

# The Fallacies Behind The Excise Tax: On “Excessive” Charity Compensation

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*This Article examines the fundamental flaws in Section 4960 of the Internal Revenue Code, which imposes an excise tax on nonprofit executive compensation exceeding \$1 million. The provision, enacted as part of the 2017 Tax Cuts and Jobs Act, rests on three problematic fallacies. First, Congress incorrectly assumed that an excise tax on nonprofits would function equivalently to the elimination of a tax deduction for excessive compensation in the for-profit sector under Section 162(m). Second, lawmakers failed to recognize that nonprofits respond differently to tax incentives than for-profit entities due to their distinct governance structures and sensitivity to public opinion about overhead costs. Third, and most significantly, Section 4960 was never truly intended to regulate excessive compensation, but rather serves to reinforce harmful narratives about nonprofit wages while raising revenue from an already disfavored sector. The Article argues that Section 4960's mechanical approach ignores the complex realities of nonprofit compensation and governance while potentially damaging organizational capacity. Rather than relying on bright-line excise taxes, meaningful reform requires addressing underlying issues. This Article concludes that Section 4960 represents a misguided attempt to regulate nonprofit compensation that may ultimately harm the charitable sector it purports to protect.*

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## INTRODUCTION

“Corporate chief executives have come under fire in recent years for their skyrocketing pay. But there’s a place that puts those executives to shame: academia.”<sup>1</sup> So begins a 2016 CBS News article on executive compensation for college presidents.<sup>2</sup> The article goes on to question the propriety of college executive compensation in the face of rising tuition costs and student debt loads, trends that have not changed since that article was written.<sup>3</sup> CBS updated its reporting on college president

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1. Aimee Picchi, *Are CEO’s Overpaid? Not Compared with College Presidents*, CBS NEWS (Feb. 26, 2016, 5:15 AM), <https://www.cbsnews.com/news/are-ceos-overpaid-not-compared-with-college-presidents/> [<https://perma.cc/2B2R-GZC2>]; see also Richard Vedder, *College Presidential Pay Makes No Sense: Little Relation to Excellence*, FORBES (Sept. 8, 2021, 7:00 AM), <https://www.forbes.com/sites/richardvedder/2021/09/08/college-presidential-pay-makes-no-sense-little-relation-to-excellence/?sh=470e4c7fde7c> [<https://perma.cc/WT3P-5WKJ>] (describing how college presidential pay has little association with university excellence, financial success, or school size).

2. Picchi, *supra* note 1.

3. See Picchi, *supra* note 1 (“College presidents on average earn . . . more than twice the average of pay [of] CEOs . . . . At the same time, American students face ever-increasing tuition bills. . . .”);

salaries in January 2024, with a focus on the salary of Harvard University's former president Claudine Gay, who recently stepped down amid controversy over free speech and plagiarism.<sup>4</sup> The article lists Stephen Klasko of Thomas Jefferson University as the top-earning college president for 2020, with an annual compensation of \$8.4 million.<sup>5</sup>

At the same time, about two-thirds of the respondents in a 2016 survey believed that college coaches should not make more than college presidents.<sup>6</sup> This public outcry has done little to stem the tide of increasing compensation for college coaches in high-profile programs. For example, in 2022, the University of Alabama agreed to pay Coach Nick Saban \$93.6 million over the next eight years,<sup>7</sup> making him the highest paid coach in NCAA football at the time.<sup>8</sup> On January 10, 2024, Saban announced his retirement<sup>9</sup> and walked away from his Alabama contract to become an analyst for ESPN for the 2024 college football season for a rumored \$30 million deal.<sup>10</sup>

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*see generally* Dane Gebauer, *25 Highest-Paid College Football Coaches in 2024*, COLLEGE TRANSITIONS (Nov. 6, 2023), <https://www.collegetransitions.com/blog/highest-paid-college-football-coaches/> [https://perma.cc/3YC8-9ZED]; *see also* Laura McKenna, *The Madness of College Basketball Coaches' Salaries*, THE ATL. (Mar. 24, 2016), <https://www.theatlantic.com/education/archive/2016/03/the-madness-of-college-basketball-coaches-salaries/475146> [https://perma.cc/PL57-VKTB] (noting that college basketball coaches get paid millions of dollars per year while tuition costs spiral).

4. Megan Cerullo, *How Much Money Do College and University Presidents Make?*, CBS NEWS (Jan. 4, 2024, 4:49 PM), <https://www.cbsnews.com/news/how-much-do-university-presidents-make/> [https://perma.cc/B5ST-CFSP].

5. *Id.* (citing *How Much are Private-College President's Paid?*, THE CHRON. HIGHER EDUC., (Feb. 15, 2024) <https://www.chronicle.com/article/president-pay-private-colleges> [https://perma.cc/N4WS-ZHWT]).

6. Lauren Camera, *Survey [sic]: Coach's Salary Shouldn't Best President's*, U.S. NEWS (Mar. 15, 2016, 3:31 PM), <https://www.usnews.com/news/articles/2016-03-15/new-survey-college-coaches-shouldnt-make-more-than-college-presidents> [https://perma.cc/BXN5-VBMG] (finding that 63% of respondents surveyed thought coaches should not make more than college and university presidents).

7. Aaron Suttles, *Alabama Approves Nick Saban Contract Making Him Highest-Paid Coach in Football*, THE ATHLETIC (Aug. 23, 2022), <https://theathletic.com/3531391/2022/08/23/nick-saban-alabama-contract-salary/> [https://perma.cc/2M4V-3TCQ].

8. According to *Sports Illustrated*, Saban had a clause in his contract that required him to be one of the top three paid coaches in the SEC and top five in college football; as a result, his compensation was increased shortly after his contract renewal. Katie Windham, *Nick Saban Is the Highest Paid Coach in College Football*, SPORTS ILLUSTRATED (Aug. 23, 2022, 2:56 PM), <https://www.si.com/college/alabama/bamacentral/new-contract-announced-for-nick-saban> [https://perma.cc/Q55T-XBLW].

9. *Alabama Football Coach Nick Saban Announces Retirement*, ESPN, (Jan. 10, 2024, 5:16 PM ET), [https://www.espn.com/college-football/story/\\_/id/39281202/alabama-crimson-tide-football-coach-nick-saban-retiring](https://www.espn.com/college-football/story/_/id/39281202/alabama-crimson-tide-football-coach-nick-saban-retiring) [https://perma.cc/44VR-ZZ82].

10. *Former Alabama Coach Nick Saban Joins ESPN, 'College Game Day' as Analyst*, ESPN, (Feb. 7, 2024, 4:59 PM), [https://www.espn.com/college-football/story/\\_/id/39479204/former-](https://www.espn.com/college-football/story/_/id/39479204/former-)

The outcry over charity<sup>11</sup> executive compensation is not limited to academia: “[b]ut while millions of people face serious financial troubles due to the high cost of healthcare, some hospital CEOs are raking in millions each year in salaries and other benefits.”<sup>12</sup> As the debate over the cost and funding of health care rages, the increasing compensation packages of hospital and health system administrators has come under increasing public scrutiny.<sup>13</sup> For example, the approximately \$10 million compensation package of the former CEO of charitable hospital UPMC in Pittsburgh, Jeffrey Romoff,<sup>14</sup> triggered public outrage,<sup>15</sup> with critics accusing Romoff “of putting market dominance and revenues ahead of the best interests of patients and the community.”<sup>16</sup>

In response to this popular outcry, Congress has repeatedly attempted to address the perception and reality of excessive compensation by charities through the Internal Revenue Code.<sup>17</sup> The original statutory

alabama-coach-nick-saban-joins-espn-college-gameday-analyst [https://perma.cc/5XLS-XZEZ]. Unconfirmed media rumors put his ESPN salary at \$30 million; see Farouk Yusuf, *Is Nick Saban Leaving Alabama for a \$30,000,000 ESPN Contract? JJ Watt Turns to Pat McAfee regarding Crimson Tide's HC Future Plans*, SPORTSKEEDA (Dec. 14, 2023, 1:42 PM), <https://www.sportskeeda.com/college-football/is-nick-saban-leaving-alabama-30-000-000-espn-contract-jj-watt-turns-pat-mcafee-regarding-crimson-tide-s-hc-future-plans> [https://perma.cc/4HSP-UGSF]; (citing anonymous sources on X (formerly Twitter)).

11. For the sake of simplicity, this Article will use the term “charity” to refer to state law nonprofit organizations, regardless of state law entity type, that are exempt from federal income taxation under Code Section 501(c)(3). The author acknowledges that there are state law nonprofit organizations that might be called charities that are not Section 501(c)(3) organizations, and that there are federally tax-exempt organizations that are subject to compensation restrictions that are not charities (such as Code Section 501(c)(4) organizations).

12. Shawn Radcliffe, *Hospital CEO Pay Rises While Americans Drown in Medical Debt*, HUFFPOST (Aug. 29, 2016, 7:41 PM), [https://www.huffpost.com/entry/hospital-ceo-pay-rises-wh\\_b\\_11767768](https://www.huffpost.com/entry/hospital-ceo-pay-rises-wh_b_11767768) [https://perma.cc/32WT-XGDS].

13. Vikas Saini et al., *Nonprofit Hospital CEO Compensation: How Much Is Enough?* HEALTH AFFAIRS (Feb. 10, 2022), <https://www.healthaffairs.org/doi/10.1377/forefront.20220208.925255/> [https://perma.cc/997D-K8CP].

14. Steve Twedt, *CEO Romoff's \$6.99 Million Tops List of UPMC Compensation*, PITT. POST-GAZETTE (May 13, 2017), <http://www.post-gazette.com/business/healthcare-business/2017/05/12/upmc-romoff-salary-compensation-Form-990/stories/201705120201> [https://perma.cc/82H6-6HWA].

15. See, e.g., Paul J. Bates, *UPMC Executives' Compensation Is Outrageous*, PITT. POST-GAZETTE (May 16, 2017, 11:00 PM), <http://www.post-gazette.com/opinion/letters/2017/05/17/UPMC-executives-compensation-is-outrageous/stories/201705170029> [https://perma.cc/M6LN-PXFT] (discussing the outrage in Pittsburgh as a result of UPMC CEO Jeffrey Romoff's compensation report).

16. David Wenner, *New CEO of UPMC, Who Climbed the Ranks While Raising Three Kids, Looks for More Growth*, BRADFORD ERA (Aug. 10, 2021), [www.bradfordera.com/news/new-ceo-of-upmc-who-climbed-the-ranks-while-raising-three-kids-looks-for-more/article\\_237421c8-1d96-5ec3-9fc2-6c36d150f954.html](http://www.bradfordera.com/news/new-ceo-of-upmc-who-climbed-the-ranks-while-raising-three-kids-looks-for-more/article_237421c8-1d96-5ec3-9fc2-6c36d150f954.html) [https://perma.cc/5HGM-VVRV].

17. See generally Paul Amsberger et al., *A History of The Tax-Exempt Sector: An SOI Perspective*, STATISTICS OF INCOME BULLETIN, Winter 2008, at 107, (<https://www.irs.gov/pub/irs-soi/tehistory.pdf>) [https://perma.cc/UF6Z-EARF].

language that created tax-exempt status for charities in 1913 included a prohibition against excessive compensation in the form of disguised dividends.<sup>18</sup> When that language proved insufficient, Congress tried again, adding compensation provisions<sup>19</sup> to the Code in 1950<sup>20</sup> and again in 1969.<sup>21</sup> Those two sets of revisions, however, were generally only applicable to what we now refer to as private foundations,<sup>22</sup> so the vast majority of charities were unaffected by the 1950 and 1969 amendments.

Even with these legislative enactments, the public criticism of excess compensation by charities continued unabated. In 1996, Congress revisited the issue for the fourth time by adding Code Section 4958, a specific, comprehensive provision targeting excess compensation and other conflict of interest transactions.<sup>23</sup> Code Section 4958, sometimes colloquially referred to as “intermediate sanctions,”<sup>24</sup> governs charities exempt under Code Section 501(c)(3) other than private foundations, which still must comply with the 1969 rules introduced previously.<sup>25</sup>

One might have thought that such comprehensive legislation would be the end of the story. But maybe not surprisingly, the intermediate

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18. The Revenue Act of 1913, which imposed the federal income tax, first included the language “no part of the net income of which inures to the benefit of any private stockholder or individual.” Revenue Act of 1913, Pub. L. No. 63-16, ch. 16, 38 Stat. 114, 172 (1913).

19. See John E. Riecker, *Foundations and The Patman Committee Report*, 63 MICH. L. REV. 95, 117 (1964) (providing a listing prohibited transactions under then Section 503 that included, including the “[p]ayment of any compensation in excess of a reasonable allowance for salaries for personal services actually rendered (presumably not blanket retainer fees)” to statutorily defined related parties).

20. The Revenue Act of 1950, Pub. L. No. 814, ch. 994, 64 Stat. 906 (1950). Under current law, Section 503 only applies to organizations exempt under Section 501(c)(17) and Section 501(c)(18) as well as certain retirement plans. As originally enacted, however, Section 503 applied to Section 501(c)(3) organizations. See Arnsberger et al., *supra* note 17 (discussing the issues addressed by the Revenue Act of 1950).

21. I.R.C. § 4941. Code Section 4941 was enacted as part a comprehensive series of excise taxes that regulate private foundations, which are a specific subset of Code Section 501(c)(3) organizations, described more fully. *Infra* beginning at note 64.

22. Code Section 501(c)(3) organizations are broadly divided into two general categories: private foundations and public charities. See I.R.C. § 509(a). As of 2019, only 7% of all Section 501(c)(3) organizations were private foundations. See *Key Facts on U.S. Nonprofits and Foundations*, CANDID (Apr. 2020), <https://www.issuelab.org/resources/36381/36381.pdf> [<https://perma.cc/3QQ2-K647>] (citing December 2019 IRS Business Master File).

23. See generally I.R.C. § 4958; see also Taxpayer Bill of Rights, Pub. L. 104-168, § 1311, 110 Stat. 1452, 1475 (1996).

24. See STAFF OF JOINT COMM. ON TAX’N, 109TH CONG., HIST. DEV. AND PRESENT L. OF THE FED. TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGS. 5 (Comm. Print 2005) (“In 1996, however, Congress imposed excise taxes, frequently referred to as ‘intermediate sanctions,’ on ‘excess benefit transactions’ between certain exempt organizations and ‘disqualified persons.’”)

25. Intermediate sanctions apply to some other organizations, for good measure. By its terms, Code Section 4958 applies to Section 501(c)(3), 501(c)(4), and 501(c)(29) organizations. I.R.C. § 4958(e)(1). Private foundations that are subject to Code Section 4941, which was adopted as part of the 1969 Code revisions, remain subject to those stricter rules.

sanctions provisions did not quell the public criticism of excessive charity compensation. More than twenty-five years after the enactment of intermediate sanctions, Congress tried again. In 2017, the Tax Cuts and Jobs Act (“TCJA”)<sup>26</sup> imposed a new excise tax on executive compensation packages exceeding \$1 million paid by charities<sup>27</sup> and certain other tax-exempt organizations.<sup>28</sup>

Like its predecessors, this new excise tax provision (found in Code Section 4960)<sup>29</sup> is bound to fail in both regulating excessive executive compensation and addressing the public’s perception of such compensation. Code Section 4960 is based on at least two—and in reality, three—fundamental fallacies that undermine its effectiveness:

- The tax provisions regulating charity compensation can and should be based on the mechanisms used to limit for-profit public company compensation, found in Code Section 162(m);
- All charities will adjust their behavior in response to a tax incentive (or tax disincentive, in this case) in the same manner that for-profit public company; and
- Code Section 4960 is really intended to create parity between charities and for-profits, or even effectively regulate excessive compensation, at all.

First, Congress said that the Code Section 4960 excise tax mirrors the manner in which the Code regulates compensation paid by for-profit publicly traded companies under Code Section 162(m).<sup>30</sup> Passed in 1993,<sup>31</sup> Code Section 162(m) was “motivated by then-current concerns regarding the amount of executive compensation in public companies, and that the purpose of the provision was to reduce ‘excessive’ compensation.”<sup>32</sup> There are two fundamental problems with this

26. Pub. L. No. 115-97, 94 Stat. 2054 (2017). The bill from which the legislation originated, H.R.1 of the 115th Congress, was originally entitled the Tax Cuts and Jobs Acts, or the TCJA for short. However, on December 16, 2017, the parliamentarian of the Senate determined that the section of the act that contained the title violated the budget reconciliation rules because it had no budgetary impact; accordingly, this provision was removed from the bill and the final legislation has no official title. See Naomi Jagoda, *Senate Parliamentarian Rules Against GOP Tax Bill’s Name*, THE HILL (Dec. 19, 2017, 6:04 PM), <http://thehill.com/policy/finance/365691-senate-parliamentarian-rules-against-gop-tax-bills-name> [https://perma.cc/2U69-3AM2]. This article will continue to refer to the new legislation as the “TCJA” for convenience.

27. Specifically including organizations described in I.R.C. § 501(c)(3).

28. I.R.C. § 4960(c)(1).

29. I.R.C. § 4960(a).

30. For a discussion of TCJA House Ways and Means Committee Report, see *infra* note 131.

31. See generally Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469.

32. STAFF OF JOINT COMM. ON TAX’N, 109TH CONG., *supra* note 24 at 6 (citing H.R. Rep. No. 103-111, at 646 (1993)).

assertion. First, business executives, compensation consultants, and scholarly commentators agree almost universally that Code Section 162(m) did not actually function to limit executive compensation in public companies, so it is an ineffective model to copy.<sup>33</sup> Even if Code Section 162(m) were effective, Code Section 4960 does not mechanically function in the same way as Code Section 162 in significant ways. In fact, Code Section 4960 is far more punitive to charities than the analogous for-profit compensation limitations of Code Section 162(m).

The Code Section 4960 excise tax also reflects the second fallacy: all charities approach tax incentives and disincentives in the same manner as for-profit, publicly traded businesses. As a result, one cannot assume that utilizing the same mechanism to control compensation—a tax provision crafted to disincentivize large compensation packages by changing their economic impact—will function similarly within different types of organizations. This type of thinking promotes the erroneous notion that “charities should function like a business”<sup>34</sup> and blurs the real and important distinctions between the charitable and for-profit sectors. If a charity is “functioning like a business,” then it will respond in the same manner that for-profit businesses responded to Section 162(m), which was to manipulate the structure of compensation packages in a manner to avoid Section 162(m)’s impact without decreasing compensation.<sup>35</sup> Alternatively, charities may be susceptible to over-reacting to an excise tax to the detriment of the organization in the long term.

Finally, the most important fallacy is that the new excise tax was ever about parity between charity and for-profit organizations or placing reasonable limitations on compensation at all. In reality, the purpose of the excise tax was to reinforce the narrative that nonprofits should pay below market compensation,<sup>36</sup> to punish nonprofits that violate that narrative by defining compensation in excess of \$1 million as de facto excessive, and to raise revenue while doing it.<sup>37</sup>

At first blush, this new excise tax might be met with popular support—after all, it is a common refrain that charities are not spending on their

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33. See *infra* note 148–161 (noting examples of executive compensation compliance studies in colleges and hospitals).

34. See, e.g., Lucy Morillo, *Why Nonprofits Should Run Like Businesses*, NONPROFITPRO (Jan. 13, 2015), <https://www.nonprofitpro.com/post/why-nonprofits-should-run-like-businesses/all/> [<https://perma.cc/2JK9-2AGP>] (“For nonprofits, it’s important to invest in key aspects of the organization just as any business does to help it grow and prosper.”).

35. See *infra* note 150–153 (recognizing the small number of organizations that were subject to compensation review).

36. See *infra* note 298–308 (describing donor perspectives on high executive compensation).

37. See *infra* note 310–325 (explaining the consequences of donor expectations that charities operate efficiently while maintaining low administrative costs).

programs because they are paying such high salaries.<sup>38</sup> Some argue that employees at charitable organizations should accept lower salaries in the name of “doing good” and because they receive personal satisfaction from doing work that is perceived to have value.<sup>39</sup> This “donative labor theory” posits that nonprofit employees accept lower salaries as a form of donation to the nonprofit, and in return received greater job satisfaction knowing that they have contributed to the greater public good.<sup>40</sup> Donative labor theory is not without its flaws, the most significant of which is that the actual harm of donative labor theory does not fall on executives, it falls on rank and file employees.<sup>41</sup> Enshrining donative labor theory into law is a convenient mask for a general intent to raise money on the back of a sector that has fallen into political disfavor with some lawmakers while not actually assisting those members of the labor force harmed by it.

