

# Compensating Foundation Insiders



ENSURING PAY IS BOTH  
“REASONABLE AND NECESSARY”

When individuals devote time to foundation matters—whether as officers, directors, trustees, executive directors, employees, or professional service providers—they may expect to be fairly compensated for their time and effort. Unfortunately, because of a few bad actors, **the issue of compensating insiders for their work on the foundation has become something of a lightning rod for controversy.**

No one wants foundations to use compensation as a pretext for the transfer of tax-exempt funds to family members. Private foundations, after all, are organized expressly for charitable purposes. Federal and state laws discourage abuse, but some foundations have charter documents that prohibit compensation outright, requiring that those who serve on the foundation do so strictly as volunteers. For those foundations that do compensate insiders—and many do—attention must be paid to make sure compensation is both “reasonable and necessary.” Failure to do so could expose the foundation, and possibly the compensated individual, to federal tax penalties—not to mention humiliating press coverage and public derision.

## What The Law Says /

Generally speaking, as spelled out in Section 4941, the IRS prohibits all financial transactions between a private foundation and its “disqualified persons” (insiders). All such transactions are considered self-dealing, and such violations can result in tax penalties and even the loss of the foundation’s exempt status.

Who is considered an insider? Any and all of the following:

- Foundation managers (directors, officers, trustees, and those with similar powers or responsibilities)
- Substantial contributors and individuals or entities with a 20% or greater interest in an entity that is a substantial contributor
- The family members of all such individuals
- Certain entities partially or wholly owned, directly or indirectly, by disqualified persons

However, Section 53.4941(d)-3(c)(1) of the Treasury Regulations provides an interesting exception to the prohibition against financial transactions: It permits compensation for personal services rendered in carrying out foundation affairs, provided that the services provided are reasonable and necessary, and the compensation is not excessive. Compensation that meets these standards can be counted as a charitable expenditure, contributing toward the 5% annual distribution requirement that foundations must make<sup>1</sup>.

**THE SERVICES RENDERED MUST BE BOTH “NECESSARY” FOR THE FOUNDATION TO CARRY OUT ITS TAX-EXEMPT PURPOSE AND “PERSONAL” IN NATURE.**



For the foundation to furnish compensation, the services rendered must be both “necessary” for the foundation to carry out its tax-exempt purpose and “personal” in nature. Although the term “personal services” has not been well defined by the IRS, the Treasury Regulations provide examples indicating that it includes investment management, legal, and banking services. Further, it is generally understood to 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.

<sup>1</sup> Please note that the salary of a person who exclusively manages the foundation’s investments, like a Chief Investment Officer, won’t count toward the 5% payout.

Personal services typically fall into one of three categories:

### **Board, officer, or trustee service**

To qualify for compensation, personal services would need to have the function of oversight: review foundation investments and finances, chair committees, plan ways for the foundation to achieve its mission, etc.

### **Professional advisor**

A board member, officer, or other insider (or his or her relation) who is also a CPA, attorney, or financial planner might be compensated for rendering his or her professional services to the foundation.

### **Staff services**

The foundation's executive director or other staff, such as a program officer.

So, how does a foundation determine what constitutes "reasonable" and "necessary" compensation? Well, this is where it gets a little tricky.

## Standards for Determining "Reasonable" /

The rules are a lot easier for public charities, where, under the "excess benefit transactions" regulations, the compensation paid to a disqualified person is presumed to be reasonable, provided that certain procedures are followed; if the procedures are followed, the burden shifts to the IRS to rebut that presumption. Private foundations don't have a clear set of procedures to follow. The Treasury Regulations applicable to public charities do, however, set forth procedures for determining reasonable compensation that the private foundation sector has adopted as best practice.

The standards set forth in the Treasury Regulations require that the amount of compensation is comparable to what would ordinarily be paid by similar organizations for like services. This depends on the individual's job description, the skill or knowledge required to perform the job, the amount of time needed to fulfill the functions required and the salaries paid for comparable positions. In practice, this means that foundations need to benchmark any proposed compensation against what other for-profit and nonprofit companies pay similarly qualified candidates. Foundation Source facilitates a benchmarking service for its client foundations.

