Executive Compensation in the Charitable Sector: Beyond the Tax Cuts and Jobs Act

Lauren Rogal[*]

This Article examines charity executive compensation in light of the reforms enacted by the Tax Cuts and Jobs Act of 2017. Charities receive preferential tax treatment under Section 501(c)(3) of the Internal Revenue Code because they provide humanitarian, educational, and other services that benefit the public. The payment of excessive compensation undermines the policy purpose of charitable tax status by diverting resources from the public good to private gain. The costs are borne by the intended charitable beneficiaries, the subsidizing taxpayers, and the charitable sector as a whole, which requires public confidence to sustain its work.

The Tax Cuts and Jobs Act reformed charity compensation laws for the first time in decades, imposing an excise tax on compensation over $1 million. With its enactment, there are now three legal constraints on charity compensation that together provide piecemeal accountability. This Article deconstructs the three mechanisms, assessing their enforceability and metrics for appropriate compensation. It argues that the excise tax is the mechanism best tailored to the goals of Section 501(c)(3), but that it is impaired by a blunt and arbitrary metric. This Article then explores alternative metrics that may better align with the policy objectives of 501(c)(3) status and proposes avenues for further investigation.

[*] Assistant Clinical Professor of Law and Director of the Turner Family Community Enterprise Clinic at Vanderbilt University Law School. Thank you to Alicia Plerhoples, David Super, Margaret Blair, Priya Baskaran, and Joseph Pileri for their insights

I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 ("TCJA") reformed charity executive compensation for the first time in decades, introducing an across-the-board excise tax on compensation over $1 million.[1] Its enactment represents a significant step toward securing accountability for the use of the charitable tax exemption under Section 501(c)(3) of the Internal Revenue Code. These organizations receive preferential tax treatment to subsidize their provision of socially beneficial outputs that would otherwise be undersupplied. Overcompensation of charity executives subverts this purpose by diverting those subsidies for private gain and undermining public confidence in the charitable sector.

With the enactment of the TCJA, federal tax law now offers three mechanisms to constrain charity executive compensation. This Article examines each mechanism with regard to its metric for gauging appropriate compensation and its enforceability. The first mechanism is mandatory public disclosure of compensation arrangements, which in theory facilitates donor-imposed accountability. In practice, however, donors seldom have adequate information, incentives, and market power to police compensation. The second mechanism is regulatory enforcement against individual charities that overcompensate executives. This tool relies on weak metrics for appropriate compensation and resource-intensive investigations. The third mechanism is the TCJA's blanket excise tax on the most generous compensation packages. This is a potentially effective and easily administered tool, but it too applies an arbitrary metric for appropriate compensation. Together, these mechanisms provide some piecemeal accountability but are poorly tailored to the goals of the charitable tax exemption.

The lack of an effective regulatory framework both permits some charities to pay exorbitant salaries[2] and obscures the extent of the overcompensation problem. While there is reason to believe that overcompensation is confined to a small minority of charities,[3] this is difficult to confirm without effective oversight. Moreover, while abuse

[1] I.R.C. § 4960(a)(1) (2018).

[2] *2014 Charity CEO Compensation Study*, CHARITY NAVIGATOR 1 (Oct. 2014), https://www.charitynavigator.org/docs/2014_CEO_Compensation_Study.pdf (defending compensation in the sector generally, while conceding that some salaries are clearly "out-of-line").

[3] In 2014, the median CEO compensation at charities with over $1 million in revenues was $123,462. *2016 Charity CEO Compensation Study*, CHARITY NAVIGATOR 11 (Oct. 2016), https://d20umu42aunjpx.cloudfront.net/2016+CEO+Comp+Study/2016+CEO+Compensation+Study.pdf.

may be rare, it generates media headlines[4] that harm public confidence in the charitable sector. In a 2015 public opinion survey, 41% of respondents indicated that nonprofit leaders are paid too much.[5] Among the 35% who reported little or no confidence in the charitable sector, salaries and other spending were a major concern.[6] Because charities rely on indirect subsidies, which accrue only to the extent that the public provides financial support, a perception of profligacy may inflict long-term damage to the sector.[7] This trend reinforces the need for effective regulation of executive compensation.

This Article proceeds in seven parts. Part II introduces the charitable sector and the underlying policy objectives of the charitable tax exemption. Part III reviews the literature on determinants of executive compensation in both the for-profit and nonprofit sectors. Parts IV, V, and VI examine the three legal constraints on charity compensation in turn, assessing their metrics and enforceability. Part VII reviews options for further reform, focused on improving the metric for reasonable compensation that could be enforced through the TCJA's excise tax.

II. THE CHARITABLE SECTOR

The United States has over 1.4 million charities,[8] ranging from churches and schools to philanthropic foundations and neighborhood organizations. Part II.A explains the general requirements and scope of the charitable tax exemption. Part II.B surveys the scholarship on policy rationales for the exemption.

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4 *See, e.g.*, *Nonprofit? She Gets Paid $761,560 to Run This Domestic Violence Group*, MIAMI HERALD (July 26, 2018), https://www.tampabay.com/florida-politics/buzz/2018/07/26/nonprofit-she-gets-paid-761560-to-run-this-domestic-violence-group/.

5 Suzanne Perry, *1 in 3 Americans Lacks Faith in Charities, Chronicle Poll Finds*, CHRON. PHILANTHROPY (Oct. 5, 2015), https://www.philanthropy.com/article/1-in-3-Americans-Lacks-Faith/233613.

6 *Id.*

7 The number of households that donate to charity declined about 11% from 2000 to 2014. The difference was made up by a small number of wealthy donors, but this trend may not be sustainable in the long term. Patrick M. Rooney, *The Growth in Total Household Giving Is Camouflaging a Decline in Giving by Small and Medium Donors: What Can We Do About It?*, NONPROFIT Q. (Aug. 27, 2019), https://nonprofitquarterly.org/2018/11/21/total-household-growth-decline-small-medium-donors/.

8 This figure includes 1,111,318 I.R.S.-registered 501(c)(3) organizations and roughly 350,000 churches, which are not required to file with the I.R.S. Because some churches opt to register, the total figure likely counts some charities twice. *Tax Exempt Organization Search*, INTERNAL REVENUE SERV., https://apps.irs.gov/app/eos/ (last updated Sept. 6, 2019); *U.S. Religion Census 2010: Summary Findings*, ASSOC'N STATISTICIANS AM. RELIGIOUS BODIES 5 (2012), http://www.usreligioncensus.org/press_release/ACP%2020120501.pdf.

A. *Exemption Standards and Scope*

The charitable sector encompasses a broad range of organizations described in Section 501(c)(3) of the Internal Revenue Code.[9] This provision affords federal income tax exemption to entities that are "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . , or for the prevention of cruelty to children or animals[.]"[10] The Department of Treasury regulations relax the statutory criteria somewhat, requiring charities to operate primarily (rather than exclusively) for exempt purposes and allowing them to pursue an "insubstantial" amount of non-exempt activities.[11] The Code also forbids charities to engage in any political campaign activities or more than an insubstantial amount of legislative lobbying.[12] Finally, the Code prohibits any inurement of charities' net earnings to shareholders or other insiders.[13] This provision effectively requires charities to have a nonprofit legal structure and limits their executive compensation to reasonable levels.[14]

There are two subcategories of charities. "Public charities" directly serve and receive support from the general public. This status is available to organizations that (i) fall into a statutory category of archetypal charities, such as churches and schools;[15] (ii) receive a significant portion of their financial support from the general public;[16] or (iii) operate for the purpose of financially supporting another public charity.[17] A 501(c)(3) organization that does not qualify for public charity status is automatically classified as a "private foundation."[18] Private foundations comprise less than ten percent

9 I.R.C. § 501(c)(3) (2018).

10 *Id.* Regulations have further defined each of the exempt purposes listed in Section 501(c)(3). For example, "charitable" is expansively construed to include such purposes as "[r]elief of the poor and distressed or of the underprivileged . . . erection or maintenance of public [structures] . . . eliminat[ing] prejudice and discrimination . . . [and] combat[ting] community deterioration and juvenile delinquency." Treas. Reg. § 1.501(c)(3)-1(d)(2) (2019).

11 Treas. Reg. § 1.501(c)(3)-1(c)(1).

12 I.R.C. § 501(c)(3).

13 *Id*.

14 Treas. Reg. § 1.501(c)(3)-1(c)(2). See Part V for a discussion of the relationship between private inurement and executive compensation. The IRS recognizes limited liability companies as exempt under Section 501(c)(3) when certain conditions are met, including that all members be Section 501(c)(3) organizations or public entities. Richard A. McCray & Ward L. Thomas, *B. Limited Liability Companies as Exempt Organizations – Update*, INTERNAL REVENUE SERV. (2001), https://www.irs.gov/pub/irs-tege/eotopicb01.pdf.

15 I.R.C. §§ 509(a)(1); 170(b)(1)(A).

16 *Id.* § 509(a)(2)(A).

17 *Id.* § 509(a)(3).

18 *Id.* § 509(a).

of the charitable sector and typically disburse grants as their primary activity, though some also conduct direct charitable programs.[19] Because private foundations are generally funded and governed by a small group of connected individuals, they are considered less accountable to the public and therefore subject to stricter regulations.[20]

Obtaining recognition as a Section 501(c)(3) organization confers several tax advantages.[21] In addition to avoiding federal income tax, charities are the only category of exempt organization authorized to receive tax-deductible donations.[22] Individuals who itemize their deductions may deduct up to fifty percent of their taxable income as charitable contributions, while corporations may deduct up to ten percent.[23] This fundraising advantage makes Section 501(c)(3) a coveted status for nonprofit organizations, which cannot raise capital through equity investment. Finally, recognized charities may also be eligible for exemption from certain state taxes.[24]

The exemption is not absolute. Charities must pay taxes when they engage in certain non-exempt activities and transactions. The unrelated business income tax ("UBIT"), for example, applies regular corporate tax rates to charity earnings from commercial activities.[25] Charities may also incur excise taxes on lobbying expenditures.[26] Finally, certain private

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19 As of September 2019, there were 108,131 private foundations and 7,678 private operating foundations registered with the I.R.S. *Tax Exempt Organization Search*, INTERNAL REVENUE SERV., https://apps.irs.gov/app/eos/ (last visited Oct. 18, 2019). Private operating foundations are foundations that expend most of their resources directly conducting charitable activities. I.R.C. § 4942(j)(3). Private operating foundations are subject to somewhat different rules than nonoperating foundations, but these distinctions do not affect executive compensation.

20 *See, e.g.*, I.R.C. § 4940 (imposing excise taxes on foundation investment income); § 4942 (imposing excise taxes on a foundation's failure to distribute 5% of its assets annually), § 4943 (imposing excise taxes on foundations that own a substantial portion of a business), § 4944 (imposing excise taxes on foundations that make risky investments), § 4945 (imposing excise taxes on foundations that expend funds in violation of private foundation rules).

21 Most organizations must apply for recognition under Section 501(c)(3), though there are exceptions for churches, certain church affiliates, and organizations with less than $5,000 in annual revenue. I.R.C. § 508(a)-(c).

22 *Id.* § 170(a).

23 *Id.* §§ 170(b)(1)(A); 170(b)(2)(A). The deductible percentage for individuals typically depends on whether the recipient is classified as a public charity or a private foundation.

24 *See, e.g.*, TEX. CODE ANN. §§ 151.310(a)(2) (West 2019) (sales, use, and excise tax exemption), 171.063(a)(1) (franchise tax exemption); CAL. REV. & TAX. CODE § 23701d(a) (West 2019) (corporate income and franchise tax exemption); VA. CODE ANN. §§ 58.1-401.5 (West 2019) (income tax exemption), 58.1-609.11.B (sales and use tax exemption).

25 I.R.C. § 512. UBIT applies to net income from a trade or business that is regularly carried on and not substantially related to the organization's exempt purposes.

26 Public charities must pay tax on lobbying expenditures in excess of a formula-based

foundations and universities must pay tax on their net investment income.[27] These exceptions restrict charities from exploiting their tax-exempt status to compete with for-profit businesses, exercise political power, or accumulate unutilized wealth. In short, the exceptions help to ensure that the scope of the exemption aligns with its policy rationale, explored below.

B. *Policy Basis for the Charitable Exemption*

Although charities have enjoyed tax-exempt status under every revenue law since Congress first imposed peacetime corporate taxes in the late nineteenth century,[28] the legislative record sheds little light on the rationale for the exemption.[29] Because tax exemption for religious and educational institutions has ancient historical roots, Congress may have considered the rationale so self-evident as to not require an explanation.[30]

Scholars have stepped into this void with a range of theories purporting to explain the exemption. They draw primarily on economics, but occasionally introduce factors such as altruism, pluralism, and critical race theory.[31] The dominant perspective is that the exemption exists to subsidize and encourage private sector provision of positive social outputs that would otherwise be undersupplied.[32] The Supreme Court stated the

threshold amount. *Id.* § 4911(a). Private foundations must pay tax on all lobbying expenditures. *Id.* § 4945(d)(1).

27 *Id.* § 4940(a)-(e) (imposing a tax of up to 2% the net investment income of private foundations that are not exempt operating foundations); *id.* § 4968(a) (imposing a tax of 1.4% on the net investment income of many private colleges and universities).

28 The Revenue Act of 1894 provided that "nothing contained herein shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes . . ." Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509. It was short-lived, however. The following year, the Supreme Court invalidated the corporate tax on constitutional grounds. Pollock v. Farmers' Loan & Tr. Co., 158 U.S. 601, 637 (1895). Following the 1913 ratification of the Sixteenth Amendment, which permits income taxation, Congress reenacted a revenue code with exempt status for certain charitable organizations. U.S. CONST. amend. XVI; Revenue Act of 1913, ch. 16, § II(G), 38 Stat. 114, 172.

29 Boris I. Bittker & Georget K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 302, 304 (1976) (noting that the enacting Congress "devoted little discussion" to the matter and concluding that "legislative history of the tax exemption reveals no systematic analysis").

30 *See* John W. Whitehead, *Tax Exemption and Churches: A Historical and Constitutional Analysis*, 22 CUMB. L. REV. 521 (1992) for an overview of tax exemption for religious institutions from ancient civilizations to the present day.

31 For excellent synopses of these theories, *see* David A. Brennen, *A Diversity Theory of Charitable Tax Exemption – Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 PITT. TAX REV. 1 (2006); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998); Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Synthesis*, 27 STETSON L. REV. 395 (1997).

32 Atkinson, *supra* note 31, at 405.

rationale as follows:

> Charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenue. History buttresses logic to make clear that, to warrant exemption under § 501(c)(3) an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest.[33]

In short, charities provide outputs that Congress has deemed beneficial to society.[34] Some of these outputs are classic public goods: they are non-rivalrous, meaning that one person's consumption does not detract from another's, and non-excludable, meaning that anyone can access the good regardless of whether they have paid for it.[35] Pure public goods are rare, but may include outputs such as public radio and clean air. Non-rivalry and non-excludability create a strong incentive for individuals to freeride, consuming public goods without contributing to their production.[36] In competitive markets, freeriding means that public goods will be underfunded and therefore supplied at less than socially optimal levels.[37]

Similar logic applies to quasi-public goods, which have characteristics of both public and private goods, and private goods with positive externalities, such as education and healthcare.[38] Most charity outputs fall into these categories. Because their marginal societal benefit exceeds their marginal private benefit, private purchasing decisions will not generate the optimal level of output.[39]

Governments can mitigate this market failure by directly providing undersupplied goods or subsidizing private suppliers. Subsidies may be direct, in the form of public spending, or indirect, in the form of preferential tax treatment.[40] While direct subsidies are more efficient than

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33 Bob Jones Univ. v. United States, 461 U.S. 574, 591–92 (1983).

34 *Id.* In addition to aligning with the permissible statutory purposes, charities must comport with established public policy. *Id.* at 591.