This is not to claim that excessive compensation does not happen. Some high-level executives at charities are, in fact, overpaid, whether due to poor board decision making, lack of oversight, or outright theft. Code Section 4960 does nothing to address these issues, and arguably is affirmatively harmful to those charities. An examination of these three fallacies highlights the fact that the problem of excessive charity compensation is not capable of the easy, one-size-fits-all fix afforded by a flat excise tax on an arbitrary bright-line number. As with Congress’ prior attempts to curb charity compensation through the Internal Revenue Code, the new excise tax never actually identifies the fundamental issue with excessive charity compensation. As such, the excise tax is merely a bandage, a show piece, and a revenue raiser, and not an actual solution for the problem (real or perceived) of excessive charity compensation.

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38. See, e.g., Dean Baker, *End Bloated Salaries in the Nonprofit Sector*, CTR. FOR ECON. AND POL’Y RSCH. (Feb. 19, 2019), <https://www.cepr.net/end-bloated-salaries-in-the-nonprofit-sector/> [<https://perma.cc/6V62-WWCB>] (“As fans of arithmetic know, the more money that goes to the CEO and other top executives, the less money is available to pay people lower on the ladder. This means less pay for both midlevel workers and the lower-level workers who clean the bathrooms and serve the food. And in the case of nonprofits, it also means less money for the beneficiaries of the charity in question.”).

39. See, e.g., Peter Manzo, *The Real Salary Scandal*, STAN. SOC. INNOVATION REV. 65, 66–67 (2004), [https://ssir.org/articles/entry/the\\_real\\_salary\\_scandal](https://ssir.org/articles/entry/the_real_salary_scandal) [<https://perma.cc/HZ3B-4C59>] (discussing the reasons individuals will “forego opportunities” with higher salaries to pursue nonprofit work).

40. Mirae Kim & Étienne Charbonneau, *Caught Between Volunteerism and Professionalism: Support by Nonprofit Leaders for the Donative Labor Hypothesis*, 40(2) REV. OF PUB. PERS. ADMIN. 329 (2020); see also MILTON FRIEDMAN, CAPITALISM AND FREEDOM 161–76 (3rd. ed. 2002).

41. See Baker, *supra* note 38 (explaining that when CEOs and top executives are paid more, less money is available for lower ranked employees); see also Kim & Charbonneau, *supra* note 40, at 327.

This Article will begin with a brief review of the law governing both charity and for-profit compensation before the TCJA and how Code Section 4960 purports to build on those bodies of law. From there, Part II will address each of the three compensation fallacies that underly Code Section 4960 in turn. The article will conclude with a plea for regulators to articulate the root causes of the perceived compensation issue and implement actual solutions—rather than simply enacting a mechanically applied excise tax and calling the problem “Solved.”

### I. THE TAX TREATMENT OF “EXCESSIVE” COMPENSATION

In order to understand why Code Section 4960 neither addresses the issue of excessive compensation at charities nor create parity between charities and public companies, it is helpful to understand generally how the Congress has attempted to regulate compensation through the tax code. Part I begins with an overview of the provisions regulating nonprofit compensation. Because Congress purported to base Code Section 4960 on its for-profit analogy, Code Section 162, this Part continues with a brief overview of Code Section 162.

#### A. Regulating Excessive Charity Compensation pre-TCJA

*The Private Inurement Prohibition.* Code Section 501(c)(3) provides the statutory authority for exempting charities from the federal income tax.<sup>42</sup> Since inception of the modern federal income tax,<sup>43</sup> the statutory language of Code Section 501(c)(3)<sup>44</sup> and its predecessors<sup>45</sup> has clearly prohibited a tax-exempt charity from making distributions of its profits: “[N]o part of the earnings of which can inure to the benefit of any private shareholder or individual.”<sup>46</sup> Referred to as the inurement prohibition,

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42. I.R.C. § 501(c)(3).

43. See Arnsberger et al., *supra* note 17, at 107 (“The . . . Revenue Act of 1913 established the modern Federal income tax system.”).

44. See IRS, INTERNAL REVENUE SERV., in EXEMPT ORGS. CONTINUING PRO. EDUC. TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1990 (1989) [hereinafter *Overview of Inurement*], <https://www.irs.gov/pub/irs-tege/eotopic90.pdf>. [https://perma.cc/KF7Z-F64D] [hereinafter 1990 EO CPE] (“The statutory prohibition against inurement of net earnings first appeared in 1894.”); see generally I.R.C. § 501(c)(3) (2014); Arnsberger et al., *supra* note 17, at 107.

45. Revenue Act of 1913, Pub. L. No 63-16, 38 Stat. 114, 172 (1913). The inurement language found in the Revenue Act of 1913 was derived from the Revenue Act of 1909. See Arnsberger et al., *supra* note 17, at 107 (“The [Revenue Act of 1913] used identical language found in the . . . 1909 [Act] with regard to . . . private inurement.”).

46. I.R.C. § 501(c)(3). See also I.R.C. § 501(c)(4)(B) (stating the exemption for social welfare organizations “shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.”); I.R.C. § 501(c)(6) (2014) (“Business leagues . . . not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.”).

this statutory language covers not only obvious profit distributions as returns on equity but also anything (including excess compensation) that can be characterized as a distribution of profits in the form of a disguised dividend.<sup>47</sup> Because the inurement prohibition is a statutory requirement of exemption, any violation of this standard, no matter how small, should theoretically cost an organization its tax-exempt status.<sup>48</sup>

Standing alone, Code Section 501(c)(3)'s private inurement prohibition proved insufficient to prevent excessive compensation.<sup>49</sup> There were two significant issues in regulating compensation through only the private inurement prohibition. First, the provision does not actually prohibit actual compensation; it prohibits disguised equity distributions that constitute unjust enrichment.<sup>50</sup> Clearly, these disguised equity distributions could be in the form of excess compensation, but that is not necessarily always the case.<sup>51</sup> What is a disguised equity

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47. See e.g., Gen. Couns. Mem. 39862 (Nov. 21, 1991) ("The inurement proscription does not prevent the payment of reasonable compensation for goods or services."); Gen. Couns. Mem. 39670 (Oct. 14, 1987) (stating that the IRS approved a deferred compensation plan for athletic coaches under a reasonable compensation standard).

48. See Gen. Couns. Mem. 39862, *supra* note 47 ("[I]nurement may be found even though the amounts involved are small. . . . There is no *de minimis* exception to the inurement prohibition." (citing *Spokane Motorcycle Club v. United States*, 222 F.Supp. 151, 153 (E.D. Wash.)); see also STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., HIST. DEV. AND PRESENT LAW OF THE FED. TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGS. 5 (Comm. Print 2005), *supra* note 24 ("There is no 'de minimis' exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status.").

49. By its terms, the statutory private inurement prohibition only applies to a "private shareholder[s] or individual." See I.R.C. § 501(c)(3); see also I.R.S. Gen. Couns. Mem. 39498 (Apr. 24, 1986) (noting that Treas. Reg. § 1.501(a)-1(c) has interpreted "private shareholder or individual" to mean people with "personal and private interest[s] in the activities of the organization."). In other words, a "private shareholder or individual" is equivalent to an "insider"—defined as "the equivalent of an owner or manager". The definition of an "insider" is historically relatively narrow, thus limiting its applicability to individuals who can influence policy although technically not in a position of complete authority. In addition, the definition of an insider is somewhat difficult to find, often relegated to the difficult realm of the "facts and circumstances test." As a result, it can be difficult for a nonprofit to determine whether someone who is not a de facto insider (such as director or officer) rises to the level of an insider for inurement analysis. See e.g., Gen. Couns. Mem. 39862, (Dec. 2, 1991) (expanding the definition of an insider to certain employees (citing Gen. Couns. Mem. 39498 EE-46-85 (Jan. 28, 1986) and I.R.S. Gen. Couns. Mem. 39670, EE-119-86 (June 17, 1987)); *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999) ("The test is functional. It looks to the reality of control rather than to the insider's place in a formal table of organization. The insider could be a "mere" employee—or even a nominal outsider.").

50. See 1990 EO CPE, *supra* note 44 (citing *People of God Community v. Comm'r*, 75 T.C. 127, 132-34 (1980)).

51. See *id.* ("Such transactions may include assignments of income, compensation arrangements, sales or exchanges of property, commissions, rental arrangements, gifts with retained interests, and contracts to provide goods or services to the organization.").

distribution versus actual compensation is not well-defined as a matter of law or capable of exacting precision as a matter of fact.<sup>52</sup>

The private inurement prohibition only has an “all or nothing” penalty option.<sup>53</sup> Because the provision was a statutory requirement of exemption, the only penalty available for violation of the prohibition was revocation of exemption—even if the violation was relatively minor or inadvertent.<sup>54</sup> The IRS was particularly reluctant to revoke the exemption of large organizations (such as a hospital or university) where compensation might have been somewhat excessive under some objective measurement, but not so egregious as to call into question the significant charitable works and the exempt status of the entire organization.<sup>55</sup>

*Historical Code Section 503.* In response to the shortfalls of the private inurement prohibition standing alone, Congress attempted to address the compensation question specifically in 1950. As part of the Tax Act of 1950,<sup>56</sup> Congress enacted then Code Section 503,<sup>57</sup> which required certain charitable organizations to engage in only arms-length transactions<sup>58</sup> (including compensation) with its related parties.

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52. See Jean Wright & Jay H. Rotz, *Reasonable Compensation*, INTERNAL REVENUE SERV., EXEMPT ORGS. CONTINUING PRO. EDUC. (1993) [hereinafter 1993 EO CPE] <https://www.irs.gov/pub/irs-tege/eotopici93.pdf> [<https://perma.cc/EE49-Q2AQ>] (“Numerous courts have held that reasonableness is a question of fact . . . ‘to be resolved . . . under all the existing circumstances.’”).

53. See John Simon et al., *The Tax Treatment of Nonprofit Organizations*, in THE NONPROFIT SECTOR, 267, 283 (Walter W. Powell & Richard Steinberg eds., 2nd ed. 2006) (“As early as 1965, one state bar association commented that an ‘all or nothing sanction’ could lead to a ‘breakdown of enforcement’ because the harshness of the remedy could deter the IRS from invoking it and the courts from decreeing it.”) (citation omitted).

54. See e.g., *Patman Conducts Study of Tax-Exempt Foundations*, CQ ALMANAC (1964) (“Dillon said that the existing laws were being properly enforced by the Treasury but felt that the penalties calling for revocation of a foundation’s exempt status were ‘too extreme.’ Because the courts were reluctant to impose a penalty which ‘presumably they found too strong,’ Dillon said, the Treasury Department had been ‘eminently unsuccessful’ in litigation in the area of unreasonable accumulation.”).

55. See STAFF OF JOINT COMM. ON TAX’N, 104TH CONG., GEN. EXPLANATION OF TAX LEGIS. ENACTED IN THE 104TH CONG. 60 (Comm. Print 1996) (“In general, the intermediate sanctions are the sole sanction to be imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization.”); see also Revenue Act of 1913, Pub. L. No 63-16, 38 Stat. 114, 172 (noting that nothing in this section will apply to charitable organizations).

56. Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906 (1950).

57. I.R.C. § 503 (1954).

58. See generally I.R.C. § 503(c) (1954); see also James J. Fishman, *The Private Foundation Rules at Fifty: How Did We Get Them and Do They Meet Current Needs?*, 17 PITT. TAX REV. 247, 254–55 (2020) (detailing how the original version of Code Section 503 from the House Ways and Means Committee included a prohibition on financial transactions with insiders, but that was softened to “arms length” by the Senate Finance Committee).

Specifically, Code Section 503 enumerated a number of “prohibited transactions,”<sup>59</sup> including “any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .”<sup>60</sup> If an organization covered by then Code Section 503 engaged in a prohibited transaction, then it lost its tax-exempt status.<sup>61</sup> This loss of exemption was not necessarily permanent; rather, the organization lost its exemption only for the tax year of the transaction unless “[the] organization entered into such prohibited transaction for the purpose of diverting corpus or income of the organization from its exempt purpose, and such transaction involved a substantial part of the corpus or income of such organization.”<sup>62</sup> The organization could be treated as tax exempt in following years if it demonstrated that it would “not knowingly again engage in a prohibited transaction. . . .”<sup>63</sup>

The reach of Code Section 503 was quite limited, as the statute provided broad exemptions from the application of the general prohibition.<sup>64</sup> Section 503 did not apply to religious organizations<sup>65</sup> and certain of their affiliated entities,<sup>66</sup> schools,<sup>67</sup> charities that received a substantial amount of their support from public contributions,<sup>68</sup> hospitals, and certain medical research and education organizations.<sup>69</sup> In modern parlance, this would mean that Code Section 503 applied, for the most part, only to what we would today call a private foundation, although the definitions are not completely identical.<sup>70</sup>

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59. I.R.C. § 503(c) (1954).

60. I.R.C. § 503(c)(2) (1954).

61. I.R.C. § 503(a)(1) (1954).

62. I.R.C. § 503(a)(2) (1954).

63. I.R.C. § 503(d) (1954).

64. *See generally* I.R.C. § 503(b) (1954).

65. I.R.C. § 503(b)(1) (1954).

66. I.R.C. § 503(b)(4) (1954).

67. I.R.C. § 503(b)(2) (1954).

68. I.R.C. § 503(b)(3) (1954).

69. I.R.C. § 503(b)(5) (1954).

70. Under current law, a Code Section 501(c)(3) organization is deemed to be a private foundation unless it demonstrates that it is entitled to public charity status. I.R.C. § 509(a). Generally, public charity status is currently afforded to churches, schools, hospitals, medical research organizations, state university foundations, governmental entities, charities substantially supported by donations from the public, charities substantially supported by fees for charitable services, and supporting organizations. *See* I.R.C. § 509(a)(1)–(3); *also* I.R.C. § 170(b)2022. Broadly speaking, Code Section 503 would have applied to what we currently consider to be private foundations, as well as state university foundations, fee for service charities, and supporting organizations. *See* Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52, 54 n.12 (2000) (“The Committee Reports offer no explanation for the exception of public charities from the general reporting requirement” and when Congress dealt with the problem, “[I]t applied the same remedy to private foundations and public charities alike, excepting only churches.”).

It is clear then that Code Section 503's effectiveness was hampered in a number of ways. First, a significant number of organizations simply escaped its reach given its limited applicability.<sup>71</sup> In addition, the question of what constituted a reasonable allowance for compensation remained, as it did under the private inurement language of Code Section 501(c)(3).<sup>72</sup> The penalty was simultaneously too harsh and not harsh enough. Loss of exemption for one year was a relatively nominal penalty and would not deter certain organizations from taking an aggressive stance on reasonable compensation and promising not to do it again if (not when) they were caught. At the same time, having only one level of penalty—revocation—leads to the same concerns that arose with enforcement under the private inurement principle.<sup>73</sup>

Congress soon recognized that Code Section 503 was not adequate to address ongoing self-dealing issues in the entirety of the charitable sector.<sup>74</sup> With the passage of the private foundation excise taxes in 1969, described below, Code Section 503 became mostly superfluous. It was amended to apply only to organizations described in Code Section 501(c)(17) (supplemental unemployment compensation trusts) and 501(c)(18) (certain trusts related to pension plans), and to some retirement plans.<sup>75</sup>

*The Private Foundation Excise Tax on Self-Dealing.* As time progressed, it became clear that the loose standard of Code Section 503 was ineffective in curbing excessive compensation and other self-dealing transactions in the charitable sector. Starting in the early 1960s, Congress investigated the operations of private foundations, focusing on abuses of and benefits accruing to the wealthiest families in America. Referred to

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71. See Ellen P. Aprill, *The Private Foundation Excise Tax on Self-Dealing: Contours, Comparisons, and Character*, 17 PITT. TAX REV. 297, 301 (2020) (detailing the practical effects of the restrictions).

72. See Fishman, *supra* note 58 at 255 (citing Troyer, *supra* note 70, at 53); see also *id.*, at 259; see also Aprill, *supra* note 71 at 302 (“The 1950 self-dealing rules relied on such inherently ambiguous terms as ‘substantial,’ ‘adequate,’ and ‘reasonable,’ were unsatisfying and unworkable. They left too much discretion to donors as to what is reasonable and requiring too much expensive effort by the IRS to administer such a vague standard.”).

73. See Fishman, *supra* note 58 at 277 (“Previously the only remedy was loss of tax-exemption, which was rarely used.”).

74. S. COMM. ON FIN., 89TH CONG., TREASURY DEP'T REP. ON PRIVATE FOUNDATIONS 1 (Comm. Print 1965).

75. I.R.C. § 503(a)(1); see also Tax Reform Act of 1969, Pub. L. 91-172, §§ 101(j)(7), 101(j)(8), and 121(b)(6)(B)(ii), 83 Stat. 487. In combination, these sections of the Tax Reform Act amended Section 503 by removing references to Section 501(c)(3) organizations, correcting the format of existing references to Section 501(c)(17), adding Code Section 501(c)(18), and then renumbering the Section as so amended.

as the Patman Hearings,<sup>76</sup> these hearings highlighted the manner in which wealthy families used private foundations to preserve and grow dynastic fortunes.<sup>77</sup> At least in partial response to the Patman Hearings and public criticism,<sup>78</sup> Treasury, at Congress's behest, undertook a fairly comprehensive study of private foundations in the mid-1960s.<sup>79</sup> As a result of these reports, Congress (after even more hearings) enacted a number of excise taxes designed to regulate private foundation behavior in 1969. These excise taxes specifically include Code Section 4941, which governs executive compensation and other self-dealing transactions by private foundations.<sup>80</sup>

Unlike Code Section 503, Code Section 4941 generally prohibits all self-dealing transactions between a private foundation and certain of its related parties, known as "disqualified persons."<sup>81</sup> The term "disqualified persons" includes an organization's officers, directors, substantial contributors, their family members, and certain related organizations and trusts.<sup>82</sup> Under this general rule, a private foundation is prohibited from compensating a disqualified person unless an exemption applies.

That being said, Code Section 4941 does contain a very specific exception from the definition of self-dealing for "the payment of compensation . . . by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the foundation . . . if the compensation . . . is not excessive."<sup>83</sup> Thus, as most of a private foundation's executives are disqualified persons, executive compensation is an act of self-dealing

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76. The hearings were named after Congressman Wright Patman of Texas. For an excellent description of Congressman Patman's personal role in the eventual passage of the private foundation excise taxes, see Troyer, *supra* note 70, at 12 n.19; see also Fishman, *supra* note 58 at 253 n.27.

77. Interestingly, many of the criticism leveled at private foundations during the Patman Hearings originally found a voice in the Industrial Relations Report issued by the Walsh Commission in 1916, demonstrating that public criticism of such organizations has existed for some time. See generally COMM'N ON INDUSTR. RELATIONS, FINAL REP. & TESTIMONY, 64TH CONG. 7916-17 (1st Sess. 1916); See generally Frank P. Walsh, *Perilous Philanthropy*, 83 THE INDEP. 262 (1915).

78. Fishman details that Wright Patman was a bombastic figure that had limited influence with his colleagues, but the output of his hearings no doubt set in motion the process then ended with the Tax Reform Act of 1969 and the private foundation excise taxes. Fishman, *supra* note 58 at 252. See Fishman's description of Patman's testimony at the hearings in advance of the Tax Reform Act of 1969, at *id.* at 261-63.

79. Fishman, *supra* note 58, at 257 (citing Troyer, *supra* note 70, at 55).

80. See generally I.R.C. § 4941.

81. I.R.C. § 4941(d)(1) (2018).

82. I.R.C. § 4946(a).

83. I.R.C. § 4941(d)(2)(E).

subject to the excise tax unless it is all of the following: (1) for personal services, (2) reasonable and necessary, and (3) not excessive.<sup>84</sup>

If a private foundation pays excessive executive compensation, then Section 4941 imposes a 10% excise tax on the disqualified person (that is, the recipient of the compensation).<sup>85</sup> In addition, a 10% excise tax is imposed on any foundation manager that authorized the compensation knowing it was an act of self-dealing, unless the participation is “not willful and due to reasonable cause.”<sup>86</sup> If the act of self-dealing is not corrected in a timely fashion, an additional 200% excise tax may be imposed upon both the disqualified person and any foundation manager that refused to participate in the correction.<sup>87</sup> As private foundations are simply a subset of Code Section 501(c)(3) organizations, they always remain subject to the general private inurement prohibition, although the Internal Revenue Service reserves revocation of exempt status as a penalty in the most flagrant of cases.

By most accounts, the private foundation excise taxes were an improvement over Code Section 503.<sup>88</sup> While not without their faults, the excise taxes have been relatively successful in curbing much of the abusive transactions at large dynastic foundations described in the Patman Hearings, including limiting excessive private foundation compensation.<sup>89</sup> As noted by nonprofit scholar Professor James Fishman, “the excise tax has an *in terrorem* effect. The amounts it raises are relatively small. Because of the impact of these penalties, private foundations and their managers generally are the most compliant of taxpayers.”<sup>90</sup>

To a limited extent, this is borne out by Internal Revenue Statistics on private foundations. A 2008 report prepared by statisticians and economists at the Special Studies Project Section of the IRS found that:

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84. *Id.*; See also 26 C.F.R. § 53.4941(d)-3(c).

