

Form 990 Policy Series

The attached Memorandum is a part of the *Form 990 Policy Series*, developed by a group of lawyers, all members of the California bar and practicing nonprofit law (the “Form 990 Policy Series Group”). The *Form 990 Policy Series* includes Memoranda containing rationales and procedures for legal counsel to use in advising their clients on drafting and adopting appropriate policies responding to the new Form 990 as well as form policies and/or questionnaires.

The members of the Form 990 Policy Series Group with respect to the attached Memorandum (posted July, 2011) were as follows: Joel S. Corwin, Co-Chair; Barbara Rosen, Co-Chair; Elizabeth Bluestein; Lani Meanley Collins; the late Gerald A. Laster; Henry Lesser; Nancy McGlamery; Louis Michelson; Joy P. Paeske; Alicia Plerhoples; Lisa A. Runquist; Robert Siemer; Myron Steeves; Patrick Sternal; and Martin J. Trupiano. The views expressed in the Memoranda do not necessarily reflect the views of the law firms or employers at which these lawyers practice or any individual member of the Group.

The date at the top of the attached Memorandum is the date that the Memorandum was finalized, and the Memorandum may not reflect changes in law or practice since that date.

**FORM 990 POLICY SERIES
MEMORANDUM**

**Re: Compensation Policy
Form 990, Part IV, Line 23; Part VI, Section B, Line 15; Part VII, Section A,
Lines 1a – 5; Schedule J (Form 990 Policy Series Memo # 1)**

Date: May 26, 2010

NOTE ON THE SCOPE OF THIS MATERIAL

This material is designed to provide general guidance about an aspect of nonprofit corporate governance in the specific and limited context of the governance questions contained in the new IRS Form 990 (published by the IRS in 2008 and applicable to 990 filers based on a 2009-2011 filing year phase-in period depending on the size of the nonprofit). It is intended to provide some general guidance on the establishment of processes and/or policies to address a specific governance question in the Form. The subject matter of that question implicates a broad array of legal and practical issues ranging far beyond the immediate subject matter of the question itself. This material may address some of those issues but does NOT attempt to review them comprehensively and is NOT intended to be relied on for guidance on how they should be addressed in any specific situation.

Whether or not a nonprofit organization adopts a specific governance process or policy (or modifies an existing one), either in response to the disclosure requirements of the new IRS Form 990 or to change its governance practices for other reasons is a matter to be carefully considered by that organization, with input from its board and advisors and evaluation of its specific circumstances. The IRS has explicitly stated that adoption of the policies and practices about which the new Form 990 asks is not mandatory, although the IRS has also indicated that it attaches significance to the manner in which all tax-exempt nonprofit organizations govern themselves. The inclusion of a sample policy in this material is not intended to suggest that the policy is appropriate for every nonprofit organization nor that, if a policy on that topic is determined to be appropriate, the formulation in the sample necessarily fits the needs of an individual nonprofit organization. A customized approach, with outside professional advice, is recommended. Accordingly, this material is intended as general information for legal practitioners advising nonprofit organizations as to their governance and does not constitute legal advice for any particular nonprofit organization.

Although the subject matter of this material may have relevance to nonprofit organizations that are not required to file informational tax returns with the IRS or are permitted to file on an IRS form other than Form 990, the focus of this material is 990 filers. While this material is meant to apply to Form 990 filers who are exempt under Section 501(c) of the Internal Revenue Code, certain portions of this material may be applicable only to Section 501(c)(3) organizations. In addition, although this material may be of assistance with respect to nonprofit organizations that are not subject to oversight under California law, there may be portions of this material that are relevant only to nonprofits organized under, or (by reason of their California-related activities) otherwise subject to, California law and, except as specifically discussed in this material, the laws of other States are not addressed.

1. Summary

This Memorandum is intended to provide general guidance for the consideration and adoption of a compensation policy responsive to revised Form 990 and related Instructions. The new IRS Form 990 expands the reporting of executive compensation to *all* Form 990 filers, and significantly revises the information required in reporting executive compensation. This Memorandum identifies the principal parts of the Form 990 that address compensation, provides references to the Internal Revenue Code and

related regulations, describes some of the considerations in preparing a compensation policy for a nonprofit organization, and provides a sample policy. This Memorandum also addresses the obligation of certain nonprofit organizations and persons (with significant exceptions) under section 12586(g) of the California Government Code to review and approve the compensation of specified executive officers.

2. Rationale for Adoption of a Compensation Policy

The basic purpose of a compensation policy is to provide procedures by which tax exempt organizations may determine reasonable compensation for their officers, staff and, if applicable, directors or trustees. Among other reasons for the adoption of a compensation policy are (1) to define the individuals whose compensation must be reported on the Form 990; (2) to assure that the review and approval of the compensation of such individuals are conducted according to the procedures set forth in the Internal Revenue Code and pertinent regulations establishing the rebuttable presumption of reasonableness; and (3) to identify those compensation arrangements that must be reviewed and approved by the governing body or authorized committee as “just and reasonable” under California Government Code § 12586(g).

