

**RECOMMENDED BEST PRACTICES**  
**IN DETERMINING**  
**REASONABLE EXECUTIVE COMPENSATION**

A Guidance Memorandum from  
the Board of Directors of the  
Council on Foundations



**Council on Foundations**

**December 6, 2002**

**BOARD RECOMMENDATION:** The Board of Directors of the Council on Foundations strongly recommends that when reviewing and approving executive compensation, all foundations – private and public – adopt and follow the three-step procedure set forth in the regulations that implement the intermediate sanction rules for public charities.

## I. Background

The Internal Revenue Code provides excise tax penalties that can be imposed by the Internal Revenue Service whenever unreasonable or excessive compensation is paid to high-level employees of charitable organizations.<sup>1</sup>

When examples of excessive compensation come to light, they receive considerable media attention and negatively influence the perception of foundations and other charitable organizations in the minds of elected officials, their staff members (especially on Capitol Hill) and the general public. Most frequently, the examples that are publicized involve compensation paid to the president or chief executive officer.

## II. Purpose of this Memorandum: Best Practices in Determining Reasonable Executive Compensation

Over and above any legal requirements or public scrutiny, good stewards of philanthropic resources should go the extra mile to be certain that levels of compensation are reasonable. Thus, the Board of Directors of the Council on Foundations strongly urges all foundations to take great care in reviewing and approving the total executive compensation paid to all high level employees, particularly the top executive.

Position of the Council. The Board of Directors of the Council is firmly opposed to excessive or unreasonable compensation. Even the public perception of excessive compensation can be damaging to the whole field of philanthropy.

What is reasonable compensation? Generally, reasonable compensation is defined as what similar persons in similar positions with similar duties at similar organizations are paid.

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<sup>1</sup> While this guidance memorandum relies heavily on U.S. law, the principles are applicable in other countries as well. The self-dealing provisions under Section 4941 apply to private foundations; the intermediate sanction provisions under Section 4958 apply to community foundations and other public charities.

Common procedures. Most foundations rely heavily on salary and compensation surveys to guide them in finding a reasonable level of compensation.<sup>2</sup> It is also common for foundations to compare compensation levels with specific foundations of similar size, operations and geographic location. Some foundations contract with independent advisors to provide advice and specificity regarding reasonable compensation and benefits.

New guidance from IRS and Treasury. For many years, the IRS could impose penalty sanctions only for excessive compensation paid to executives of private foundations. However, in 1996, Congress passed the so-called “intermediate sanction” rules.<sup>3</sup> These rules now provide similar excise tax penalties that can be applied in instances of excessive compensation involving public charities. In publishing the final regulations to implement the intermediate sanction rules, the Treasury Department set forth an important set of procedures that provide a distinct advantage and a presumption of reasonableness for any public charity that follows them. These procedures are known as the “rebuttable presumption” rules.

At the time of this memorandum, the opportunity to take advantage of these rebuttable presumption procedures was available only to public charities under the intermediate sanction rules. Public charities and their governing boards are not *required* to take these steps; rather it is an option with attractive benefits if done correctly. However, the IRS is currently reviewing whether or not to amend the private foundation regulations to provide a similar rebuttable presumption under the self-dealing rules.<sup>4</sup>

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<sup>2</sup> The Council’s annual *Grantmakers Salary and Benefits Report* covers base compensation levels for 36 positions, as of February 1. Data are collected for four grantmaker types—community, corporate, private and public. Among the privates, family foundation data are separated from independents for 10 of the 36 positions—CEO, program director, senior program officer, program officer, program associate, program assistant, grants manager/administrator, executive assistant, administrative assistant and secretary. The salary tables are made available to members on the website in August. The printed survey report, usually released in December, also covers staff demographics, tenure and turnover, salary administration, bonuses and issues specific to the CEO.

Beginning with the 2000 survey, the Council is collecting and publishing benefits information annually. Topics regularly covered include benefits costs, percentage of benefits costs covered by grantmakers, types of leave offered, types of voluntary benefits offered and retirement plans (including types offered, median employer contribution and plan administration). The benefits data are presented by grantmaker type, asset group and total paid staff size. In 2002, detailed information was also collected on paid holidays, short-term disability programs, severance, telecommuting, section 125 plans and health care cost containment measures.

<sup>3</sup> Section 4958.

<sup>4</sup> Announcement 2002-47, Internal Revenue Bulletin, 2002-18, (May 6, 2002).

### III. Rebuttable Presumption Rules: Three Steps<sup>5</sup>

What is a “rebuttable presumption”? The phrase “rebuttable presumption” is a legal term used in a variety of ways. Generally, it means that if certain steps are taken, then it will be presumed that the person taking those steps acted in a certain way (fairly, reasonably, without negligence, etc.). In the context of intermediate sanctions, when a foundation (or its governing board) approves a level of compensation, the law will presume that it is reasonable so long as certain steps are taken. Under most circumstances, when the IRS challenges the reasonableness of compensation, the burden is on the foundation and the person being compensated to prove the amount is reasonable.

The advantage of a rebuttable presumption in compensation cases is that the burden of proof shifts to the IRS. Having a presumption in your favor can often be a major advantage in a dispute or in litigation. Said another way, if the rebuttable presumption steps are followed, there is a presumption that the compensation is reasonable. However, the IRS may counter with sufficient evidence to disprove (or rebut) the presumption.<sup>6</sup>

#### What are the three required steps?

Under the regulations implementing the intermediate sanction rules, three conditions must be satisfied to take advantage of the rebuttable presumption.

1. Approval by disinterested governing board. The compensation arrangement must be approved in advance (before any payment) by the governing body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement (example: neither the executive whose compensation is being determined nor any of his/her family members may be present during the discussion/debate or participate in the vote).
2. Reliance on comparable data. The governing body must obtain and rely upon appropriate data as to comparability prior to making its determination. Relevant information includes, but is not limited to, current compensation surveys compiled by independent firms, compensation levels paid by similarly situated organizations for functionally comparable positions and written offers from similar institutions competing for the services of the person under consideration.

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<sup>5</sup> The rules are spelled out in Treasury Regulation Section 53.4958-6T.

<sup>6</sup> The IRS may rebut the presumption only if it develops sufficient contrary evidence to challenge the probative value of the comparability data relied upon by the governing body.

3. Concurrent documentation. The governing body must adequately document the basis for its determination concurrently with making that determination (within 60 days of the decision or the date of the next meeting of the governing body, whichever is later). To qualify as concurrent documentation, written or electronic records of the governing body (such as meeting minutes) must note a) the terms of the transaction and the date it was approved; b) the members of the governing body who were present during the debate on the transaction that was approved and those who voted on it; c) the comparability data obtained and relied upon and how the data were obtained; and d) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body but who had a conflict of interest with respect to the decision on the compensation.

#### IV. Legal Advice

The contents of this guidance memorandum provide a summary of applicable law. Foundations are encouraged to consult with experienced legal counsel for more detailed advice. Any questions may be directed to the Council on Foundations' Legal Department at 202/467-0466.