35 Tyler Cowen, *Public Goods and Externalities: Old and New Perspectives*, *in* PUBLIC GOODS AND MARKET FAILURES: A CRITICAL EXAMINATION 3 (Tyler Cowen ed., 1988).

36 Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1215–16 (2010) [hereinafter *Keep Charity Charitable*].

37 *Id.* at 1216.

38 Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 787–88 (2012) [hereinafter *The Role of Charity*]; *Keep Charity Charitable*, *supra* note 36, at 1216 n.8.

39 *Keep Charity Charitable*, *supra* note 36, at 1216.

40 This preferential tax treatment includes both the exemption and the deduction.

indirect subsidies, scholars have suggested reasons to prefer indirect subsidization. First, indirect subsidization allocates the cost disproportionately to those persons who most value the outputs (i.e. donors).[41] Second, having taxpayers select the subsidized organizations through their donations builds civic engagement.[42] Third, the indirect approach may help to ensure that subsidies reach minority groups that would not have enough political power to compete for direct subsidies.[43] In order to realize these advantages, members of the public must provide funds to suppliers and, therefore, must have some degree of confidence in their performance.

According to Professor Hansmann, this need for public confidence explains why the subsidies are reserved for nonprofit organizations, even though for-profit companies are, at least in theory, equally capable of producing charitable outputs.[44] Hansmann identified the hallmark of nonprofit organizations as the "nondistribution constraint," which precludes the dissemination of net earnings to owners, managers, or other insiders.[45] The nondistribution constraint helps to alleviate three "contract failures" in the delivery of charitable outputs.[46] Each contract failure impairs the ability of funders—whether donors or purchasers—to monitor the quality or quantity of outputs, allowing for-profit suppliers to divert

Daniel E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 552–53 (2006) ("In Congress, the courts, the media, and now academia . . . the deduction is widely viewed as a government subsidy . . . .").

[41] *See, e.g.*, Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1399–1406 (1988).

[42] *See, e.g.*, David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 229 (2009); Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405 (1998). Detractors point out, however, that the exemption only benefits those organizations that have positive net revenues and therefore less need for subsidization than those that merely break even or operate at a loss. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 355–57 (1991).

[43] Hall & Colombo, *supra* note 42, at 392–93.

[44] *See generally* Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L. J. 54 (1981) [hereinafter *Rationale*]; Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter *Role of Nonprofit Enterprise*]. Other scholars have supplemented or slightly revised Hansmann's theory of contract failure, but it remains the prevailing rationale for restricting charitable tax-exempt status to nonprofits. For example, Daniel Shaviro added the insight that certain nonprofits, particularly those with a "virtuous or public-spirited halo," attract altruistically motivated workers, whom purchasers can trust to perform even without close monitoring. Daniel Shaviro, *Assessing the "Contract Failure" Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1003–04 (1997) (conceding that he differs with Hansmann "in little beyond emphasis").

[45] *Role of Nonprofit Enterprise*, *supra* note 44, at 838.

[46] *Role of Nonprofit Enterprise*, *supra* note 44, at 845.

funds to their shareholders.[47]

The first contract failure affects donation-funded charitable activities.[48] Because donors generally do not consume the outputs of their donations, they have difficulty monitoring the quality of those outputs.[49] The second contract failure arises in the case of public goods.[50] While some people may be inclined to fund public goods out of beneficence or the prospect of reputational benefits, the non-rivalrous quality of public goods makes it difficult for funders to monitor whether their contributions actually increase output.[51] The third contract failure involves the provision of "complex personal services," such as education and healthcare.[52] While individuals often purchase these services for their own consumption, most are not sophisticated enough to cost-effectively assess the quality of the services they receive.[53] These contract failures give for-profit suppliers latitude to shirk on the provision of charitable outputs in favor of distributing greater profits to their shareholders.

In order for indirect subsidization to succeed, suppliers must have structural safeguards to prevent the misappropriation of resources for private gain. The nonprofit structure, with its nondistribution constraint, provides assurance that resources are not siphoned to owners through dividend payments.[54] Yet nonprofits can still divert resources into private hands by extravagantly compensating their executives. Part III examines the economic and organizational dynamics that facilitate executive overcompensation.

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47 *Role of Nonprofit Enterprise*, *supra* note 44, at 843.

48 *Role of Nonprofit Enterprise*, *supra* note 44, at 846.

49 *Role of Nonprofit Enterprise*, *supra* note 44, at 847.

50 *Role of Nonprofit Enterprise*, *supra* note 44, at 850.

51 *Role of Nonprofit Enterprise*, *supra* note 44, at 850–851.

52 *Role of Nonprofit Enterprise*, *supra* note 44, at 862–66.

53 *Role of Nonprofit Enterprise*, *supra* note 44, at 872.

54 Hansmann believes tax subsidies are necessary to offset the fact that the nonprofits cannot raise equity capital. In this sense, Hansmann has the exemption flowing from the preference for nonprofit provision of services, rather than the other way around. *Rationale*, *supra* note 44, at 74–75. Detractors have pointed out that tax exemption confers the greatest benefits to the charities with the most capital. Hall & Colombo, *supra* note 42, at 388. Indeed, Hansmann concedes that his theory is a particularly poor fit for the case of nonprofit hospitals, which are often flush with capital. *Rationale*, *supra* note 44, at 87. A simpler explanation is that the subsidizing government does not wish its subsidies to be diverted to shareholders. Atkinson, *supra* note 31, at 406.

III. THE DYNAMICS OF EXECUTIVE COMPENSATION

Executive compensation has been the focus of extensive scholarship,[55] much of it seeking to explain the dramatic increase in C-Suite pay over the past several decades.[56] One study found that inflation-adjusted CEO compensation rose nearly 1000% from 1978 to 2015.[57] Compensation in the nonprofit sector has risen at a slower pace overall, but jumped sharply among the highest-paid executives.[58] Part III reviews the literature on the determinants of executive compensation. Part III.A examines research on the for-profit sector, which primarily uses public company data and is far more extensive than nonprofit compensation scholarship. Part II.B discusses how dynamics evident in for-profit businesses appertain to the charitable sector.

A. *Theories of Executive Compensation*

There are two dominant theoretical perspectives in the literature on executive compensation in the for-profit sector.[59] Optimal contracting theory puts faith in the arms-length bargaining process between self-interested companies and executives. Managerial power theory disputes the fairness and efficiency of that process, deriding market failures that result in excessive pay. This Part discusses both theories in turn, but begins by summarizing the agency principles that underpin them.

Agency theory instructs that business principals (i.e. investors) appoint agents (i.e. executives) to serve their interests and relieve them of their immediate stewardship responsibilities.[60] But the interests of principal and agent are misaligned in various ways.[61] First, self-interested

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[55] For a review, *see* Cynthia E. Devers et al., *Executive Compensation: A Multidisciplinary Review of Recent Developments*, 33 J. MGMT. 1016–72 (2007).

[56] Lawrence Mishel & Jessica Schieder, *CEO Compensation Grew Faster Than the Wages of the Top .01 Percent and the Stock Market*, ECON. POL'Y INST. (Jul. 13, 2016), http://www.epi.org/publication/ceo-compensation-grew-faster-than-the-wages-of-the-top-0-1-percent-and-the-stock-market/.

[57] *Id.*

[58] Andrea Fuller, *Charity Officials Are Increasingly Receiving Million-Dollar Paydays*, WALL ST. J. (Mar. 6, 2017), https://www.wsj.com/articles/charity-officials-are-increasingly-receiving-million-dollar-paydays-1488754532.

[59] *See, e.g.*, Pete Woodlock & Sheen Liu, *Two Views of CEO Compensation: Part of the Problem or Part of the Solution?*, 2 J. THEORETICAL ACCT. RES. 52 (2007); Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 258 (2005).

[60] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (defining an agency relationship as a "contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent").

[61] *Id.*

executives have an incentive to shirk their duties or mobilize company resources for personal gain rather than investor profit.[62] Second, because executives' human and reputational capital is disproportionately invested in one company, they tend to be more risk-averse than the diversified investors.[63] The divergence of interests forces principals to monitor their agents, but effective oversight is impeded by resource constraints, coordination problems among the principals, and information asymmetries between the principals and agents. As a result, companies incur a residual loss, which is simply a deadweight loss to principal welfare.[64] Agency costs[65] increase as enterprises expand and investors appoint intermediaries (i.e. directors or managers) to select and monitor executives on their behalf.[66]

The traditional perspective on executive compensation, optimal contracting theory, maintains that competitive market pressures produce efficient compensation arrangements.[67] Boards negotiate with executives at arm's length and determine the minimum compensation necessary to procure their services.[68] In order to more closely align executive and shareholder interests, boards may issue performance-based compensation in the form of equity grants, options, or contingent cash payouts.[69] Performance-based compensation causes executives to internalize the consequences of company performance, motivating them to take more risk[70] and work harder than they otherwise might.[71]

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62 *Id.* at 312; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 296 (1980).

63 *See* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1351 (2007) ("Managers of healthy companies generally prefer taking less risk than they would if they were acting in the interests of their presumptively diversified shareholders. A shareholder has shares in many companies; a manager has only one job.") (footnote omitted).

64 Jensen & Meckling, *supra* note 60, at 308–10.

65 Jensen and Meckling identify three components of agency cost: (1) monitoring costs by the principal; (2) bonding costs, which include any costs that the principal requires the agent to expend in order to minimize the risk of agent malfeasance; and (3) the "residual loss" from divergence between principal and agent interests that monitoring and bonding cannot neutralize. Jensen & Meckling, *supra* note 60, at 308.

66 Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1016 (2009).

67 Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 762 (2002) [hereinafter *Managerial Power*]; Dorff, *supra* note 59, at 258.

68 Dorff, *supra* note 59, at 261.

69 David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 618 (2011).

70 In the aftermath of the financial crisis, several commentators condemned equity compensation packages that rewarded short-term over long-term gains and therefore encouraged excessive risk taking. *See generally,* Sanjai Bhagat & Brian Bolton, *Financial*

Optimal contracting theorists are generally skeptical of claims that executives are overcompensated.[72] Instead, they attribute skyrocketing executive pay to the scarcity of talent and the increasing complexity of management duties.[73] Moreover, because equity compensation concentrates a significant portion of executives' investment portfolios in one company, it is reasonable—necessary, even—to provide an additional cash premium to offset this non-diversification burden.[74] This dynamic, optimal contracting theorists claim, explains the simultaneous surge in equity and salary compensation over the past two decades.[75]

The main rival to optimal contracting theory is managerial power theory, promulgated most notably by Harvard professors Lucian A. Bebchuk and Jesse M. Fried.[76] Managerial power theory attributes the boom in executive compensation not to market forces, but rather to rent extraction by entrenched executives.[77] Rents refer to private gains without a corresponding creation of value – in this context, to compensation that is not warranted by performance.[78] Rent extraction is effectively a redistribution of wealth from shareholders to executives.[79]

Crisis and Bank Executive Incentive Compensation, 25 J. CORP. FIN. 313, 341 (2014); Lucian A. Bebchuk, *How to Fix Bankers' Pay*, 139 DAEDALUS 52, 60 (2010). However, the conventional concern has been that executives will behave more conservatively than shareholders' interests dictate. Walker, *supra* note 69, at 621 n.24.

71 In larger firms, managerial slack is generally considered a lesser concern than risk aversion. Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 689 (2011) (noting that "even the most strident incentive pay proponents do not suppose that, absent incentive pay, there would be large-scale loafing going on in corner offices"); Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1592 (2005) ("[Executives] have survived multiple rounds of weeding out of individuals with any appreciable taste for slack and have self-selected or become acculturated to hard work.").

72 *See, e.g.*, Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, 64 HARV. BUS. REV. 125 (1986).

73 Dorff, *supra* note 59, at 262.

74 Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 5 (2002) (showing that the cost of options to shareholders "significantly exceeds the value of the option from the perspective of a risk-averse, undiversified executive who can neither sell the option nor hedge against its risk").

75 *Id.*

76 *See generally Managerial Power*, *supra* note 67; Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003) [hereinafter *Agency Problem*]; Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005) [hereinafter *Overview*]; LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE (2004).

77 *See generally Managerial Power*, *supra* note 67.

78 Robert D. Tollison, *The Economic Theory of Rent Seeking*, 152 PUB. CHOICE 73, 74 (2012). Profits, in contrast, refer to gains from the efficient allocation of resources. *Id.*

79 Dean Baker, *The Upward Redistribution of Income: Are Rents the Story?*, CTR. FOR ECON. AND POL'Y RES. 13 (2015), http://cepr.net/documents/working-paper-upward-

Managerial power theory attributes executive rent extraction to failures of corporate governance. In part, this takes the form of an implicit quid pro quo between directors and executives.[80] Executives can reward cooperative directors in a variety of ways, including by recommending higher board compensation, providing social and professional connections, and ensuring that they are re-nominated to their lucrative positions.[81] Procedural and psychological factors also facilitate rent extraction.[82] Board decisions are largely based on information provided by the executives themselves.[83] Directors also tend to be wealthy, which distorts their perception of reasonable compensation,[84] and have "a natural psychological tendency to believe that the high salaries of corporate executives accurately reflect executives' intrinsic worth."[85]

To bolster the legitimacy of their compensation packages, companies often task independent compensation consultants and committees with recommending compensation levels based on market-rate metrics.[86] Managerial power theorists are quick to point out that this has done little to contain the rise in executive pay, because consultants and committee members are just as influenced as directors by their desire for reappointment.[87] Companies cannot resolve managerial power dynamics simply by outsourcing decisions.

Bebchuk and Fried identify shareholder "outrage" as the chief constraint on executive compensation.[88] Shareholders have several avenues to express such outrage. First, they may vote to remove directors

distribution-income-rents.pdf. *See also* Catherine T. Jeppson et al., *CEO Compensation and Firm Performance: Is There Any Relationship?*, 7 J. BUS. & ECON. RES. 81, 85 (2009) (concluding that despite "a presumed strong relationship between CEO compensation and firm performance, we did not find this to be the case").

80 *Agency Problem*, *supra* note 76, at 73.

81 *Overview*, *supra* note 76, at 656–57; *Agency Problem*, *supra* note 76, at 73–74. Median director compensation in 2015 was $258,000 per year, nearly double the 2000 figure. Sacha Pfeiffer & Todd Wallack, *Few Hours, Soaring Pay for Corporate Board Members*, BOS. GLOBE (Dec. 2, 2015), http://www.bostonglobe.com/business/2015/12/01/good-work-you-can-get-corporate-directors-among-highest-paid-part-time-employees-america/rYHPP7ozPXU0AG8VSo37MM/story.html?p1=Article_Related_Box_Article.

82 Posner, *supra* note 66, at 1023.

83 *Managerial Power*, *supra* note 67, at 772.

84 Charles A. O'Reilly III & Brian G.M. Main, *Economic and Psychological Perspectives on CEO Compensation: A Review and Synthesis*, 19 INDUS. & CORP. CHANGE 675, 686 (2010).

85 Posner, *supra* note 66, at 1023 (footnote omitted).

86 *Agency Problem*, *supra* note 76, at 78.

87 Agency Problem, *supra* note 76, at 79; Bernice Grant, *Independent Yet Captured: Compensation Committee Independence After Dodd-Frank*, 65 HASTINGS L.J. 761, 777–83 (2014).

88 *Agency Problem*, *supra* note 76, at 75.

whom they believe have overcompensated executives. Second, shareholders have also initiated derivative suits claiming that the directors' approval of certain compensation packages constitutes a fiduciary breach or waste of corporate assets, though with decidedly mixed results.[89] Finally, the Securities and Exchange Commission often requires public companies to obtain shareholder approval before issuing equity compensation,[90] and the Dodd-Frank Wall Street Reform and Consumer Protection Act requires periodic, non-binding shareholder votes on executive compensation.[91] Companies unsurprisingly respond to shareholder outrage by scaling back pay.[92] Nevertheless, shareholder outrage has its own constraints. For example, positive economic forecasts in the industry tend to diminish outrage.[93] Companies can also curtail outrage by obscuring the true value of compensation through non-salary arrangements such as deferred compensation, expense accounts and other perks, equity stakes, guaranteed future consulting contracts, and exorbitant severance payments.[94] It is therefore atypical for shareholder outrage to serve as a strong bulwark against executive rent extraction.