As a general matter, written policies governing the payment of compensation, benefits, and other perquisites support an organization’s mission, values and strategies by providing (1) a consistent basis for compensation decisions; (2) a procedural framework for making such decisions; (3) increased compliance with complex federal, state and other applicable laws and regulations; (4) reduced risk to a nonprofit organization, its governing board and management for compensation which constitutes an improper private benefit, private inurement or, for certain organizations, an “excess benefit” (potentially subject to an excise tax); and (5) enhanced confidence of donors, members and supporters of an organization.

3. Background of Requirements/Sources for the Policy

This Memorandum focuses on the development of policies to satisfactorily respond to the compensation questions contained in the IRS Form 990 for all nonprofit organizations that file Form 990s. The Memorandum also addresses policies which will meet the requirements of the California Nonprofit Integrity Act and, in particular, Government Code § 12586(g) relating to the review and approval of the compensation of certain executive officers of charitable organizations. Private foundations and other organizations that do not file the new Form 990 may have considerations in adopting a compensation policy that are not addressed within this Memorandum.

A. The IRS Form 990¹ (All Form 990 Filers).

Part IV, Line 23. To help filers determine which of the 16 possible schedules may need to be completed for the new Form 990, the form includes a new Part IV, Checklist of Required Schedules, which contains a list of 37 questions for that purpose. Line 23 of Part IV asks whether the reporting organization answered “yes” to Lines 3, 4 or 5 in Part VII, Section A (discussed below) and, if so, instructs the organization to complete Schedule J—Compensation Information.

Part VI, Section B, Line 15. In Part VI, Governance, Management and Disclosure, Section B, Policies, Line 15 asks about the process for determining compensation for the organization’s CEO, Executive Director or top management official, or other officers and key employees:

Line 15. Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision: (a) The organization’s CEO, Executive Director, or top management official? (b) Other officers or key employees of the organization? Describe the process in Schedule O.

The 2009 Form 990 Instructions relating to this line state:

Line 15. Answer “Yes” on line 15a if the organization used a process for determining **compensation** (reported in Part VII or Schedule J (Form 990)) of the CEO, executive director, or other person who is the top management official, that included all of the following elements.

- Review and approval by a governing body or compensation committee, provided that persons with a conflict of interest with respect to the compensation arrangement at issue were not involved. For purposes of this question, a member of the governing body or compensation committee has a conflict of interest with respect to a compensation arrangement if any of the following circumstances apply.
 1. The member (or a family member of the member) is participating in or economically benefitting from the compensation arrangement
 2. The member is in an employment relationship subject to the direction or control of any person participating in or economically benefitting from the compensation arrangement.
 3. The member receives compensation or other payments subject to the approval by any person participating in or economically benefitting from the compensation arrangement.

¹ The IRS has issued lengthy instructions and a series of “tips” for the new Form 990 and its schedules that should be reviewed for additional information pertinent to the specific Form 990 questions addressed in this Memorandum.

4. The member has a material financial interest affected by the compensation arrangement.

5. The member approves a transaction providing economic benefits to any person participating in the compensation arrangement, who in turn has approved or will approve a transaction providing economic benefits to the member. See Regulations section 53.4958-6(c)(1)(iii).

- Use of data as to comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations.

- Contemporaneous documentation and recordkeeping with respect to deliberations and decisions regarding the compensation arrangement.

Answer “Yes” on line 15b if the process for determining compensation of one or more **officers** or **key employees** other than the **top management official** included all of the elements listed above.

If the answer was “Yes” on line 15a or 15b, describe the process on Schedule O (Form 990), identify the offices or positions for which the process was used to establish compensation of the persons who served in those offices or positions, and state the year in which this process was last undertaken for each such person.

Part VII, Section A. This section requires detailed information on the compensation of officers, directors, trustees, key employees and highest compensated employees, as well as *former* officers, key employees and highest compensated employees who received more than \$100,000 in reportable compensation from the organization and any related organization, and *former* directors or trustees who received, in the capacity of former director or trustee of the organization, more than \$10,000 of reportable compensation from the organization or any related organization.

Line 1a states:

Line 1a. Complete this table for all persons required to be listed. Report compensation for the calendar year ending with or within the organization’s tax year. Use Schedule J-2 if additional space is needed.

- List all of the organization’s **current** officers, directors, trustees (whether individuals or organizations), regardless of amount of compensation. Enter -0- in columns (D), (E), and (F) if no compensation was paid.

