UT LAW CLE | THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

2019 Nonprofit Organizations Workshop and Institute
January 16, 17-18, 2019
Austin, Texas

Doing Business with and Compensating Insiders: Strategies for Success and Intermediate Sanctions Compliance

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and

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I. Governing Law

Both state corporate law[1] and federal tax law contain certain provisions that govern executive compensation and transactions with insiders of tax-exempt organizations. As a general matter in both contexts, transactions with insiders are not prohibited if reasonable and in the best interests of the organization, but transactions that are unreasonable can be penalized.

Generally, a state's attorney general serves as the protector of charitable assets on behalf of the public and may scrutinize and intervene where excessive compensation or an insider transaction threatens to waste or divert charitable assets. Such scrutiny can arise when nonprofits engage in significant transactions requiring attorney general notice or review (e.g. selling or otherwise disposing of a significant portion of assets, merger, or dissolution), but public scandals can also draw attorney general attention. In addition, insider transactions can be the subject of legal actions brought by directors or members of a nonprofit where a transaction may be inconsistent with the fiduciary duties of those who approved it.

Federal tax law is enforced by the Internal Revenue Service (IRS). The IRS may become involved in compensation issues or an insider transaction as a result of information reported on a Form 990 or based on an audit (which could arise in a number of ways, including a complaint from the public).

Governance and oversight are critical components of federal and state frameworks for regulating insider transactions. Accordingly, the governing documents and policies of most organizations contain provisions consistent with applicable state and federal legal standards. In some cases, these documents may contain provisions that deal with unique organizational risks. For example, a conflict of interest policy may spell out how conflicted transactions are to be dealt with (incorporating state and federal law) but could also state that some transactions shall never be entered into (on the basis of organizational issues).

But even if a nonprofit acts in ways consistent with legal standards, the court of public opinion can nonetheless harshly judge a nonprofit where compensation seems excessive or unjustified to segments of the public.

a. State Corporate Law

State corporate laws generally contain standards for fulfilling fiduciary duties, and approving transactions involving conflicts of interest and self-dealing.

Typically, fiduciary duties include the duty of care, duty of loyalty, and duty of obedience. Under the duty of care, a nonprofit director/officer (fiduciary) is required to perform his or her duties in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Under the duty of loyalty, a fiduciary must act in the interest of the

[1] Since a vast majority of nonprofit organizations are nonprofit corporations, this outline focuses on corporate law. However, generally, similar rules apply to nonprofits organized as trusts.

nonprofit and put the nonprofit's interests above his or her own. This generally requires following the nonprofit's conflict of interest policy, not seizing business opportunities that should inure to the nonprofit, and maintaining confidential information appropriately. Under the duty of obedience, which is sometimes considered a component of the duties of care and loyalty, directors need to be true to the organization's purposes, mission and governing documents.

As a component of the fiduciary duty standards, states often have specific regulations regarding transactions involving conflicts of interest and self-dealing. Generally, these rules provide a process that governing bodies can follow to appropriately approve an insider transaction. Importantly, the applicable standards can vary from state to state in material ways. For example, the Model Nonprofit Corporation Act, on which many states base their corporate law applicable to nonprofits, provides that as part of the approval process a board of a nonprofit needs to determine that a conflicted transaction is "fair" to such nonprofit.[2] On the other hand, in California, the code applicable to nonprofit corporations provides that the nonprofit must not have been able to have obtained a more advantageous arrangement with reasonable effort under the circumstances.[3] On occasion, an organization will unknowingly develop a conflict of interest policy based on a standard that is either more or less stringent than applicable state law, so periodic review by counsel is always prudent.

As a feature of state nonprofit corporate law, nonprofits generally cannot distribute profits or assets to their insiders.[4] Many states specifically exclude reasonable compensation from the definition of prohibited distributions. For example, the law applicable to Texas nonprofits provides that a Texas nonprofit may pay compensation "in a reasonable amount" to directors and officers.[5]

b. Federal Tax Law

Federal tax law also contains provisions pertaining to executive compensation and transactions with insiders. The key federal tax law concept involved in compensation to executives and transactions with insiders is private inurement.[6]

i. Private Inurement

Private inurement can be defined as the assets or income of a nonprofit flowing to or for the benefit of an insider (including excess compensation). No amount of private inurement is permitted under Section 501(c)(3) and the penalty for private inurement is loss of exemption. However, there are also "intermediate sanctions" under Section 4958 of the Internal Revenue Code, discussed below, which generally regulate insider transactions that overcompensate the insider.

1. Section 4958 (Intermediate Sanctions)

Section 4958 allows the IRS to penalize insider transactions without necessarily revoking tax-exemption under the private inurement doctrine. Specifically, Section 4958 applies excise taxes on "excess benefit transactions" between an applicable tax-exempt organization (501(c)(3) public charities and 501(c)(4) organizations) and "disqualified persons" (persons who can exercise

[2] Model Nonprofit Corporation Act, § 8.60 (2008 version).
[3] Cal. Corp. Code, § 5233.
[4] *See e.g.* North Carolina General Statutes §§ 55A-1-40(8), 55A-13-01 (generally prohibiting direct and indirect transfers of money or other property to or for the benefit of members, directors or officers, with some exceptions).
[5] Tex. Bus. Org. Code, § 22.226.
[6] Private foundations are subject to Section 4941 self-dealing excise taxes, which are not discussed in this outline.

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First appeared as part of the conference materials for the
36th Annual Nonprofit Organizations Institute session
"Doing Business with and Compensating Insiders: Strategies for Success and Intermediate Sanctions Compliance"