting requirements and, in a move for greater transparency, has released a report on compensation at large Massachusetts nonprofits in 2013 that included recommendations on best practices with respect to setting nonprofit executive compensation.[58] Similarly, New York enacted the New York Non-Profit Revitalization Act of 2013, which reformed statutory requirements for nonprofit governance and expanded the enforcement powers of the Attorney General.[59]

These discussions at both the state and federal level are important because they may be indicative of potential future policies and levels of scrutiny. While a board or compensation committee may not be able to predict changes down the road, it can ensure that it understands the currently applicable legal standards, including their various nuances, in order to make reasoned and sound decisions now, and follow best practices to anticipate the future legal landscape of nonprofit compensation.

Conclusion

When setting executive compensation, nonprofit boards and other decision-makers should make sure that the benefit the organization receives in return is proportionate, in order to comply with the various legal standards. Organizations should be particularly careful in approving the compensation of highly-paid employees such as investment staff, who often come from for-profit backgrounds and may receive substantial bonuses tied to financial performance. By understanding the regulations and safeguards, following best practices, and taking a generally conservative approach to compensation, a nonprofit can help ensure that it complies with the regulations now and in the future. ■

[58] Press Release, Attorney General of Massachusetts, "AG Coakley Releases Report Examining CEO Compensation at Large Public Charities" (12/19/13), available at www.mass.gov/ago/news-and-updates/press-releases/2013/2013-12-19-nonprofit-ceo-comp.html.

[59] Press Release, New York State Office of the Attorney General, "A.G. Schneiderman's Nonprofit Revitalization Act Signed Into Law" (12/19/13), available at www.ag.ny.gov/press-release/ag-schneidermans-nonprofit-revitalization-act-signed-law.