- List the organization’s five **current** highest compensated employees (other than an officer, director, trustee, or key employee) who received reportable compensation (Box 5 of Form W-2 and/or Box 7 of Form 1099-

MISC) of more than \$100,000 from the organization and any related organizations.

- List all of the organization's **former** officers, key employees, and highest compensated employees who received more than \$100,000 of reportable compensation from the organization and any related organizations.

- List all of the organization's **former directors or trustees** that received, in the capacity as a former director or trustee of the organization, more than \$10,000 of reportable compensation from the organization and any related organizations."

Line 2 asks the filer to provide:

Line 2. Total number of individuals (including but not limited to those listed above) who received more than \$100,000 in reportable compensation from the organization. [There are no Form 990 Instructions relating to this line.]

Lines 3-5 ask:

Line 3. Did the organization list any **former** officer, director or trustee, key employee, or highest compensated employee on line 1a? *If "Yes," complete Schedule J for such individual.*

Line 4. For any individual listed on line 1a, is the sum of reportable compensation and other compensation from the organization and related organizations greater than \$150,000? *If "Yes," complete Schedule J for such individual.*

Line 5. Did any person listed on line 1a receive or accrue compensation from any unrelated organization for services rendered to the organization? *If "Yes," complete Schedule J for such person.*

Part VII, Section B, Lines 1 - 2 of the Form 990 states:

Line 1. Complete this table [not shown] for your five highest compensated independent contractors that received more than \$100,000 of compensation from the organization.

Line 2. Total number of independent contractors (including but not limited to those listed above) who received more than \$100,000 in compensation from the organization.

Schedule J. This schedule, entitled “Compensation Information,” requests additional detailed information regarding those persons identified in response to Lines 3, 4 or 5 of Section A of Part VII.

Schedule J, Part I, Lines 1a – 9 of the Form 990 provide:

Line 1a. Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items.

- First-class or charter travel
- Travel for companions
- Tax indemnification and gross-up payments
- Discretionary spending account
- Housing allowance or residence for personal use
- Payments for business use of personal residence
- Health or social club dues or initiation fees
- Personal services (e.g., maid, chauffer, chef).

Line 1b. If Line 1a is checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above? If “No,” complete Part III to explain.

Line 2. Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in Line 1a?

Line 3. Indicate which, if any, of the following the organization uses to establish the compensation of the organization’s CEO/Executive Director. Check all that apply.

- Compensation committee
- Independent compensation consultant
- Form 990 of other organizations
- Written employment contract
- Compensation survey or study
- Approval by the board or compensation committee

Line 4. During the year, did any person listed on Form 990, Part VII, Section A, line 1a, with respect to the filing organization or related organization:

- a** Receive a severance payment or change-of-control payment?
- b** Participate in or receive payment from, a supplemental nonqualified retirement plan?
- c** Participate in, or receive payment from, an equity-based compensation arrangement?

If “Yes” to any of lines 4a-c, list the persons and provide the applicable amounts for each item in Part III.

Lines 5 through 8 pertain only to 501(c)(3) and 501(c)(4) organizations.

Line 5. For persons in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the revenues of:

a The organization?

b Any related organization?

If “Yes” to line 5a or 5b, describe in Part III.

Line 6. For persons in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the net earnings of:

a The organization?

b Any related organization?

If “Yes” to line 6a or 6b, describe in Part III.

Line 7. For persons in Form 990, Part VII, Section A, line 1a, did the organization provide any non-fixed payments not described in response to Lines 5 or 6. If “Yes,” describe in Part III.

Line 8. Were any amounts reported in Form 990, Part VII, paid or accrued pursuant to a contract that was subject to the initial contract exception described in [Treasury] Regs. section 53.4958-4(a)(3)? If “Yes,” describe in Part III.

Line 9. If “Yes” to line 8, did the organization also follow the rebuttable presumption procedure described in Regulations section 53.4958-6(c)?

Schedule J, Part II of the Form 990 provides:

For each individual whose compensation must be reported in Schedule J, report compensation from the organization on row (i) and from related organizations, described in the instructions, on row (ii). Do not list any individuals that are not listed on Form 990, Part VII.

Following this provision, the Schedule is divided into columns (A) through (F) and, as indicated in the question, the name of each individual is listed on a separate row in Column A which is subdivided into rows (i) and (ii) for the remaining columns: Column B—W-2 and/or 1099-MISC compensation broken down by (i) base compensation, (ii) bonus and incentive compensation, and (iii) other reportable compensation; Column C—Retirement and other deferred compensation; Column D—Nontaxable benefits; Column E—Total of Columns B(i) through D; and Column F—Compensation reported in prior Form 990 or Form 990-EZ.