Scholars have empirically tested both optimal contracting and managerial power theories with inconsistent results.[95] A 2015 meta-study of over 200 empirical research studies concluded that both optimal contracting and managerial power factors influence compensation to varying degrees and that the two theories "do not represent competing

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[89] *See, e.g.*, Rubin v. Murray, 943 N.E.2d 949 (Mass. App. Ct. 2011) (upholding a finding of fiduciary breach due to excessive compensation). In Delaware, such claims have settled with the payment of plaintiff attorneys' fees, but face high barriers to success at trial. *See, e.g.* City of Plantation Police Officers' Emp.'s Retirement Sys. v. Jeffries, No. 2:14-cv-1380, 2014 WL 470400, at *8-9 (S.D. Ohio Dec. 30, 2014) (approving a settlement in a derivative lawsuit claiming fiduciary breach and corporate waste, while noting that "[e]ven if plaintiff were able to rebut the presumption created by the business judgment rule, plaintiff's claim for excessive compensation would nevertheless be difficult to prove" and "plaintiff would also face significant hurdles in proving a breach of fiduciary duty"); *In re* Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005), *aff'd* 906 A.2d 27 (Del. 2006).

[90] In 2003, the Securities and Exchange Commission issued a rule mandating that firms listed on the New York Stock Exchange or NASDAQ obtain shareholder approval of any new equity compensation plans and material amendments to existing plans. Self-Regulatory Organizations, SEC Release No. 34-48108, 2003 SEC LEXIS 1540 (June 30, 2003).

[91] Pub. L. No. 111-203, 124 Stat. 1367, 1899 (2010). Section 951 of Dodd-Frank amended the Securities Exchange Act. 15 U.S.C. § 78n-1 (2018).

[92] *Agency Problem*, *supra* note 76, at 75–76.

[93] *Agency Problem*, *supra* note 76, at 76.

[94] *Agency Problem*, *supra* note 76, at 79–80.

[95] Marc van Essen et al., *Assessing Managerial Power Theory: A Meta-Analytic Approach to Understanding the Determinants of CEO Compensation*, 41 J. MGMT. 164, 166 (2015).

explanations but describe points on a continuum . . . ."[96] In other words, the compensation practices of many companies reflect a hybrid of market-based forces and rent extraction.

B. *Compensation in the Charitable Sector*

Agency principles also apply, if not identically, to the charitable sector. While charities have no shareholders, the board of directors has a legal duty to steward the charity in furtherance of its exempt purposes.[97] To that end, the board appoints executives and monitors their performance.

In certain respects, the charity principal and agent have more convergence of interests than in the for-profit sector. They likely share a commitment to the charity's mission,[98] and charity directors do not have an equity stake in the charity that might drive a predilection for risk-taking. Yet rational charity executives still have an incentive to shirk and maximize their personal gain.[99] They also have a disproportionate investment of human and reputational capital in the charity compared to directors, which may affect their preferences.[100] The charity structure does not, therefore, nullify the agency problem found in other organizations.

Charities have certain governance dynamics that Bebchuk and Fried found to facilitate rent extraction in public companies. Charity executives typically have influence in the compensation-setting process, directing the flow of performance-related information to the board.[101] Nonprofit

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[96] *Id.* at 187 (concluding after a regression of 219 studies that, "[m]anagerial power . . . has an important influence over the pay-setting process, but optimal contracting arrangements may also exist"). Bebchuk and Fried also concede that compensation is "likely to be shaped both by market forces that push toward value-maximizing outcomes, and by managerial influence[.]" *Agency Problem*, *supra* note 76, at 73.

[97] *See, e.g.* Summers v. Cherokee Children & Family Svcs., 112 S.W. 3d 486, 504 (Tenn. Ct. App. 2002) (directors must be "principally concerned about the effective performance of the nonprofit's mission"); *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (N.Y. Sup. 1999) (a nonprofit board must "in the first instance, seek to preserve its [. . .] mission."). While nonprofit organizations do not have shareholders, they may have "members" who elect or appoint directors. In such cases, the members would function as principals in the agency relationship.

[98] In a 2015 survey, 86% of nonprofit directors reported that they joined their respective boards "to serve the organization and contribute to its success." Only one quarter reported being motivated by the prospect of furthering personal or professional interests. *2015 Survey on Board of Directors of Nonprofit Organizations*, STAN. GRADUATE SCH. BUS. & ROCK CTR. FOR CORP. GOVERNANCE 7 (2015), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-nonprofit-board-directors-2015.pdf.

[99] Brian Galle & David I. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities*, 94 B.U. L. REV. 1881, 1895–96 (2014).

[100] For example, directors may favor a merger that will bolster charitable impact, whereas executives may object due to the risk to their position.

[101] Even when charities take advantage of the legal safe harbor for executive compensation arrangements (discussed in Part V), the executive may provide information

leadership is highly homogenous,[102] and directors have social and professional ties to executives that may foster a culture of deference.[103] These factors may contribute to overcompensation in the charity context much as they do in public companies.

Moreover, certain aspects of the agency problem may be more difficult to address in the charitable sector than in the for-profit sector. First, charity principals have additional barriers to monitoring performance. They nearly always serve on a volunteer basis,[104] which may deprioritize their charity duties relative to their other professional obligations. They may also have a more difficult task in assessing executive performance. While for-profit companies can utilize the simple metric of profits as a proxy for firm performance (and, by extension, executive success), charitable impact is more nuanced and susceptible to distortion by a self-interested executive.[105]

Second, while for-profit companies may try to align principal and agent interests by issuing equity compensation, charities cannot do so without violating the non-distribution constraint and prohibition on private inurement. Charities can offer non-equity forms of incentive compensation, such as cash bonuses for achievement of certain benchmarks, but only if the overall compensation remains reasonable and the benchmarks denote individual performance.[106] This makes it difficult

relevant to his or her compensation before recusing herself from board deliberations. *See* Treas. Reg. § 53.4958-6(c)(1)(ii). While the regulations permit an executive to "answer questions" from the board prior to deliberations, the I.R.S.'s sample conflict of interest policy for charities provides broader latitude, allowing a conflicted person to "make a presentation" before recusal. *Instructions for Form 1023*, INTERNAL REVENUE SERV. 26 (2017), https://www.irs.gov/pub/irs-pdf/i1023.pdf.

102 A 2017 survey found 84% of directors, 90% of chief executives and board chairs, are white, and that 83% of directors are over 40. While the survey did not collect data on the income levels of board members, it found that only 22% of chief executives and 39% of board chairs are satisfied with their board's level of socioeconomic diversity. *Leading with Intent: 2017 National Index of Nonprofit Board Practices*, BOARDSOURCE 11 (2017), https://leadingwithintent.org/wp-content/uploads/2017/11/LWI-2017.pdf.

103 Tivoni Devor, *The Face of Nonprofit Boards: A Network Problem*, NONPROFIT Q. (Mar. 4, 2015), https://nonprofitquarterly.org/the-face-of-nonprofit-boards-a-network-problem/.

104 Approximately one percent of charities pay salaries or honoraria to board members, though this increases among private foundations to three percent paying salaries and five percent paying honoraria. *Supra* note 102, at 52.

105 Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 2 (2011) ("Accountability to mission is exceedingly difficult to measure and police."); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 919 (2007) ("Measuring effectiveness may be the most intractable problem that charities have: Because their goals rarely translate into measurable returns, and are often long-term, there may be no way to measure success in a timely way, or at all.").

106 I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) (disallowing payment to

to devise a compensation structure where executives internalize organizational outcomes.

Finally, the major constraint against overcompensation in the for-profit sector, shareholder outrage, has no close analogue in the charitable sector. The losers from overcompensation are not shareholders, but the intended charitable beneficiaries. Unlike shareholders, charitable beneficiaries usually have no voting rights or standing to sue. Concerned members of the public can refer charities to the I.R.S. by submitting a complaint form, but it is unclear how often these are actually reviewed.[107] The outrage constraint is therefore more likely to be imposed by donors, who have the power to inflict financial pain in much the same way as divesting shareholders.[108] Yet, as Part IV explores in depth, even donors are much less equipped than shareholders are to monitor and respond to compensation practices.

Because charities, like for-profit businesses, are susceptible to executive rent seeking and other market distortions, there is a risk that these subsidized organizations will misappropriate resources as executive overcompensation. In order to safeguard the intent of the exemption, the law offers several mechanisms to constrain executive compensation. Parts IV, V, and VI explore these mechanisms and their effectiveness in upholding the policy purposes of the charitable exemption.

IV. FIRST MECHANISM: PUBLIC DISCLOSURE AND DONOR MARKET ORDERING

The first constraint on compensation is mandatory public disclosure. The availability of compensation data permits donors and other stakeholders to withdraw their support from charities that extravagantly compensate their executives, putting downward pressure on compensation levels. Part IV.A details the disclosure rules. Part IV.B explains why, in practice, transparency seldom leads to donor-based accountability.

physicians based on hospital or departmental earnings and contrasting the decision with that of Rev. Rul. 69-383, which approved a compensation arrangement where a hospital paid a radiologist a fixed percentage of his individual gross billings); World Family Corp. v. Comm'r, 81 T.C. 958, 970 (1983) (approving the payment of commissions to individuals based on the amount they personally procured for the organization and distinguishing the instant case from situations where an individual received commissions based on total fundraising regardless of personal performance); *see also* I.R.S. Priv. Ltr. Rul. 200601030 (Oct. 12, 2005); I.R.S. Priv. Ltr. Rul. 9316052 (Jan. 29, 1993); I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987).

[107] *I.R.S. Complaint Process - Tax-Exempt Organizations*, INTERNAL REVENUE SERV. (last updated Feb. 21, 2019), https://www.irs.gov/charities-non-profits/irs-complaint-process-tax-exempt-organizations.

[108] Galle & Walker, *supra* note 99, at 1887.

A. *Overview of the Public Disclosure Regime*

All charities, with the exception of certain religious and small organizations, must file an annual informational return (Form 990) with the I.R.S..[109] Charity returns disclose the amount of compensation paid to (i) current officers, directors, trustees, key employees, and highest-compensated employees;[110] (ii) former directors and trustees who receive more than $10,000 in their capacity as former directors or trustees; and (iii) former officers, key employees, and highest-compensated employees who currently receive more than $100,000 in any capacity.[111] For each of these listed individuals, the return must disclose the hours worked and the value of reportable and non-reportable compensation paid by the charity and any related organizations.[112]

Charities must submit a supplemental Schedule J for any listed individuals who are former executives, who receive over $150,000 in aggregate from the charity and related organizations, or who receive compensation from unrelated parties for services rendered to the charity.[113] Schedule J requires a detailed breakdown of the compensation components, such as deferred and incentive compensation.[114] It also requires disclosure of lavish benefits such as first class travel, discretionary spending accounts, and housing allowances.[115] Finally, charities must explain the compensation-setting process, including whether they use salary surveys and independent decision-makers.[116]

Form 990 must be made available for public inspection upon request.[117] This requirement permits watchdog organizations to aggregate and publish the returns of most charities on their websites in a searchable format.[118] They periodically generate reports revealing the most highly

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109 I.R.C. § 6033(a)(3)(A) (2018).

110 *Id.* § 6033(b)(7); Treas. Reg. § 1.6033-2(a)(2)(ii)(h) (2019). A "key employee" is one who (i) earns more than $150,000 in reportable compensation from the organization and related organizations; (ii) has responsibilities resembling those of directors or officers, or oversees ten percent or more of the organizational operations or budget; and (iii) is among the highest-compensated twenty employees. *Instructions for Form 990*, INTERNAL REVENUE SERV. 65 (2017), https://www.irs.gov/pub/irs-pdf/i990.pdf.

111 *Form 990*, INTERNAL REVENUE SERV. 7 (2018), https://www.irs.gov/pub/irs-pdf/f990.pdf.

112 *Id*.

113 *Id*. at 8.

114 *Schedule J Form 990*, INTERNAL REVENUE SERV. 2 (2018), https://www.irs.gov/pub/irs-pdf/f990sj.pdf.

115 *Id*. at 1.

116 *Id.*

117 Treas. Reg. § 301.6104(b)-1(d)(1) (2019).

118 *See* GUIDESTAR USA, INC., https://www.guidestar.org (last visited Oct. 1, 2019); CHARITY NAVIGATOR, https://www.charitynavigator.org (last visited Oct. 1, 2019).

compensated charity executives.[119] Many watchdogs also maintain a ratings system for larger charities, complete with gold stars or other accolades for high-rated organizations.[120] These rating systems seldom assess executive compensation per se, instead focusing on the ratio of programmatic expenses to management and fundraising expenses.[121] This ratio comes directly from the Form 990, where charities must allocate each expenditure line item among these categories.[122] The I.R.S. instructions indicate that executive salaries generally belong in the management category, unless "a part of their time is spent directly supervising program services or fundraising activities," in which case the allocation should be based on how the executives divide their time.[123] This nebulous distinction between program and management activities means that charities often have some latitude to allocate executive compensation in a manner that positively affects their ratings.[124]

B. *Assessment of the Public Disclosure Regime*

The public disclosure mechanism effectively appoints donor perception as the metric of reasonable compensation. This conveniently removes the thorny task of metric determination from the government's purview, but raises the normative question of whether donor perception is a

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119 *See Top Compensation Packages*, CHARITY WATCH, https://www.charitywatch.org/top-charity-salaries (last visited Oct. 1, 2019).

120 Charity Navigator rates organizations with at least $1 million in revenues on a 100-point scale. It gives charities up to four stars based on a 100-point rating system, but will only rate charities that meet longevity, revenue, public support, and other criteria. *Charity Navigator's Methodology*, CHARITY NAVIGATOR, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=5593 (last visited Oct. 18, 2019). Charity Watch focuses charities with over $1 million in revenues that have been operating for at least three years. It gives a letter grade to charities based on their financial efficiency. *Frequently Asked Questions*, CHARITY WATCH, https://www.charitywatch.org/about-charitywatch/faq#charity_selection (last visited Oct. 18, 2019); *Our Charity Rating Process*, CHARITY WATCH, https://www.charitywatch.org/our-charity-rating-process (last visited Oct. 18, 2019).

121 *Financial Score Conversions and Tables*, CHARITY NAVIGATOR (last updated June 1, 2016), https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48#PerformanceMetricOne; *Criteria & Methodology*, CHARITYWATCH, https://www.charitywatch.org/about-charitywatch/criteria-methodology/3113/3147 (last visited Nov. 7, 2019).

122 *Form 990*, *supra* note 111, at 10.

123 *Instructions for Form 990*, *supra* note 110, at 42.

124 *The Quality of Financial Reporting by Nonprofits: Findings & Implications*, URBAN INST. 1-2 (Aug. 2004), https://www.urban.org/sites/default/files/publication/57736/311045-The-Quality-of-Financial-Reporting-by-Nonprofits.PDF. The Urban Institute's study of nine organizations of all sizes found that, at most sites, "one or two staff members make a retrospective judgment once per year about how everyone spent their time, and this is the basis for the functional allocation of personnel costs" for the Form 990. *Id.* The report noted that nonprofits are "responding to perceived and explicit pressure to keep real and reported administrative and fundraising costs low." *Id.*

satisfactory barometer. Although donors disproportionately subsidize charities through their contributions, non-donating taxpayers ultimately subsidize charity compensation as well. Relying on donors to identify overcompensation presumes that they can meaningfully stand in for the interests of all taxpayers.

