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Compensation Considerations for Foundation Insiders

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Many foundations have family members serve on their board, however sometimes foundations have trouble deciding whether or how much to pay those family members. Careful consideration must be taken when deciding these factors to avoid the foundation using a family member's seat on the board as a vehicle for making a tax-exempt transfer of assets. The risk of this occurrence can be avoided by following the regulations imposed by the IRS, which we've summarized below.

REGULATIONS

The law on the matter of family compensation within foundations is very clear in that any financial transaction between a foundation and an "insider," or a disqualified person,[1] is considered self-dealing, and therefore not allowed. An insider could be a foundation manager (i.e. officer, director or trustee), a foundation contributor with a 20% or greater business interest, owners and family members of any of those individuals. Certain entities owned or controlled by disqualified persons may also fall under this category.

While this is a strict rule, there is an exception found in Treasury Regulation 53.4941(d)-3(c)(1) that permits compensation to one of those insiders for personal services rendered to the foundation, so long as the services are reasonable and necessary and the compensation is not excessive. Compensation that meets these standards can even be counted as a charitable expenditure, contributing to the 5% annual distribution required of foundations. So let's spend a moment breaking down the definitions of these standards:

I. PERSONAL SERVICES

In order for an insider's actions to be considered "personal services," the individual needs to be in a position of oversight, like a board committee chair, a professional advisor, an executive director, or other member of the staff. Services rendered under one of these categories will be considered personal services.

II. REASONABLE AND NECESSARY

The standards for considering a personal service reasonable and necessary are more complicated than fulfilling a specific role in the foundation. The reasonable standard is also different for public and private foundations. A public company requires that compensation paid to an insider is already presumed to be reasonable.

Reasonable compensation for private charities is a similar amount to what would ordinarily be paid by similar organizations for the same services rendered. This standard requires private organizations to keep records of the job requirements and actions—not only for their officers, but also for officers of similar companies—in order to compare compensation rates before their officers are paid.

There is also an extensive process for the compensation to be approved. First, a committee of disinterested individuals must decide upon the amount. In doing so, the committee shall compare the proposed compensation with appropriately compiled data regarding similar charities and the compensation for their officers. Their decision will be based on the equality of the proposed compensation and data.

There are many factors private charities should consider when compiling data from other charities to compare compensation rates. For example, considering the size and location of the comparable charities is important because certain regional markets and certain sized charities would pay more than others for the same position. In addition, the specific job responsibilities as well as the individualized qualifications of the insider should be analyzed. Education level and difficulty of responsibilities are going to be significant factors in determining how much compensation is necessary. Lastly, the value of the compensation is a factor to consider. Is this a full-time position? Will benefits be administered?

BENCHMARKING COMPARABLE SALARY DATA	
☑	Use reasonable comps in terms of geographic region and organizational size
☑	Consider job responsibilities/time commitment
☑	Consider education/skill level of insider
☑	Consider total compensation value (e.g. benefits, paid time off, etc.)

[1] As defined in IRC § 4946.

PENALTIES

There are penalties for charities that neglect the IRS guidelines and proceed to compensate their insiders in an unreasonable manner.

I. SELF-DEALING

Self-dealing is when an insider is paid an excessive amount or is paid for services that are not considered personal in nature.[2] In other words, the insider is being paid solely because he or she is an insider. The IRS would most likely impose a penalty on the insider of 10% of the amount involved.[3] There could also be a penalty imposed on the foundation director who allowed the unreasonable transaction to occur. The IRS will require him or her to pay the fee personally, but the penalty would be 5% instead of 10%.

Furthermore, the insider must return any self-dealing compensation, with interest, to the foundation. If the compensation is not returned by the deadline imposed by the IRS, the IRS can levy a punitive second-tier tax on the foundation, which is currently 200% of the amount deemed excessive. The foundation director would also be responsible for correcting the compensation violation. If the foundation director does not collect the excess compensation, the IRS could impose a second-tier tax on them as well. That rate would be 50% of the amount involved.

SELF-DEALING: INSIDER IS PAID EXCESSIVELY OR RENDERS SERVICES NOT CONSIDERED "PERSONAL"	
IRS PENALTIES FOR VIOLATION	
FOR INSIDER	**FOR FOUNDATION DIRECTOR**
Must return excess comp with interest to foundation + pay fee of 10% of that amount to IRS	Must collect excess comp from insider + pay fee of 5% of that amount (to be paid personally to IRS)
DISCRETIONARY PUNITIVE MEASURES BY IRS	
FOR FOUNDATION	**FOR FOUNDATION DIRECTOR**
For late payment or failure to collect payment, risk of additional taxes equal to 200% of the amount deemed excessive	For late payment or failure to collect payment, risk of additional taxes equal to 50% of the amount deemed excessive
IRS can also revoke the foundation's tax-exempt status if pattern is suspected.	

Lastly, the IRS can seek revocation of the foundation's tax-exempt status if the instances of self-dealing compensation indicate a pattern by the foundation.

II. TAXABLE EXPENDITURE

Penalties will be imposed on a foundation for expenditures that do not further the foundation's charitable purposes, including unreasonable compensation.[4] If the foundation is found to compensate their insiders unreasonably, the IRS will subject the foundation as a whole to 20% of the amount that is considered unreasonable. In addition, the foundation director that agreed to pay the compensation, knowing it is a taxable expenditure, could be personally liable for 5% of the unreasonable compensation.

Similar to the self-dealing compensation, the violation for taxable expenditures must be corrected in the eyes of the IRS. Therefore, the insider must return the portion of his or her compensation that was deemed unreasonable. If the compensation is not returned to the foundation in a timely manner, the IRS can impose second-tier taxes on the foundation, which is 100% of the expenditure. Additionally, the IRS can impose a second-tier tax on the foundation director, which is 50% of the expenditure.

TAXABLE EXPENDITURE: EXPENDITURES THAT DO NOT FURTHER THE FOUNDATION'S CHARITABLE PURPOSE (E.G. UNREASONABLE COMPENSATION TO INSIDERS)	
IRS PENALTIES FOR VIOLATION	
FOR FOUNDATION	**FOR FOUNDATION DIRECTOR**
Must collect excess comp from insider + pay fee of 20% of that amount to IRS	Must pay fee of 5% of the amount deemed excessive (to be paid personally to IRS)
DISCRETIONARY PUNITIVE MEASURES BY IRS	
FOR FOUNDATION	**FOR FOUNDATION DIRECTOR**
For late payment or failure to collect payment, risk of additional taxes equal to 100% of the amount deemed excessive	For late payment or failure to collect payment, risk of additional taxes equal to 50% of the amount deemed excessive

BOTTOM LINE

Excessive compensation for insiders is a problem foundations can easily avoid. It is possible, and even a fairly common practice, to pay insiders for their work on a foundation, as long as they are compensated according to IRS rules. Correcting a penalty for excessive compensation is expensive and stressful. Taking the extra steps to ensure the foundation is following regulations for the personal services and reasonable and necessary compensation standards is key to remaining in compliance and avoiding the IRS penalties.

[2] As defined in IRC § 4941.
[3] Note that the "amount involved" in cases involving unreasonable compensation is generally only the excess compensation paid by the private foundation.
[4] As defined in IRC § 4945.

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