Schedule J, Part III of the Form 990 provides a place for the supplemental information, if required, for Part I, lines 1a, 1b, 4c, 5a, 5b, 6a, 6b, 7 and 8, as well as additional information the filer may desire to include.

B. Significant Internal Revenue Code Sections

1. Private Inurement (All 990 Filers).

Tax exempt organizations in general may not engage in the private inurement of insiders such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. The definition of proscribed inurement, however, may be different for exempt organizations under different subsections of 501(c).

2. Excess Benefit Transactions. (Section 501(c)(3) and 501(c)(4) Organizations).

Disqualified persons and the managers of organizations that are tax exempt under section 501(c)(3) and (4) are subject to sanctions and excise taxes if they are involved in “excess benefit transactions.”

Of particular relevance to determining compensation, the IRS regulations regarding “excess benefit transactions” provide a “safe harbor” *rebuttable presumption* that a compensation arrangement is reasonable if it is approved and documented according to specific procedural steps taken before the transaction is finalized. The procedure described in Treasury Regulation § 53.4958-6(a) has been integrated into the questions presented in the Form 990, Part VI, Line 15. Consequently, this regulation may be very helpful in framing an appropriate compensation policy.

Section 4958(c)(1)(A) of the Internal Revenue Code defines an “excess benefit transaction”:

The term "excess benefit transaction" means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

As defined in section 4958 of the Internal Revenue Code, disqualified persons include voting members of the governing body and most officers. The pertinent regulations expand upon that definition. Treasury Regulations § 53.4958-4 states:

An excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. Subject to the limitations of paragraph (c) of this section (relating to the treatment of economic benefits as compensation for the performance of services), to determine whether an excess benefit transaction has occurred, all consideration and benefits (except disregarded benefits described in paragraph (a)(4) of this section) exchanged between a disqualified person and the applicable tax-exempt organization and all entities the organization controls (within the meaning of paragraph (a)(2)(ii)(B) of this section) are taken into account. For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. The rules of this section apply to all transactions with disqualified persons, regardless of whether the amount of the benefit provided is determined, in whole or in part, by the revenues of one or more activities of the organization. For rules regarding valuation standards, see paragraph (b) of this section. For the requirement that an applicable tax-exempt organization clearly indicate its intent to treat a benefit as compensation for services when paid, see paragraph (c) of this section.

The regulations describe a procedure by which an organization may establish a *rebuttable presumption* that a transaction is reasonable. Treasury Regulation § 53.4958-6(a) states:

Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied --

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization with the meaning of §53.4958-4(a)(2)(ii)(B)) composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;

(2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, as described in paragraph (c)(2) of this section; and

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

For an organization that has average annual gross receipts of less than \$1 million for the prior three tax years, the Governing Body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services/positions. Treas. Reg. §§ 53.4958-4(b); 53.4958-6(c)(2).

C. Select California Laws (Charities and Those Holding Property for Charitable Purposes).

The California Nonprofit Integrity Act in 2004 imposed an obligation on “all charitable corporations, unincorporated associations, trustees, and other legal entities holding property for charitable purposes” (California Government Code § 12581) to “review and approve” as “just and reasonable” the compensation of its president or CEO and treasurer or CFO (Government Code § 12586(g)).

Entities Covered. Section 12581 of the Government Code provides:

This article applies to all charitable corporations, unincorporated associations, trustees, and other legal entities holding property for charitable purposes, commercial fundraisers for charitable purposes, fundraising counsel for charitable purposes, and commercial coventurers, over which the state or the Attorney General has enforcement or supervisory powers. The provisions of this article shall not apply to any committee as defined in Section 82013 which is required to and does file any statement pursuant to the provisions of Article 2 (commencing with Section 84200) of Chapter 4 of Title 9.

Section 12582 of the Government Code provides:

"Trustee" means (a) any individual, group of individuals, corporation, unincorporated association, or other legal entity holding property in trust pursuant to any charitable trust, (b) any corporation or unincorporated association which has accepted property to be used for a particular charitable purpose as distinguished from the general purposes of the corporation or unincorporated association, and (c) a corporation or unincorporated association formed for the administration of a charitable trust, pursuant to the directions of the settlor or at the instance of the trustee.

Section 12582.1 of the Government Code provides:

“Charitable corporation” means any nonprofit corporation organized under the laws of this State for charitable or eleemosynary purposes and any similar foreign corporation doing business or holding property in this State for such purposes.