Donor market ordering also presents practical problems, since donor backlash against overcompensation only materializes in the rare event of mass media coverage.[125] For example, donations to the Wounded Warrior Project plummeted after the *New York Times*'s front-page exposé of extravagant pay and other spending.[126] Without media attention, however, compensation practices have no statistically significant effect on donations.[127] The reasons for this non-effect can be broadly classified as donor information deficits and donor outrage deficits.

Most donors have informational deficits with respect to charity compensation. For small or unsophisticated donors, performing due diligence is simply not cost-effective.[128] Even donors who research the compensation figures may have difficulty assessing whether they are commensurate with the executives' responsibilities and performance. As Hansmann pointed out in his discussion of contract failures, donors seldom have firsthand knowledge of operations.[129] Donors may refer to charity ratings, if available, but ratings usually do not dig deeper than the charity's reported expenditure breakdown. This information may be meaningful in some cases, but in other cases may give acclaim to operations that spend liberally but ineffectually. Often, a donor in search of information about the charity's mission outcomes must rely on annual reports and other charity-generated publications, which may project a misleading image by highlighting anecdotes over data, opportunistically selecting metrics, and omitting caveats. These information deficits impair donors' ability to assess and react to compensation levels.

Outrage deficits mean that donors continue to contribute to charities despite knowledge of lavish executive compensation. There are several potential explanations for this. First, donors may not be troubled by

125 Steven Balsam & Erica E. Harris, *The Impact of CEO Compensation on Nonprofit Donations*, 28 ACCT. REV. 425, 437 (2014) (showing a strong and statistically significant negative correlation between media coverage of high compensation and subsequent donations).

126 Dave Philipps, *Helping Veterans Recover, Spending Lavishly on Itself*, N.Y. TIMES, Jan. 28, 2016, at A1; Mark Hrywna, *Revenue, Program Spending Decline Again at Wounded Warrior Project*, NONPROFIT TIMES (Apr. 23, 2018), http://www.thenonprofittimes.com/news-articles/revenue-program-spending-decline-wounded-warrior-project/.

127 Balsam & Harris, *supra* note 125, at 437.

128 Balsam & Harris, *supra* note 125, at 439.

129 *Role of Nonprofit Enterprise*, *supra* note 44, at 843.

overcompensation because, unlike in for-profits, it does not come at their expense. Donors may not even mind the diversion of their resources from the charitable mission if they are principally motivated by the promise of public recognition, event invitations, or other perks.[130] Second, donors with a personal affinity for the charity (e.g. because it is their alma mater or religious denomination) may be disinclined to reallocate their funding in response to overcompensation. Third, large donors who balk at paying for high executive compensation can simply require by contract that their donations be allocated elsewhere. Fourth, wealthy donors may be more inclined to perceive even very high compensation as reasonable. This possibility has particular salience because charitable giving is increasingly concentrated among high-income households, a trend that experts expect to accelerate in light of the TCJA's near doubling of the standard income tax deduction.[131] All of these factors can preclude donors from punishing charities that overpay executives.

Despite the evidence that donors are generally unresponsive to executive compensation levels, the disclosure requirement could still constrain compensation by making charities wary of backlash from the media or particularly scrupulous contributors. There is evidence that religiously affiliated colleges and universities with small endowments contain their compensation for fear of alienating donors.[132] This finding suggests a deterrent value to mandatory disclosure, but also highlights that donor market ordering principally affects donor-dependent charities. Yet for many charities, private giving accounts for a minority of overall revenues.[133] The other major sources of nonprofit revenue, government grants and program fees, appear equally insensitive to compensation levels in the absence of media attention.[134] Some charities also enjoy funding

[130] Rene Bekkers & Pamala Wiepking, *A Literature Review of Empirical Studies of Philanthropy: Eight Mechanisms That Drive Charitable Giving*, 40 NONPROFIT & VOLUNTARY SECTOR Q. 924, 934-37 (2011).

[131] *Charitable Giving and Tax Incentives*, INDIANA U. LILLY FAM. SCH. PHILANTHROPY 6 (2019), https://scholarworks.iupui.edu/bitstream/handle/1805/19515/tax-policy190603.pdf?sequence=4&isAllowed=y.
The increase is effective for eight years, until 2026, unless it is extended. Pub. L. 115-97, 131 Stat 2054
§ 11021(a) (2017).

[132] Galle & Walker, *supra* note 99, at 1919.

[133] Brice S. McKeever, *The Nonprofit Sector in Brief 2015: Public Charities, Giving, and Volunteering*, URB. INST. 5 (Oct. 2015), https://www.urban.org/research/publication/nonprofit-sector-brief-2015-public-charities-giving-and-volunteering. The data showed that, among public charities, private charitable contributions comprised merely 13.3% of revenues. This figure, however, is driven largely by universities and hospitals receiving a high proportion of tuition payments, patient fees, and Medicaid and Medicare payments.

[134] Balsam & Harris, *supra* note 125, at 441.

from endowments and long-term institutional grants, and therefore do not rely on ongoing donor goodwill.

Public disclosure as a mechanism to regulate charity executive compensation relies on the judgment, motivation, and market power of donors. Due to donor information and outrage deficits, transparency is unlikely to operate as an effective check on executive compensation. The weakness of market-based accountability reinforces the need for an effective regulatory structure to ensure that compensation practices do not subvert the purpose of the charitable tax exemption.

V. SECOND MECHANISM: REGULATORY ENFORCEMENT ACTIONS

The second constraint on compensation is regulatory enforcement. The Code directly prohibits private inurement and permits executives to receive only reasonable compensation. Violations can result in substantial financial penalties and/or the loss of tax-exempt status. Part V.A describes the legal framework in depth. Part V.B examines the merits and weaknesses of this mechanism.

A. *Regulatory Enforcement Regime Overview*

For over a century, Congress has conditioned charitable tax exemption on the absence of private inurement.[135] This term refers to the diversion of charitable resources to individuals with "a personal and private interest in the activities of the organization,"[136] including executives.[137] Inurement may take a variety of forms, including loans with unusually lenient terms,[138] payment of inflated rent,[139] and insider use of charity-owned vehicles and housing.[140] Early private inurement cases mostly dealt with

[135] *See, e.g.*, Corporate Tax Act of Aug. 5, 1909, ch. 6, 36 Stat. 112 (1909); Revenue Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 166 (1913). The prohibition on inurement also expressly applies to nine of the twenty-seven other categories of exempt organizations. I.R.C. §§ 501(c)(3), (4)(B), (6), (7), (8), (11)(A), (13), (19)(C), (26)(D), (29)(B)(ii) (2018). Subsection (20) was repealed in 2014.

[136] Treas. Reg. § 1.501(a)-(1)(c) (2019).

[137] The I.R.S. considers the rules on private inurement applicable to highly-paid employees who are not directors or officers. *See, e.g.* I.R.S. Gen. Couns. Mem. 39,498 (Apr. 24, 1986) (applying the inurement ban to hospital physicians); I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987) (applying the inurement ban to college athletic coaches). The Tax Court, however, has repudiated the application of the inurement rules to mere employees, opting instead to apply the private benefit doctrine. *See, e.g.* Senior Citizens of Mo., Inc. v. Comm'r, 56 T.C.M. (CCH) 480 (1988).

[138] Orange Cty. Agr. Soc., Inc. v. Comm'r, 893 F.2d 529, 534 (2d Cir. 1990).

[139] Tex. Trade Sch. v. Comm'r, 272 F.2d 168 (5th Cir. 1959).

[140] Founding Church of Scientology v. United States, 412 F.2d 1197, 1201 (Ct. Cl. 1969).

annuity payments to insiders,[141] but by the 1940s and 1950s, regulators had turned their attention to compensation as a potential source of inurement.[142]

The I.R.S. has articulated three factors relevant to whether compensation arrangements violate the ban on inurement: (i) the underlying purpose of the compensation; (ii) the process by which the compensation was decided; and (iii) the reasonableness of the compensation amount.[143] Agency and court decisions consistently consider these factors, but without any explicit balancing test or order of priority.

The first factor is whether the purpose of the compensation package is to procure services or merely disguise the distribution of profits.[144] This can be inferred from the circumstances and structure of the compensation. For example, a long-term contract that guarantees fixed compensation irrespective of performance is considered a distribution of profits.[145] Similarly, a significant increase in compensation without a commensurate expansion of responsibilities is likely to be construed as a distribution of profits.[146] This inquiry calls for particular scrutiny of incentive compensation structures that calculate pay based on financial performance.[147] For years, the I.R.S. vacillated between per se rejection

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141 *See, e.g.*, Lederer v. Stockton, 43 S. Ct. 5 (1922) (allowing an exemption despite the payment of annuities); Scholarship Endowment Found. v. Nicholas, 106 F.2d 552 (10th Cir. 1939) (rejecting an exemption due to the payment of annuities); Orton v. C.I.R., 9 T.C. 533, 542 (1947) (allowing an exemption despite the payment of annuities where the "clear and predominant purpose [is] to aid the charity and where the noncharitable benefits are incidental to that purpose").

142 *See, e.g.*, Home Oil Mill v. Willingham, 68 F. Supp. 525, 529 (N.D. Ala. 1945) (holding that a charitable trust's payment of "reasonable and . . . fair" compensation to the grantor's sister in exchange for her active management of the trust did not defeat the exemption), *aff'd*, 181 F.2d 9 (5th Cir. 1950), *cert. denied*, 340 U.S. 852; Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953) (denying an exemption due to an excessive fixed salary paid to the founder).

143 I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987); Rev. Rul. 69-383, 1969-2 C.B. 113 (articulating the three-factor test).

144 Rev. Rul. 69-383, 1969-2 C.B. 113.

145 *Mabee*, 203 F.2d at 876 (holding that the "purported salary payments were not intended merely to compensate him for services to be rendered, but were really authorized to assure him substantial distributions . . . in the form of salary"). The contract in question had a term of fifteen years, which would have taken the executive to the age of eighty-two.

146 *See, e.g.*, *Founding Church of Scientology*, 412 F.2d at 1201 (surmising that the steady increase in L. Ron Hubbard's compensation, which took the form of fees, loans, and commissions as well as base salary, reflected Hubbard's influence in the organization rather than any growth in his responsibilities); Incorp. Trs. of the Gospel Worker Soc'y v. United States, 510 F. Supp. 374, 379 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. denied*, 456 U.S. 944 (1982) (finding that 300%, 350%, and 600% increases in compensation over eight years reflected the organization's improved fundraising capacity rather than an expansion of individual responsibilities).

147 People of God v. Comm'r, 75 T.C. 127, 132 (1980) (holding in the case of a minister who received a percentage of tithes, that "[w]hatever [the minister]'s services are worth, they are not directly related to [the church]'s gross receipts; the value of solace and spiritual

and conditional acceptance of such incentive structures.[148] Since the 1980s, however, it has generally accepted incentive arrangements that have a predetermined ceiling[149] and depend on individual achievement rather than organizational or exogenous factors.[150]

The second factor focuses on how the compensation was determined. The I.R.S. considers the number of decision-makers, their relationship to the executive, and the bargaining process. If the compensation arrangement did not result from arms-length bargaining,[151] the organization

leadership cannot be measured by the collection box”).

148 *See, e.g.* Rev. Rul. 69-383, 1969-2 C.B. 113 (permitting an exempt hospital to compensate a radiologist with a percentage of departmental gross proceeds after determining that the amount was reasonable and the arrangement was negotiated at arm’s length); I.R.S. Gen. Couns. Mem. 35,865 (Jun. 21, 1974) (deeming profit-sharing plans per se inurement); I.R.S. Gen. Couns. Mem. 37,180 (Jun. 24, 1977) (finding per se inurement in a deferred compensation plan for hospital physicians that included payment of investment gains and losses, even though the compensation amount and manner of adoption met I.R.S. standards); I.R.S. Gen. Couns. Mem. 38,283 (Feb. 15, 1980) (reversing the Service’s previous position and concluding that incentive compensation in which profits are a factor does not automatically constitute inurement); I.R.S. Gen. Couns. Mem. 39,670 (1987) (recognizing that deferred compensation may be invested without violating the inurement); I.R.S. Gen. Couns. Mem. 39,674 (Jun. 17, 1987) (allowing profit-sharing plans if they otherwise satisfy a three-part test).

149 *People of God*, 75 T.C. at 132 (“By basing [the executive’s] compensation upon a percentage of . . . gross receipts, apparently subject to no upper limit, a portion of [the organization]’s earnings is being passed on” to the executive as private inurement.); I.R.S. Priv. Ltr. Rul. 201235021 (Jun. 4, 2012) (An organization pledged to pay twenty percent of its donations to a related organization for technology and administrative services. The “lack of cap limit entails that [a related company] can receive unlimited income that will more than compensate [the company] for the services [it] renders to you.”); I.R.S. Gen. Couns. Mem. 38,322 (Mar. 24, 1980) (compensating a trust administrator and general counsel with a set percentage of contributions constituted inurement in part because “[n]o ceiling or maximum payment was imposed on the amount of compensation”); I.R.S. Advisory Letter 2002-0021 (Jan. 9, 2002) (IRS advisory letter indicating that a ceiling on compensation is one factor in determining whether a physician’s compensation amounts to inurement); *see also Instructions for Form 990*, INTERNAL REVENUE SERV. 42 (2017), https://www.irs.gov/pub/irs-prior/i990—2017.pdf (“The fact that a bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation.”).

150 I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) (disallowing payment to physicians based on hospital or departmental earnings and contrasting the decision with that of Rev. Rul. 69-383, which approved a compensation arrangement where a hospital paid a radiologist a fixed percentage of his individual gross billings); *World Family Corp.*, 81 T.C. at 970 (approving the payment of commissions to individuals based on the amount they personally procured for the organization and distinguishing the instant case from situations where an individual received commissions based on total fundraising regardless of personal performance).

151 I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987); *World Family Corp.*, 81 T.C. at 969 (“We must consider then whether a commission which may be reasonable when paid to an unrelated third party becomes unreasonable when paid to an individual having a personal and private interest in the payor organization. Although in some circumstances such a finding may be warranted, it is clear that payment to an interested individual does not make

may bear a higher burden of proof to demonstrate that the arrangement is reasonable.[152] The I.R.S. applies particular scrutiny to organizations dominated by a single individual or small group of individuals.[153]

The third factor is the reasonableness of the compensation amount.[154] Reasonableness is "purely a question of fact to be resolved in the light of all the evidence."[155] For decades, decisions offered little consistent reasoning or usable guidance on what constituted reasonable compensation, except to suggest that insider pay should not consume all organizational earnings.[156] Some decisions referenced Section 162 of the Code, which allows businesses a tax deduction for "reasonable . . . salaries or other compensation for personal services actually rendered[.]"[157] Under Section 162, reasonable compensation means the amount that would "ordinarily be paid for like services by like enterprises under like circumstances."[158] In 1996, Congress effectively endorsed this definition when it legislated a safe harbor for charities that could demonstrate their payment of fair market value.[159]

Upon a finding of private inurement, the I.R.S. may revoke the organization's exempt status, but this is relatively rare. Between 2011 and 2013, the I.R.S. revoked the exempt status of fewer than 100 organizations

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a commission unreasonable as a matter of law.").

152 *Orange Cty. Agr. Soc., Inc.*, 893 F.2d at 534 ("The burden of proof is on the taxpayer to demonstrate that insiders do not benefit from the tax-exempt organization, especially where the facts indicate transactions arguably not on arm's length terms.").

153 *See, e.g.*, Bubbling Well Church of Universal Love, Inc. v. Comm'r, 74 T.C. 531, 535 (1980) (finding an "obvious opportunity for abuse" where a single family comprised the entire voting board of directors and staff), *aff'd*, 670 F.2d 104 (9th Cir. 1981).

154 I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987).

155 *Bubbling Well Church*, 74 T.C. at 537–38.