85. I.R.C. § 4941(a)(1).

86. I.R.C. § 4941(a)(2). Code Section 4962 allows the abatement for some of the private foundation excise taxes if they are due to reasonable cause and not willful neglect; however, abatement is specifically unavailable for the Code Section 4941 excise tax. See I.R.C. § 4962(b).

87. I.R.C. § 4941(b).

88. Fishman, *supra* note 58, at 277 (“One of the most unique innovations was the adoption of a graduated penalty scheme of taxes placed on foundations and their managers . . . if they engaged in prohibited activities or failed to meet the minimum annual distribution or the excise tax on investment income requirements.”).

89. *Id.* at 286.

90. See *id.* (citing Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59, 63 (2004)); see also Aprill, *supra* note 71, at 308 (“At least to some extent, the existence of § 4941 appears to have an *in terrorem* effect to succeed in presenting self-dealing transactions.”).

In 2003, self-dealing accounted for \$400,000 of the \$4.1 million total of reported excise taxes. By 2006, the amount had increased to \$2.1 million of the \$5.3 million total. As a percentage of total excise tax reported, self-dealing quadrupled from 10 percent to 40 percent. A small number of filers were responsible for this increase. From 2003 to 2006, the median tax on self-dealing actually fell.<sup>91</sup>

In that 2008 report, the authors found that the most significant source of tax liability under the private foundation excises taxes came from the tax on undistributed income under Code Section 4942 by a significant amount; by contrast, the liability for the Code Section 4941 self-dealing excise tax was relatively small.<sup>92</sup>

As Professor Ellen Aprill points out, the relatively small amount of excise tax collected under Code Section 4941 (which includes all acts of self-dealing, not just excessive compensation) does “not ineluctably lead to the conclusion that § 4941 is working well.”<sup>93</sup> The private foundation excise tax regime relies in significant part on self-reporting. While in general voluntary compliance in the nonprofit sector seems high,<sup>94</sup> Professor Aprill notes that there is likely significant under-reporting of self-dealing transactions.<sup>95</sup> Professor Lloyd Mayer, in looking at tax compliance by nonprofit organizations, notes with regard to private foundations:

There are nevertheless some indications that at least minor noncompliance may be relatively widespread in the larger exempt organizations universe. For example, a recent project focusing on large private foundations resulted in additional taxes or penalties in almost half of the closed examinations, although apparently no revocations as of the last report from the IRS.<sup>96</sup>

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91. Arnsberger et al., *supra* note 17 at 118.

92. *Id.* at 116–17 (“[T]axes on undistributed income accounted for the majority of total taxes reported on Form 4720 and were the most frequently reported excise tax.”); Aprill, *supra* note 71, at 307. The 2008 report studies only Form 4720 from 2003–2006. A brief review of the statistical data for years after 2006, available on the IRS website, shows that these trends have continued. *See generally id.*

93. Aprill, *supra* note 71, at 308. For an additional critique of the private foundation excise taxes, see Ray Maddoff, *The Five Percent Fig Leaf*, 17 PITT. TAX. R. 341 (2020).

94. Lloyd Mayer, “*The Better Part of Valor Is Discretion*”: *Should the IRS Change or Surrender Its Oversight of Tax Exempt Organizations?*, 7 COLUM. J. TAX L. 80, 95 (2016) (“The IRS estimated a voluntary payment compliance rate for all tax-exempt and government entities in tax year 2001 of 99.87 percent%, the highest rate among the four IRS operating divisions. It is not clear how reliable or how reflective of actual compliance that figure is, given that violations of the requirements for exemption rarely result in revocation.” (citing IRS, REDUCING THE FED. TAX GAP: A REP. ON IMPROVING VOLUNTARY COMPLIANCE 16 (2007))).

95. Aprill, *supra* note 71, at 308.

96. *See* Mayer, *supra* note 94, at 95–96 (citing IRS EXEMPT ORG.: FY 2012 ANN. REP. & FY 2013 WORKPLAN 19 (2012), [http://www.irs.gov/pub/irs-tege/FY2012\\_EO\\_AnnualRpt\\_2013\\_Work\\_Plan.pdf](http://www.irs.gov/pub/irs-tege/FY2012_EO_AnnualRpt_2013_Work_Plan.pdf) [<https://perma.cc/N56P-BKYD>]).

The comparative (although not perfect) success of Code Section 4941 is due to significant structural differences between it and Code Section 503. Both statutes employ a reasonableness standard for compensation: Code Section 503 requires a “reasonable allowance” for compensation while Code Section 4941 requires a “reasonable and necessary” compensation that is “not excessive.” The primary differences between the provisions are in the nature of and liability for the applicable penalty. Under old Code Section 503, the penalty was on the organization only and was, in most instances, limited to the tax-exempt status for the year of the violation. In theory, if an organization were taxed as a C corporation for a year, it is possible that the organization’s C corporation deductions (including the compensation deduction under Code Section 162) could significantly limit its taxable income for that year, causing the “penalty” of loss of exemption to be nominal. In reality, the most significant penalty would likely fall on individual donors facing the disallowance of any charitable deductions for donations for that year, if any.<sup>97</sup>

In contrast, the penalty under Code Section 4941 is a percentage of the amount of the excessive transaction.<sup>98</sup> The penalty falls personally on the compensation recipient, and potentially, on any foundation manager acting without good cause.<sup>99</sup> It does not fall on the charity unless there are multiple, willful acts of self-dealing,<sup>100</sup> or if the self-dealing rises to the level of endangering the charity’s tax-exempt status under Code Section 501(c)(3) as prohibited inurement.<sup>101</sup> As a result, the recipient of the compensation has, for the first time, exposure to the penalty. The executive and the individual members of the governing body, with a real financial penalty on the participants in the transaction, now have a personal reason to care about whether a compensation transaction is excessive.

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97. I.R.C. § 503(e) (1954) (removing the ability for a donor to take deductions for donations to disallowed charities).

98. I.R.C. § 4941(a) (2018) (establishing a 10 percent% tax on all property involved in self-dealing).

99. To bring home the point, the Treasury Regulations under Code Section 4941 make it clear that it is a separate act of self-dealing to indemnify a foundation manager against the imposition of the excise tax if the foundation manager acted willfully and without reasonable cause unless the indemnification itself is treated as part of the foundation manager’s own reasonable compensation package. Treas. Reg. § 53.4941(d)-2(f)(iii)(3) to (5) (2024); *see generally* Treas. Reg. § 53.4941(d)-3 (2024).

100. *See generally* I.R.C. § 507(a)(2).

101. A transaction can be beneficial to a foundation (such as a bargain sale) and still be an act of self-dealing under Code Section 4941. *See* Treas. Reg. § 53.4941(d)-1(a) (2024). However, an act of self-dealing that was detrimental to the foundation could rise to the level of private inurement. *See generally* I.R.C. § 501(c)(3).

*Intermediate Sanctions under Code Section 4958.* Code Section 4941 by its terms only applies to private foundations, as did its predecessor, Code Section 503, at least functionally.<sup>102</sup> As a result, until 1995 compensation at most public charities was subject only to the general prohibition against private inurement found in the statutory language of Code Section 501(c)(3) itself.<sup>103</sup> As previously mentioned, the bright line rule of the statutory language of Code Section 501(c)(3) left little room for nuance—even one penny of inurement was theoretical grounds of revocation of tax-exempt status. It became difficult for the IRS to police excess compensation transactions without a sanction short of revocation of exempt status—and thus, “intermediate sanctions” were born.<sup>104</sup>

At the time the private foundation excise taxes were passed, the fact that public charities escaped compensation scrutiny seemed unimportant. Public outcry was directed at wealthy families using private foundations as a tax scam, and therefore, private foundations were the villains of the day. As Professor Fishman notes

in contrast to private foundations, public charities in 1969 and before did not seem to have the same number of bad actors, a view that would not hold today as the nonprofit sector is scrutinized more closely through the Internet, social media, and the news.<sup>105</sup>

After 1969, however, a number of significant compensation and self-dealing scandals hit the news, including high profile issues at Adelphi University and The United Way.<sup>106</sup> In light of these mounting scandals,

102. See *supra* notes 54–59 for a discussion of and accompanying text discussing the implementation of Code Section 503 and the provisions that required separating the economic actions of charitable and for-profit institutions.

103. Celia Roady & Shira M. Helstrom, 476-2nd T.M., *Tax-Exempt Organizations—Intermediate Sanctions (Section 4958)* 11–12 (arguing that full revocation was an inadequate sanction for all types of abuse).

104. *Id.* at 121–24 (arguing that the policy punished the organization instead of the individual, that the sanctions were disproportionate, and the revocation of exempt status had adversely affected the charitable mission the Code sought to promote).

105. Fishman, *supra* note 58, at 284.

106. In 1985, Peter Diamandopoulos, the president of Adelphi University, was removed from office for conflict-of-interest transactions, including excessive compensation. In addition, most of Adelphi’s Trustees were removed for violating their duty of care in overseeing Diamandopoulos and engaging in their own conflict transactions. A.S. Zaidi, *Adelphi Recovers “The Long View”*, AGAINST THE CURRENT (1998), <https://againstthecurrent.org/atc077/p866/> [<https://perma.cc/GDV3-AHU3>]. In 1992, the IRS and FBI investigated William Aramony, the then CEO of the United Way, for excessive compensation and misuse of charitable funds. In 1995, Aramony and two conspirators, Thomas Merlo and Stephen Paulachak, were convicted of defrauding the United Way. Aramony was convicted on twenty-five felony counts and sentenced to seven years in prison. Matt Marshall, *United Way Scandal Puts New Focus on Nonprofit Pay Levels*, L.A. TIMES (May 14, 1992, 12:00 AM), <https://www.latimes.com/archives/la-xpm-1992-05-14-mn-3008-story.html> [<https://perma.cc/H65Q-HY58>]. For more examples from a variety of

Congress enacted self-dealing and excessive compensation rules that were applicable to public charities in 1995.<sup>107</sup> These rules, found in Code Section 4958, finally gave the IRS a tool that was short of revocation of exemption with which to police excessive compensation and self-dealing transactions at public charities.<sup>108</sup>

Code Section 4958 imposes an excise tax on transactions that provide an “excess benefit” to certain individuals, including excess compensation.<sup>109</sup> Specifically, Code Section 4958 imposes an excise tax on any “excess benefits” given to a disqualified person in an “excess benefit transaction.” The term “excess benefit transaction” means

any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (*including the performance of services*) received for providing such benefit. For purposes of the preceding sentence, *an economic benefit shall not be treated as consideration for the performance of services* unless such organization clearly indicated its intent to so treat such benefit.<sup>110</sup>

As indicated by the statutory language, Congress clearly contemplated that “unreasonable” compensation arrangements would be excess benefit transactions subject to sanctions.<sup>111</sup> In order to determine whether a compensation arrangement is an excess benefit transaction, the charity must determine the market value for the performances of services and compare that value to the compensation actually received.<sup>112</sup> To the extent that the total compensation received exceeds the fair market value of the service performed, a taxable excess benefit has occurred.<sup>113</sup> Of course, the obvious difficulty is determining what the market value of a specific set of services is.<sup>114</sup>

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eras, see *Hall of Shame: The Personalities Behind Charity Scandals*, CHARITYWATCH (last updated Aug. 24, 2018), <https://www.charitywatch.org/charity-donating-articles/charitywatch-hall-of-shame> [<https://perma.cc/WP2K-8UUA>].

107. By its terms, Code Section 4958 applies to all Code Section 501(c)(3) organizations as well as Sections 501(c)(4) and 501(c)(29) organizations other than private foundations; private foundations continued to be governed by Code Section 4941. See generally I.R.C. § 4958(e).

108. H.R. REP. NO. 104-506, at 1, 54–55 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1177–78.

109. I.R.C. § 4958(c).

110. *Id.* § 4958(c)(1)(A) (emphasis added).

111. H.R. REP. NO. 104-506, at 56 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1179.

112. See generally Treas. Reg. § 53.4958-4(a) (2024).

113. Treas. Reg. § 53.4958-4(a) (2024).

114. Treas. Reg. § 53.4958-4(b)(1)(ii) (2024).

When Treasury issued regulations under Code Section 4958 in 2002,<sup>115</sup> it paid close attention to compensation arrangements, and specifically, the determination of how one might calculate market compensation.<sup>116</sup> Under these Regulations, compensation is reasonable if “[t]he value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).”<sup>117</sup> Accordingly, when determining the market value of services, a charity can look at what is being paid in both the for-profit and charitable sectors.

It is also important to note that the Regulations already incorporate the notion of parity between the charitable and for-profit sector for purposes of determining reasonable compensation. As will be discussed,<sup>118</sup> Code Section 162, which regulates for profit compensation, requires compensation to be “reasonable” to be deductible.<sup>119</sup> The Regulations under Code Section 4958 also utilize a “reasonableness” standard for determining whether an excess benefit transaction has occurred.<sup>120</sup> In fact, these Regulation specifically incorporate Code Section 162’s standard for reasonableness into the Code Section 4958 definition.<sup>121</sup> Additionally, Code Section 4958’s Regulations specifically allow the use of for-profit market data when evaluating compensation packages.<sup>122</sup>

Procedurally, the Regulations grant a charity a rebuttable presumption that a compensation package is reasonable if the charity takes certain procedural steps when approving the compensation.<sup>123</sup> Under this procedure, a charity must show that (1) the compensation arrangement

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115. Lawrence M. Brauer & Leonard J. Henzke, *Intermediate Sanctions (IRC 4958) Update, in EXEMPT ORGS. CONTINUING PRO. EDUC. TECH. INSTRUCTION PROGRAM FOR FISCAL YEAR 2003* (2003), <https://www.irs.gov/pub/irs-tege/eotopice03.pdf> [<https://perma.cc/BGK7-7WKX>]; *see also* Excise Tax on Excess Benefits Transactions, 67 Fed. Reg. 3076 (Jan. 23, 2002) (reproducing T.D. 8978).

116. *See generally* Treas. Reg. §§ 53.4958-4, 53.4958-6 (2024).

117. Treas. Reg. § 53-4958-4(b)(1)(ii)(A) (2024).

118. *See infra* Part I.B for further discussion on determining reasonable compensation under Code Section 162.

119. *See generally* I.R.C. § 162(a); *see also* Stumpff, *infra* note 160 (providing the deduction for ordinary and necessary business expenses includes “reasonable allowance for salaries or other compensation”).

120. Treas. Reg. § 53.4958-4(b)(1)(ii) (2024).

121. *Id.* (“Section 162 standards apply in determining the reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under paragraph (a)(4) of this section) provided to a person and the rate at which any deferred compensation accrues.”)

122. *Id.* (“The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).”)

123. *See generally* Treas. Reg. § 53.4958-6 (2024).

was approved in advanced by an independent and authorized governing body, (2) the authorized governing body obtained and relied on comparability data, and (3) the authorized governing body adequately and contemporaneously documented its decisions and the basis thereof.<sup>124</sup>

A governing body will meet the first factor if it is authorized to act and is independent, *i.e.*, free from conflicts of interest.<sup>125</sup> An authorized governing body specifically includes compensation committee or third parties as long as they are authorized to act under State law.<sup>126</sup> To be free from conflicts of interest, a member of the governing body must not have a direct conflict, but may also not approve compensation for an individual who, in turn, will approve that person's compensation.<sup>127</sup>

In meeting the second factor, the decision-making body must obtain and rely upon appropriate data to determine the fair market value of the services to be performed. For compensation decisions, "relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions"<sup>128</sup> as well as other factors.<sup>129</sup> These Regulations specifically acknowledge that charitable organizations compete in the same labor pool with for-profit entities. As discussed further,<sup>130</sup> there is a popular notion that those working for charity should simply accept lower compensation, presumably in return for the psychic benefit of doing good. This approach was specifically not intended by Congress<sup>131</sup> and not adopted in the Treasury Regulations. Rather, a charity can pay the same amount that a for-profit organization and qualify for the reasonableness presumption.

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124. Treas. Reg. § 53.49458-6(a) (2024).

125. Treas. Reg. § 53.4958-6(c)(1) (2024).

126. Treas. Reg. § 53.4958-6(c)(1)(i) (2024).

127. Treas. Reg. § 53.4958-6(c)(1)(iii) (2024).

128. Treas. Reg. § 53.4958-6(c)(2)(i) (2024). The examples in the Regulations specifically discuss compensation for a university president. In examples 1 and 2, the board did not have appropriate comparability data because they looked at the range for all university presidents, rather than universities of a similar size and geographic location. Similarly, examples 3 and 4 in the Regulations discuss the determination of reasonable compensation for a hospital administrator and a subsequent renegotiation of that package. Treas. Reg. § 53.4958-6(c)(2)(iv) (2024).

129. Treas. Reg. § 53.4958-6(c)(2)(i) (2024) (listing other factors including availability, geography, compensation surveys and other actual offers).

130. *See infra* Part II.C pp. 161–66 for a discussion of the donative labor theory.

131. STAFF OF JOINT COMM. ON TAX'N, 104TH CONG., GEN. EXPLANATION OF TAX LEGIS. ENACTED IN THE 104TH CONGR. 69, n. 5 ("In this regard, the Committee intends that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization.").

Like Code Section 4941 before it, Code Section 4958 imposes the excise tax on excess benefit transactions on the disqualified person<sup>132</sup> involved in the transaction<sup>133</sup> and on any organization manager, personally, who participated in the transaction unless such participation was not willful and due to reasonable cause.<sup>134</sup> That being said, the general inurement principles of Code Section 501(c)(3) continues to apply, so a charity could lose its exempt status due to an excess benefit transaction taxable under Code Section 4958. The Regulations under Code Section 501(c)(3) provide a list of factors that the IRS should consider when determining whether an excess benefit transaction or transactions give rise to an inurement violation.<sup>135</sup> “Both the legislative history and early court decisions . . . confirm the view that § 4958 should be interpreted so far as possible to be precisely congruent with the scope of the inurement proscription . . . .”<sup>136</sup>

Although Code Section 4958 purported to be a comprehensive solution to the problem of excess charity compensation and similar self-dealing transactions, the results have not been clear. There was a significant amount of confusion about enforcement between the enactment of Code Section 4958 in 1996 until the first set of proposed regulations under Code Section 4958 were adopted in August 1998.<sup>137</sup> Treasury issued temporary regulations in 2001, with final regulations becoming effective on January 23, 2002, a full eight years after the Code section was first enacted. These regulations were amended in 2008, with the addition of the provision clarifying the interaction between the inurement prohibition of Code Sections 501(c)(3) and 4958.<sup>138</sup>

Since the enactment of Code Section 4958, case law has been scarce.<sup>139</sup> The first intermediate sanctions case, *Caracci v.*

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132. The definition of a disqualified person is different in Code Section 4941 and Code Section 4958. Generally, the definition under Code Section 4958 is broader. For example, with the Code Section 4958 definition including references to supporting organizations and donor advised funds and includes siblings as family members. *Compare* I.R.C. § 4958(f)(1) *with* I.R.C. § 4946(a)(1).

133. I.R.C. § 4958(a)(1).

134. I.R.C. § 4958(a)(2).

135. Treas. Reg. § 1.501(c)(3)-1(f)(2) (2024).

136. Simon et al., *supra* note 53.

137. Terry Knoepfle, *The Pension Protection Act of 2006: A Misguided Attack on Donor-Advised Funds and Supporting Organizations*, 9 FLA. TAX REV. 221, 232 (2009).

138. *See id.* at 237–38 (detailing the clarifications provided by the IRS).

139. In addition to the *Caracci* and *Ononju* cases, discussed immediately below, *see also* *Dzina v. United States*, 345 F. Supp. 2d 818 (N.D. Ohio 2004) (regarding potential excess benefit transactions involving the sale, lease, and improvement of land); *Lintzenich v. United States*, 371 F. Supp. 2d 972 (S.D. Ind. 2005) (involving the standard for issuing a subpoena in a potential excess benefit transaction case); and *Fumo v. Commissioner*, 121 T.C.M. (CCH) 1475 (2021) (regarding fraudulent personal use of a controlled charity by a public official.) None of these cases would have been covered by I.R.C. § 4960.

*Commissioner*,<sup>140</sup> did not deal specifically with compensation issues; rather, it addressed the value of a home health care operation that was being sold by a nonprofit organization to a for-profit corporation controlled by the same disqualified persons. The more recent case *Ononuju v. Commissioner*<sup>141</sup> involves more traditional compensation issues, where individuals in control of the organization simply took cash out of a tax-exempt medical clinic as needed, with no regard to whether such amounts constituted compensation. More than just a disagreement about the reasonableness of a compensation package, the *Ononuju* case involved essentially fraudulent activities, resulting in both the imposition of the excise tax and the revocation of exemption for the medical clinic.<sup>142</sup> It is important to note that *Caracci* did not involve compensation and the aggregate amounts at issue in *Ononuju* were under \$1 million, so neither case would not have triggered the new excise tax on excessive compensation under Code Section 4960.