Non-filing Entities. Section 12583 of the Government Code provides:

The filing, registration, and reporting provisions of this article do not apply to the United States, any state, territory, or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or to any of their agencies or governmental subdivisions, to any religious corporation sole or other religious corporation or organization that holds property for religious purposes, or to any officer, director, or trustee thereof who holds property for like purposes, to a cemetery corporation regulated under Chapter 19 (commencing with Section 9600) of Division 3 of the Business and Professions Code, or to any committee as defined in Section 82013 that is required to and does file any statement pursuant to Article 2 (commencing with Section 84200) of Chapter 4 of Title 9, or to a charitable corporation or unincorporated association organized and operated primarily as a religious organization, educational institution, hospital, or a health care service plan licensed pursuant to Section 1349 of the Health and Safety Code.

Compensation Review and Approval Required. Section 12586(g) of the Government Code provides:

(g) The board of directors of a charitable corporation or unincorporated association, or an authorized committee of the board, and the trustee or trustees of a charitable trust shall review and approve the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to assure that it is just and reasonable. This review and approval shall occur initially upon the hiring of the officer, whenever the term of employment, if any, of the officer is renewed or extended, and whenever the officer's compensation is modified. Separate review and approval shall not be required if a modification of compensation extends to substantially all employees. If a charitable corporation is affiliated with other charitable corporations, the requirements of this section shall be satisfied if review and approval is obtained from the board, or an authorized committee of the board, of the charitable corporation that makes retention and compensation decisions regarding a particular individual.

Regulations provide that within the scope of the referenced executives is “every person, regardless of title, with powers, duties, or responsibilities comparable to the president, chief executive officer, treasurer, or chief financial officer.” California Code

of Regulations, Title 11 § 312.1. An executive director ordinarily comes within the scope of this definition.

D. California Attorney General Position on Compensation Standards (Charities and Those Holding Property for Charitable Purposes).

In the *Guide for Charities*, the California Attorney General states,

Charities may not pay excessive or unreasonable compensation to their officers and employees. The board of directors or an authorized committee of the board, and the trustee or trustees of a charitable trust, must review and approve the compensation of the president or chief executive officer and the treasurer or chief financial officer to assure that it is reasonable. (Government Code section 12586.)

Guide at 19.

The Attorney General also states in the Frequently Asked Questions (FAQs) on the Registry of Charitable Trusts website that the compensation review requirement of Government Code § 12586(g)

does not supersede the existing fiduciary duties of officers, directors and trustees in managing charitable organizations. They have a continuing duty to pay compensation to officers and directors that does not exceed what is fair and reasonable to the organization, and may incur personal liability for paying excessive compensation. Therefore the payment of excessive compensation at any time is a violation of the law. (Government Code § 12586(g); Corporations Code § 5235)

ag.ca.gov/charities/faq.php, Question 17.

As to staff members of charitable organizations, the Attorney General states in the same FAQs, that

the members of the board of directors have a continuing duty to pay compensation that does not exceed what is fair and reasonable to the charity. Moreover, if a staff member actually performs the duties and functions of a president or CEO or a treasurer or CFO, a charity may not avoid the compensation-review required by the Act by giving that person a different job title. (California Code of Regulations Title 11, Div. 1, Chapter 4, section 312.1)

ag.ca.gov/charities/faq.php, Question 18.

How the board discharges its obligations with respect to positions other than the president or chief executive officer, treasurer or chief financial officer (or individuals with

equivalent powers, duties or responsibilities comparable to these positions), is up to the board of the particular organization.

4. Considerations and Procedures for Implementation of the Policy

All Form 990 Filers

A. All organizations required to file Form 990 are subject to revised and increased compensation reporting obligations.

B. To develop a policy that is suitable for the organization, the client should provide information regarding its management structure (size of governing body, officer positions, types of compensation, including all benefits, dollar range of total compensation paid, and former officers and directors receiving compensation).

A shorter, simpler policy may be appropriate if compensation includes only salary and bonus, and health insurance, if there is no compensation paid to an individual officer, director, trustee, key employee or highest compensated employee which equals or exceeds \$100,000, and if no *former* officers, directors, trustees, key employees, or highest compensated employees receive any compensation from the organization or related organizations.

As executive compensation involves more complex arrangements with a greater variety of benefits in larger amounts to both present and former officers, directors, trustees, key employees or highest Compensated Individuals, a longer, more complex policy is likely required.

C. Regardless of the length and complexity of the compensation policy, it should clearly create a procedure which permits an affirmative response to Line 15 in Part VI, Section B of the Form 990. That would include (a) review and approval by independent persons, (b) the use of comparability data, and (c) contemporaneous substantiation of the deliberation and decision for compensation of (d) the organization's CEO, Executive director, top management official, other officers and key employees. *N.B.* "Directors," "Trustees," "officers," "key employees," and "independent persons" are defined in the 2009 Form 990 instructions. See the Appendix at page 20.

D. Consideration should be given as to whether the whole governing body or an authorized committee of the governing body will make compensation decisions or whether an authorized committee will be responsible for making recommendations to the governing body. Smaller organizations may likely leave the decision with the governing body; larger organizations will likely delegate the review and approval to an authorized committee of the governing body.