156 In a number of cases, courts held that the organization had failed to provide adequate justification for compensation that consumed a high proportion of earnings. *See, e.g.*, *Bubbling Well Church*, 74 T.C. at 535; Church of the Transfiguring Spirit, Inc. v. Comm'r, 76 T.C. *1, *5-6 (1981); *see also* Brian Ruud Int'l v. United States, 733 F. Supp. 396, 402 (1989) (finding that compensation was reasonable in amount because it was "relatively modest" compared to the organization's earnings). Others deemed compensation reasonable without further explanation. *See, e.g.*, Saint Germain Found. v. Comm'r, 26 T.C. 648, 659 (1956) (finding the organization's payment of personal living expenses in lieu of salary "to be reasonable in every respect").

157 *See, e.g.*, Senior Citizens of Mo., Inc. v. Comm'r, 56 T.C.M. (CCH) 480, 480 (1988); Enter. Ry. Equip. Co. v. United States, 161 F. Supp. 590, 595 (Ct. Cl. 1958) (referencing the analogous section on business deductions of the previous internal revenue law).

158 Treas. Reg. § 1.162-7(b)(3) (2019).

159 Interestingly, decisions had long cited fair market value as the determining factor in whether the sale of assets created inurement, but this was not regularly applied to the analysis of compensation. *See, e.g.*, Anclote Psychiatric Ctr., Inc. v. Comm'r, 76 T.C.M. (CCH) 175, at *9 (1998) (to avoid inurement, the price of assets sold to an insider must be "within a reasonable range of what could be considered fair market values").

for private inurement and related problems.[160] In lieu of, or in addition to, revocation, the I.R.S. may impose potentially severe financial penalties for excessive compensation. These penalties depend on whether the Code characterizes the organization as a public charity or a private foundation.

1. Public Charities

Public charities that overcompensate their executives may be penalized with "intermediate sanctions."[161] Enacted by Congress in 1996, the intermediate sanctions regime allows the I.R.S. to penalize private inurement without necessarily resorting to revocation of tax-exempt status.[162] Intermediate sanctions apply to any "excess benefit transaction" between a public charity and a "disqualified person."[163] An excess benefit transaction is one where "the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."[164] Consideration in this context includes all forms of cash and noncash compensation, including salary, fees, bonuses, severance, taxable fringe benefits, expense allowances, below-market loans, and vested benefits under a qualified pension, profit sharing, or stock bonus plan.[165] Executives generally count as disqualified persons,[166] but the Code is primarily concerned with insider

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160 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-164, TAX-EXEMPT ORGANIZATIONS 23 (2014) [hereinafter G.A.O. Report]. This figure includes revocations premised on both private inurement and private benefit.

161 Treas. Reg. §§ 53.4958-2(a)(1); 53.4958-2(a)(2)(i) (excepting private foundations from the intermediate sanctions rules).

162 Caracci v. Comm'r, 118 T.C. 379, 417 (2002), *rev'd on other grounds* 456 F.2d 444 (5th Cir. 2006); H.R. REP. NO. 104-226, at 55 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1177–78 (explaining that before the enactment of intermediate sanctions to penalize private inurement, the only sanction provided by law was revocation of the organization's exempt status).

163 I.R.C. § 4958(a)(1) (2018).

164 *Id.* § 4958(c)(1)(A).

165 *Id.*; Treas. Reg. §§ 53.4958-1(e)(2), 53.4958-4(b)(1)(ii)(B).

166 I.R.C. § 4958(f)(1). Disqualified persons include "any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization," a family member of such a person, or an entity that is at least thirty-five percent controlled by disqualified persons. *Id.* The regulations simplify the disqualified person test by creating three categories. The first category, consisting of the president, CEO, COO, CFO, treasurer, voting members of the governing body, and others performing similar functions are automatically considered disqualified persons. Treas. Reg. § 53.4958-3(c). The second category, which includes organizations exempt under Section 501(c)(3) of the Code and employees who receive less than the I.R.S. indexed amount for "highly compensated employees," and are not otherwise considered disqualified persons, are automatically excluded from the definition of disqualified persons. *Id.* § 53.4958-3(d)(1), (3). The third category encompasses all other persons. In this catch-all category, all the facts and circumstances are considered in a determination of whether a person is disqualified. *Id.* § 53.4958-3(e)(1).

rent-seeking and exempts most new recruits from outside the organization.[167]

Intermediate sanctions consist of two tiers of taxation on the excess benefit amount.[168] The initial tier is a twenty-five percent tax charged to the disqualified person[169] and a ten percent tax charged to each organization manager who knowingly approved or acquiesced to the transaction.[170] The second tier—a 200% tax on the excess benefit amount, payable by the disqualified person—applies if the charity does not correct the transaction before the I.R.S. assesses the initial tax.[171] Correction generally involves reversing the transaction and restoring the charity to the position it would have occupied had the transaction never occurred.[172] If the charity indemnifies the disqualified person or managers against intermediate sanctions, the I.R.S. will consider the amount of the indemnity to be additional compensation.[173]

Charities that follow certain procedures are entitled to a rebuttable presumption that their transactions do not confer an excess benefit.[174] These procedures are: (i) approval by disinterested decision-makers; (ii) use of comparative data demonstrating that the transaction is market-rate; and (iii) concurrent documentation of the decision.

First, the board (or a board-authorized committee) must approve the compensation in advance by a vote of its disinterested members.[175] Members must recuse themselves if they (i) will participate in or may economically benefit from the transaction; (ii) are in an employment relationship subject to the control of another disqualified person participating in or economically benefiting from the transaction; (iii)

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[167] *Id.* § 53.4958-4(a)(3)(i). The intermediate sanctions regime does not apply to fixed payments made pursuant to an initial contract so long as the compensated individual substantially performs his or her obligations under the contract. *Id.* A "fixed payment" may include contingencies based on objective criteria, including organization or activity revenues, but may not be subject to board discretion. *Id.* § 53.4958-4(a)(3)(ii)(A).

[168] I.R.C. § 4958(a)-(b).

[169] *Id.* § 4958(a)(1).

[170] *Id.* § 4958(a)(2); Treas. Reg. § 53.4958-1(d)(3). Managers may avoid liability if their participation was not willful and was due to reasonable cause. I.R.C. § 4958(a)(2).

[171] I.R.C. § 4958(b), (f)(5).

[172] *Id.* § 4958(f)(6). For example, a disqualified person who received an excessive salary would likely need to repay not only the excess amount, *but also* any interest that the organization would have earned on the excess amount had it been invested rather than paid to the disqualified person.

[173] Treas. Reg. § 53.4958-4(b)(1)(ii)(B)(2)(i). State law generally permits such indemnification so long as the individuals acted in good faith. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (2011); N.Y. NOT-FOR-PROFIT CORP. LAW § 722(a) (McKinney 2014); CAL. CORP. CODE § 5238 (West 2012).

[174] Treas. Reg. § 53.4958-6(a).

[175] *Id.* §§ 53.4958-6(a)(1), 6(c)(1)(i).

receive compensation or other benefits subject to the approval of the disqualified person; (iv) have a material financial interest in the compensation arrangement; or (v) approve the compensation of a disqualified person who has or will approve the member's compensation.[176] These rules are designed to prevent the quid pro quo approval of compensation among insiders.

Second, the governing body must base its decision on information demonstrating that the compensation is fair market value.[177] Generally, this means data showing that comparable organizations provide similar compensation for similar services.[178] Comparability is based on a range of factors, including geographical region, organization size, and the nature of its services.[179] Crucially, comparable organizations need not be tax-exempt.[180] Small organizations, with annual receipts normally less than $1 million, need only to identify three comparable organizations that pay similar compensation in order to take advantage of the presumption of reasonableness.[181] Larger organizations generally rely on salary surveys compiled by independent firms, but may also use "actual written offers from similar institutions competing for [the candidate's] services."[182] Relevant information may also include the availability of similar services in the organization's geographic area (i.e., whether the organization needs to offer enough to entice a candidate—frequently a physician—to relocate).[183] The rules expressly permit the governing body to decide that reasonable compensation falls above (or below) the range of the comparability data, so long as it records the basis for this decision.[184]

Finally, the governing body must fully and concurrently document its decision,[185] including the members who were present and voting, the comparability data and how it was obtained, and any actions taken to manage conflicts of interest.[186] Documentation must occur within sixty days and be deemed accurate by the decision-making body within a reasonable time thereafter.[187] An organization that complies with these steps will enjoy a presumption of reasonable compensation that can only be

176 *Id.* §§ 53.4958-6(a)(1), 6(c)(1)(iii).
177 *Id.* § 53.4958-6(a).
178 *Id.* § 53.4958-6(c)(2)(i).
179 Treas. Reg. § 53.4958-6(c)(2)(i).
180 *Id.*
181 *Id.* § 53.4958-6(c)(2)(ii).
182 *Id.* § 53.4958-6(c)(2)(i).
183 *Id.*
184 *Id.* § 53.4958-6(c)(3)(ii).
185 Treas. Reg. § 53.4958-6(a)(3).
186 *Id.* § 53.4958-6(c)(3)(i); § 53.4958-6(c)(3)–(ii).
187 *Id.* § 53.4958-6(c)(3)(ii).

overcome through an I.R.S. examination.

2. Private Foundations

Private foundations may face penalties for excessive compensation under the Code's self-dealing rules.[188] Section 4941 prohibits transactions between a private foundation and its disqualified persons, but exempts compensation "for personal services which are reasonable and necessary to carrying out the exempt purpose . . . if the compensation (or payment or reimbursement) is not excessive."[189] Section 4941 defines excessive compensation in accordance with Section 162, which governs the deductibility of for-profit business expenses.[190] Unlike the public charity regime, Section 4941 offers no procedural safe harbor or initial contract exception.

Like the intermediate sanctions rules for public charities, the Code imposes two tiers of self-dealing penalties on private foundations. Under the first tier, the self-dealer must pay a ten percent tax on the excess compensation for each year until the self-dealing is corrected or discovered by the I.R.S..[191] Managers complicit in the self-dealing must pay a five percent tax for each applicable year unless their participation was not willful and was due to reasonable cause.[192] If the I.R.S. detects the self-dealing before it has been corrected,[193] the self-dealer and complicit managers are liable for taxes of 200% and 50%, respectively.[194] Manager liability is joint and several, but capped at an aggregate $20,000 for any act of self-dealing.[195] Foundations thus work within a similar legal framework for compensation as their public charity counterparts, but cannot access the rebuttable presumption that compensation is reasonable.

B. Regulatory Enforcement Regime Assessment

The regulatory enforcement regime uses market rate as its metric for reasonable compensation, defining the market to include comparable exempt and non-exempt entities. This metric gives charities discretion to make fact-specific compensation decisions, as well as woo for-profit

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188 I.R.C. § 4941 (2018).

189 *Id.* §§ 4941(a)(1), (d)(2)(E). "Disqualified person" is defined more narrowly in Section 4941 than under Section 4958, encompassing only managers, substantial contributors, and their related businesses and family members. *Id.* § 4941. There is no catchall category for other influential persons.

190 Treas. Reg. § 53.4941(d)-3(c)(1) (referring to Treas. Reg. § 1.162-7).

191 I.R.C. §§ 4941(a)(1), (e)(1).

192 *Id.* § 4941(a)(2).

193 *Id.* §§ 4941(b), (e)(1).

194 *Id.* §§ 4941(b)(1)–(2).

195 *Id.* §§ 4941(c)(1)–(2).

executives with competitive remuneration. In short, it recognizes the reality of a diverse set of organizations with unique needs. Additionally, the procedural safe harbor encourages charities to address the governance failures that impair charities' ability to set appropriate compensation in the first place.

Despite these strengths, the framework presents normative and practical challenges. First, the market rate metric creates a self-perpetuating spiral of inflated compensation that has little to do with performance or economic conditions. Second, analogizing to the for-profit sector is inappropriate due to cross-sector differences in the components of compensation. Third, enforcement is labor-intensive and impractical. This section addresses each problem in turn.

1. The Market Rate Metric

The market rate metric for reasonable compensation facilitates a cycle of ever-increasing pay. This generally occurs through two practices: (i) pegging the executive's pay to the higher end of the market range on the grounds that the executive is above average; and (ii) opportunistically selecting comparability data for higher pay. As this process repeats, "the inflated compensatory arrangements become market rate, and salaries continue to soar."[196]

The first practice consists of targeting executive compensation above the market median. In large organizations that use salary survey data, directors frequently consider their executives to be above average and peg compensation to the higher end of the market compensation band.[197] One hospital survey revealed routine attempts to keep CEOs in the top twenty-five percent of the market data.[198] A similar dynamic occurs in the for-profit sector: when for-profit firms perform well, compensation consultants suggest performance-based compensation above the industry average,[199] and when they perform poorly, consultants nevertheless argue for compensation that reflects prevailing pay in the industry.[200] One study found that the "vast majority of the firms that use peer groups target pay

196 Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit*, 76 FORDHAM L. REV. 735, 740 (2007).

197 Ben Gose & Marisa López-Rivera, *Nonprofit CEO Pay Won't See Big Gains in 2012, Say Experts*, CHRON. PHILANTHROPY (Sept. 20, 2012), https://www.philanthropy.com/article/Nonprofit-CEO-Pay-Won-t-Rise/156113; *see also* Alan M. Cantor, *Nice Work If You Can Get It: Why Foundation CEOs Are Overpaid*, INSIDE PHILANTHROPY (May 3, 2016), http://www.insidephilanthropy.com/home/2016/5/3/nice-work-if-you-can-get-it-why-foundation-ceos-are-overpaid.html#.

198 Gose & López-Rivera, *supra* note 197.

199 *Agency Problem*, *supra* note 76, at 79.

200 *Id.*

levels at or above the 50th percentile."[201]

The safe harbor rules for public charities permit such above-median targeting so long as the charity records the basis for its decision.[202] This latitude may be advantageous where the charity differs in important respects from its peer group or the executive brings unique skills and expertise. Yet while there may be good reasons to target compensation above the median in certain cases, the prevalence of this practice suggests that other organizational and behavioral dynamics may be at work. The literature on public companies suggests a few possible explanations for this "Lake Wobegon effect," a term coined for radio host Garrison Keillor's mythical Minnesota town where "all children are above average."[203] Directors may be reluctant to insult and demotivate executives who believe themselves to be above average with median or below-median pay.[204] Boards also believe that positioning their executives in the top half of their peer group affects market perceptions of firm value.[205] The charitable sector may have an analogous tendency to see executive pay as a signal to certain donors (particularly high-net worth and institutional donors) that an organization is professional, well-managed, and financially sound.

The second practice that inflates compensation is the opportunistic selection of peer groups. This has been observed in the for-profit sector, where compensation committees select peer firms that are larger and perform more strongly.[206] Mandatory peer group disclosure, which the SEC sometimes requires, [207] appears to restrain this tendency somewhat but not entirely.[208] Charities do not have any analogous requirement to disclose their peer groups unless faced with an I.R.S. examination. Smaller charities, which only need to identify three comparable compensation arrangements to take advantage of the safe harbor, may be particularly

201 John M. Bizjak et. al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 153 (2008).

202 Treas. Reg. § 53.4958-6(c)(3)(ii) (2019).

203 *See, e.g.*, *Are CEOs Worth Their Salaries?*, WASH. POST (Oct. 2, 2002), https://www.washingtonpost.com/archive/business/2002/10/02/are-ceos-worth-their-salaries/e548ce2d-b69e-418a-84eb-096d81942759/; Adam Bryant, *Earning It; Flying High on the Option Express*, N.Y. TIMES (Apr. 5, 1998), http://www.nytimes.com/1998/04/05/business/earning-it-flying-high-on-the-option-express.html?pagewanted=all; Peter Whoriskey, *The "Lake Wobegon Effect" Lifts CEOs' Pay*, WASH. POST, Oct. 4, 2011, at A1.

204 Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 521 (2013).

205 Rachel M. Hayes & Scott Schaefer, *CEO Pay and the Lake Wobegon Effect*, 94 J. FIN. ECON. 280, 281 (2009).

206 *See* John Bizjak et. al., *Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design*, 100 J. FIN. ECON. 538, 539 (2011).