Although there is not much in the way of precedential guidance under Code Section 4958, there was (and is) widespread belief that there is significant technical non-compliance—although not in necessarily significant amounts of excess compensation or with larger organizations. In 2004, Treasury instituted the Executive Compensation Compliance Initiative, a project that involved the use of review of Forms 990 and targeted compliance checks focusing specifically on compensation, sometimes involving questionnaires and other times full audits.<sup>143</sup> While the Initiative did find non-compliance, it was often in the form of reporting failures or the management of certain types of benefits.<sup>144</sup> There was, however, significant non-compliance with the requirements for the rebuttable presumption of reasonableness under the Treasury Regulation, with only 51% of reporting charities successfully complying with all three prongs of the test for reasonableness.<sup>145</sup>

That being said, the number of entities with actual excessive compensation was relatively small—excise taxes were imposed on 25 of

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140. 188 T.C. 379 (2022), *aff'd*, 456 F.3d 444 (5th Cir. 2006).

141. 122 T.C.M. (CCH) 109 (2021).

142. For more background, see generally Bob Johnson, *Former Saginaw, Flint Doctor Sentenced for Medicaid Fraud*, MLIVE, (December 7, 2016, 6:31 PM), [https://www.mlive.com/news/saginaw/2016/12/former\\_saginaw\\_flint\\_doctor\\_se.html](https://www.mlive.com/news/saginaw/2016/12/former_saginaw_flint_doctor_se.html) [https://perma.cc/Q42D-WUYZ].

143. IRS, REP. ON EXEMPT ORGS. EXEC. COMP. COMPLIANCE PROJECT—PARTS I AND II (March 2007), [https://www.irs.gov/pub/irs-tege/exec\\_comp\\_final.pdf](https://www.irs.gov/pub/irs-tege/exec_comp_final.pdf) [https://perma.cc/DGG5-ZB6H].

144. The report found that 85% of public charities reported compensation correctly on the Form 990, and similarly, 94% of private foundations reported compensation correctly on the Form 990-PF. *Id.* at 8.

145. *Id.*

782 organizations examined (although some examinations remained open at when the report was issued in 2007) and only 5% for private foundations reported excessive compensation.<sup>146</sup> As one practitioner noted, “Only a relatively small number of tax-exempt organizations have problems under these provisions, but when problems do arise the tax assessments can be very high.”<sup>147</sup> Unfortunately, the report does not break down the compensation packages by amount, so it is impossible to determine whether these amounts would have been subject to the new excessive compensation excise tax of Code Section 4960.

Similarly, in 2008, the IRS began a compliance project specifically targeting colleges and universities, which covered executive compensation as well as several other topics. In 2013, the IRS released a final report on the project.<sup>148</sup> The final report indicated that approximately 20% of the 400 colleges and universities examined would not have qualified for the rebuttable presumption of reasonableness under the Regulations, primarily due to either poor comparability data or the failure to include non-salary benefits, including retirement plans.<sup>149</sup> That is not to say, however, that this compliance project found a significant number of excess benefit transactions. Rather, most compensation was found to be within the range of comparable data, although admittedly on the high end of the range.<sup>150</sup> The median salaries in each case for the top official (typically, a college president), investment manager, and college coaches were all under the \$1 million number that would have triggered Code Section 4960’s excise tax.<sup>151</sup>

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146. *Id.* at 7, 9.

147. Robert J. Lowe, *IRS Provides Audit Results for Executive Pay by 501(c)(3)s*, MSK (March 2007) <https://www.msk.com/newsroom-publications-141> [<https://perma.cc/JHP8-9633>].

148. IRS, COLLS. AND UNIVS. COMPLIANCE PROJECT FINAL REP. 4 (May 2, 2013) [https://www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_050213.pdf](https://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_050213.pdf). [<https://perma.cc/M6X7-7XFG>].

149. *Id.*

150. *Id.* at 23 states:

After engineers either accepted the comparability data presented or established alternative comparability data, they determined where compensation paid by the examined organization fell within the range of compensation paid by colleges and universities in the comparable data set for each position. The compensation for most positions analyzed was set in the range of the 75th percentile. Moreover, compensation set at or above the 90th percentile was much more common than compensation set in the range of the 50th percentile among the examined colleges and universities.

In total, the IRS issued written advisories in 24 cases, involving 117 separate Form 990 returns. *Id.* at 24.

151. *See generally id.* at 16–18, 28–29.

Finally, in 2009, the IRS instituted a hospital compliance project that included reporting on executive compensation.<sup>152</sup> Of the 544 hospitals that were sent questionnaires, 20 resulted in compensation examinations.<sup>153</sup> The report found much higher levels of compliance with the rebuttable presumption procedures and, generally, mostly reasonable compensation.<sup>154</sup> In her press briefing, then IRS Director of the IRS' Exempt Organizations Division stated:

The hospitals selected for examination were chosen based on their apparent high compensation relative to others within the study . . . The exams confirmed the widespread use of the rebuttable presumption procedure available to these hospitals, which means that organizations relied on comparability data and independent personnel to establish the compensation, and documented the basis for the decisions that were made. Nearly all the compensation amounts we reviewed were reasonable under the current statutory standard, even though some of the amounts were quite substantial.<sup>155</sup>

The average annual compensation for hospitals generally was under the \$1 million threshold of Code Section 4960; however, the group selected for examination had an average compensation package of \$1.4 million.<sup>156</sup>

Overall, the IRS' compliance checks appear to indicate that while compensation packages more than \$1 million continue to exist in certain markets (large urban hospitals, college coaches), this compensation is not necessarily "excessive"—that is, unreasonable—given the markets in which they exist. IRS reports appear to indicate that truly high-end excessive compensation appears to be limited to a few egregious instances, resulting in significant penalties.

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152. The Hospital Compliance Project examined 487 hospitals for a variety of issues, including executive compensation. IRS, HOSPITAL COMPLIANCE PROJECT INTERIM REP. 1, [https://www.irs.gov/pub/irs-tege/eo\\_interim\\_hospital\\_report\\_072007.pdf](https://www.irs.gov/pub/irs-tege/eo_interim_hospital_report_072007.pdf) [<https://perma.cc/74FW-8DYB>]; IRS, IRS EXEMPT ORGANIZATIONS (TE/GE) HOSPITAL COMPLIANCE PROJECT FINAL REPORT 1, <https://www.irs.gov/pub/irs-tege/frephosproj.pdf> [<https://perma.cc/XUJ3-DXHA>].

153. IRS, STATEMENT BY LOIS LERNER, DIRECTOR OF THE IRS EXEMPT ORGANIZATIONS DIVISION, ON THE IRS REPORT ON NONPROFIT HOSPITALS, PRESS BRIEFING, FEB. 12, 2009 3 (Feb. 12, 2009) [hereinafter STATEMENT BY LOIS LERNER] [https://www.irs.gov/pub/irs-tege/lernerstatement\\_hospitalproject\\_021209.pdf](https://www.irs.gov/pub/irs-tege/lernerstatement_hospitalproject_021209.pdf) [<https://perma.cc/F7LK-XF94>].

154. Wilson Hayman, *Final Report of IRS Study of Nonprofit Hospital Compliance Answers Some Questions, Raises Others*, NAT'L L. REV. (August 25, 2009), <https://www.natlawreview.com/article/final-report-irs-study-nonprofit-hospital-compliance-answers-some-q> [<https://perma.cc/T2S8-8KZ4>] ("The average and median total compensation amounts (including benefits) reported for the top management official of the responding hospitals were \$490,000 and \$377,000, respectively. The average and median total compensation amounts for the 20 specially examined hospitals were \$1.4 million and \$1.3 million, respectively.").

155. STATEMENT OF LOIS LERNER, *supra* note 155, at 3–4.

156. Hayman, *supra* note 154.

The enactment of Code Section 4941 for private foundations and Code Section 4958 for public charities clearly impacted the regulation of nonprofit compensation. And still, press reports and public complaints decrying excessive compensation by charities continued after 1995. As a result, the public perception, with which Congress apparently agreed, is that further efforts in regulating charity compensation were necessary.<sup>157</sup> Thus, the new excise tax on excessive compensation under Code Section 4960 was born.

*B. Code Section 162's Limits on Deductions for Public Company Compensation*

In enacting Code Section 4960 as part of the TCJA, Congress specifically stated that part of the rationale behind the excise tax was to place charitable and for-profit employers on a level playing field, stating that

[t]he Committee further believes that alignment of the tax treatment of excessive executive compensation (as top executives may inappropriately divert organizational resources into excessive compensation)

between for-profit and tax-exempt employers furthers the Committee's larger tax reform effort making the system fairer for all businesses."<sup>158</sup>

Because one of the stated goals of Code Section 4960 was to bring the taxation of charitable compensation in line with that of for-profit companies, it is important to understand the general scheme of taxation of excessive executive compensation for for-profit companies.

All taxpayers are generally allowed to deduct the costs of operating a business, including reasonable compensation for services rendered. Specifically, Code Section 162(a)(1) allows a deduction for ordinary and necessary expenses incurred in carrying on a trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered."<sup>159</sup> Until the enactment of Code Section

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157. See Lauren Rogal, *Executive Compensation in the Charitable Sector: Beyond the Tax Cuts and Jobs Act*, SETON HALL L. REV. 449, 451–52 (discussing a 2015 public opinion survey regarding charity compensation).

158. H.R. Rep. No. 115-409, at 333 (2017) REP. NO. at 333 (2017). The Committee's discussion of the addition of Code Section 4960 is not addressed in the exempt organizations section of the Ways and Means Report; instead, it is right after the revisions to Code Section 162(m) in Business Tax Reform portion of the Ways and Means Report.

159. I.R.C. § 162(a)(1).

162(m) in 1993, this “reasonable allowance” standard provided the primary tax limitation on the compensation for for-profit businesses.<sup>160</sup>

As indicated above, the intermediate sanctions regulations specifically incorporate by reference the general reasonableness standard of Code Section 162(a)(1).<sup>161</sup> Thus, parity among all compensation paying organizations already existed. Both public and private companies were subject to the general reasonableness limitation of Code Section 162. All charities (public charities and private foundations) were subject to a reasonableness standard through the private inurement prohibition of Section 501(c)(3) generally and through the application of Code Section 4941 for private foundations or Code Section 4958 for public charities. As a result, all for-profit businesses and all Section 501(c)(3) organizations were already subject to the same standard—a reasonableness standard—until the enactment of Code Section 162(m).

While there has been a long history of ebbs and flows in executive compensation, for our modern purposes, the 1980s saw a particular surge in CEO compensation<sup>162</sup> that remained generally unchecked until the economic recession of 1990.<sup>163</sup> Popular outcry against the perceived excesses of the 1980s, including the salaries of CEOs, was a significant issue<sup>164</sup> in the 1992 presidential election:

Bill Clinton attacked “overpaid” corporate executives. This issue became more salient following President George Bush’s December 1991 visit to Japan, during which Japanese politicians responded to American demands for more open markets by assigning blame for poor U.S. export performance to the “overpaid CEOs” who were traveling with Bush.<sup>165</sup>

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160. For a review of the reasonable compensation rule as applied to closely held businesses in the pre-Code Section 162(m) era, see Andrew Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 375–77 (1999).

161. See generally Treas. Reg. § 53.4958–4(b)(1)(ii).

162. Carola Frydman & Raven E. Saks, *Historical Trends in Executive Compensation 1936–2003* 10, 56 fig. 1 (Sloan Sch. of Mgmt., MIT, Working Paper) (2005), [https://inequality.stanford.edu/sites/default/files/media/\\_media/pdf/Reference%20Media/Frydman%20and%20Saks\\_2005\\_Elites.pdf](https://inequality.stanford.edu/sites/default/files/media/_media/pdf/Reference%20Media/Frydman%20and%20Saks_2005_Elites.pdf) [<https://perma.cc/CA83-L494>].

163. Congress enacted Code Sections 280G and 4999 in 1984, which cap golden parachute arrangements and imposes an excise tax on excess parachute payments. See generally Ryan Miske, *Can’t Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1674–75 (2004).

164. *Id.* at 1686; see also Sarah Anderson, *The Failure of Bill Clinton’s CEO Pay Reform*, POLITICO (Aug. 31, 2016, 7:35 PM) <https://www.politico.com/agenda/story/2016/08/bill-clinton-co-pay-reform-000195/> [<https://perma.cc/YY3C-V7P5>].

165. Nancy Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20 J. LABOR ECON. 138, S140 (2002).

After President Clinton took office in 1993, Congress enacted Code Section 162(m) to address the “overpaid CEO” issue.<sup>166</sup> “According to the Senate Finance Committee, Congress added Code Section 162(m) because “the amount of compensation received by corporate executives has been the subject of scrutiny and criticism.”<sup>167</sup>

As originally enacted, Code Section 162(m) generally limited a public company’s deduction for executive compensation to \$1 million per covered executive.<sup>168</sup> Importantly, Code Section 162(m) did not apply to all for-profit employers; it only applied to publicly-traded companies.<sup>169</sup> In addition, the deduction limitation only applied to “covered employees,” which was defined as the Chief Executive Officer<sup>170</sup> and the next four highest compensated officers who would need to be reported to the shareholders under the Securities and Exchange Act of 1934.<sup>171</sup>

The definition of compensation (or, statutorily, “applicable employee remuneration” for Code Section 162(m) purposes) included only those amounts for which a deduction would have otherwise been allowed. As a result, executive compensation automatically excluded non-taxable fringe benefits,<sup>172</sup> such as health insurance and qualified housing

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166. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993) (codified as amended at I.R.C. § 162(m) (2000)).

167. Miske, *supra* note 163 at 1686 (citing H.R. REP. NO. 103-11 at 646, *reprinted in* 1993 U.S.C.C.A.N. 378, 877).

168. Prior to the TJCA, Code Section 162(m)(1) stated, “In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.” Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a) 107 Stat. 312, 469-70 (codified as amended at I.R.C. § 162(m) (2000)).

169. Covered companies were then defined as any “corporation issuing any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934.” I.R.C. § 162(m)(2) (2000). Section 12(a) of the 1934 Act generally prohibits “transaction in any security . . . on a national securities exchange” unless the security is registered. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, § 12(a) 48 Stat. 881 (1934). This definition was changed in the TCJA. *See* discussion *infra* note 189.

170. I.R.C. § 162(m)(3)(A) (2000). The TCJA changed this definition. *See generally* discussion *infra* note 189.

171. I.R.C. § 162(m)(3)(B) (2000) (“[T]he total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest-compensated officers for the taxable year (other than the chief executive officer).”); *see* 17 C.F.R. 229.402(a) (“This Item [402] requires clear, concise, and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to . . . the registrant’s three most highly compensated executive officers other than the PFO and PEO. . . .”).

172. *See* I.R.C. § 162(m)(4)(A) (2000) (providing that applicable employee remuneration “means . . . the aggregate amount allowable as a deduction under this chapter for such taxable year

allowances.<sup>173</sup> As originally passed, Congress also excepted from compensation some high profile benefits: commission-based compensation payments,<sup>174</sup> stock options and other equity-based compensation plans,<sup>175</sup> and some bonuses and incentive compensation payments.<sup>176</sup> These exceptions provided significant avenues to avoid the \$1 million limitation, which ultimately eviscerated the effectiveness of Section 162(m) in curbing overall executive compensation packages.<sup>177</sup>

Code Section 162(m) on its face was an effort to reduce total executive compensation packages at public companies by “raising their cost to shareholders. . . .”<sup>178</sup> The total economic cost of an executive’s compensation package could not be offset by the tax savings from the Code Section 162 deduction that the compensation generated. In theory, if a company cared about total economic cost, a company would lower the executive’s compensation package so that it would have the same after-tax economic impact after accounting for the disallowance of deduction under Code Section 162(m).

But Code Section 162(m) did not result in public companies lowering CEO or other executive compensation. Rather, it prompted many companies to restructure compensation packages to reduce salary but increase those types of compensation that were excluded from “applicable employee remuneration.” In many instances, public companies simply placed a greater emphasis on incentive and equity-based compensation, specifically including stock options. One study found that “[b]etween 1992 and 2000 . . . there was a shift in the composition of CEO compensation as reported by the Standard & Poor’s 500 Industrials from 27% stock options to 51% stock options.”<sup>179</sup>

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(determined without regard to this subsection) for remuneration for services performed by such employee. . . .”).

173. See, e.g., Jean Murray, *What Fringe Benefits for Executives are Deductible?*, THE BALANCE SMALL BUS. (Sept. 19, 2022), <https://www.thebalance.com/deductible-fringe-benefits-executives-397603> [<https://perma.cc/SZY4-JA52>]. .

174. I.R.C. § 162(m)(4)(B) (2000).

175. Treas. Reg. § 1.162-7(b).

176. I.R.C. § 162(m)(4)(C) (2000) (excluding “remuneration payable solely on account of the attainment of one or more performance goals.”). If performance goals are set by an outside compensation committee, the goals are disclosed to and approved by shareholders, and the compensation committee certifies that the goals were met. *Id.*

177. Jim Swanick, *Changes to the \$1 Million Section 162(m) Compensation Deduction Limitation*, GLOB. TAX MGMT. (Mar. 9, 2018) <https://gtmtax.com/tax-insights/articles/section-162m-compensation-deduction-limitation/>; see also Anderson, *supra* note 164 **Error! Bookmark not defined.**

178. See Rose & Wolfram, *supra* note 165 at 139.

179. Miske, *supra* note 163, at 1688–89, 1689 n.105 (citing Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 848–49 (2002)).

Similarly, a study by the Institute for Policy Studies<sup>180</sup> found that “the top 20 U.S. banks paid out more than \$2 billion in fully deductible performance bonuses to their top five executives. At a 35 percent corporate tax rate,<sup>181</sup> this translates into a reduction in their tax bills of more than \$725 million, or \$1.7 million per executive per year.”<sup>182</sup>

This restructuring of compensation had its own benefits and problems. Some economists thought that aligning CEO compensation with company performance through stock options or other types of equity compensation would incentivize management.<sup>183</sup> Others believed that the increase in equity-based compensation caused management to take a short-term view of public company success at the expense of long-term strategic planning.<sup>184</sup> More ominously, “for some executives, because so much of their compensation was tied to stock options, ‘there was an

180. Sarah Anderson & Sam Pizzigati, *Executive Excess 2016: The Wall Street CEO Bonus Loophole*, INST. FOR POL’Y STUD. (Aug. 31, 2016), <https://ips-dc.org/executive-excess-2016-wall-street-ceo-bonus-loophole/> [<https://perma.cc/587L-S7A7>].

181. Prior to the TCJA, the Code Section 11 corporate tax rate was a progressive rate structure topping out at 35%. Section 13001 of the TCJA implemented a flat 21% rate effective. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13001 94 Stat. 2054, 2096 (2017).

182. Anderson & Pizzigati, *supra* note 180. The presumptive use of a flat 35% corporate rate is probably an overstatement of the tax savings for a variety of reasons, starting with the progressive nature of the rate structure at that time.

183. The agency theory principles underlying this assumption are discussed *infra* at Part II.B.

184. See Ira Kay, *Regulating CEO Pay Is Not the Answer*, HARV. BUS. REV. (June 8, 2009), <https://hbr.org/2009/06/ceo-pay-regulation-can-do-real.html> [<https://perma.cc/558X-MCLD>] (“The conventional wisdom says executive pay played a substantial, perhaps dominant, role in the financial crisis and recession by encouraging excessive risk-taking.”). *Id.* Similarly, then Chairman of the U.S. Federal Reserve Board Alan Greenspan stated in a speech to the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta in Sea Island, Georgia:

Stock-option grants, properly constructed, can be highly effective in aligning the interests of corporate officers with those of shareholders. Such an alignment is an essential condition for maximizing the long-term market value of the firm.

Regrettably, some current issuance practices have not created the alignment of incentives that encourages desired corporate behavior. One problem is that stock options, as currently structured, often provide only a loose link between compensation and successful management. A company’s share price, and hence the value of related options, is heavily influenced by economy-wide forces—that is, by changes in interest rates, inflation, and myriad other forces wholly unrelated to the success or failure of a particular corporate strategy.

There have been more than a few dismaying examples of CEOs who nearly drove their companies to the wall and presided over a significant fall in the price of the companies’ stock *relative* to that of their competitors and the stock market overall. They, nonetheless, reaped large rewards because the strong performance of the stock market as a whole dragged the prices of the forlorn companies’ stocks along with it.