A compensation committee is normally a standing committee of the governing body composed of independent members of the governing body. It is responsible for

either authorizing compensation or recommending to the governing body the compensation of certain executives and regularly reviewing and developing the executive compensation and benefits program. If the committee has authority to specifically authorize compensation, the governing body should nevertheless be informed of all actions the committee takes.

E. Whether compensation is determined by the governing body or an authorized committee, a member of the governing body or authorized committee who receives compensation from the organization, either directly or indirectly, may not vote on matters before the board that relate to his/her compensation.

F. Prior to adoption, it should be determined where the policy should be placed in the organization's documentation. Alternatives may include, for example, in the bylaws, in a policies and procedures manual, in an employee manual, or as a stand-alone policy.

G. The manner in which the policy will be adopted by a vote of the governing body should also be determined.

H. In every case, the policy should be disseminated to all affected constituencies such as officers, directors, key employees, members and volunteers.

I. In view of the range of compensation policies which could be adopted, it is important to take the time to develop a policy which fits the client's size, administrative style, and need. Again, it cannot be stressed enough, that the organization should only adopt policies which it is confident it can follow.

J. The review and approval of compensation may also raise questions regarding conflicts of interest, independence of the members of the governing body, business and family relationships among the organization's officers, directors, trustees and key employees, and self-dealing.² Due to the interrelated nature of these issues, when addressing compensation, conflict of interest, independence of members of the governing body, business and family relationships and self-dealing issues, one must be mindful of potential issues arising in these related areas. The *Form 990 Policy Series*, of which this Memorandum is a part, includes two memoranda addressing these related areas, *Conflict of Interest (Form 990 Policy Series Memo #2.1)* and *Independent Members of Governing Body; Business and Family Relationships (Form 990 Policy Series Memo #2.2)*. Before finalizing a policy or questionnaire that addresses compensation, it is recommended that these memoranda be carefully reviewed.

² In California, Section 5233 of the Corporations Code governs financial conflict of interest transactions of directors of nonprofit public benefit corporations, and by virtue of Corporations Code § 7238, directors of mutual benefit corporations holding assets in charitable trust (in respect to such assets). Corporations Code Sections 5234 (as to public benefit corporations) and 7233 (as to mutual benefit corporations) should also be consulted.

Charities and Those Holding Properties for Charitable Purposes

K. In addition to facilitating compliance with the reporting requirements on the Form 990, a compensation policy should also take into account an organization's obligations regarding compensation under California law. Under Government Code § 12586(g), the governing body or authorized committee of the board of "any entity which holds property for charitable purposes" must review and approve the compensation of its president or chief executive officer and its treasurer or chief financial officer as "just and reasonable." Thus, a compensation policy for such an entity should apply to the compensation determination regarding the individuals whose compensation arrangement must be reviewed and approved under Government Code § 12586(g) or reported on the Form 990. Such an entity should also consider the position of the California Attorney General that, in addition to the governing body's obligations under Government Code § 12586(g), it also has a continuing duty to pay compensation to officers, directors and staff members that does not exceed what is fair and reasonable to the charity.

L. If Government Code § 12586(g) is applicable to a charitable organization, the policy should assure that its requirements are generally met by (a) the governing body or authorized committee (b) reviewing and approving the compensation, including benefits, (c) at the times required in the statute, (d) of the president or chief executive officer and the treasurer or chief financial officer (e) to assure that it is just and reasonable.

5. Sample Policy

COMPENSATION POLICY FOR OFFICERS, DIRECTORS, TOP MANAGEMENT OFFICIAL AND KEY EMPLOYEES

1. Policy and Purposes

This is the policy of ORGANIZATION (the “organization”) with respect to the review and approval of compensation of its officers and employees. [*Alternate introductory sentence for 501(c)(3) and 501(c)(4) organizations: It is the policy of ORGANIZATION (the “organization”) that all compensation paid by the organization is reasonable based upon a review of comparability information.*] This policy provides a procedure for the review and approval of the compensation of the officers, directors [trustees], CEO, executive director or top management official, and key employees of the organization (“Compensated Individuals”) consistent with applicable federal tax law and California law. (The IRS Form 990 definitions for some of the identified positions are included in the Appendix and used in this policy with the same meanings.)

2. Procedure for Approval of Compensation

A. General. The board of directors or trustees, or authorized committee (“Governing Body”) shall review and approve the compensation of Compensated Individuals.