It probably goes without saying, but this benchmarking process must be undertaken before any compensation is paid. Moreover, the process must be conducted so that it meets these requirements:

- The compensation is approved in advance by an authorized body of disinterested individuals.
- The authorized body obtained appropriate comparability data prior to making its determination as to reasonableness.
- The authorized body concurrently made its determination and adequately documented the basis for that determination

Essential elements of the benchmarking analysis include the consideration of relevant factors, which might include:

- The size of the organization
- The employment history of the candidate and any special qualifications (e.g., licenses and certifications)
- The geographic location of the foundation (some regional employment markets pay more than others)
- The specific job duties and responsibilities
- The time commitment (is it a full-time job?)
- The total value of the compensation package, including benefits

Finally, when determining reasonableness, it's important to consider the total compensation paid to all insiders and how this amount compares to the foundation's assets and level of annual grantmaking. If the foundation appears to be paying its insiders disproportionately, the IRS and/or the Attorney General might start to wonder whether the organization is genuinely dedicated to charitable purposes.

## Proceed With Caution /

Foundations and their insiders that fail to meet the “reasonable and necessary” and “personal services” requirements with respect to compensation face an array of possible self-dealing and/or taxable expenditure penalties:

### Self-dealing penalties

If the services rendered by the insider are not personal in nature, or the amount paid is found to be excessive, the IRS may impose a penalty on the insider who engages in the act of self-dealing. The penalty, payable by the insider personally, not the foundation, will be equal to ten percent of the “amount involved.”<sup>2</sup> The IRS also could impose an additional five percent penalty on any foundation manager who was aware that the transaction was self-dealing yet participated in it nonetheless. The insider must return any impermissible compensation, with interest, to correct the self-dealing violation, and if the self-dealing act is not undone or corrected in a timely manner, the IRS may impose punitive second-tier taxes, currently 200% of the amount involved. Similarly, a second tier tax of 50% may be imposed on any foundation manager who refuses to correct the violation. Finally, the IRS may seek revocation of the foundation's tax-exempt status if it believes that the violations around compliance constitute a pattern of self-dealing that essentially nullifies the foundation's purpose as a charitable enterprise.

**FOUNDATIONS NEED TO BENCHMARK ANY PROPOSED COMPENSATION AGAINST WHAT OTHER FOR-PROFIT AND NONPROFIT COMPANIES PAY SIMILARLY QUALIFIED CANDIDATES.**



<sup>2</sup> The calculation of the “amount involved” for an act of self-dealing varies depending on the type of transaction that triggered the self-dealing violation. See Section 4941(e)(2) and Treasury Regulations Section 53.4941(e)-1(b). Note that the amount involved in cases involving unreasonable compensation generally is only the excess compensation paid by the private foundation.

## Taxable expenditure penalties

Section 4945 of the Internal Revenue Code imposes penalties on a foundation's "taxable expenditures," which include expenditures that do not further charitable purposes. If the foundation pays compensation that is deemed unreasonable, a taxable expenditure would result, subjecting the foundation to a penalty in the amount of 20% of the portion that is considered unreasonable. Further, a foundation manager that agrees to pay unreasonable compensation, knowing that the payment is a taxable expenditure, could be personally liable for a penalty in the amount of five percent of the unreasonable compensation. In addition to these penalties, the violation must be corrected, which could necessitate that the individual return to the foundation the portion of the compensation deemed unreasonable—with interest. If the taxable expenditure is not corrected in a timely manner, the IRS may impose confiscatory second-tier taxes on the foundation, currently 100% of the amount of the expenditure. Similarly, a second-tier tax of 50% may be imposed on any foundation manager who refuses to correct the violation.

Excessive compensation can lead to additional headaches for the foundation. As discussed earlier, compensation that meets IRS requirements may be counted toward the foundation's annual minimum distribution requirement; excessive compensation does not. As a result, the foundation might not have met its distribution requirement during the years that the compensation was paid, giving rise to yet more penalties. To make matters even worse, correcting a self-dealing violation necessitates both the insider and the foundation to file penalty returns with the IRS. A penalty return reporting only self-dealing may not be open to public inspection, but a penalty return reporting a taxable expenditure is a public document, available to anyone who cares to see it.

The bottom line for foundations is that it is possible and even a fairly common practice to pay insiders for their work on the foundation, as long as you follow the rules. However, given the complexity and nuances of the process, it's important to ensure that your foundation undertakes all the steps necessary to remain in compliance.

## ABOUT FOUNDATION SOURCE

Foundation Source empowers people and companies to create a better world through philanthropy. We make giving easier for more than 2,000 foundations with innovative technology backed by philanthropic expertise.

## HAVE A QUESTION?

Call 800.839.0054 or send us an email at [info@foundationsource.com](mailto:info@foundationsource.com).

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