207 17 C.F.R. § 229.402(b)(2)(xiv) (2019).

208 Bizjak et. al., *supra* note 206, at 539.

tempted to identify above-average compensation arrangements.[209]

2. The For-Profit Analogue

Public charities may justify their compensation levels based on those of exempt and non-exempt organizations—including for-profit companies. While experts generally advise against relying exclusively on for-profit comparability data,[210] any inclusion is likely to skew the data upwards.[211] This may facilitate charity recruitment of business executives, but it also imports inapplicable components of for-profit compensation into the subsidized charitable sector.

An ostensible benefit of the for-profit analogue is in allowing charities to compete for talent and attract high-caliber leadership. Pay parity can help medical research charities recruit candidates from high-paying biotechnology firms, and foundations may find it easier to attract financial managers with for-profit banking and investment experience. Yet the importance of matching for-profit pay should not be overstated. Charity executives value their positions for a range of pecuniary and non-pecuniary reasons, including the gratification of charitable work.[212] Despite the existing pay gap between the nonprofit and for-profit sectors, over two-thirds of nonprofit executives report satisfaction with their compensation.[213] Overwhelmingly, nonprofits report that executive retention is not a challenge, and only seven percent describe it as

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209 Manny, *supra* note 196, at 740.

210 *See, e.g.*, Gerald M. Griffith, *The Dollars and Sense of Executive Compensation*, 9 COMPLIANCE TODAY 20, 25 (Apr. 2009), https://www.jonesday.com/files/Publication/6c2193f4-d546-419e-99d8-fe2c13fb2a9d/Presentation/PublicationAttachment/966d1b03-ffa9-49e2-bbda-054707127416/ct0407_GriffithKing.pdf; Eileen Morgan Johnson, *Executive Compensation for Exempt Organizations*, WHITEFORD, TAYLOR & PRESTON, L.L.P. 3 (2006), http://www.wtplaw.com/sites/default/files/document_pdf/article/executive_compensation_for_exempt_organizations_2.pdf.

211 Bureau of Labor Statistics, *Nonprofit Pay and Benefits: Estimates from the National Compensation Survey*, MONTHLY LABOR REV. (Jan. 2016), http://www.bls.gov/opub/mlr/2016/article/nonprofit-pay-and-benefits.htm (reporting a compensation differential of $4.67 per hour between nonprofit and for-profit management and professional workers). A study comparing charity and for-profit executive compensation would likely show a far greater difference.

212 *Keep Charity Charitable*, *supra* note 36, at 1223.

213 Bureau of Labor Statistics, *supra* note 211. (reporting an average compensation differential of $4.67 per hour between "management, professional, and related workers" in nonprofit and for-profits). Because the nonprofit sector is broader than the charitable sector and includes, for example, political organizations and labor unions, this figure is likely to underestimate of the wage difference between charity and for-profit leaders. Marla Cornelius, *Demographics & Salary*, DARING TO LEAD (June 13, 2011), http://daringtolead.org/demographics/demographics-salary/. Only ten percent of executives were "not at all" satisfied, which corresponds to the percentage of respondents earning less than $30,000. *Id.*

"significantly challenging."[214] This suggests that while the ability to pay competitive rates may be an advantage, matching for-profit pay is generally not vital to attracting and retaining executive talent.

For-profit compensation is a flawed analogue for charitable compensation due to cross-sector differences in the appropriate components of remuneration. Three elements in particular are not transferable to the charitable sector: (i) profits distribution, which is forbidden to charities; (ii) cash premiums to compensate for the risk of accepting equity compensation, which has no application to charities; and (iii) unearned rents, which are normatively less acceptable in the charitable sector. Because these components are not neatly labeled as such, it is virtually impossible to extricate them from the overall for-profit compensation amounts in order to determine appropriate charity compensation levels.

Profits Distribution. Charities are forbidden to allocate net earnings to executives or other insiders. The prohibition on private inurement is strictly construed, precluding even executive compensation tied to organization revenues or other performance measures.[215] Business compensation, on the other hand, is often inextricably tied to profits distribution.[216] For-profit executives frequently receive a combination of base salary, benefits, bonuses, stock, and stock options.[217] It would be convenient to presume that base pay represents the value of services while equity and bonuses represent profits distribution, but companies frequently switch between these forms of compensation based on exogenous factors. For example, the Great Recession prompted a surge in equity grant compensation, but businesses largely reverted to cash in 2014 amid fears that the market had peaked.[218] This increase in cash compensation did not reflect an abrupt increase in the value of the executives' services. Similarly, equity compensation skyrocketed in the 1990s after Congress enacted favorable tax treatment for performance-based remuneration,[219] but the TCJA's repeal of that provision has at least some companies

[214] *2013 Nonprofit Employment Trends Survey*, NONPROFIT H.R. SOLUTIONS 21 (2013), http://www.nonprofithr.com/wp-content/uploads/2013/03/2013-Employment-Trends-Survey-Report.pdf. They overwhelmingly reported greater retention problems in low- and mid-level positions than in experienced and executive positions. *Id.* at 19.

[215] *See* World Family Corp. v. Comm'r, 81 T.C. 958, 968 (1983); I.R.S. Gen. Couns. Mem. 39,670 (Oct. 14, 1987).

[216] Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 HAW. L. REV. 425, 465 (1999).

[217] Jeppson et. al., *supra* note 79, at 83–84.

[218] Theo Francis & Joann S. Lublin, *CEOs Awarded More Cash Pay*, WALL ST. J. (Apr. 21, 2015), http://www.wsj.com/articles/ceos-awarded-more-cash-pay-1429608602.

[219] Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y. 283, 289–91 (2005).

reconfiguring their compensation packages to increase base salaries and curb bonus arrangements.[220] Profits distribution is not easily divisible from the rest of the compensation package, and using for-profit compensation as a benchmark risks incorporating profits distribution into charity compensation.

Risk Premiums. As discussed in Part III, optimal contracting theorists claim that providing equity compensation to executives necessitates an additional cash premium to offset the resulting non-diversification burden.[221] This notion purported to explain why the 1990s spike in equity compensation was accompanied by an immense surge in cash compensation.[222] To the extent that this explanation bears out, it has no application to the charitable sector. Since charities cannot provide equity compensation, there is no rationale for a compensatory risk premium.

Unearned Rents. There is evidence to support the managerial power theory contention that executives extract at least some rents from for-profit businesses.[223] To the extent that this occurs, such arrangements do not reflect reasonable compensation for services, but weaknesses in corporate governance and organizational dynamics. Transferring the value of such arrangements wholesale to the charitable sector, as permitted by current regulations, would result in the diversion of taxpayer-subsidized charitable resources into the hands of private executives. While rent extraction is sub-optimal in any organization, including for-profit companies, it is normatively even less appropriate for charities due to their tax subsidization and the lack of recourse available to beneficiaries.

3. Enforceability

The I.R.S. does not—and will not for the foreseeable future—enforce the private inurement rules with sufficient vigor to secure compliance or even ascertain the scale of the problem.[224] Because most charities can access the presumption of reasonable compensation by following simple procedures, regulatory enforcement involves a fact- and resource-intensive investigation.[225] The I.R.S. must review the organization's procedures and

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220 Renae Merle, *Skyrocketing Executive Pay Packages Are About to Become More Costly for Corporate America*, WASH. POST. (Jan. 3, 2018), https://www.washingtonpost.com/news/business/wp/2018/01/03/skyrocketing-executive-pay-packages-are-about-to-become-more-costly-for-corporate-america/?utm_term=.8c6bd3185598.

221 Hall & Murphy, *supra* note 74, at 5.

222 Bebchuk & Grinstein, *supra* note 219, at 291.

223 *See, e.g.*, van Essen et. al., *supra* note 95, 183–84; Chongwoo Choe et. al., *CEO Power and the Structure of CEO Pay*, 35 INT'L REV. FIN. ANALYSIS 237–48 (2014) (finding support for the managerial power theory in the relationship between power and pay).

224 G.A.O. Report, *supra* note 160, at 40–41.

225 *See infra* Part V.

comparability data, determine whether the organization is in fact entitled to the presumption, and, if so, amass sufficient rebuttal evidence to impose penalties.[226] At present, I.R.S. resource constraints prevent this sort of investigation from occurring at a meaningful scale.

The I.R.S. operates under ever-tightening budgetary constraints that have decimated enforcement.[227] Between 2010 and 2016, its workforce shrank by 17,000 employees.[228] In roughly the same period, funds for employee training declined by nearly seventy-five percent.[229] These trends have particularly strained the enforcement capabilities of the Tax Exempt and Government Entities Division (TEGE).[230] From 2011 to 2016, funding declined by twenty percent and staffing by twenty-seven percent.[231] The rate of I.R.S. charity examinations is anemic and falling.[232] In 2017, the I.R.S. examined just one-fifth of one percent of charity tax returns,[233] and completed only 109 examinations of charities for private inurement issues.[234] The examination rate is likely to further decline as the I.R.S. recognizes around 80,000 new charities each year.[235]

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[226] *Id.*

[227] Chuck Marr & Cecile Murray, I.R.S. *Funding Cuts Compromise Taxpayer Service and Weaken Enforcement*, CTR. ON BUDGET AND POLICY PRIORITIES (Apr. 4, 2016), http://www.cbpp.org/research/federal-tax/irs-funding-cuts-compromise-taxpayer-service-and-weaken-enforcement.

[228] *Hearing Before the Senate Fin. Comm.*, 114th Cong. 1 (2016) (written testimony of John A. Koskinen, Comm'r. of Internal Revenue), http://www.finance.senate.gov/imo/media/doc/2016%20JAK%20testimony%20SFC%20on%20FY17%20budget%20021016x.pdf.

[229] NAT'L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 86 (2017), https://taxpayeradvocate.irs.gov/reports/2017-annual-report-to-congress/full-report.

[230] *See, e.g.*, Josh Hicks, *Shrinking I.R.S. Struggles to Keep Pace with Growing Number of Tax-Exempt Charities*, WASH. POST (Jan. 9, 2015), https://www.washingtonpost.com/news/federal-eye/wp/2015/01/09/shrinking-irs-struggles-to-keep-up-with-growing-number-of-tax-exempt-charities/.

[231] Robert O'Harrow, Jr., *Fallout from Allegations of Tea Party Targeting Hamper I.R.S. Oversight of Nonprofits*, WASH. POST (Dec. 17, 2017), https://www.washingtonpost.com/investigations/fallout-from-allegations-of-tea-party-targeting-hamper-irs-oversight-of-nonprofits/2017/12/17/6403c1c0-c59e-11e7-a441-3a768c8586f1_story.html?utm_term=.5de5269dc993.

[232] G.A.O. Report, *supra* note 160, at 1–2.

[233] The I.R.S. examined 2,375 returns in fiscal year 2017. *Data Book, 2017, Pub. 55B*, INTERNAL REVENUE SERV. 1, 34 (Mar. 2018), https://www.irs.gov/pub/irs-soi/17databk.pdf. There were 1,286,181 recognized charities in this period. *Id.* at 57.

[234] *Tax Exempt and Government Entities FY 2017 Accomplishments*, INTERNAL REVENUE SERV. 1, 3–4 (Mar. 19, 2018), https://www.irs.gov/pub/irs-tege/tege_fy2017_accomplishments.pdf. Three of these examinations resulted in revocation. *Id.* It is unknown how many resulted in financial penalties.

[235] FY2017 had 79,699 approvals. *Data Book, 2017, Pub. 55B*, *supra* note 233, at 52. FY2016 had 79,545 approvals. *Data Book, 2016, Pub. 55B*, INTERNAL REVENUE SERV. 1, 52 (Mar. 2017), https://www.irs.gov/pub/irs-soi/16databk.pdf. FY2015 had 86,915 approvals. *Data Book, 2015, Pub. 55B*, INTERNAL REVENUE SERV. 1, 54 (Mar. 2016),

In response to resource constraints and the political fallout of allegations that the TEGE unfairly targeted conservative organizations for scrutiny,[236] the TEGE has turned to technology to guide its review of charities.[237] The TEGE has also begun implementing a data-driven process of selecting charities to examine.[238] Rather than targeting particular sub-sectors based on the perceived prevalence of abuse, the TEGE will use data analytics to identify likely violations from Form 990 responses and discrepancies.[239] It is not yet known whether data-driven targeting of examinations will offset the decline in trained examiners and examinations. Previous attempts at streamlining exempt organization oversight have not been an unqualified success. In 2014, the TEGE introduced a dramatically simplified online application for exemption,[240] which the I.R.S.'s own studies show has resulted in an erroneous approval rate of over forty percent.[241] Even if the TEGE's analytic targeting is effective in identifying likely violators, it will still need to conduct a time- and labor-intensive examination to rebut the presumption of reasonableness and impose sanctions. If current trends in I.R.S. funding persist, charities are unlikely to face accountability through this mechanism.

VI. THIRD MECHANISM: THE TCJA EXCISE TAX

The third constraint on compensation is the TCJA's across-the-board excise tax on remuneration in excess of $1 million. In some respects, this is the most promising measure to date, offering a consistently enforceable

https://www.irs.gov/pub/irs-soi/15databk.pdf.

[236] The "I.R.S. targeting scandal" alleged that the TEGE unfairly targeted groups affiliated with the Tea Party movement that applied for tax exemption under Section 501(c)(4) of the Code. Some conservative commentators likened the accusations to Watergate and called for abolition of the agency. O'Harrow, *supra* note 231.

[237] Ruth McCambridge & Virginia Gross, *Changes in the I.R.S. Oversight of Nonprofits: A Conversation with Virginia Gross*, NONPROFIT Q. (Aug. 8, 2016), https://nonprofitquarterly.org/2016/08/08/changes-irs-501-c-3-oversight-nonprofits/. The targeting scandal involved the I.R.S. applying disproportionate scrutiny to "tea party" advocacy organizations as they proliferated in 2013.

[238] McCambridge & Gross, *supra* note 237.

[239] *Id.*

[240] Form 1023-EZ is permitted for organizations that project average annual revenues of no more than $50,000 for their first three years and meet a variety of other standards. *2017 Annual Report to Congress*, TAXPAYER ADVOCATE SERV. 1, 64 n.2 (2017), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2017-ARC/ARC17_Volume1_MSP_05_ExemptOrganizations.pdf. By the third quarter of 2017, sixty-four percent of applications were submitted on Form 1023-EZ. *Id*. at 64 n.5.

[241] *Id.* at 65. This figure was calculated by reviewing the articles of incorporation of organizations in the 24 states that post them online. In 2015-16, forty-six percent of organizations that successfully submitted the streamlined application did not even meet the basic "organizational test" for 501(c)(3) status. This test is based exclusively on the language in the organization's paperwork. *See* Treas. Reg. § 1.501(c)(3)-1(b)(1).

mechanism of accountability that upholds the purpose of the tax exemption while preserving some charity discretion. The metric for imposing the tax, however, is arbitrary and untethered to any meaningful measure of reasonableness or performance.

A. *Excise Tax Regime Overview*

Under the TCJA, charities must pay the standard corporate tax rate of twenty-one percent on all remuneration to any "covered employee" over $1 million, including any parachute payments and remuneration paid by related organizations.[242] Covered employees include the five highest-compensated employees in the present tax year or any preceding tax year after December 31, 2016.[243] The Code creates an exception for compensation paid to procure the services of licensed medical and veterinary professionals,[244] perhaps in recognition of the high cost of luring these professionals to underserved rural areas. At the time of publication, the I.R.S. had not yet finalized regulations to govern implementation of the excise tax.