Alan Greenspan, Chairman, Fed. Res. Bd., *Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia: Stock Options and Related Matters* (May 3, 2002) FED. RES. BD., <https://www.federalreserve.gov/boarddocs/speeches/2002/20020503/default.htm> [<https://perma.cc/4ALB-DV5T>].

irresistible impulse to cook the books.”<sup>185</sup> In some cases, Code Section 162(m) had the perverse impact of actually increasing public company pay—as \$1 million was deductible, why not pay it?<sup>186</sup> As the \$1 million limit became the new norm, some companies actually increased their salaries to come in line with this new market expectation.<sup>187</sup>

Finally, some companies simply choose to continue to pay executive compensation in excess of \$1 million even though it was partially non-deductible. Section 162(m) doesn't prohibit the payment of compensation over \$1 million; it just makes it more expensive to the company. The economic cost of a fully deductible salary is offset in part by the tax savings created by the tax deduction created by that salary. If that salary is nondeductible, then a company would need to determine if the increase in the bottom-line economic cost to the company was a price it was willing to pay to meet its labor needs. Section 162(m) did not change the demand for top executives, or the labor market forces that shaped executive pay demands. Moreover, it did not change the relative cost of one individual versus another; rather, it merely made it more expensive for all public companies to pay for the same services, as now all public companies would absorb the same amount of compensation with no offsetting tax savings in the form of a deduction.<sup>188</sup>

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185. Miske, *supra* note 163, at 1691 (citing Joel Hoekstra, *Executive Privilege: Has Pay for America's Bosses Spun Out of Control?* CARLETON C. VOICE, Fall 2003, at 40, 44) (quoting Lawrence Perlman, former chair and CEO of Ceridian Corporation and former chair of Seagate Technology)).

186. See generally 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 (Oct. 2002).

187. Miske, *supra* note 163, at 1687 (citing John A. Byren, *That's Some Pay Cap, Bill*, BUS. WK. (Apr. 25, 1994). Code Section 162(m) has been subject to significant criticism from both sides of the political spectrum since its enactment in 1993, as it has generally been seen as ineffective in curbing public company pay. According to one commentator writing after the passage of Code Section 162(m), “[d]uring the decade spanning 1999 and 2000, CEO compensation increased an average of 1300% and in 2004 the average pay received by CEOs of major companies was \$9.84 million.” Lauren Kellis, *Should Executive Compensation Be Regulated? An Investigation of the Economics Involved in the Societal Discussion of this Topic*, 17 DUKE J. ECON. 1, 1 (2005). See also Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 24–25 (2000) (“[T]ax reform is unlikely to limit compensation, and it may fuel the increase of compensation.”); Rose & Wolfram, *supra* note 165, at 142 (“The formulaic approach does not entirely eliminate boards’ discretion, however.”).

188. See Robert M. Halperin, et al., *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 J. AM.TAX’N ASS’N. 52, 60, 63 (2001) (concluding that section 162(m) might have mixed results in regard to executive compensation); see generally Steven Balsam & 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 (2005).

The million-dollar limitation of Code Section 162(m) was an arbitrary line drawing that had no relationship to actual labor market needs or issues, and the exceptions in the original version of the statute gutted the impact of the rule.<sup>189</sup> Since its passage, commentators have criticized the perverse and artificial incentives that caused companies to alter their compensation packages purely for tax purposes. In retrospect, Code Section 162(m) with all of its loopholes was more of a political statement than an actual attempt to regulate CEO compensation—in fact, it appears to have backfired. The lesson learned is that it is difficult “for those outside the firm . . . to alter internal compensation decisions.”<sup>190</sup> Rather, corporate pay is likely more responsive to “direct pressure brought to bear at the individual firm level by stakeholder groups<sup>191</sup> . . . or through the regulatory process.”<sup>192</sup>

### C. The TCJA’s Nonprofit Executive Compensation Excise Tax

Given their parallel histories of public outcry and Congressional response, it is understandable that Congress might want the new nonprofit compensation excise tax of Code Section 4960 to track the provisions of the for-profit deduction limits of Code Section 162(m). One might also think, at first glance, that there is a certain amount of equity to be had in treating executive compensation similarly, regardless of the tax status of the employer.

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189. As an epilogue, the TCJA amended Code Section 162(m) to eliminate some of the exceptions from the definition of “applicable employee remuneration” that allowed for the deduction of compensation in excess of the \$1 million cap. Effective as of January 1, 2018, public companies can no longer exclude most incentive and option-based compensation from the \$1 million deduction cap of Code Section 162(m). Other exceptions—specifically including the exception for benefits that were otherwise excluded from income—remain. Ultimately, it continues to be the case that Code Section 162(m) does not disallow the payment of compensation over \$1 million to an executive; it merely continues to limit (albeit more strictly) the amount that would be deductible. Recent scholarship on the impacts of the amendments to Code Section 162(m) in the TCJA indicate that

the repeal of the performance-based pay exception changed the most significant and salient compensation features, namely the proportion of performance-based pay to total pay and the overall amount of pay. On the other hand, . . . our data suggests that the tax change has had a significant influence. This suggests that tax rules may be only consequential in shaping executive compensation when no one else is paying attention otherwise.

Brian Galle et al. et al., *Does Tax Matter? Evidence on Executive Compensation after 162(m)’s Repeal*, 26 STAN. J. L. BUS. & FIN. 1,1 (2021).

190. Rose & Wolfram, *supra* note 165, at 166.

191. *Id.* (citing Marilyn F. Johnson et al., *Stakeholder Pressure and the Structure of Executive Compensation* (May 1997), <https://ssrn.com/abstract=41780> [<https://perma.cc/39JR-9AE5>]).

192. *Id.* (citing Paul L. Joskow et al., *Political Constraints on Executive Compensation: Evidence from the Electric Utility Industry*, 27 RAND J. ECON. 165 (1996)).

As charities generally do not pay income tax in the first place, the loss of a Code Section 162 deduction for excess compensation is technically irrelevant.<sup>193</sup> Accordingly, simply making the terms of Code Section 162(m) applicable to charities would be ineffectual. Rather, Congress needed a way to make a charity “feel” the economic impact of the loss of a deduction in a way that would be comparable to that experienced by a taxable entity—and settled on an excise tax.

Code Section 4960 mechanically imposes an excise tax on the employer in an amount equal to the tax rate applicable to C corporations (currently, a flat 21% rate) on compensation in excess of \$1 million<sup>194</sup> paid to the five highest employees of the organization.<sup>195</sup> This \$1 million limit is not arbitrary; neither is the use of the same tax rate as applied to C Corporations. The new excise tax was specifically designed to subject covered charities to compensation rules similar to those found in Code Section 162(m).<sup>196</sup> Congress’ stated conception was that the economic cost of the imposition of a 21 percent excise tax on excess compensation would be similar to the loss of a deduction against a statutory tax rate of 21% on excess compensation for a publicly traded company.

Code Section 4960 defines compensation by incorporating by reference the definition of “wages” for payroll tax purposes in Code Section 3401(a).<sup>197</sup> As a result, compensation includes amounts paid by the charity directly to the executive as well as payments from certain related organizations, subject to certain significant exceptions. These exceptions

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193. *But see* sources cited *supra* notes 177–180 and accompanying text regarding the unrelated business income tax.

194. Found in Section 13602 of the TCJA, certain adjustments are made for “excess parachute payments,” which are certain payments made contingent upon an employee’s separation of service. I.R.C. § 4960(c)(5).

195. The excise tax applies only to “covered employees,” which is defined for purposes of Section 4960 as a current or former employee that is one of the five highest compensated employees or previously was a covered employee at any time after December 31, 2016. I.R.C. § 4960(c)(2).

196. This change “would bring nonprofit salary taxation in line with longstanding tax policy governing for-profit corporations.” Steven Porter, *Tax Reform Redefines ‘Reasonable’ Compensation for Nonprofit Execs*, HEALTHLEADERS (Dec. 20, 2017), <http://www.healthleadersmedia.com/finance/tax-reform-redefines-%E2%80%98reasonable%E2%80%99-compensation-nonprofit-execs#> [<https://perma.cc/VV8A-3BA4>] (quoting Michael Wyland, *What Nonprofits Can Expect in the GOP Tax Bill*, NONPROFIT Q. (Dec. 18, 2017), <https://nonprofitquarterly.org/2017/12/18/what-nonprofits-can-expect-in-the-gop-tax-bill> [<https://perma.cc/WZA4-CL3B>]).

197. *See* I.R.C. § 3401(a) (specifying that “wages” does not include certain Roth contributions and amounts that are included as income under section 457).

have the effect of exempting certain medical and religious personnel from the excise tax.<sup>198</sup>

If many highly compensated employees of hospitals and churches are exempt from Code Section 4960, who is left? Clearly, a significant target of the provision was both public and private universities. This intent is evidenced by the definition of which organizations are covered by Code Section 4960. An “applicable tax-exempt organization” includes an organization exempt under Code Section 501(a) and an organization that “has income excluded from taxation under section 115(1). . . .”<sup>199</sup> Private universities are typically Code Section 501(c)(3) organizations, which are clearly covered by Code Section 4960.<sup>200</sup> As for public universities, the reference to Code Section 115(1) was designed to capture any organization whose income is “derived from . . . the exercise of any essential government function and accruing to a state or any political subdivision thereof.”<sup>201</sup> While the provision’s intent may have been to capture public universities,<sup>202</sup> poor drafting may have undermined this intent.<sup>203</sup> This is because public universities are governmental entities that are not subject to the income tax under Code Section 501(c)(1) in the first instance, and as such are typically not described in Code Section 115(1).<sup>204</sup> While some public universities have also obtained recognition under Code Section 501(c)(3), many have

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198. There is a significant exception for compensation provided to a medical or veterinary professional for performing medical services. I.R.C. § 4960(c)(3)(B). The exception is only for medical services rendered; accordingly, if a doctor performs both medical services and administrative services, the doctor’s salary would need to be allocated proportionately for purposes of applying the excise tax. *Id.* There is also an indirect exception for ministers, as the definition of wages for payroll tax purposes under section 3401(a) specifically excludes compensation “for services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry.” I.R.C. § 3401(a)(9).

199. I.R.C. § 4960(c)(1)(C).

200. Code Section 4960(c)(1)(A) includes in the definition of an applicable tax-exempt organizations any organization that “is exempt from taxation under section 501(a).” I.R.C. § 4960(c)(1)(A). Code Section 501(a) exempts from taxation “an organization described in subsection (c). . . .”, which specifically includes Section Code 501(c)(3) charitable organizations. I.R.C. § 501(a).

201. I.R.C. § 115(1).

202. H.R. REP. NO. 155-466, at 492 (2017) (Conf. Rep.) (explaining that an “applicable tax-exempt organization” is an organization exempt from tax under section 501(a), an exempt farmers’ cooperative, a Federal, State, or local governmental entity with excludable income, or a political organization.); I.R.C. § 4960(c)(1) (2018).

203. Ellen P. Aprill, *Congress Fumbles the Ball on Section 4960*, MEDIUM (Dec. 26, 2017), <https://medium.com/whatever-source-derived/congress-fumbles-the-ball-on-section-4960-guest-post-by-ellen-aprill-18a2dbf98c5f> [<https://perma.cc/AB6Q-F736>]; see also Ellen P. Aprill, *Section 4960’s Failure to Tax Governmental Entities*, TAX NOTES 539, at 543 (Jan. 22, 2018), <https://ssrn.com/abstract=3128412> [<https://perma.cc/V7BY-MZBN>].

204. Aprill, *Section 4960’s Failure*, *supra* note 205 (citing I.R.S. Tech. Adv. Mem. 7904006 (Jan. 1, 1979)).

not. Moreover, most state and political subdivisions do not rely primarily on Code Section 115 to exclude their income from taxation, as the doctrine of “implied statutory immunity”<sup>205</sup> assumes that governmental entities are not subject to tax unless specifically listed.<sup>206</sup>

Although Code Section 501(c)(3) exempts charities from the standard C corporate income tax, they do occasionally pay the unrelated business income tax (UBIT).<sup>207</sup> UBIT is an income tax paid by an otherwise tax-exempt organization on income generated by business activities that are not related to its tax exempt purpose.<sup>208</sup> When calculating UBIT, an exempt organization is normally able to deduct expenses allocable to the unrelated business activity, including reasonable compensation expenses under Code Section 162.<sup>209</sup> When calculating UBIT, however, an organization’s unrelated business income is increased by the amount of allocable compensation that would not have been deductible if the organization were a for-profit entity.<sup>210</sup> These amounts would specifically include amounts that would have been non-deductible under Code Section 162(m), as well as other non-deductible fringes and expenses (for example, entertainment and meal expenses limited by Code Section 274).

Code Section 4960(c)(6) specifically states that compensation that is not deductible under Section 162(m) is not also taxed under Code Section 4960. This makes sense if one views Code Sections 4960 and 162(m) as analogous provisions, such that it is necessary to ensure that the economic penalty is only applied once. In reality, this would be an extraordinarily rare situation. Recall that Code Section 162(m) only applies to publicly traded companies. As a result, the only way that a compensation package would be subject to both Code Section 162(m) and Code Section 4960 is if one of the top five executives of a publicly traded company received

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205. *Id.* (citing Rev. Rul. 87-2, 1987-1 C.B. 18).

206. The Treasury acknowledged this issue in temporary guidance issued under Code section 4960, its Proposed Regulations issued in 2020, and in the Final Regulations issued in 2021. Tax on Excess Tax-Exempt Organization Executive Compensation, 86 Fed. Reg. 6196, 6196–97 (Jan. 19, 2021) (to be codified at 26 C.F.R. Pts. 1, 53) (citing I.R.S. Notice 2019-09, 2019-04 I.R.B. 403 (2018); Prop. Treas. Reg. § 122345-18, 85 Fed. Reg. 35746 (June 11, 2020)).

207. *See* I.R.C. § 511(a)(1) (explaining the taxes imposed on charitable organizations at corporation rates); *see also* I.R.C. § 511(b)(1) (explaining the taxes imposed on charitable trusts).

208. I.R.C. § 512(a)(1); I.R.C. § 513(a).

209. *See* I.R.C. 511(a)(1) (imposing unrelated business taxable income for charitable organizations at corporate rates); *see also* I.R.C. § 511(b)(1) (imposing unrelated business taxable income on charitable trusts); I.R.C. § 512(b)(1) (stating that unrelated business income is calculated less the deductions allowed by the I.R.C.).

210. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13703, 131 Stat. 2054, 2169 (2017)

part of his or her compensation from a charitable organization that controlled or was controlled by the public company.<sup>211</sup>

## II. THE COMPENSATION FALLACIES

Congress essentially views Code Section 4960 as the tax-exempt analog to Code Section 162(m). In enacting Code Section 4960, Congress specifically stated that part of the rationale behind the structure of the excise tax was to place nonprofits and for-profits on a level compensation playing field. As previously noted, the House Ways and Means Committee Report states that

[t]he Committee further believes that alignment of the tax treatment of excessive executive compensation (as top executives may inappropriately divert organizational resources into excessive compensation) between for-profit and tax-exempt employers furthers the Committee's larger tax reform effort making the system fairer for all businesses.<sup>212</sup>

After all, both Code Sections disincentivize excessive compensation by making compensation packages in excess of \$1 million more costly—specifically, 21 percent more costly.

Upon deeper review, Congress' stated view about the regulation and parity is based on at least two obvious fallacies that make Code Section 4960 significantly more punitive to nonprofit organizations than their for-profit counter parts—first, the actual mechanics of Code Section 4960 and second, the manner in which charities make decisions about compensation.

But those two fallacies assume that Congress' stated intent to regulate compensation in a manner that provides parity with for-profit institutions was truly the issue. That assumption leads to the third fallacy: Code Section 4960 is primarily intended to regulate excessive compensation at all. Rather, Code Section 4960 does not actually address excessive compensation issues, but instead reinforces the narrative of the wasteful charity. This allowed Congress to punish a disfavored sector through an excise tax all while raising revenue for other priorities. As a result of these fallacies, Code Section 4960 is, at best, poorly conceived and ineffectual as all but a revenue offset, and at worst, affirmatively harmful not only to the charities to which it applies, but to the charitable sector as a whole.

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211. I.R.C. § 4960(c)(4)(B) (2018).

212. H.R. Rep. No. 115-409, at 333 (2017).

*A. The First Fallacy: Code Sections 162 and 4960 are Mechanically Equivalent*

According to the Ways and Means Committee Report quoted above Congress appears to believe that inappropriate diversions of assets via excessive compensation, whether by charities or public companies, will be disincentivized if the inappropriate compensation costs the organization 21 percent more after tax. Assuming that this is true,<sup>213</sup> Congress further assumes that the imposition of a 21% excise tax on a nonprofit is economically equivalent to the denial of a deduction to a C Corporation that is subject to a statutorily imposed 21% rate on taxable income.<sup>214</sup>

This is, put simply, not true. As a global matter, the point of any income tax is to raise revenue for government expenditures.<sup>215</sup> Beyond that general and fairly obvious aim, tax provisions can accomplish additional (or even sometimes, contrary) goals.<sup>216</sup> Very generally, a tax expenditure is a provision of a tax law that loses revenue in the pursuit of some other non-tax outcome, such as incentivizing social and economic goals.<sup>217</sup> By way of example, the charitable deduction under Code Section 170 does not raise revenue, but it does theoretically incentivize the support of charity.<sup>218</sup> On the other hand, a tax provision that accomplishes a tax policy goal by potentially bringing in revenue is sometimes referred to as a negative tax expenditure. The Department of Treasury itself has specifically identified the Code Section 162(m) limitation as a negative tax expenditure<sup>219</sup>—the goal of the section is to limit excessive public company compensation, not to raise revenue. If

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213. For a discussion testing that assumption, see *infra* Section II.B.

214. See generally I.R.C. § 11.

215. Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 3 (2006) (“The obvious answer is that taxes are needed to raise revenue for necessary governmental functions, such as the provision of public goods. And, indeed, all taxes have to fulfill this function to be effective. . .”).

216. *Id.* at 3–4 (noting a redistributive function and a regulatory component, which “can be used to steer private sector activity in the directions desired by governments. This function is also controversial, as shown by the debate around tax expenditures.”).

217. See generally STANLEY SURREY & PAUL MCDANIEL, TAX EXPENDITURES, Harvard University Press (1985).

218. For a critique of Surrey’s negative view of the charitable deduction, see David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 222–23 (2009).

219. *Tax Expenditures*, U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures> [<https://perma.cc/U2W3-5RMT>] (last visited Sept. 8, 2024) (“The Budget Act defines a tax expenditure as a revenue losing provision of tax law. A revenue increasing tax provision is sometimes referred to as a negative tax expenditure. . . . Examples that might be considered negative tax expenditures include the denial of a deduction of non-performance-based compensation in excess of \$1 million for public companies. . .”).

Code Section 162(m) were 100% effective in disincentivizing excessive compensation (that is, no public company paid more than \$1 million in compensation), then Code Section 162(m) would bring in no revenue.

The basic premise of Code Section 162(m) and other disincentive tax provisions is to change the economics of the underlying compensation deal so that the taxpayer will decide that the transaction, now burdened by the cost of additional income tax, is simply too expensive to undertake.<sup>220</sup> Nothing compels this outcome. Tax disincentive provisions can be ineffective for a variety of reasons. One such reason is because the intended additional cost never materializes or at least doesn't cost the company as much as Congress intended.<sup>221</sup> If the cost is not significant enough to change the company's decision-making process, then the tax disincentive is ineffective.<sup>222</sup>

With Code Section 162(m), Congress attempted to regulate executive compensation by disallowing a deduction for compensation in excess of \$1 million. In theory, this costs the employer money—that is, the employer must now absorb the cost of the compensation unreduced by the amount of tax that the company would have saved if the compensation deduction had been allowed. Again, in theory, the increased cost of the compensation package should disincentivize companies to pay compensation over the deduction limitation amount.

To illustrate this very basic point, assume a public company otherwise governed by Code Section 162(m) has \$5 million in taxable income before the deduction of the company's CEO's compensation package; \$5 million in taxable income would generate \$1,050,000 in federal income tax at 21%. If that CEO received \$1 million in compensation that is fully deductible under Code Section 162(m), then the company would pay a 21% tax on \$4 million (\$5 million less the \$1 million compensation deduction), which would be \$840,000 in federal income tax. Thus, the company saves \$210,000 in federal income taxes due to the Code Section 162 deduction. Therefore, the economic cost to the company of the \$1 million in compensation paid to the CEO is actually only \$790,000—it pays out \$1 million in salary, but that is offset by \$210,000 in federal income tax savings from the Code Section 162 deduction.

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220. See Rose & Wolfram, *supra* note 165, at 139 (“Section 162(m) may have altered this, directly affecting compensation by increasing the after-tax cost of CEO pay to the corporation or indirectly affecting pay by inducing firms to change their compensation-setting processes.”).

221. Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 26 n.14 (2006) (stating that Stanley Surrey “emphasized how tax incentives in general can be wasteful . . . because they may generate little behavior response.”).

