September 15, 2004

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association to address concerns communicated by legislative staff members of the Senate Finance Committee during the July 22, 2004 roundtable discussion on nonprofit organizations. The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

During the roundtable discussion that the Senate Finance Committee convened on July 22, 2004, several legislative staff members expressed concern about the regulations to Internal Revenue Code Section 4958 (imposing taxes on excess benefit transactions) that address how certain nonprofit organizations may avail themselves of a rebuttable presumption that their transactions with insiders are reasonable. The staff members specifically raised concerns about the use of for-profit sector data in determining whether compensation paid by nonprofit organizations is reasonable (such a determination is a condition of obtaining a rebuttable presumption) and whether excluding the initial contract from Section 4958 (imposing taxes on excess benefit transactions) that address how certain nonprofit organizations may avail themselves of a rebuttable presumption that their transactions with insiders are reasonable. The staff members specifically raised concerns about the use of for-profit sector data in determining whether compensation paid by nonprofit organizations is reasonable (such a determination is a condition of obtaining the rebuttable presumption) and whether excluding the initial contract from Section 4958, as the Regulations currently require, is appropriate. In response to these concerns, individual members of the Exempt Organizations Committee of the American Bar Association Tax Section have prepared these comments.

We believe that Section 4958 and its accompanying regulations, with the limited modifications suggested here, provide the necessary regulatory framework for compensation decisions. The twin goals of providing useful guidance to law-abiding nonprofit organizations and preventing both intentional and negligent excess benefit transactions are well served by Section 4958 and its regulations, particularly when modified as we suggest here. We also believe that requiring prompt and clear disclosure of compensation arrangements and other transactions between nonprofit organizations and insiders will further prevent abuses that rightfully concern the Committee and its staff. We begin with the disclosure issue.

A. Revised Compensation Reporting Obligations

We agree with the improved annual disclosure suggestions made by a former chair of the Exempt Organizations Committee, Douglas Mancino, in his letter of July 27, 2004, to Dean Zerbe of the Senate Finance Committee staff. Building on Mr. Mancino’s suggestions, we believe that all nonprofit organizations should be required to submit as part of their annual Form 990 and Form 990-PF, respectively, a “Schedule C” reporting compensation for the current year, as well as for the preceding two years, for all officers, directors or trustees, and the top five highest compensated employees and independent contractors. The new Schedule C...
should require more precise and expanded reporting of compensation arrangements that break out and describe in
detail each category of compensation – base salary, benefits (health and life insurance, car, parking, housing, etc.),
bonuses (including the criteria for awarding such bonuses), long-term incentive compensation, deferred
compensation and other financial arrangements or transactions (e.g., loans, sale of property, etc.) between the
nonprofit organization and any individual or entity identified on the Schedule.

B. Use of For-Profit Comparables

The reasonableness of compensation paid by a nonprofit organization is based on a number of factors,
including the comparability of such compensation to that paid by similar entities for comparable services. Several
Congressional staff members have expressed concern about the use – and abuse – by nonprofit organizations and
their advisors of for-profit comparables in setting compensation levels for nonprofit employees. The Regulations to
Section 4958 currently allow nonprofit employers to look both to the nonprofit and for-profit sectors for
comparability data. We believe that banning the use of for-profit comparables would harm the nonprofit sector by
making it much more difficult for those nonprofits that compete with for-profit employers for qualified employees
to attract and retain “the best and the brightest” employees. We also think it would be inappropriate and excessive
to limit the authority and discretion of the nonprofit organization’s governing body in reviewing comparables when
setting compensation. Rather, we believe that perceived and actual abuses in the use of for-profit comparables can
be eliminated through revised Section 4958 Regulations outlining when the use of for-profit comparables is
appropriate, coupled with increased disclosure on a new Schedule C or a revised Form 990 or 990-PF providing
details of when and why for-profit comparables have been used.

We believe that the Regulations should require nonprofit organizations to look primarily to comparisons
from the nonprofit sector in determining whether compensation is reasonable. For-profit comparison data may be
used to supplement nonprofit data, but the nonprofit organization would have to explain the necessity of looking to
the for-profit sector.

For example, it is simply not necessary to look to for-profit data to supplement existing non-profit data in
setting compensation for job categories that do not exist in the business sector. A program officer who works for a
private foundation with $50 million in assets, whose job is to review grant proposals made by, and monitor existing
grants to, performing arts organizations, has no counterpart in the business world. The foundation could gather
sufficient data from similarly situated nonprofits to “price” such a position, and for-profit entities would not offer
useful or competitive data.

On the other hand, when a large public charity that operates in several countries and employs numerous
staff seeks to attract or retain a chief operating officer, we believe it is appropriate for that charity to supplement data
about compensation paid by other similarly-sized nonprofits with salary, benefit and bonus information from for-
profit corporations with operations of similar scope and complexity. Similarly, when an educational institution
reviews the compensation package for a financial analyst with an MBA, who is charged with managing the
institution’s $100 million endowment, the institution should be permitted to review data about compensation paid by
other universities to their money managers, along with salary, benefits and bonuses information from for-profit
money management firms and investment advisors. We suggest, however, that in setting the financial analyst’s base
salary, performance-based incentive payments and other benefits, the nonprofit employer should not simply adopt
the compensation structure of the for-profit entities. Incentive compensation that would not be excessive in the Wall
Street context might well make the total compensation package excessive in the nonprofit context. Thus, it may be
appropriate for the university to put in place a dollar cap that would limit the total compensation, including all
performance-based incentives, to a figure that is objectively reasonable.