In enacting the excise tax, Congress created symmetry with the compensation rules for publicly held corporations under Section 162(m) of the Code. While businesses may generally deduct from their taxable income "a reasonable allowance for salaries or other compensation for personal services actually rendered[,]"[245] Section 162(m) forbids publicly traded corporations from deducting compensation amounts over $1 million paid to covered employees,[246] including the CEO and four other highest-paid officers.[247]

B. Excise Tax Regime Assessment

It is too early to determine whether the TCJA excise tax will actually affect compensation levels. Its for-profit analogue, Section 162(m), has failed to curtail executive pay in the quarter-century since its enactment.[248] Observers have often attributed this failure to Section 162(m)'s broad exception for performance-based compensation.[249] This exception, which

[242] I.R.C. §§ 4960(a), (c)(4) (2018).

[243] *Id.* § 4960(c)(2).

[244] *Id.* § 4960(c)(3)(B).

[245] *Id.* § 162(a)(1).

[246] *Id.* § 162(m).

[247] *See id.* § 162(m)(3).

[248] *See* Meegan Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747 (1994) (noting that while the law generates $2.5 billion in annual tax revenue, its stated goal was to reduce executive compensation).

[249] *Executive Compensation: Backdating to the Future: Hearing Before the Senate Committee on Finance*, 109th Cong. 37 (2006) (closing statement of Senator Chuck

was repealed by the TCJA, covered commissions based on income directly attributable to the individual's performance.[250] It also covered any other pay based on the achievement of objectively measurable performance goals, so long as an independent board committee and the shareholders approved the arrangement in advance.[251] In the aftermath of Section 162(m)'s passage, equity skyrocketed from thirty-seven percent to fifty-five percent of total executive compensation.[252] At the same time, cash compensation boomed nearly forty percent,[253] which optimal contracting theorists justify as a "non-diversification premium," and managerial power theorists ascribe to rent extraction.[254]

Even discounting the now-repealed exception for performance-based compensation, Section 162(m) does not appear to have achieved the intended effect. Perversely, some smaller companies increased their compensation to the $1 million limit because Section 162(m) nudged perceptions of reasonableness upward.[255] Others forewent the deduction and continued to compensate executives in excess of the ceiling.[256]

It is plausible that the TCJA cap may likewise fail to curb overcompensation, but this does not necessarily render the excise tax mechanism ineffectual. Even if it does little to curtail compensation levels, it will nevertheless provide a measure of accountability for use of the 501(c)(3) exemption.[257] The excise tax mechanism effectively treats charity income used to provide excessive compensation as non-exempt. This mirrors the treatment of charity earnings from commercial activities: if a commercial activity does not "contribute importantly" to the charity's

Grassley), https://www.finance.senate.gov/imo/media/doc/090606cga.pdf. Sen. Grassley, then serving as Chair of the Senate Committee on Finance, described the law as "broken" and having "more holes than Swiss cheese." *Id.*

[250] I.R.C. § 162(m)(4)(B) (repealed 2017)..

[251] *Id.* § 162(m)(4)(C) (repealed 2017).

[252] Bebchuk & Grinstein, *supra* note 219, at 289–91.

[253] Bebchuk & Grinstein, *supra* note 219, at 291.

[254] Hall & Murphy, *supra* note 74, at 5; Bebchuk & Grinstein, *supra* note 219, at 301.

[255] David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997, 997 (2002); John Byrne, *That's Some Pay Cap, Bill*, BUS. WK. (Apr. 24, 1994), https://www.bloomberg.com/news/articles/1994-04-24/thats-some-pay-cap-bill.

[256] Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million Dollar Cap*, 24 J. ACCT. & PUB. POL'Y 300, 321 (2005). Their willingness to do so depends on a variety of factors, including shareholder lobbying, the cost of restructuring compensation arrangements, and whether the loss of the deduction will actually and immediately result in more tax liability. *Present Law & Background Related to Executive Compensation*, JOINT COMMITTEE ON TAXATION 1, 6 (Sept. 6, 2006), http://www.jct.gov/x-39-06.pdf.

[257] The excise tax does not completely negate the Section 501(c)(3) tax advantage with respect to that income, as it may still be deductible to the donor.

exempt purposes, its net proceeds are generally subject to UBIT.[258] Both the TCJA excise tax and UBIT evince the principle that charities warrant tax exemption only to the extent that they behave like charities.[259] When charities behave like conventional businesses, they cannot take advantage of preferential tax treatment. Similarly, to the extent that charities pay excessive compensation to their executives, they should not benefit from preferential tax treatment. The excise tax therefore upholds both charities' discretion to make fact-specific compensation decisions and Congress's intent that the taxpayer subsidy be used for charitable outputs rather than private gain.

The ceiling on tax-advantaged compensation also has the benefit of enforceability. Unlike the public disclosure regime, which is hindered by the donor information and outrage deficits, and the regulatory enforcement regime, which relies on fact-intensive individual examinations, the TCJA excise tax is easily administered. Charities have clear directions, and the I.R.S. can easily detect noncompliance. The I.R.S. may still investigate cases of suspected private inurement and revoke the exemption altogether, but this is no longer the only source of accountability. The TCJA excise tax assures the public that charities face certain consequences for the egregious diversion of their resources.

The most salient weakness of the excise tax mechanism is its failure to offer a meaningful metric for reasonable compensation. It imports the arbitrary $1 million limitation of Section 162(m), which originated from the early 1990s trend of executive salaries topping the million-dollar mark.[260] It also fails to impose accountability for excessive compensation beneath the million-dollar ceiling. While it may capture certain egregious cases of overcompensation, it does not go far enough in ensuring that public subsidies are devoted exclusively to the public good.

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[258] Unrelated business income tax applies to the net income from a trade or business that is regularly carried on and is not substantially related to the organization's exempt purposes. I.R.C. § 511(1) (2018); Treas. Reg. § 1.513-1(a) (2019). A trade or business is substantially related to an organization's exempt purposes if it contributes importantly to the accomplishment of those purposes. Treas. Reg. § 1.513-1(d).

[259] Treas. Reg. § 1.513-1(b).

[260] Ryan Miske, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1688 (2004). Legislative history does not reveal any clear rationale for the selection of the $1 million figure, but it may have been a response to the trajectory of executive compensation in the early 1990s—rising from $624,996 in 1980 to $1.9 million in 1990. Linda Levine, CONGRESSIONAL RESEARCH SERV., *A Comparison of the Pay of Top Executives and Other Workers* 3-4 (2004), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1181&context=key_workplace.

VII. BEYOND THE TAX CUTS AND JOBS ACT

With the enactment of the TCJA excise tax, the law now offers three legal mechanisms to constrain charity compensation. Taken together, they impose a piecemeal accountability, likely to affect only the few charities that fall into the media's crosshairs, are individually examined by the I.R.S., or pay over $1 million to their top executives.

The general construct of the excise tax provides the most promising oversight framework. It offers a consistently enforceable system, latitude for charity leaders to make decisions based on their specific circumstances, and accountability for the use of the charitable tax exemption. Its primary weakness is the failure to offer a meaningful metric for determining whether compensation should be tax-advantaged. This Part examines the metrics used by two analogous regulatory frameworks—first, for public sector pay, and second, for compensation of bankruptcy trustees—and their respective transferability to the charitable sector. The overall goal of this inquiry is to align the regulatory system with the policy purpose of the charitable exemption; that is, to ensure that tax subsidies further exempt purposes rather than private enrichment. This Part then suggests a synthesis of these frameworks that could improve compensation metrics in the charitable sector, and proposes avenues for further research.

A. *Public Sector Metric*

Given the weakness of the for-profit analogue, a potential alternative is to benchmark executive compensation in the charitable sector against that of public-sector employees. This idea is not new—state proposals to limit executive compensation frequently invoke the pay levels of government officials.[261] A Florida bill, for example, aimed to restrict nonprofit employees to the salary of the highest-paid statewide official unless the organization received special dispensation from the state budget commission.[262] Such comparisons have intuitive appeal, since the public sector, like charities, receives public subsidies and operates for the purpose

[261] In 2016, lawsuits thwarted ballot initiatives in California and Arizona to limit hospital executive compensation to that of the U.S. President. *See* Howard Fischer, *Hospital Pay Cap Initiative Won't Be on November Ballot*, ARIZ. DAILY STAR (Aug. 16, 2016), http://tucson.com/news/state-and-regional/hospital-pay-cap-initiative-won-t-be-on-november-ballot/article_366ae68c-0a9b-5b7e-895a-e4c839a26e55.html; John Myers, *Healthcare Workers Union Is Withdrawing Its November Initiative on Hospital CEO Salaries*, L.A. TIMES (June 30, 2016), http://www.latimes.com/politics/la-pol-sac-essential-politics-healthcare-workers-union-is-pulling-its-1467156556-htmlstory.html.

[262] S. 596, 2012 Leg. Session (Fla. 2012), https://www.flsenate.gov/Session/Bill/2012/0596/BillText/c1/HTML; *see* H.R. 545, 2012 Leg. Session (Fla. 2012), https://www.flsenate.gov/Session/Bill/2012/0545/BillText/Filed/PDF (corresponding bill).

of providing socially beneficial goods.[263]

1. Overview

Federal employees are generally compensated in accordance with "their rank in a pay schedule."[264] The General Schedule ("GS"), which covers a majority of federal employees,[265] consists of fifteen grade levels, with ten salary steps within each grade.[266] Nationwide standards determine the grade of a given position based on its complexity, responsibility, and prerequisite levels of education and experience.[267] Employees generally receive salary step increases in accordance with a standardized timeline—annually for steps one to three, biennially for steps four to six, and triennially for steps seven to nine.[268] They can also ascend salary steps through exceptional performance, or "quality steps," and receive annual bonuses that boost their compensation for a particular year of strong performance.[269] Locality payments are intended to adjust the federal pay scale to account for the local cost of living in forty-seven geographical areas.[270] Generous benefits, including health and retirement plans,[271] constitute approximately thirty-nine percent of total federal compensation.[272]

263 For this reason, there is a level of public accountability and transparency regarding public sector salaries that is not generally seen in the for-profit world. *See* Josh Hicks, *New Web Site Allows Easy Salary Spying on Federal Workers*, WASH. POST (Aug. 16, 2013), https://www.washingtonpost.com/news/federal-eye/wp/2013/08/16/new-web-site-allows-easy-salary-spying-on-federal-workers/.

264 *Comparing the Compensation of Federal and Private-Sector Employees*, CONG. BUDGET OFFICE 1, 15 (Jan. 2012), https://www.cbo.gov/publication/42921.

265 *Id.*

266 *General Schedule Classification and Pay*, OFFICE PERSONNEL MGMT., https://www.opm.gov/policy-data-oversight/pay-leave/pay-systems/general-schedule/ (last visited Feb. 27, 2019).

267 *See id.*

268 *Id.*

269 *Id.*

270 *Id.*

271 The Federal Employees Retirement System ("FERS") allows employees who have completed five years of service to receive a portion of their salary upon retirement, calculated as one percent of their highest three-year average salary multiplied by years of service. Enhanced benefits are available for certain employees, including law enforcement officers and firefighters. After retirees turn 62, their payout is somewhat adjusted for cost of living, giving them some protection against inflation. FERS also includes the equivalent of a 401(k) in the Thrift Savings Plan, which matches 100% the first three percent of employee contributions and fifty percent of contributions for the next two percent. *FERS Information*, OFF. MGMT. & BUDGET, https://www.opm.gov/retirement-services/fers-information/ (last visited Nov. 7, 2019).

272 *Comparing the Compensation of Federal and Private-Sector Employees*, *supra* note 264, at 9.

In general, non-GS employees have more variable and higher average compensation than GS employees,[273] but may not receive locality pay.[274] The Executive Schedule establishes pay rates for Cabinet members, non-Cabinet agency directors, deputy heads of agencies, chairpersons of federal commissions and boards, and specified lower-level executives.[275] The Senior Executive Service consists of employees in designated leadership positions across federal agencies.[276] Agencies have latitude in awarding performance bonuses for these positions,[277] but compensation is subject to an aggregate limit of the Vice President's total pay.[278] As of January 2019, this limitation was $243,500.[279] A similar non-GS system governs the compensation of specialized research scientists.[280]

The public sector has long grappled with the balance between attracting talent and responsibly stewarding taxpayer money. By law, the federal government seeks to provide pay parity with non-federal employment (i.e., in state and local government as well as the private sector).[281] The Congressional Budget Office has found that the difference

[273] *Characteristics and Pay of Federal Civilian Employees*, CONG. BUDGET OFFICE 1, 9 (Mar. 2007), https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/03-15-federal_personnel.pdf.

[274] *Continuation of Locality Payments for Non-General Schedule Employees*, THE PRESIDENT'S PAY AGENT (Nov. 9, 2018), https://www.opm.gov/policy-data-oversight/pay-leave/salaries-wages/2018/continuation-of-locality-payments-for-non-general-schedule-employees-november-9-2018.pdf.

[275] *See* 5 U.S.C. §§ 5312, 5313 (2018).

[276] *Id.* § 3132(a)(2) (A senior executive is a non-presidential appointee who "directs the work of an organizational unit[,] is held accountable for the success of one or more specific programs or projects[,] [. . .] supervises the work of employees other than personal assistants[,] or otherwise exercises important policy-making, policy-determining, or other executive functions[.]"); *Id.* § 3132(a)(3). SES positions are designated by agencies "in accordance with [OPM] guidelines." 5 C.F.R. § 214.202(a) (2019).

[277] Each agency must develop a performance management system and appoint a performance review board to ensure the integrity of bonus decisions. 5 C.F.R. § 430.304(a). Federal regulations set forth requirements for performance criteria, monitoring, and assessment. *See* 5 C.F.R. §§ 430.305–09. Performance awards are between five and twenty percent of the executive's basic pay. *Senior Executive Service Compensation*, OFFICE OF PERSONNEL MGMT., https://www.opm.gov/policy-data-oversight/senior-executive-service/compensation/ (last visited Feb. 27, 2019).

[278] 3 U.S.C. § 104(a) (establishing the Vice President's per annum salary rate); 5 C.F.R. § 530.202 (defining "aggregate limitation" as the Vice President's total annual compensation under 3 U.S.C. § 104).

[279] Exec. Order No. 13,856, 85 Fed. Reg. 65 (Dec. 28, 2018).

[280] 5 C.F.R. §534(e).

[281] The Federal Employees Pay Comparability Act of 1990, Pub. L. 101-509, § 529, 104 Stat. 1389 (1990), declared it the policy of Congress with respect to the General Schedule for "[f]ederal pay rates [to] be comparable with non-Federal pay rates for the same levels of work within the same local pay area" and "any existing pay disparities between Federal and non-Federal employees should be completely eliminated." 5 U.S.C. §§ 5301(3)–(4). This statement applies specifically to GS employees, who account for over sixty percent of the

between GS and private-sector salaries depends on educational attainment. Compared to the private sector, federal employees without a bachelor's degree earn higher salaries (by twenty-one percent), those with a bachelor's degree earn equivalent salaries, and those with an advanced degree earn lower salaries (by twenty-three percent).[282] Due to generous government benefits, however, federal employees with a bachelor's degree earn fifteen percent more in total compensation, and the differential for those with advanced degrees drops to eighteen percent.[283] Federal employment therefore imposes a higher opportunity cost for those credentialed individuals who are more likely to fill executive positions in the private sector.

2. Metric Assessment

Public sector pay offers a well-developed, location- and skill-specific metric that is designed to balance the need for talent with responsibility for taxpayer money. The Senior Executive Service scale provides a rough analogue to the skills and responsibilities of charity executives. Moreover, the public and charitable sectors have similar goals of furthering public welfare. Unlike the for-profit sector, which is systematically (if imperfectly) accountable to shareholders, the public and charitable sectors are held accountable primarily through government ombudsmen, regulators, and occasional episodes of media-driven public outrage. The public-sector analogue is also more appropriate than the for-profit analogue because it does not permit profits distribution, does not incentivize risk-taking, and does not have some of the features facilitate rent extraction.