222. See STAFF OF J. COMM. ON TAX'N, 117TH CONG., ESTIMATES OF FED. TAX EXPENDITURES FOR FISCAL YEARS 2022-2026 4 (Comm. Print 2022) (listing Code Section 162 as a negative tax expenditure).

Assume the same CEO received a \$2 million compensation package, but Code Section 162(m) limits the company's deduction to \$1 million. The company's taxable income would still be \$4 million, with the \$5 million in taxable income reduced by a \$1 million compensation deduction; the second \$1 million received by the CEO would not be deductible. The company would continue to pay \$840,000 in federal income tax (that is, 21% on \$4 million in taxable income).

Accordingly, the economic cost of the compensation package would now be the amount actually paid of \$2 million, reduced by the \$210,000 in tax savings allocable to the first \$1 million of deductible compensation, for a total economic cost of \$1,790,000. If Code Section 162(m) did not apply, then the company would have taken a full \$2 million deduction, for a taxable income of \$3 million. At a flat rate of 21 percent, the company would pay a tax of \$630,000; thus, the denial of the deduction for the full compensation package cost the company an additional \$210,000 of tax.

The tax policy question is whether the additional economic cost of \$210,000 would cause a company to think twice about paying the CEO a \$2 million compensation package, rather than only paying the CEO the fully deductible \$1 million. In the static world described above, where the only difference in tax savings is the denial of the deduction for excess compensation, Code Section 162(m) could make a compensation package more than \$1 million slightly more expensive for a for-profit business. Standing alone, that may (or may not) impact the decision-making process for the employer.

The valuation of the economic cost of loss of a deduction to a particular company is not that static.<sup>223</sup> Rather, the relative tax worth of a deduction is informed by the company's other federal, state, and even international, income tax circumstances. The basic economic cost of the loss of a deduction to a specific corporation is, very generally, the increase in taxes paid if the corporation calculated its income tax with the deduction, and then without the deduction. As a result, the true value of the corporate deduction is dependent upon other variables, specifically including the corporation's deductions and income from all sources, and the rate of tax applicable to the corporation without the deduction.

In the most basic example, if a C corporation had sufficient deductions other than the Code Section 162 compensation deduction (for example, net operating losses or depreciation) to offset its gross income for the

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223. See Boris I. Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 193 (1973) (discussing the relative value of a deduction among three taxpayers based upon the marginal tax rate of the taxpayer).

year, then it would already pay no federal income tax (as 21% of zero taxable income is zero).<sup>224</sup> In this case, the loss of a deduction is meaningless, at least for the current tax year. Arguably, the excess deduction might be carried forward as part of a net operating loss deduction under Code Section 172—raising the question of when, if ever, that loss would be used.<sup>225</sup> If it is used, the value of the deduction would be reduced based on the time-value of the use of the deduction.

In addition to the direct amendments to Code Section 162(m), the TCJA made other changes that impact executive compensation decision making.<sup>226</sup> When Code Section 162(m) was first enacted, C Corporations were subject to a progressive rate of tax, with statutory rates ranging from 10 to 35%.<sup>227</sup> The TCJA reduced the corporate rate to a flat 21% of taxable income, which should generally lower the overall tax burden of C Corporations. Obviously, a deduction against income taxed at a 21% rate should be less economically valuable than a deduction against income taxed at a 35% rate. Thus, the economic impact of the denial of the excess compensation deduction due to Code Section 162(m) is even less of a consideration under the new C Corporation rates than it was when Code Section 162(m) was originally passed, all other things being equal.

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224. This is hardly a hypothetical, as one recent report found that 55 instances of public companies that paid zero income tax in 2020. See Matthew Gardner & Steve Wamoff, 55 Corporations Paid \$0 in Federal Taxes on 2020 Profits, INST. TAX'N ECON. POL'Y (April 21, 2021), <https://itep.org/55-profitable-corporations-zero-corporate-tax/> [<https://perma.cc/JTD9-984Q>] (discussing how major corporations partake in tax avoidance via accelerated depreciation, carrying back losses, and by other undisclosed means).

225. Code Section 172 allows a taxpayer to carry forward excess deductions that cannot be used in a tax year—in some instances, they can also be carried back to prior tax years. See I.R.C. § 172(a) (discussing allowed deductions). The net operating loss deduction may be limited depending upon the tax year in which the excess deductions were generated. See I.R.C. § 172(b)(1) (discussing net operating loss carrybacks and carryovers).

226. The TCJA also added Code Section 199A, which allows a deduction for 20 % of taxpayer's "qualified business income," which generally includes business income from pass through entities, such as partnerships and S Corporations, as well as income from sole proprietorships. See generally I.R.C. § 199A. For these entities, the marginal tax rate applicable to qualified business income reportable by owners should also be reduced. *Id.* § 199A(a)(2) (discussing the allowed deduction in "an amount equal to 20 percent of the excess (if any) of—the taxable income of the taxpayer . . . over the net capital gain of the taxpayer. . ."). These rate changes will also significantly impact the economic cost of a tax deduction, which subsequently varies the impact of tax disincentives based upon the individual characteristics of the business. This has limited impact in the context of Code Section 162(m), as publicly traded companies are by and large C Corporations; however, Code Section 199A provides significant incentives for changing compensation packages in non-C Corporation settings.

227. Pre-TCJA Section 11 paralleled the individual income tax, showing progressive taxation tiers for corporations. See I.R.C. § 11 (discussing taxes imposed on corporations). A corporation's first \$50,000 was taxed at a rate of 15%; in addition, at 25%, 34%, and at 35% for increasing ranges of profit.

Corporations will attempt to shift the cost of an increased tax burden to other stakeholders, such as capital, labor, or consumers; the collective impact of these individual tax decisions can have macroeconomic effects on supply and demand.<sup>228</sup> Tax incidence theory explains how markets may react to the interjection of a tax into an economic system, although it does not necessarily predict the decisions of any particular firm in the system.<sup>229</sup>

Assumptions about for-profit capital market activity are often not easily applied to the nonprofit world, as by definition there is no obvious market.<sup>230</sup> One author notes that “the differing objectives, sources of funds, and constraints (especially the nondistribution constraint) may result in a different pattern of tax incidence” in economic sectors where nonprofit firms operate.<sup>231</sup> Exemption from the corporate level tax as well as subsidized donations give a charity a “cushion” that allows it to act in ways that profit-seeking business would not.<sup>232</sup> A nonprofit can

228. Basic macroeconomic theory states that an economy activity should tend toward a hypothetical state of equilibrium (partial equilibrium for the activity standing alone, as opposed to the general equilibrium of the entire economy), where supply and demand are in balance, all other things being equal. See ROSS M. STARR, *GENERAL EQUILIBRIUM THEORY: AN INTRODUCTION* 3 (Cambridge Univ. Press 2011) (discussing the “concept and history of general equilibrium theory”). But all other things are not equal, and economic activities do not occur in isolation. When a tax variable is introduced to the equation, tax incidence theory posits that the market will absorb the impact of the tax by adjusting supply, demand, or both in such a way as to return to equilibrium. See Laurence J. Kotlikoff & Lawrence H. Summers, *Chapter 16: Tax Incidence*, in 2 HANDBOOK PUB. ECON, 1043, 1043 (Alan J. Auerbach & Martin Feldstein eds., Elsevier Sci. Publishers B.V. 1987) (“The distinctive contribution of economic analysis to the study of tax incidence has been the recognition that the burden of taxes is not necessarily borne by those upon whom they are levied.”); see also Mark J. Cowan, *A GAAP Critic’s Guide to Corporate Income Taxes*, 66 TAX LAW. 209, 227 (2012) (distinguishing between the legal and economic incidence of corporate taxation). Generally, tax incidence theory predicts that as between producers and consumers, “taxes are borne by those who can not easily adjust.” Kotlikoff & Summers, *supra* note 228, at 1047. At its most basic, the mix of where the tax impact falls on the supply/demand equation depends, at least in part, on the elasticity of demand of the good at issue. Tax incidence theory predicts that if demand for a good is inelastic, then the impact of the tax should fall on the demand side of the equation. See, e.g., Scott D. Dyreng et al., *Tax Incidence and Tax Avoidance*, 39 CONTEMP. ACCT. RSCH., 2622, 2622 (2022) (“[T]he relation between corporate tax incidence and corporate tax avoidance depends on the elasticity of labor supply, the productivity of capital relative to labor, and the tax deductibility of labor and capital.”).

229. See, e.g., Kotlikoff & Summers, *supra* note 228, at 1043–44 (explaining the theory of tax incidence and its “ambiguous effects”).

230. Richard Steinberg, “Unfair” Competition by Nonprofits and Tax Policy, 44 NAT’L TAX J. 351, 355 (1991) (“It seems clear that [nonprofits] reside in a second best world. Many relevant markets fail to exist or are not perfectly competitive. . . .”). While capital exists, but it is in different, more diffuse forms than public markets or direct equity ownership by private shareholders, such as charitable donations or debt. See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J. 835, 877 (1980) (attempting to “develop a broad perspective on the economic role that nonprofit organizations perform”).

231. Steinberg, *supra* note 230, at 354.

232. *Id.* at 356.

utilize these funds to provide goods that would not be available in the for-profit market, better or lower cost goods, or even provide goods with external benefits such as health care, arts and education.<sup>233</sup> There is also the possibility that the cushion could be devoted to “managerial [perks]” thereby increasing the nonprofits costs.<sup>234</sup> Thus, if a tax is reintroduced (here, not the corporate income tax but the Code Section 4960 excise tax), the economic cost of the Code Section 4960 excise tax will either reduce the compensation or, more likely, simply lessen the “cushion” by lowering the charity’s output of its services and goods to its direct customers or to the public at large.<sup>235</sup>

Thus, if an organization is tax-exempt, the question of whether an expense is deductible is irrelevant (except to the extent necessary to calculate the unrelated business taxable income).<sup>236</sup> The flat excise tax is the excise tax—it will be mechanically applied to the excess compensation. The economic cost of that compensation package will always be 21 percent of the excessive compensation, unchanged by the impact of other deductions or income, the time value of money, or shifting tax rates. Furthermore, the charity’s ability to minimize the economic burden on the organization by shifting the burden of taxation to other stakeholders is far more limited without impacting the price or availability of charitable goods and services.<sup>237</sup> Even this very basic analysis undermines the stated rationale of Code Section 4960. No person with even a rudimentary understanding of the distinction between an excise tax and the disallowance of deduction can see them as equivalent from an economic perspective—the excise tax regime is far harsher on charities. This leads one to wonder whether Congress has a rudimentary understanding of the Federal income tax, or if this section really has nothing to do with Congress’ purported effort to make the system “fairer for all businesses.”

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233. *Id.* at 357; *see also* Hansmann, *supra* note 230, at 843 (“Undoubtedly many factors help explain why nonprofit institutions have proliferated in some areas of activity and . . . these factors are peculiar to particular types of nonprofits . . .”).

234. Steinberg, *supra* 230, n.9.

235. *Id.* at 358 (citing Susan Rose-Ackerman, *Ideals versus Dollars: Donors, Charity Mangers, and Government Grants*, 95 J. POL. ECON. 810, 810–12 (1987) (“a perfect match between donors’ and managers’ preferences is unlikely.”)).

236. Code Section 512(a)(1) defines “unrelated business taxable income” as gross income from “any unrelated trade or business . . . less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business. . . .” I.R.C. § 512(a)(1).

237. Steinberg, *supra* note 230, at 358 (recognizing that non-profit organizations are still driven to compete in a market with for-profit businesses are not incentivized to underprice).

*B. The Second Fallacy: Negative Tax Incentives Work the Same Way*

One rationale behind Code Section 162(m)—and at least facially, Code Section 4960—is that the governing bodies of nonprofits and businesses will consider these negative tax incentives similarly when making compensation decisions. If reducing excessive compensation is the actual goal, the penalties imposed by these two Code Sections ought to cause governing bodies to prevent the diversion of assets by lowering questionable compensation packages to non-excessive levels (i.e., below \$1 million).<sup>238</sup>

The question then becomes whether for-profit entities and nonprofit entities, each faced with a penalty due to “excess” compensation, will act similarly in response. They shouldn’t, and they don’t.

This Article hypothesizes payment of non-deductible compensation is explained by agency theory in the context of public companies. Agency theory does not apply as neatly for nonprofits; however, Agency loss can occur in nonprofits, but for most nonprofits, it is a result of boards being oversensitive to complaints (from the public generally and donors, specifically) about compensation at mid-range level, not high-end levels. For high-end compensation that is reasonable, the charity will reduce other non-executive staff costs to respond to this sensitivity in response to pressure from donors and other stakeholders. For high-end compensation that is truly *unreasonable* because of non-feasance or malfeasance, the imposition of the excise tax will not be the additional factor that will finally trigger board oversight of wayward agents.

To examine how agency theory works differently for nonprofits, it is important to examine how a public company would approach the issue of the Code Section 162(m) penalty as a matter of corporate governance.<sup>239</sup> The Internal Revenue Code arbitrarily posits that compensation over \$1 million is “excessive.” That is not necessarily true as a matter of firm economics or the labor market: “non-deductible” is not the same as

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238. Mike Kaercher, *The Million Dollar Question — How Section 162(m) Limits Executive Compensation Deductions and How the President’s Budget Proposal Would Change It*, MEDIUM (Mar. 25, 2024), <https://medium.com/@taxlawcenter/the-million-dollar-question-how-section-162-m-limits-executive-compensation-deductions-and-how-69887346b09a> [<https://perma.cc/HEC5-775C>] (“It could be viewed as intending to change corporate behavior by imposing a higher effective tax rate on compensation in excess of \$1.0 million.”).

239. This Article focuses on agency theory in the public company context because Code Section 162(m), the purported analog to Code Section 4960, only applies to public companies. *See* I.R.C. § 162(m)(2) (“The term ‘publicly held corporation’ means any corporation which is an issuer as defined in section 3 of the Securities Exchange Act of 1934. . . .”).

“excessive.”<sup>240</sup> Thus, when faced with non-deductible compensation, the business will need to determine whether the total economic cost of the compensation package to the firm is appropriate. If the economic cost to the firm is still appropriate, the firm will continue to pay it, notwithstanding the lack of a full tax deduction. If the economic cost of the compensation package is truly excessive, then one of two things will happen. First, the corporation could lower the executive’s compensation package. Alternatively, the corporation could continue to pay the compensation even without the full deduction. If a truly excessive compensation package continues to be paid, the agency theory would lead one to believe that there is an agency failure somewhere that did not effectively curb the excess compensation.<sup>241</sup>

Agency theory<sup>242</sup> in the for-profit corporate governance context recognizes that the managers of a corporation are contractual agents<sup>243</sup> for shareholders as the principals of a corporation.<sup>244</sup> When managers are working effectively as agents, their actions are at the service of the principal-shareholders and therefore, generally increase shareholder value. When managers are not working fully at the service of their principals, then there is “agency cost”—that is, a loss of shareholder value due to managerial actions that are in the service of other, non-shareholder focused goals, plus the costs of avoiding or monitoring these agency costs.<sup>245</sup> These other goals may be self-serving; the managers are

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240. Even though compensation may be taxable under Code Section 4960, that “is not determinative as to whether remuneration paid to the covered employee is excessive or unreasonable compensation” for purposes of both Section 4958 and 4941. *See* I.R.S. Notice 19-09, 2019-04 I.R.B. 403, 428 (providing interim guidance under section 4960 and discussing answers to application questions Q-36 and Q-37).

241. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 15–19 (2004).

242. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1979) (stating the author’s intention to “integrate[] elements from the theory of agency, the theory of property rights and the theory of finance to develop a theory of the ownership structure of a firm.”).

243. Jensen & Meckling “define 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.” *Id.* at 308.

244. *Id.* at 309 (discussing the principal-agent relationship).

245. *Id.* at 308 (explaining the agency cost associated with a principal-agent relationship); *see also* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPS. 71, 71–72 (2003) (“Managers may use their discretion to benefit themselves personally in a variety of ways. . . . For example, . . . [m]anagers also may entrench themselves in their positions, making it difficult to oust them when they perform poorly. . . .”) (citations omitted).

working for their own interests, either institutionally or individually, specifically including seeking excessive compensation for themselves.<sup>246</sup>

The question then becomes how does one minimize agency loss from excessive compensation in a for-profit company? Under the optimal contracting approach to agency theory, firms will contract with their agents about the scope of their authority and their compensation optimally, as constrained by the market; failure to contract optimally results in agency loss.<sup>247</sup> Market forces will penalize companies with excessive agency loss: the company will not be successful, the agent will be terminated, or the company will be taken over by more efficient forces that believe that they could be profitable by reducing agency loss when the current management could not.<sup>248</sup> These controls are obviously strongest in publicly-traded companies, where the stock market and the market for takeovers play a unique role.<sup>249</sup>

The managerial power approach<sup>250</sup> to agency theory believes that market forces are not sufficient to limit agency losses because managers have too much internal power over the operation of the corporation and use that power to seek rents—here, to seek excessive compensation. As a result, reform (including legal reform) of governance mechanisms is necessary to give shareholders the ability to protect themselves from agency losses: channels need “to be opened for shareholder inputs because agency cost reduction enhances value and enhanced principal control conceivably can lower agency costs.”<sup>251</sup> Shareholders could act directly in providing these inputs—reforms such as “say on pay” fall into

246. It is generally thought to be impossible to have no agency loss; the goal really is to minimize it to an acceptable level. Jensen & Meckling, *supra* note 242, at 309 (noting how “agency costs arise in any situation involving cooperative effort. . .”).

247. See Alex Edmans & Xavier Gabaix, *Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories*, 15 EUR. FIN. MGMT., 486, 487 (2009) (referencing Bebchuk & Fried’s argument that statistics on CEO compensation are “evidence that compensation is decided by executives themselves, who seek to maximize their own wealth . . .”).

248. William Bratton, *Agency Theory and Incentive Compensation*, in RSCH. HANDBOOK ON EXEC. PAY 101–04 (Randall S. Thomas & Jennifer G. Hill eds., Edward Elgar 2012) (discussing agency theory with the “hierarchies” and “markets” perspective); see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. ECON., 301, 302, 313 (1983) (explaining the function of the stock market as an external monitor of corporations).

249. Fama & Jensen, *supra* note 248 (explaining how the market for takeovers and the stock market are unique to open corporations).

250. BEBCHUK & FRIED, *supra* note 241, at 61–79 (defining the managerial power perspective); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 59 (1989) (“[F]rom a theoretical perspective, the positivist stream has been most concerned with describing governance mechanisms that solve the agency problem.”); see also Josh Bendickson et al., *Agency Theory: Background and Epistemology*, 22 J. MGMT. HIST. 437, 439 (2016) (discussing the “principal-agent research and positivist agency theory.”).

251. Bratton, *supra* note 248, at 105.

this category.<sup>252</sup> In a public company context, however, it can be difficult for shareholders to act collectively<sup>253</sup> and provide the inputs necessary to control manager action directly. Therefore, the board of directors is tasked with collecting shareholder input and overseeing manager-agents to reduce rent seeking on behalf of those shareholders.<sup>254</sup>

To assist with this oversight, businesses have developed a variety of mechanisms to reduce agency loss.<sup>255</sup> We have already seen one of these outcome-based mechanisms—equity ownership by managers, whether through stock options or otherwise. In theory, when the managers are also shareholders, their managerial duty to limit agency loss by working for shareholders aligns with their personal interest in value creation.<sup>256</sup>

When Code Section 162(m) was originally passed, the underlying assumption was that the tax penalty would cause the economic cost of the compensation package to go up to unacceptable levels,<sup>257</sup> which would in turn decrease shareholder value. The appropriate response to that—either because the market demanded it, or governance mechanisms

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252. For a good discussion of the research on the efficacy of “say on pay,” see Jill Fisch et al., *Is Say on Pay All About Pay? The Impact of Performance*, 8 HARV. BUS. L. REV. 101, 101 (2018) (finding that shareholders are overwhelmingly willing to approve compensation packages so long as there are no obvious performance issues); see also Kym Sheehan, *Say on Pay and the Outrage Constraint*, in RSCH. HANDBOOK ON EXEC. PAY 255 (Randall S. Thomas & Jennifer G. Hill eds., Edward Elgar 2012) (providing a theoretical and empirical analysis of the “say on pay” principle).

253. See Peter Gourevitch, *Collective Action Problems in Monitoring Managers: The Enron Case as a Systemic Problem*, 3 ECON. SOCIOL.: EUR. ELEC. NEWSL. 3, 3–4 (2002) (discussing obstacles to collective action).