[THE FOLLOWING VERSION OF PARAGRAPH B IS FOR FORM 990 FILERS (OTHER THAN 501(c)(3) AND (c)(4) ORGANIZATIONS):]

B. Specific Requirements. The Governing Body reviewing and approving compensation for Compensated Individuals shall satisfy the following requirements or procedures:

(1) Approval by Persons Without a Conflict of Interest. Compensation shall be reviewed and approved by the Governing Body, provided that persons with a conflict of interest with respect to the compensation arrangement at issue are not involved. Members of the Governing Body do not have a conflict of interest if they (a) are not benefitting from or participating in the compensation arrangement; (b) are not in an employment relationship subject to the direction or control of any person benefitting from or participating in the compensation arrangement; (c) do not receive compensation or other payments subject to the approval of any person benefitting from or participating in the compensation arrangement; (d) have no material financial interest affected by the compensation arrangement; and (e) do not approve a transaction providing economic benefits to any person participating in the compensation arrangement, who in turn has or will approve a transaction providing economic benefits to the member. (Form 990, Part VI, Line 15, 2009 Instructions; Treas. Reg. § 53.4958-6(c)(1)(iii).)

(2) **Use of Comparability Data.** In its review and approval of compensation, the Governing Body shall review and use data and surveys of comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations. (Form 990, Part VI, Line 15, 2009 Instructions.)

(3) **Recording Compensation Deliberations.** The Governing Body shall contemporaneously document and maintain records with respect to the deliberations and decisions regarding the compensation arrangement. (Form 990, Part VI, Line 15, 2009 Instructions.)

[IF THE ORGANIZATION HOLDS PROPERTY FOR CHARITABLE PURPOSES AND THEREFORE MAY BE SUBJECT TO CALIFORNIA GOVERNMENT CODE § 12586(g), THE FOLLOWING LANGUAGE SHOULD BE ADDED:]

(4) **Review and Approval for Certain Executive Officers.** In addition to the requirements of this policy applicable to all Compensated Individuals, any compensation set for the CEO or president, and CFO or treasurer, (or individuals with equivalent powers, duties or responsibilities comparable to these positions), must also be determined to be just and reasonable. The Governing Body's review and approval shall occur initially upon hiring, whenever the term of employment, if any, is renewed or extended, and whenever the compensation is modified. Separate review and approval shall not be required if a modification of compensation extends to substantially all employees.

[THE FOLLOWING ALTERNATIVE VERSION OF PARAGRAPH B IS FOR 501(c)(3) AND 501(c)(4) ORGANIZATIONS, WHICH ARE SUBJECT TO INTERMEDIATE SANCTIONS FOR EXCESS BENEFITS UNDER 26 U.S.C. § 4958. (NOTE: COMPLIANCE WITH DETAILED REGULATIONS MAY CREATE A REBUTTABLE PRESUMPTION THAT THE COMPENSATION IS REASONABLE AND NOT AN EXCESS BENEFIT PURSUANT TO TREAS. REG. § 53.4958-6):]

B. Specific Requirements. The Governing Body reviewing and approving compensation for Compensated Individuals shall satisfy the following requirements or procedures:

(1) **Approval by Persons Without a Conflict of Interest.** Compensation shall be reviewed and approved by the Governing Body, provided that persons with a conflict of interest with respect to the compensation arrangement at issue are not involved. Members of the Governing Body do not have a conflict of interest if they (a) are not benefitting from or participating in the compensation arrangement; (b) are not in an employment relationship subject to the direction or control of any person benefitting from or participating in the compensation arrangement; (c) do not receive compensation or other payments subject to the approval of any person benefitting from or participating in the compensation arrangement; (d) have no material financial interest affected by the compensation arrangement; and (e) do not approve a transaction providing economic benefits to any person participating in the compensation arrangement, who in turn has or

will approve a transaction providing economic benefits to the member. (Form 990, Part VI, Line 15, Instructions; Treas. Reg. § 53.4958-6(c)(1)(iii).)

(2) Use of Comparability Data. In its review and approval of compensation, the Governing Body shall affirmatively determine that compensation is reasonable to the organization based upon information sufficient to determine whether the value of services is the amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax exempt, under like circumstances. Relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax exempt, for functionally comparable positions; the availability of similar services in the geographic area of the organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the compensated person. If the organization has average annual gross receipts of less than \$1 million for the prior three tax years, the Governing Body will have appropriate comparability information if it has information on compensation paid by three comparable organizations in the same or similar communities for similar services. (Form 990, Part VI, Line 15, 2009 Instructions; Treas. Reg. §§ 53.4958-4(b), 53.4958-6(c)(2)).