Despite these advantages, using federal compensation as an analogue for reasonable charity compensation would pose considerable challenges. First, federal employees of all education levels enjoy more job security than private sector workers,[284] due to both the stability of taxpayer financing[285] and constitutional protections against arbitrary dismissal.[286]

federal workforce. *Comparing the Compensation of Federal and Private-Sector Employees*, *supra* note 264, at 15.

282 *Comparing the Compensation of Federal and Private-Sector Employees*, *supra* note 264, at viii.

283 *Comparing the Compensation of Federal and Private-Sector Employees*, *supra* note 264, at ix.

284 Jason L. Kopelman & Harvey S. Rosen, *Are Public Sector Jobs Recession Proof? Were They Ever?*, 44 PUB. FIN. REV. 370, 382–84 (2016) (finding federal employees 4.2% "less likely to lose their jobs than private sector workers," and between 5.3–6.5% less likely to lose their jobs during a recession); *id.* at 389 (finding slightly smaller gap in job loss probability for those with a college degree).

285 *Id.* at 389.

286 In *Cleveland Board of Education v. Loudermill*, the Supreme Court held that public sector employees have a property interest in their employment and therefore a Constitutional

Charity executives would rationally demand higher compensation to offset greater job risk.[287] Second, it may be impracticable for charities to either identify comparable federal positions or apply the complex federal wage determination system. The federal government relies on an expensive bureaucracy to administer the system, which is not a luxury available to most charities.[288] Enforcement, too, would be difficult, as the I.R.S. would need to individually determine whether charities had appropriately applied the federal pay scale.

B. *Expenditure-Based Formula*

Another model that merits consideration is a compensation ceiling tied to the amount of charitable work conducted by the organization. This would resemble the compensation framework for Chapter 11 bankruptcy trustees, whose legal duty resembles that of charity executives and whose maximum compensation is linked to payments in furtherance of that duty.

1. Overview

Chapter 11 trustees oversee reorganization bankruptcies wherein the entity continues to operate but agrees to repay all or a portion of its outstanding debt in accordance with a court-approved payment plan.[289] The appointment of a trustee is rare, typically reserved for cases of gross mismanagement, dishonesty, or fraud by the current management.[290] In addition to regular trustee responsibilities, which include investigating the debtor's financial situation,[291] identifying and reporting any

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entitlement to due process before termination. 470 U.S. 532, 542–43 (1985).

287 *See* Florian S. Peters & Alexander F. Wagner, *The Executive Turnover Risk Premium*, 69 J. FIN. 1529, 1556 (2014).

288 The Office of Personnel Management reported that the cost of administering the federal wage system was approximately $5.8 million in the 2001 fiscal year. The report was prepared at the direction of the House Committee on Appropriations, and does not appear to have been replicated in the subsequent years. OFFICE OF PERSONNEL MANAGEMENT, REPORT TO CONGRESS: COST OF ADMINISTERING THE FEDERAL WAGE SYSTEM (March 2002), https://www.opm.gov/policy-data-oversight/pay-leave/pay-systems/federal-wage-system/reports-to-congress/cost-of-administering-the-federal-wage-system/#wagesurveys.

289 11 U.S.C. §§ 1123(a)(1)–(5), 1129(a) (2018). In contrast, when a business undergoes Chapter 7 liquidation bankruptcy, all assets are sold, the proceeds go to repay creditors, and the business ceases to operate. *Id.* § 726(a). The court may authorize the trustee to continue operating the business for a limited period of time if it determines that continued operations are in the best interest of the estate and consistent with orderly liquidation. *Id.* § 721.

290 11 U.S.C. § 1104(a); In re Texasoil Enterprises, Inc., 296 B.R. 431, 435 (N.D. Tex. 2003) (calling the appointment of a trustee "draconian and correspondingly rare."). In most cases, the debtor-in-possession assumes the duties of a trustee, but without entitlement to compensation under the scheme described in this Part. 11 U.S.C. §§ 1107(a), 1108.

291 *Id.* § 1106(a)(3).

mismanagement or irregularities,[292] and formulating and implementing a payment plan,[293] a Chapter 11 trustee may also operate the debtor's business.[294] This expansive role encompasses "services similar to those that would be provided by a corporate executive, such as a chairman of the board and chief executive officer."[295]

Trustees have fiduciary obligations similar to those of charity executives. While federal statutes do not clearly explain the trustee's standard of conduct,[296] beyond providing that a trustee must serve as "the representative of the estate"[297] and "be accountable for all property received,"[298] courts have consistently held that bankruptcy trustees owe fiduciary duties to the beneficiaries of estates.[299] Generally, these duties include the duty of care (i.e., to not act negligently), the duty of loyalty (i.e., to not act in the trustee's own interests), and the duty of obedience (i.e., to not act outside the fiduciary's designated authority).[300] Trustees must observe these duties in the course of allocating and distributing assets to creditors. Their fundamental responsibility parallels that of charity directors and officers—to ensure that a particular pool of assets is used exclusively for designated purposes.

Bankruptcy courts may award trustees "reasonable compensation for actual, necessary services rendered," as well as "reimbursement for actual, necessary expenses."[301] The amount may be set on an hourly, fixed, percentage, or contingency basis.[302] The law forbids compensation for

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292 *Id.* § 1106(a)(4).

293 *Id.* § 1106(a)(5).

294 *Id.* §1108.

295 *In re* Marvel Entm't Grp., Inc., 234 B.R. 21, 42 (Bankr. D. Del. 1999).

296 *See* Elizabeth H. McCullough, *Bankruptcy Trustee Liability: Is There a Method in the Madness?*, 15 LEWIS & CLARK L. REV. 153, 156 (2011).

297 11 U.S.C. § 323(a).

298 *Id.* §§ 704(a)(2), 1106(a)(1).

299 Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("[T]he fiduciary duty of the trustee runs to shareholders as well as to creditors."); Flugence v. Axis Surplus Ins. Co. (*In re* Flugence), 738 F.3d 126, 131 (5th Cir. 2013) ("Because the trustee is the fiduciary of the estate, he has a duty to ensure that the compensation arrangements made with attorneys and others are in the best interests of the creditors."); Dye v. Brown (*In re* AFI Holding, Inc.), 530 F.3d 832, 844 (9th Cir. 2008) ("A trustee is the 'legal representative' and 'fiduciary' of the estate."); Martin v. Martin (*In re* Martin), 91 F.3d 389, 394 (3d Cir. 1996) ("[T]he district court was correct in emphasizing the role of the trustee as a fiduciary.").

300 *In re* Novak, 383 B.R. 660, 671 (Bankr. W.D. Mich. 2008). Some scholars have also attributed a wide range of other duties to bankruptcy trustees, including duties of distribution maximization, diligence, accountability, competence, candor, civility, good faith, and fair dealing. Steven Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 AM. BANKR. L.J. 147, 154 (2006).

301 11 U.S.C. § 330(a)(1).

302 *Id.* § 328(a).

services that are duplicative, unnecessary, or not "reasonably likely to benefit the [debtor's] estate."[303] The compensation amount is capped based on on the value of assets distributed to creditors.[304] Aggregate compensation of all trustees involved in a case may not exceed twenty-five percent of the first $5,000 disbursed, ten percent of the next $45,000 disbursed, five percent on the next $950,000 disbursed, and three percent on any amounts exceeding $1 million.[305] The compensation of a trustee who distributed $1 million could therefore not exceed $53,250.

Because the statute commands courts to treat all bankruptcy trustee compensation as a "commission,"[306] some trustees have claimed that they are presumptively entitled to the statutory maximum.[307] Courts have rejected this argument on the grounds that the Chapter 11 provisions specifically require courts to set compensation based on a range of variables relating to the nature, extent, and value of a trustee's services.[308] In light of this, courts generally seek to use an objective market-rate standard, subject to the statutory maximums.[309] Notably, courts are obliged to independently review the reasonableness of fees, even if the interested parties have consented to (or failed to object to) the fees.[310]

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303 *Id.* § 330(a)(4)(A)(ii)(I).

304 *Id.* § 326(a).

305 *Id.* §§ 326(a), (c).

306 *Id.* § 330(a)(7).

307 *See, e.g.*, *In re* Virgin Offshore USA, Inc., Debtors, No. 11-13028, 2015 WL 350898, at *3 (Bankr. E. D. La. Jan. 26, 2015).

308 *Id.*; *see also In re* Marvel Entm't Grp., Inc., 234 B.R. 21, 38–39 (Bankr. D. Del. 1999) (rejecting the notion that Congress intended to provide an automatic commission based on assets disbursed). The *Marvel* court cited six reasons for its conclusion: (1) the statutory language, which states that the percentages only constituted a cap and provides other factors upon which the court should fix compensation levels; (2) the absence of support for this approach in the case law; (3) the absence of "any principled relationship between the amounts disbursed by a debtor corporation and what would be reasonable compensation for a trustee appointed to represent the estate"; (4) the risk that such an entitlement could lead to corruption in the appointment of trustees; (5) the risk that trustees will remain in place beyond their usefulness in order to capture financial gains; and (6) the risk that "extraordinarily high levels of compensation that bear no reasonable relation to the value of the services provided" could cause courts to avoid appointing trustees when it may otherwise be appropriate. *Id.* at 38–40. *But see* Mohns, Inc. v. Lanser, 522 B.R. 594, 599 n.1 (Bankr. E.D. Wis. 2015) (stating in the dicta of a Chapter 7 case that "in the case of a Chapter 11 trustee, the court should follow § 330(a)(7) and calculate the commission pursuant to the formula in § 326. Then, the court should adjust the commission by applying the § 330(a)(3) factors.").

309 *In re Marvel Entm't Grp., Inc.*, 234 B.R. at 41.

310 *See, e.g.*, *In re* Fleming Companies, Inc., 304 B.R. 85, 89 (Bankr. D. Del. 2003) (stating that "the Bankruptcy Court has an independent duty to review fee requests of all professionals retained in a [c]hapter 11 case to assure that the services rendered were necessary and appropriate and that the fees requested are reasonable") (citation omitted); *In re* Busy Beaver Bldg. Ctrs., Inc., 19 F.3d 833, 844 (3d Cir. 1994) (holding that the court "must protect the estate, lest overreaching attorneys or other professionals drain it of wealth

2. Metric Assessment

Trustee compensation is structured with a clear nexus to the trustee's legal duty and scale of work. The compensation ceiling formula depends on achievement of the trustee's legal mandate—payment to creditors—rather than the size of the company. This incentivizes trustees to avoid waste and furthers the policy purpose of the statute. In the charity context, an equivalent approach may be to link the compensation ceiling to the organization's charitable expenditures. This metric, which includes most administrative and fundraising costs of operating charitable programs,[311] is already used to determine the maximum allowable amount that charities may spend on lobbying activities,[312] and could feasibly transfer to the compensation context as well.

Applying the trustee compensation model to the charitable sector would nevertheless be inapt in certain respects. First, beneath the formula-based ceiling, trustee compensation is fixed by a judge according to market rate. As discussed in Part V, the market-rate standard is helpful in attracting qualified professionals, but can facilitate inflation when insiders perform the benchmarking rather than independent judges. Second, while the respective legal mandates of bankruptcy trustees and charity executives have similarities, expenditures are a stronger proxy for trustee performance than charity executive performance. Charity executives are expected to build the long-term financial health of their organization and achieve an efficient charitable impact. This may involve trimming expenses, growing reserves in anticipation of economic downturns, and pursuing cost-effective programming, all of which may be discouraged under a system that pegged allowable executive compensation to expenditures. A formula-based ceiling may, in short, create incentives antithetical to responsible charity stewardship.[313]

which by right should inure to the benefit of unsecured creditors").

311 I.R.C. § 4911(e)(1) (defining "exempt purpose expenditures" for the purpose of calculating the allowable level of lobbying expenses); Treas. Reg. § 56.4911-4 (elaborating upon the meaning of "exempt purpose expenditures"). The exempt expenditures formula includes compensation amounts but not lobbying expenditures; this may need to be inverted in an exempt expenditures formula for the purpose of determining the compensation ceiling.

312 I.R.C. § 4911(c)(2) (permitting charities to spend up to a certain percentage of their "exempt purpose expenditures" on lobbying without incurring a penalty tax).

313 While charity mismanagement is socially sub-optimal, it would not necessarily undermine the policy purpose of the charitable tax exemption. Eligibility for exemption depends on whether an organization operates for exempt purposes, not whether it operates efficiently or sustainably. Nevertheless, at a certain point, profligacy in furtherance of a higher executive salary must surely contravene the requirements of Section 501(c)(3).

C. *Potential Synthesis and Further Investigation*

The compensation frameworks for federal employees and bankruptcy trustees both offer transferable elements that could enhance the metric for reasonable compensation in the charitable sector. The federal employee scale provides an analytically sound analogue to the charitable sector, as both are subsidized by taxes in order to provide socially beneficial outputs. The most salient weakness of the analogue, the relative security of federal employment vis-à-vis the private sector, can be measured and incorporated into the scale. The trustee framework contributes the notion of a formula-based rather than fixed-ceiling. This acknowledges the variance in responsibility and complexity in organizations of different sizes and provides an opportunity to link compensation to the furtherance of charitable purposes, albeit at the risk of introducing incentives for suboptimal management.

A synthesis of these strengths might be a graduated scale of ceilings for tax-advantaged compensation based on charitable expenditures. Ceilings could be determined with reference to federal compensation levels, plus a risk premium. For example, an organization with large charitable expenditures may have a ceiling based on Level 1 Senior Executive Service pay (including the value of federal benefits), while an organization with smaller expenditures may have a ceiling based on Level 2. Charitable expenditures could be defined to exclude executive compensation amounts themselves, so that high compensation could not serve as its own justification. The relevant expenditure level could be averaged over several years so that executives are not penalized for saving funds or unduly rewarded for high spending in any given year. A graduated scale is normatively superior to the current ceiling, as it would link tax-advantaged compensation to: (1) the policy objectives of Section 501(c)(3) status; and (2) public-sector compensation, which is similarly taxpayer-funded. It also offers the practical benefit of capturing excessive compensation below the $1 million mark.

While such reform may hold promise for the charitable sector, the history of unintended consequences from compensation reform reinforces the need for further investigation. Relevant questions include (1) whether the TCJA excise tax successfully curtails charity compensation or reproduces the effects of Section 162(m) (i.e., a rise in compensation towards the $1 million ceiling, a willingness to absorb the tax consequences, etc.); (2) whether the removal of the loophole for performance-based compensation under Section 162(m) somehow tames excessive compensation in public companies; and (3) whether the I.R.S.'s analytics-based targeting initiative succeeds in identifying noncompliant charities. The outcomes of these policy changes may have implications for the viability and optimal design of the regulatory enforcement action mechanism and the excise tax mechanism. It would also be valuable to determine the effects of State-imposed limitations on charity compensation, thought these are currently few. Finally, there is the open question of whether boards can be relied upon to police the organization's finances such that an expenditure-based formula would be unlikely to jeopardize long-term financial health. Resolving these questions would be instructive in the redesign of executive compensation in the charitable sector.

VIII. CONCLUSION

While the TCJA excise tax provides a promising step forward, the oversight framework for charity executive compensation remains poorly tailored to the goals of charitable tax status. The underlying policy purpose of Section 501(c)(3) is to subsidize, through tax exemption and deductible contributions, private organizations that provide charitable outputs without diverting resources to private hands. Current law imposes only piecemeal accountability on charities that are targeted for scrutiny by the media, are individually examined by the I.R.S., or pay over $1 million to their top executives. The TCJA excise tax mechanism strikes an appropriate balance between enforcing the policy purpose of Section 501(c)(3) and preserving charity discretion. By improving the metric for appropriate compensation, the excise tax could provide accountability to taxpayers and restore confidence in the charitable sector. A graduated scale of compensation ceilings tied to public-sector salaries and charitable expenditures could provide normative and practical advantages over the existing metric, but reform efforts should be informed by further research regarding, among other things, the effects of the TCJA and I.R.S. enforcement innovations.