254. Traditionally, boards of directors serve neither as agents nor principals; rather they monitor agent behavior on behalf of the principal. In this model, legal reforms designed to address the process of electing the board of directors would make it easier for shareholders to remove a board that was not fulfilling its job of oversight. Eisenhardt, *supra* note 250, at 65 (explaining the effects a board of directors have on monitoring executives). That being said, some commentators believe that boards have been captured by upper management, thereby making it difficult if not impossible for boards to appropriately monitor its agents on behalf of the corporation. Randall Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers’ Fiduciary Duties*, 95 MINN. L. REV. 846, 847–48 (2011) (describing the Board Capture theory, in which “corporations’ executives . . . dominate their boards of directors and, in essence, set their own pay.”).

255. Indeed, part of the growth of stock options, in addition to being an exception to non-deductible compensation under Code Section 162(a) was that agency theory postulated that giving stock to managers would align their individual interests to shareholder interests, thereby acting as a remedy to agency loss. See BEBCHUK & FRIED, *supra* note 241, at 72 (citing developments in the compensation environment leading to increased shareholder interest).

256. Eisenhardt, *supra* note 250, at 59–60 (discussing methods for curbing agent opportunism).

257. As demonstrated in the prior section, the first fallacy is that Code Section 162(m) would actually increase the economic cost of the compensation package, which is only an effective assumption if the deduction has significant value in the first place. See discussion *supra* Section II.A; see also *supra* text accompanying note 189.

recognized and dealt with it—would be to decrease executive compensation.<sup>258</sup>

In evaluating whether the cost of the compensation package was unacceptable, the company would also have to take into account that, under an optimal contracting view, a reduction in compensation (especially equity-based compensation) might be counterproductive because the company would lose one of the mechanisms that theoretically keeps the agent acting appropriately.<sup>259</sup>

This analysis all assumes, however, that the economic cost of the compensation without the deduction would, in fact, be an agency loss. When “excessive” compensation is defined as an absolute dollar threshold—\$1 million under Section 162(m), for example—who is to say that compensation above that limit is per se unacceptable agency loss? Especially under a market-based view of agency theory, there may not be an agency loss at all. If the labor market dictates—or at least tolerates—the executive’s compensation package, then the executive would not be fired or have her compensation reduced because the company would remain successful.

If an executive’s compensation did not go down, then the company simply absorbed (or passed on to shareholders) the increased labor cost caused by the loss of the deduction (if any).<sup>260</sup> The additional cost of the loss of the tax deduction should not change the market’s valuation of a particular manager’s performance. In fact, in a world where all public companies are subject to the same rule, the loss of the deduction should not have changed the market at all—other than making compensation more expensive across the board. In the words of Jensen and Meckling, “[i]f my competitors all incur agency costs equal to or greater than mine I will not be limited from the market by their competition.”<sup>261</sup> And, in fact, that is what happened: Code Section 162(m) did not decrease total

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258. Rose & Wolfram, *supra* note 165, at 143.

259. See Bendickson et al., *supra* note 250, at 439 (“[W]hen agents have equity in the firm, they are more likely to embrace the actions desired by principals as those of their own.” (citations omitted)); compare Eisenhardt, *supra* note 250, at 59 with Brian Galle & David J. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities*, 94 B.U. L. REV. 1881, 1885 (2014) (differentiating between the optimal contract and managerial power approaches to agency issues in executive compensation, stating that, “[a] key question has been whether pay practices reflect agency problems or mitigate those problems or both.”).

260. Kaercher, *supra* note 238 (stating how a failure to respond to compensation structures could effectively increase the corporate tax for companies exceeding the \$1 million per employee covered pay threshold, with the tax burden primarily affecting wealthy Americans and foreign investors).

261. Jensen & Meckling, *supra* note 242, at 330.

compensation packages, and instead only restructured them across the board.<sup>262</sup>

If a for-profit company chooses to pay non-deductible compensation, the ultimate issue is whether it is in the best interest of the company for the Board of Directors to approve it? Viewed through the lens of shareholder value, is the value that a particular manager receives as compensation (in light of the services provided) worth the potential diminution of shareholder value caused by the lack of a tax deduction?<sup>263</sup> Or is paying the market rate necessary to obtain that manager worth the loss of the tax deduction because it translates to increased performance, and therefore, increased shareholder value?<sup>264</sup>

Market-based critics assert that companies should be allowed to pay the amount the market requires and that their business models allow.<sup>265</sup> For these commentators, what appears to be “excess compensation” is just an exercise of business judgement regarding what the market requires or will bear and the value of a particular manager.<sup>266</sup> For these critics, if the board is incorrect in its judgment, the market will eventually catch up to it and the deduction is somewhat irrelevant.<sup>267</sup>

As discussed, the market is not the only source of regulation of agency loss, especially in the compensation area. “Compensation arrangements are likely to be shaped both by market forces that push toward value-maximizing outcomes, and by managerial influence, which leads to departures from these outcomes in directions favorable to managers.”<sup>268</sup>

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262. See *supra* text accompanying note 150; see also Rose & Wolfram, *supra* note 165, at 138 (“[W]e conclude that corporate pay decisions have been relatively insulated from this policy [Code Section 162(m)] intervention.”); see also Austan Goolsbee, *What Happens When You Tax the Rich? Evidence from Executive Compensation*, 108 J. POL. ECON. 352, 352 (2000) (describing an increase in “the exercise of stock options” in response to the tax changes).

263. Yutaro Murakami & Toshiaki Wakabayashi, *Theoretical Analysis of Non-Deductible Expense: Implications for Design of Compensation Contracts*, 45 J. ACCT. & PUB. POL’Y 1, 2 (2024).

264. *Supra* text accompanying note 157.

265. See Alex Edmans & Xavier Gabaix, *Executive Compensation: A Modern Primer*, 54 J. ECON. LITERATURES 1232, 1233 (2016) (explaining that under a shareholder value model “in a competitive labor market, it may be optimal to pay high wages to attract talented CEOs and implement high effort from them even though doing so requires paying a premium.”).

266. Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers’ Fiduciary Duties*, 99 MINN. L. REV. 846, 849–50 (2011); Lucian A. Bebchuk & Holger Spamann, *Regulating Banker’s Pay*, 98 GEO. L. J. 247, 247 (2010); Rogal, *supra* note 157, at 449.

267. A 2017 study of public company compensation by Grant Thornton indicates that “only 55% of respondents . . . are satisfied that their organization’s incentive programs reflect risk considerations appropriately. In addition, nearly two thirds (61%) say their risk management or finance function has not undertaken a comprehensive risk-focused review of their compensation programs.” TOM THOMPSON ET AL., FIN. EXECS. RSCH. FOUND., FIN. EXEC. COMP. REP. 2017 1.

268. Bebchuk & Fried, *Executive Compensation*, *supra* note 245, at 73.

To the extent that compensation is actually unreasonable (as opposed to being deemed unreasonable by the Internal Revenue Code), the managerial power approach to agency theory would hold that there was a failure of appropriate corporate governance mechanisms to curb managerial power.<sup>269</sup> Multiple studies have shown that excessive compensation in for-profit companies often “reflect[s] managerial rent-seeking rather than the provision of efficient incentives. . . .”<sup>270</sup> If managers have an improper amount of say in compensation,<sup>271</sup> then one way to rectify the situation is to change the balance of power in favor of shareholders.<sup>272</sup>

This approach has been met with some skepticism as well; studies on increased voting rights on compensation<sup>273</sup> and disclosure of compensation<sup>274</sup> have shown that these specific mechanisms have mixed results in regulating executive compensation. It is hard to see how the bright line deduction rule of Code Section 162(m) would provide a direct mechanism to stop managerial rent seeking.

Code Section 162(m) might, however, provide an indirect mechanism to curb managerial rent seeking: public outrage.

The academic literature has, for the most part, assumed that the market for executives is efficient and that their high market wage reflects high marginal products. In contrast, the current public antagonism to executive salaries reflects a belief that top executives are paid substantially more than their contribution to productivity or, at least, far

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269. See Thomas & Wells, *supra* note 254, at 848, 852.

270. Bebchuk & Fried, *Executive Compensation*, *supra* note 245, at 72.

271. When managers (such as CEOs) are also directors, it potentially interferes with the ability of the Board of Directors to provide effective oversight of managers and prevent agency loss. One report from 1991, right around the passage of Code Section 162(m), noted that CEO/Board Chair “duality” was surprisingly high in the United States compared to other countries, citing one study finding about 80% duality among major US corporations as compared to Japan and Australia. Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTL. J. MGMT. 49, 52, 59 (1991) (noting however, that the study found that CEO/Board Chair duality did not appear to adversely impact shareholder returns).

272. See Bratton, *supra* note 248, at 111 (“Bebchuk and Fried make a short, direct prescription in the hierarchies mold: given that (1) the victims of the imbalanced arrangement are the shareholders and (b) the injury is due to management empowerment, it follows that (c) the only plausible cure lies in empowering the shareholders.”).

273. See Thomas & Wells, *supra* note 254, at 853 (“[V]oting in favor of shareholder resolutions to restrict pay, voting against management-sponsored option plans, or filing lawsuits, are indirect and weak.”).

274. Many commentators are skeptical that government regulation of executive pay through disclosure is necessary or effective. See generally Edmans & Gabaix, *supra* note 265, at 1237.

more than what is equitable given the compensation earned by other workers.<sup>275</sup>

While neither side of this divide is likely in possession of the objective truth of the matter (to the extent such a thing exists), the divide between the labor market and public sentiment impacts executive compensation indirectly.<sup>276</sup> In evaluating a large compensation package, a board should consider not only the direct economic cost (the pay itself) and the potential indirect economic cost (the value of the loss of the deduction, if any), but also the reputational harm inflicted by perceived corporate excess.<sup>277</sup>

Bebchuk and Fried identify these types of costs from reputational harm as “outrage costs.” In their view, the higher the outrage cost, the more likely shareholders will be unwilling to approve an arrangement.<sup>278</sup> The potential for outrage costs may prompt managers to disguise (or in the words of Bebchuk and Fried, to “camouflage”) the impact of the compensation package.<sup>279</sup> In such a case, political constraints may be at best ineffective, and at worst, cause collateral harms of secrecy.

There is limited evidence that political constraints, such as those that underlie Code Section 162(m), actually impact excessive compensation in the for-profit sphere. Rose and Wolfram, in their study of regulation of executive pay, found that “unregulated companies have historically had fewer channels through which general public sentiment against high CEO pay could be expressed.”<sup>280</sup> They believe that Code Section 162(m) was a statement of political and public sentiment,<sup>281</sup> but it was ultimately an ineffective one due to the exception for stock options and performance related bonuses.<sup>282</sup> For adherents of the optimal contracting school of

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275. See Paul Joskow, et al., *Regulatory Constraints on CEO Compensation*, 24 BROOKINGS PAPERS ON ECON. ACTIVITY 1, 2 (1993); see, e.g., Matthias Kiefer, et al., *Shareholders and Managers as Principal-Agent Hierarchies and Cooperative Teams*, 9 QUALITATIVE RSCH. FIN. MKTS. 48, 49 (2017) (Conflating media coverage with excessive compensation: “However, as demonstrated by media outrage at regular instances of excessive compensation and governance scandals at great cost to shareholders, governments and society as a whole; such an approach is deeply flawed.”).

276. Bart Dierynck & Annelies Renders, *An Empirical Test of the Effect of Outrage Costs on CEO Compensation Level*, AAA 2015 MGMT. ACCT. SECTION MEETING 1, 31 (2014).

277. *Id.* at 3–4, citing Bebchuk & Fried, *Executive Compensation*, *supra* note 245.

278. See Bebchuk & Fried, *Executive Compensation*, *supra* note 245, at 75 (discussing the effects the potential for public outrage might have on a board of directors).

279. *Id.* at 76. To avoid outrage, compensation designers attempt to hide, obscure, and justify—to “camouflage”—the amount and form of executive pay. *Id.*

280. Rose & Wolfram, *supra* note 165, at 139.

281. *Id.* at 140.

282. *Id.* at 143 (“The cap also may serve as a focal point for latent political hostility to high and rising executive pay levels, leading to some compression in executive pay, *ceteris paribus*. On the

thought, this type of political statement can be detrimental to the corporation, as political pressure interferes with market-based compensation contracting.<sup>283</sup>

In summary, an efficiently performing public company will not simply treat non-deductible compensation of more than \$1 million as per se excessive. Rather, the company will consider the loss of the tax deduction as just another cost to consider in setting executive compensation. As a result, it may be that the executive's compensation, even if not deductible, is not excessive from the viewpoint of the loss of shareholder value. If it is excessive to residual takers (here, shareholders), the optimal contracting view of agency theory dictates that the market (either the market for compensation, the market for the company's stock, or the market for the company itself) will ultimately correct it. The loss of the deduction due to Code Section 162(m) should have little impact on the market regulation of agency loss, because all public companies are subject to the same limitation.

If compensation is excessive, a managerial power view of agency theory would look to governance reforms to find and correct the cause of the excessive compensation; however, nothing in Code Section 162(m) directly requires any kind of governance reform. To the extent that one of the intended consequences of Code Section 162(m) was the growth in the issuance of stock options, it could have acted as a reform due to the resulting alignment of interest of principal/shareholders and agents/managers.<sup>284</sup>

The evidence shows, however, that this reform did not fix the perceived excessive compensation problem and may in fact have worsened it.<sup>285</sup> If there is hope that Code Section 162(m) might have impacted actual excessive compensation, it may be through political pressure and media scrutiny, but even that result is questionable at best. The charitable organization and the public company share a common compensation narrative: the private actors charged with curbing

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other hand, the implementation of the cap appears to mitigate many of these pressures. While the initial rhetoric concerned pay levels, the final legislation targeted reforming the compensation process with an emphasis on performance-based pay.”)

283. See e.g., Bebchuk & Fried, *Executive Compensation*, *supra* note 245, at 72 (“To some researchers working within the optimal contracting model, the main flaw with existing practices seems to be that, due to political limitations on how generously executives can be treated, compensation schemes are not sufficiently high-powered.”) (citation omitted).

284. See, e.g., Philipp Geiler & Luc Renneboog, *Managerial Compensation: Agency Solution or Problem?*, 11 J. CORP. L. STUD. 99, 102 (2011).

285. And, of course, post-TCJA, that doesn't even exist anymore, as the TCJA amended Code Section 162(m) to remove the exception for performance-based compensation and commissions. H.R. REP. NO. 115-97, at 277 (2017) (Conf. Rep.).

compensation abuses failed to do so; the public regulatory agencies charged with curbing compensation abuses failed to do so; and now, given these failures, Congress must step in and regulate through the Internal Revenue Code.

In attempting to find a framework within which to analyze nonprofit decision-making regarding compensation, traditional agency theory becomes somewhat more difficult to apply.<sup>286</sup> Jensen and Meckling's conception of agency cost was in the context of the role of equity holders and capital development in the modern corporate firm.<sup>287</sup> They argue that agency loss will also be "constrained by the market for the firm itself, i.e., by capital markets."<sup>288</sup> Of course, in the nonprofit world, equity holders per se do not exist; neither do capital markets, at least in the same manner. As a result, agency theory needs to be applied by analogy, with some other person or institution serving as the principal.

The primary issue in applying traditional agency theory to nonprofit organizations is identifying the principal. By definition, there are no equity-owning "shareholders" of a nonprofit corporation; indeed, the non-distribution constraint is the defining feature of the sector.<sup>289</sup> In the absence of shareholders, is the board itself the principal?<sup>290</sup> Are donors and grant funders?<sup>291</sup> Are the nonprofit's customers, such as patients or students? Or is it more amorphous than that—is the principal really the nonprofit's charitable purpose to which agent-managers should be

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286. Stijn Van Puyvelde, et al., *The Governance of Nonprofit Organizations: Integrating Agency Theory with Stakeholder and Stewardship Theories*, 41 *NONPROFIT & VOLUNTARY SECTOR Q.* 431, 439 (2012).

287. See generally *ORGANIZATIONAL ECONOMICS 205* (J. Barney & W. Ouchi, eds., 1986); see Galle & Walker, *supra* note 259, at 1884 ("Prior commentators have missed these connections because the agency cost story of executive compensation has focused on the for-profit sector and, in large part, on executive pay at publicly traded companies.").

288. Jensen & Meckling, *supra* note 242, at 33.

289. See Hansmann, *supra* note 230, at 840; see also Sharon Oster, *Executive Compensation in the Nonprofit Sector*, 8 *NONPROFIT MGMT. & LEADERSHIP* 205, 208 (1998) ("There are, of course, no stockholders of nonprofits—because one of the central requirements of the nonprofit is that residuals not be distributed—nor is profit maximization a necessary or even usual goal"); Rogal, *supra* note 157, at 464.

290. For example, in one study of nonprofit hospitals, the authors take the position that "[H]ospital governing boards operate in a context of principal agent relationships, assuming both roles. The board functions as an agent in representing the interest of . . . stakeholders (not for profit) . . ." H. Joanna Jiang, et al., *Enhancing Board Oversight on Quality of Hospital Care: An Agency Theory Perspective*, 37 *HEALTH CARE MGMT. R.* 144, 145 (2012).

291. See Galle & Walker, *supra* note 259, at 1884 ("Commentators recognize that agency problems exist in the nonprofit sphere, allowing managers to run organizations in ways donors or other stakeholders might not approve.").

beholden as part of its duty of obedience?<sup>292</sup> If that is the case, the personification of that concept may fall to the state Attorneys General<sup>293</sup> or maybe even the IRS itself.<sup>294</sup>

Using donors as the principal in the principal-agent relationship make sense in some ways but is fraught in others.<sup>295</sup> Some research indicates that nonprofit donors do react to compensation issues,<sup>296</sup> with organizations that are reliant on donors tend to have lower executive compensation packages.<sup>297</sup> Professors Brian Galle and David Walker studied donations to universities whose presidents appeared on a popular annual list of the most highly compensated presidents.<sup>298</sup> They found that universities that appeared on the list experienced “reduced average donations of up to US \$5 million in the first full fiscal year following disclosure” and found “some evidence” that an appearance on the list

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292. See Rogal, *supra* note 157, at 464 (“While charities have no shareholders, the board of directors has a legal duty to steward the charity in furtherance of its exempt purpose. To that end, the board appoints executives and monitors their performance.”); Galle & Walker, *supra* note 259, at 1893–94; see generally, Alan Palmiter, *Duty of Obedience: The Forgotten Duty*, 55 N.Y.L. SCH. L. REV. 457 (2010); and, Johnny Rex Buckles, *Fiduciary Assumptions Underlying the Federal Excise Taxation of Compensation Paid by Charities*, 45 REAL PROP. TR. & EST. L. J. 53 (2010).

293. Most nonprofits are subject to the oversight of the state Attorney General, who is charged with protecting assets dedicated to charitable purposes. These offices are woefully understaffed, with one study from 2016 finding that there were only 355 state charity regulators (including non-attorney support staff) nationwide. Cindy M. Lott, et al., URB. INST. ON NONPROFITS & PHILANTHROPY, *State Regulation and Enforcement in the Charitable Sector* 8 (2016) <https://www.urban.org/sites/default/files/publication/84161/2000925-State-Regulation-and-Enforcement-in-the-Charitable-Sector.pdf> [<https://perma.cc/H65F-57XT>].

294. One of the arguments against the IRS’ requirement of increased reporting on the Form 990 regarding governance procedures was that it usurped state law authority to regulate charitable organizations without Internal Revenue Code authority to do so. See, e.g., Gregory Naclerio, *Compliance Alert Form 990 Now Requires Governance, Management and Disclosure Information*, RUSKIN MOSCOU FALTISCHEK P.C. (2009), <https://rmfpc.com/news/compliance-alert-form-990-now-requires-governance-management-and-disclosure-information/> [<https://perma.cc/L2SM-FV8P>]; but see Philip Hackney, *Keep Charitable Oversight in the IRS*, 15 COLUM. J. TAX L. 130 (2024).

295. See Adonai Jose Lacruz, *Theoretical Considerations on Corporate Governance in the Third Sector in the Agency Theory Perspective*, 18 CADERNOS EBAPE BR 473, 480 (2020).

296. Phillip Davis, et al., *Agency Theory and Utility and Social Entrepreneurship: Issues of Identity and Role Conflict*, 15 REV. MANAGERIAL SCI. 2299, 2300 (2021).

297. See Brian Galle & David I. Walker, *Donor Reaction to Salient Disclosures of Nonprofit Executive Pay: A Regression-Discontinuity Approach*, 45 NONPROFIT & VOLUNTARY SECTOR Q. 787, 801 (2016). Krishnan and Yetman found a similar outcome with nonprofit hospitals. Studying a cross section of California nonprofit hospitals, they found that cost shifting away from overhead and toward program service revenue occurs more frequently in hospitals reliant on donations. Ranjani Krishnan & Michelle H. Yetman, *Institutional Drivers of Reporting Decisions in Nonprofit Hospitals*, 49 J. ACCT. RSCH. 1001, 1003 (2011).

298. Galle & Walker used The Chronicle of Higher Education’s annually published list of the top ten most-highly compensated college and university presidents. Galle & Walker, *supra* note 297, at 787.