(3) Recording Compensation Deliberations. The Governing Body's review and approval of compensation shall be promptly recorded in the minutes of its meetings and contain: (a) the terms of the compensation and the date approved; (b) the names of the members of the Governing Body who were present during the discussion and those who voted on the approved compensation; (c) the comparability data obtained and relied upon, and how it was obtained; (d) any action taken with respect to consideration of the compensation by a member of the Governing Body who had a conflict of interest with respect to the compensation; and (e) if the reasonable compensation is higher or lower than the range of comparability data obtained, the basis for the decision. Such minutes shall be reviewed and approved by the Governing Body as reasonable, accurate and complete within a reasonable time after the review and approval of the compensation. (Form 990, Part VI, Line 15, 2009 Instructions; Treas. Reg. § 53.4958-6(c)(3).)

[IF THE ORGANIZATION HOLDS PROPERTY FOR CHARITABLE PURPOSES AND THEREFORE MAY BE SUBJECT TO CALIFORNIA GOVERNMENT CODE § 12586(g), THE FOLLOWING LANGUAGE SHOULD BE ADDED:]

(4) Review and Approval for Certain Executive Officers. In addition to the requirements of this policy applicable to all Compensated Individuals, any compensation set for the CEO or president, and CFO or treasurer, (or individuals with equivalent powers, duties or responsibilities comparable to these positions), must be determined to be just and reasonable. The Governing Body's review and approval shall occur initially upon hiring, whenever the term of employment, if any, is renewed or extended, and whenever the compensation is modified. Separate review and approval shall not be required if a modification of compensation extends to substantially all employees.

APPENDIX

2009 IRS FORM 990 INSTRUCTIONS

DEFINITIONS³

Director or trustee. A “director or trustee” is a member of the organization’s **governing body**, but only if the member has voting rights. A director or trustee that served at any time during the organization’s **tax year** is deemed a current director or trustee. Members of advisory boards that do not exercise any governance authority over the organization are not considered directors or trustees. An “institutional trustee” is a trustee that is not an individual or natural person but an organization. For instance, a bank or trust company serving as the trustee of a trust is an institutional trustee.

Officer. An **officer** is a person elected or appointed to manage the organization’s daily operations. An officer that served at any time during the organization’s **tax year** is deemed a current officer. The officers of an organization are determined by reference to its organizing document, bylaws, or resolutions of its **governing body**, or as otherwise designated consistent with state law, but, at a minimum, include those officers required by applicable state law. Officers can include a president, vice-president, secretary, treasurer and, in some cases, a Board Chair. In addition, for purposes of Form 990, including Part VII, Section A, and Schedule J (Form 990), treat as an officer the following persons, regardless of their titles.

1. *Top management official.* The person who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization.

2. *Top financial official.* The person who has ultimate responsibility for managing the organization’s finances.

If ultimate responsibility resides with two or more individuals (for example, co-presidents or co-treasurers), who can exercise such responsibility in concert or individually, then treat all such individuals as officers.

Key employee. For purposes of Form 990, a current **key employee** is an **employee** of the organization (other than an **officer, director** or **trustee**) who meets all three of the following tests, applied in the following order:

1. *\$150,000 Test:* Receives **reportable compensation** from the organization and all **related organizations** in excess of \$150,000 for the **calendar year** ending with or within the organization’s **tax year**.

³ The definitions in this Appendix are taken from the IRS 2009 Instructions for Form 990 at page 22.

2. *Responsibility Test*: At any time during the calendar year ending with or within the organization's **tax year**:

a. Has responsibilities, powers, or influence over the organization as a whole that is similar to those of officers, directors, or trustees;

b. Manages a discrete segment or activity of the organization that represents 10% or more of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

c. Has or shares authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for **employees**.

3. *Top 20 Test*: Is one of the 20 employees other than officers, directors, and trustees who satisfy the \$150,000 Test and Responsibility Test with the highest reportable compensation from the organization and **related organizations** for the calendar year ending with or within the organization's **tax year**.

If the organization has more than 20 individuals who meet the \$150,000 Test and Responsibility Test, report as **key employees** only the 20 individuals that have the highest reportable compensation from the organization and related organizations. Note that any others, up to five, might be reportable as current **highest compensated employees**, with over \$100,000 in reportable compensation. Use the calendar year ending with or within the organization's tax year for determining the organization's current key employees.

An individual that is not an employee of the organization (or of a disregarded entity of the organization) is nonetheless treated as a key employee if he or she serves as an officer or director of a disregarded entity of the organization and otherwise meets the standards of a key employee set forth above. See Disregarded Entities, later [on page 24 of the Instructions], for treatment of certain employees of a disregarded entity as a key employee of the organization.

If an employee is a key employee of the organization for only a portion of the year, that person's entire compensation for the calendar year ending with or within the organization's tax year, from both the filing organization and related organizations, should be reported in Part VII, Section A. **Management companies** and similar entities that are **independent contractors** should not be reported as key employees. The organization's **top management official** and **top financial official** are deemed officers rather than key employees.