We also believe that there are at least two instances when it is entirely appropriate for a nonprofit employer
to rely “primarily” on comparability data from the for-profit sector. Specifically, the Regulations should state
expressly that a nonprofit organization will be permitted to rely “primarily” on for-profit comparables if the
organization can demonstrate either that (a) sufficient nonprofit comparables do not exist to enable the governing
body to make a decision consistent with its fiduciary duties, or (b) there is a single labor market in which both for-
profits and nonprofits must compete for the same limited pool of qualified candidates. The Regulations should
provide examples of both the insufficient data and single labor market exceptions to provide guidance regarding the parameters of each. We offer the following illustrative examples:

**Insufficient data:** There may be insufficient nonprofit comparables for nonprofit employers that work with emerging technologies or that develop innovative economic development programs for the underprivileged, such as micro-lending for inner city businesses, global financing of medical treatment programs in Africa, or the development of effective and low-cost distribution systems for medical services in developing countries.

**Single labor market:** Surgeons, intensive care nurses, and other medical professionals are in short supply and are sought by both for-profit and nonprofit hospitals. Technology experts, auditors, accountants, and the like perform tasks that are substantially similar whether they work for a nonprofit or for-profit employer. Because of the limited labor pool and the substantial similarity between the for-profit and nonprofit jobs, a nonprofit organization would have difficulty hiring qualified employees if comparable compensation packages were not offered.

The Exempt Organizations Committee is willing to draft proposed language for these modifications to the Section 4958 Regulations upon request.

C. The “First Bite” Rule

Section 4958 focuses on transactions between a nonprofit organization and its insiders, termed “disqualified persons.” One becomes a disqualified person by virtue of one’s relationship with the nonprofit organization. When a person has no relationship with the nonprofit organization, and thus no ability to exercise the “substantial influence” to which the statute refers, Section 4958 by its terms does not apply to transactions between them. Thus, an initial contract between a nonprofit organization and an unrelated third party is not covered by Section 4958. Put more technically, the Regulations to Section 4958 exclude from the reach of that statute any compensation that a person receives in the form of a “fixed payment” made pursuant to that person’s “initial contract.” For this purpose, an initial contract is a contract made between an organization subject to Section 4958 and a person who was not a disqualified person immediately before entering into the contract. A “fixed payment” is defined to include any contract under which compensation is determined by a process or formula which does not permit broad discretion on the part of the organization. This initial contract exception is more familiarly (and more memorably) known as the “first bite” rule.

We defer to Congress’ judgment that an initial contract exception is appropriate where the non-exempt party to the contract is not yet in a position to exercise substantial influence over the exempt party. We suggest, however, that the nature of the exception should be modified in two aspects.

First, we recommend limiting the initial contract exception to two years. Adopting the two-year limit will allow nonprofit organizations the flexibility they need while ensuring that the compensation of recently hired individuals is re-examined under the Section 4958 standards within a reasonable period of time. It will reduce the possibility that, given personnel and contractor turnover, Section 4958 may never reach key positions in an organization otherwise subject to that statute.

Second, we recommend creating a “good governance” incentive by extending the benefit of the rebuttable presumption of reasonableness to initial contracts that are approved in accordance with the procedures set forth in Treas. Reg. Sec. 53.4958-6 for obtaining that presumption. The presumption would apply for the two years beginning on the date on which the initial contract takes effect, and would come into play in the event of audit or allegations of private benefit or private inurement. We believe that this incentive will provide significant motivation to nonprofit organizations to adhere voluntarily to the rebuttable presumption standards.

As with our suggestions regarding the use of for-profit comparability data, we are willing to draft proposed language for modified Regulations upon request.
We appreciate the opportunity to provide comments to the Senate Finance Committee and the Committee staff. Should you wish additional information on any of the matters discussed in this paper, please contact Stuart Lewis, the Section’s Vice-Chair for Government Relations, at (202) 452-7933.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

cc:  Gregory Jenner, Acting Assistant Secretary of the Treasury (Tax Policy)
     George Yin, Chief of Staff, Joint Committee on Taxation
     Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
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1 Principal responsibility was exercised by Betsy Buchalter Adler, James P. Joseph, and Professor Frances Hill, with help from Marion R. Fremont-Smith, Douglas M. Mancino, Michael A. Clark, and other Exempt Organizations Committee members. These comments are based on the authors’ extensive experience as advisors to (and, in one case, a state governmental regulator of) nonprofit organizations.

2 All statutory references are to the Internal Revenue Code of 1986, as amended, and the accompanying Regulations.

3 In referring to “nonprofit organizations,” we are referring only to Section 501(c)(3) and Section 501(c)(4) organizations, which are the tax-exempt organizations subject to the Section 4952 intermediate sanction provisions.

4 2004 TNT 168-54.

5 Treas. Reg. Sec. 53.4958-6(c)(2).

6 We note that this problem is not limited to large institutions such as universities and hospitals. In our experience, the managerial skills required of the chief operating officer of a community food bank are not inherently different from those required of the chief operating officer of a business venture of similar size and complexity – except that, given the additional regulatory compliance obligations of the nonprofit sector, the food bank COO’s job may well be more difficult.

7 IRC Section 4958(f)(1), Treas. Reg. Sec. 53.4958-3(a)(1). A disqualified person, with respect to any transaction, is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the 5-year period ending on the date of the transaction; spouses and certain family members of such persons; and any entity in which such person, including family members, hold more than a 35% interest.

8 Treas. Reg. Sec. 53.4958-4. See also Treas. Reg. § 53.4958-1(a)(3)(i), which provides that “section 4958 does not apply to a person pursuant to an initial contract.”


The first bite rule does not apply “if the person fails to perform substantially the person’s obligations under the initial contract.” Treas. Reg. § 53.4958-4(a)(3)(iv). This provision was intended to deny the benefit of this exception to abusive situations where, for example, a charity provides a sinecure to an insider and intentionally uses the first bite rule to avoid scrutiny.