“correlated with slower compensation growth and rising enrollment in subsequent years.”<sup>299</sup> They also found that “donors react negatively to higher executive pay;” and as a result, donors may have an indirect role in the oversight over nonprofit executive pay.<sup>300</sup>

What is unclear, however, is whether donors are acting as principals for the nonprofit, or whether the university’s governing body is reacting to an outrage expressed by donors on behalf of some other principal. Although donors are a source of funding for a nonprofit, they are not its residual claimants. If donors are standing in the shoes of shareholders, then the donors should be the primary protectors and representatives of the charity’s mission. But that isn’t always so. Donors are one of the most common causes of “mission drift”—defined by one scholar as “the gradual diversion of a charity’s activities from its stated purpose” that is not intentional and strategic.<sup>301</sup> Donors may have their own view of what the charity’s mission is and how it can be accomplished—views that may be held in good faith but incorporate the donor’s personal agenda and experiences.<sup>302</sup>

Donors may also bring biases regarding corporate governance derived from the for-profit sector to bear in informing the conditions that they place on their gifts.<sup>303</sup> Finally, increasingly, donors are actually

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299. *Id.*

300. *Id.* at 789 (finding that donor attention is not a perfect measure, as “[i]t appears that donors are somewhat aware of but not fully attentive to the pay-setting process, and their negative reaction to high pay when it is made salient implies that process does not fully reflect their preferences.”); see also Brian Galle & David Walker, *Sunshine, Stakeholders, and Executive Pay: A Regression-Discontinuity Approach* 1–43 (B.U. Sch.L. Working Paper, Paper No. 14-09, 2014) (finding that “donors represent a potential source of monitoring and executive pay discipline in the nonprofit sector,” but significant agency problems remain).

301. Theresa L.M. Man, *Avoiding Mission Drift: A Due Diligence Approach*, 25 PHILANTHROPIST 73 (2013); see, e.g., PETER GREER & CHRIS HORST, *MISSION DRIFT: THE UNSPOKEN CRISIS FACING LEADERS, CHARITIES, AND CHURCHES* 15–16 (2014) (describing a donor offering substantial funding for an important project on the condition that the Christian-based organization not be “so overtly faith based.”).

302. For evidence of this, one need look no further than recent examples of donors conditioning or withholding gifts on how a school addresses the recent Israel-Hamas war. Rasheeda Childress, *What Do Donor Revolts Mean for Fundraising?*, CHRON. PHILANTHROPY (Mar. 5, 2024), [https://www.philanthropy.com/article/what-do-donor-revolts-mean-for-fundraising?utm\\_source=Iterable&utm\\_medium=email&utm\\_campaign=campaign\\_9260698\\_nl\\_Philanthropy-Today\\_date\\_20240311&cid=pt&source=ams&sourceid=\[https://perma.cc/4PYD-N8E2\]](https://www.philanthropy.com/article/what-do-donor-revolts-mean-for-fundraising?utm_source=Iterable&utm_medium=email&utm_campaign=campaign_9260698_nl_Philanthropy-Today_date_20240311&cid=pt&source=ams&sourceid=[https://perma.cc/4PYD-N8E2]).

303. Some nonprofit scholars attribute this type of mission drift so-called “New Public Management” (or “NPM”) approaches to public administration and nonprofit governance. NPM describes “how management techniques from the private sector are now being applied to public services.” NPM also draws together a set of cost-cutting management concepts from the private sector including downsizing and rightsizing, among other things. JAN-ERIK LANE, *NEW PUBLIC MANAGEMENT: AN INTRODUCTION* (2000); see also Noel Hyndman, *Editorial: The Charity Sector*

contracting parties, such as government entities and foundations, that are funding a nonprofit as a route to accomplishing the funders' mission.<sup>304</sup>

If the actual principal in a nonprofit principal-agency relationship is not the organization's donors, then the principal could be the construct that is the charity's mission. After all, at least for organizations exempt under Code Section 501(c)(3), the residual claimant for a charity is another charity or ultimately, the public. The governing documents of an organization exempt under Code Section 501(c)(3) must provide that assets are dedicated to charitable purposes in perpetuity.<sup>305</sup> The Board of Directors collects inputs from various stakeholders, including donors, but must evaluate and act on that information in a way that serves the principal—the charitable mission.

In this model, donors reflect a general outrage, which may be shared by other stakeholders, that high executive compensation undermines a charity's mission. However, that outrage is not fully informed by the reality of accomplishing the charity's mission on a day-to-day basis: work force requirements, its budget, compensation rules, contract or grant compliance, and the general labor market.<sup>306</sup> Rather, donor outrage is less about the realities of executive compensation and more of a general sense that nonprofit managers just shouldn't be paid that much, and certainly not as much as for-profit managers: “[C]learly the public’s opinion is that executives of nonprofit organizations should not earn the same compensation as equivalent business executives.”<sup>307</sup> This level of public outrage may be similar to that experienced by public companies regarding CEO compensation, where compensation levels are seen as just too high as a multiple of the salaries of rank-and-file workers.<sup>308</sup>

The place where nonprofits and public companies vary, however, is in their relative sensitivities to this outrage constraint. As discussed, it is

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– *Changing Times, Changing Challenges*, 37 PUB. MONEY & MGMT. 149, 152 (2017) (“[E]mbracing such NPM principles can result in significant mission drift whereby powerful and influential forces carry the charity away from its core mission.”).

304. See, e.g., William Foster & Gail Fine, *How Nonprofits Get Really Big*, 5 STAN. SOC. INNOVATION REV. 46, 49 (2007).

305. See 26 CFR § 1.501(c)(3)-1(b)(4) (providing that “[a]n organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose”).

306. See Galle & Walker, *supra* note 297, at 789 (“It appears that donors are somewhat aware of but not fully attentive to the pay-setting process, and their negative reaction to high pay when it is made salient implies that process does not fully reflect their preferences.”).

307. Oster, *supra* note 289, at 208.

308. See, e.g., ‘*Outrageous*’ CEO pay Targeted in New Bill from Bernie Sanders, *US Democrats*, REUTERS (Jan. 22, 2024, 1:37 PM), <https://www.reuters.com/world/us/outrageous-ceo-pay-targeted-new-bill-bernie-sanders-us-democrats-2024-01-22/> [<https://perma.cc/5233-XMYK>] (describing legislation designed to tax compensation in excess of fifty times average worker pay).

widely thought that outrage is a relatively weak constraint on managerial rent seeking in the public company context.<sup>309</sup> In the nonprofit context, however, one could argue that outrage is a far stronger constraint; indeed, nonprofits may be overly reactive to it to their detriment. In the nonprofit world, administrative expenses, specifically including compensation, is “generally [] construed as wasteful relative to program service expenses.”<sup>310</sup> Researchers identify “moral constraints” as a limit to increasing executive compensation in nonprofits and find that “frugality is viewed as a virtue.”<sup>311</sup>

As Galle and Walker demonstrated, executive compensation specifically is salient to donors—and nonprofits know this.<sup>312</sup> Faced with this knowledge, “decision makers at some poorly performing charities take advantage of this narrow view by keeping staff salaries low, instead outsourcing executive management or fundraising personnel to expensive management or professional fundraising companies.”<sup>313</sup> In this regard, ratings services such as Charity Navigator, GuideStar and the Better Business Bureau’s Wise Giving Alliance can be problematic. Donors are regularly advised to consult one of these services to make sure that their selected charity isn’t fraudulent.<sup>314</sup> But that advice goes further—donors are often looking to the percentage of administrative costs to see if charities are wasteful. One study found that a higher rating on Charity Navigator (measured by stars), which is in part a function of administrative costs, can result in more donations.<sup>315</sup>

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309. Rose & Wolfram, *supra* note 165, at 139.

310. Krishnan & Yetman, *supra* note 297, at 1007.

311. Peter Frumkin & Elizabeth K. Keating, *The Price of Doing Good: Executive Compensation in Nonprofit Organizations*, 29 POL’Y & SOC’Y 269, 270, 273 (2010).

312. See, e.g., Dottie Schindlinger, *What Affects Nonprofit Executive Compensation?*, BD. EFFECT (Jun. 6, 2024), <https://www.boardeffect.com/blog/what-affects-nonprofit-executive-compensation/> [<https://perma.cc/J8LD-EVXJ>] (“Nonprofits need strong leadership that comes with a price. Yet, donors generally pass over nonprofits that seek funds to pay for executive compensation.”).

313. *Reported Charity Salaries May Not Tell the Full Story*, CHARITYWATCH (Apr. 4, 2017), <https://www.charitywatch.org/charity-donating-articles/reported-charity-salaries-may-not-tell-the-full-story> [<https://perma.cc/PR9N-R3S9>].

314. See, e.g., Kim Komando, *Give Wisely: Before you Donate Money, Check the Charity’s Rating*, KOMANDO, (Dec. 19, 2022), <https://www.komando.com/money/check-charity-ratings/695892/> [<https://perma.cc/RJ5Z-CGRV>] (explaining that charity donors should consult organization’s ratings prior to donating to ensure that the charity is registered and appropriates funds responsibly).

315. Jennifer Mayo, *Charity Navigator Stars Can Boost Donations – but Nonprofits Might Game the System*, THE CHRON. OF PHILANTHROPY (Jun. 5, 2023), <https://www.philanthropy.com/article/charity-navigator-stars-can-boost-donations-but-charities-might-game-the-system> [<https://perma.cc/6GNB-TK6W>] (“[I]f a charity’s rating rises from two to three stars or from three to four stars, its donations rise by about 6 percent. Larger charities—that

While protection of consumers against fraud is a laudable goal, the uncritical scrutiny of administrative costs has had pernicious effects on the nonprofit sector as a whole. A Better Business Bureau Wise Giving Alliance study in 2001 showed that more than half of the people surveyed thought that charities should have overhead rates of less than 20%, and that overhead ratio was important to their decision to donate.<sup>316</sup> The perceived need to lower the administrative cost percentage and obtain that next star “creates the conditions for an excessive pursuit of administrative efficiency that may cause a steady and self-perpetuating practice of cost-cutting, which in turn may harm the nonprofit.”<sup>317</sup> Referred to as the “nonprofit starvation cycle,” charities respond to the unrealistic expectations of donors and grant funders to do more with less.<sup>318</sup> When the charity manages to underspend to meet artificial targets, it reinforces the expectation of the donors, who then continue to demand further reductions of overhead. This vicious cycle of reinforced perpetual underfunding of overhead devolves to the point of a devastating lack of nonprofit capacity.

Even worse, the drive for the appearance of administrative efficiency will cause some charities to engage in traditional camouflage activities, by artificially reducing administrative costs, such as salaries, so as to increase their program service revenue.<sup>319</sup>

Other charities find vehicles through which they can funnel significant compensation to their executives or board members without being required to report it as salary. These may include licensing fees, lease payments, legal fees, investment management fees, or other payments to for-profit companies owned by charity executives.<sup>320</sup>

A Chronicle of Philanthropy study from 2000 indicates that “a majority of nonprofits say that their accountants advised them to report zero in the

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is, those with net assets of more than \$5.6 million—benefit even more. Their donations grow 9 percent for an increase in rating from three to four stars and 12 percent for an increase from two to three stars.”).

316. PRINCETON SURV. RSCH. ASSOCS., BBB WISE GIVING ALLIANCE DONOR EXPECTATIONS SURVEY FINAL REPORT 20 (2001).

317. Jesse D. Lecy & Elizabeth A.M. Searing, *Anatomy of the Nonprofit Starvation Cycle: An Analysis of Falling Overhead Ratios in the Nonprofit Sector*, 44 NONPROFIT & VOLUNTARY SECTOR Q. 539, 540 (2014).

318. Ann Goggins Gregory & Don Howard, *The Nonprofit Starvation Cycle*, STAN. SOC. INNOVATION REV., Fall 2009, at 51.

319. See Mayo, *supra* note 315 (“Larger charities—those more reliant on donations to pay their bills and those operating in sectors like housing and social services—are the most likely to alter their spending patterns to boost their ratings.”); see also Krishnan & Yetman, *supra* note 297, at 1008 (finding “a positive association between normative institutional pressures for conformance and cost shifting in nonprofit hospitals.”).

320. *Reported Charity Salaries May Not Tell the Full Story*, *supra* note 313.

fundraising section of Form 990.”<sup>321</sup> This exacerbates the nonprofit starvation cycle. If donors and other funders are unaware what actual overhead is and should be, there is no countervailing narrative to the expectation to do more with less.<sup>322</sup>

The nonprofit starvation studies show that the primary place that these cuts happen is in compensation and training. Charities are “unable to pay competitive salaries for qualified specialists,” hire individuals with lower qualifications, and skimp on training.<sup>323</sup> One study shows that these cuts fall disproportionately on non-executive staff,<sup>324</sup> although it is unclear from the data what constitutes non-executive staff<sup>325</sup> or whether cuts are from a reduction in the number of staff or a reduction in wages, or both.<sup>326</sup>

Under this model, the agency loss experienced by the nonprofit is not excessive executive compensation. The agency loss is that agents are not furthering the interest of the principal—that is, furthering the charitable mission of the organization in the long term—because they are overvaluing donor outrage about overhead, including compensation. The agent’s self-interest in this equation is in performance metrics: the charity will generate more donations and grant-funding in the short term by responding to demands for lower overhead. Lower overhead, in and of itself, may be seen as a good performance metric, even apart from its relationship with raising funds. To the extent that managers can shift the cuts in compensation to non-executive staff, it further advances the self-interest of the manager-agents. All of this sacrifices the long-term health of the charity.

In this regard, Code Section 4960 is a far more powerful and effective representation of outrage than Code Section 162(m). In the case of both Code Section 162(m) and Code Section 4960, Congress is explicitly pointing to a particular compensation practice—compensation packages in excess of \$1 million—as a practice to be penalized. The choice of statutory language is telling Code Section 162(m) is entitled “Certain

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321. Gregory & Howard, *supra* note 318.

322. *See id.*; Lecy & Searing, *supra* note 317, at 543.

323. *See* Gregory & Howard, *supra* note 318, at 51.

324. *See* Lecy & Searing, *supra* note 317, at 539 (“[T]he brunt of the cuts have fallen on nonexecutive staff wages and professional fees, which heightens the concern of potentially ill effects derived from a fixation on overhead cost reduction.”).

325. *See id.*, at 553–54 (“The nonprofit sector is known for having limited opportunity for promotion within organizations because of small size and lengthy tenure of existing executives, so perhaps nonprofits have begun designating program managers as executives instead of staff for human resource purposes.”).

326. *See id.*, at 554 (“Perhaps these activities have been cut due to reductions in overhead costs as these tend to fall in that category, although some services like legal and accounting tend to be necessary expenditures.”).

Excessive Employee Remuneration” while Code Section 4960 is entitled “Tax on Excess Tax-Exempt Organization Executive Compensation” (emphasis added).<sup>327</sup>

Just the term “tax”, and especially excise tax, carries with it negative connotations in the nonprofit world. Excise taxes are the primary way in which the Internal Revenue Code regulates the conduct of tax-exempt charities. Imposition of an excise tax—whether it’s the excess benefit transactions excise tax<sup>328</sup> or one of the private foundation excise taxes<sup>329</sup>—is affirmatively bad. A charity cannot simply choose to engage in a behavior and bear the brunt of the economic cost of an excise tax (unlike, say, the loss of a deduction). Indeed, most of these excise taxes require correction of the errant behavior, the absence of which may cause an additional round of excise taxes<sup>330</sup> and even the loss of exempt status.<sup>331</sup> These excise taxes set the appropriate boundaries for the behavior for charities, and an imposition of one of these excise taxes means that the charity has affirmatively done something wrong. The loss of a deduction under Code Section 162(m) simply does not carry with it the imprimatur of wrongdoing in the same way.

In this context, Code Section 162(m) and Code Section 4960 could be considered “shaming,” and possibly a form of indirect “regulatory shaming” (although here, coming from a legislative body).<sup>332</sup> Professor Sharon Yadin defines indirect shaming as the establishment of a social norm as a law or rule, the violation of which is an issue in and of itself, but also shames the person violating the norm.<sup>333</sup> Yadin also defines regulatory shaming as “the publication of negative information by administrative agencies concerning private regulated bodies, mostly corporations, in order to further public interest goals.”<sup>334</sup> Applying this definition, one could view Code Sections 162(m) and 4960 as rules that establish tax

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327. I.R.C. § 162(m); I.R.C. § 4960.

328. I.R.C. § 4958.

329. I.R.C. §§ 4940–45. *See* I.R.C. § 4955 (describing the excise tax on political expenditures); I.R.C. § 4959 (noting that the hospital excise tax fails to meet the operational requirements of Code Section 501(r)); I.R.C. §§ 4966–67 (noting that the donor advised fund excise taxes on taxable distributions and prohibited benefits).

330. *See* I.R.C. § 4958(b) (imposing a 200% excise tax on a disqualified person involved in an excess benefit transaction if that transaction is not timely corrected); *see also* I.R.C. §§ 4941(b) (imposing a second round of excise taxes at 200% on the self-dealer and 50% on the foundation manager if the act of self-dealing is not timely corrected).

331. Treas. Reg. § 53.4958-8(a) (2002).

332. *See generally* Sharon Yadin, *Regulatory Shaming*, 49 LEWIS & CLARK ENV’T L. REV. 407, 407 (2019).

333. This is in contrast to direct shaming, where the government imposes shaming as penalty. *Id.* at 415–16.

334. *Id.* at 407.

consequences, but also statements of social norms about executive compensation, the violation of which is designed to shame the violators.

Shaming is not new in the for-profit executive compensation context. The Dodd-Frank Act, enacted in as a response to the 2008 financial crisis, mandates certain disclosures around executive compensation for public companies, including CEO to median employee compensation ratios and information regarding the relationship between compensation and the company's financial performance, also known as the pay versus performance rules.<sup>335</sup> As a legal construct, a corporation feels no shame itself; one can either shame the corporate entity such that its governing body feels like there is harm to the corporate brand or financial status, or one can shame individual agents of the corporation. For-profit corporations do "feel" reputational penalties, but those reputational penalties must be balanced against shareholder value.<sup>336</sup> While shaming may be of limited impact in the for-profit context, the potential for effective shaming may be "greatest when more high-powered incentive devices are absent."<sup>337</sup> Since, there are limited incentive devices in nonprofits, it follows that shaming is a more effective tool in sector than in the for-profit space.<sup>338</sup>

This heightened sensitivity to the outrage constraint by managers could play out in a variety of ways in the nonprofit context. First, if an executive's compensation exceeds \$1 million but is not excessive (that is, it is reasonable compensation given the applicable labor market), charities will likely simply need to pay the excise tax. It is, frankly, unlikely that Nick Saban would have taken \$990,000 in compensation from the University of Alabama given the current labor market.<sup>339</sup> Unlike for-profit organizations, however, nonprofits have limited ability to shift the incidence of the tax to other external stakeholders. Instead, the charity likely will internalize the cost of the excise tax, by reducing

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335. *Id.* at 424.

336. See David A. Skeel, Jr., *Shaming in Corporate Law*, 149 UNIV. PA. L. REV. 1811, 1852 (2001) ("Inanimate though corporations may be, they are far from immune from reputational penalties.").

337. Marcel Kahan, *The Limited Significance of Norms for Corporate Governance* 149 UNIV. PA. L. REV. 1869, 1899 (2001).

338. See also Paul Joskow, et al., *Regulatory Constraints on CEO Compensation*, *supra* 275 (finding that public outrage is more influential in public company industries that are regulated, as government regulators are sensitive to public outcry over CEO compensation).

339. Of course, some critics will argue that the University of Alabama shouldn't have been prioritizing its football program in that way to begin with, but this article assumes the state of the market as it currently is. See generally Victoria E. Collins, *Academics Versus Athletics? The Protection and Prioritization of College Athletics in an Era of Neoliberal Austerity*, 30 CRITICAL CRIMINOLOGY 541, 541 (2022).

its other overhead, specifically including by reduction of non-executive staff salaries.<sup>340</sup>

Generally, however, most charities do not pay compensation of more than a \$1 million. The IRS executive compensation surveys for colleges and universities show that the median compensation for most college presidents was way below this limit.<sup>341</sup> These middle range compensation packages may be unreasonable, or they may not be. For these compensation packages, Code Section 4960 is mechanically irrelevant either way, as it is simply not applicable.

That is not to say that Code Section 4960 is neutral with regard to mid-range compensation packages. To the extent that Code Section 4960 codifies the outrage—that nonprofit compensation is affirmatively bad—it may play into the nonprofit starvation cycle. Alternatively, Code Section 4960 could have a positive effect to organizations that do not pay high compensation as it signals to boards that they need to be more cautious about setting their compensation packages going forward. As with public companies, there are significant limitations on the ability of boards of directors to monitor agent behavior.<sup>342</sup> However, many of these traditional concerns are heightened in the nonprofit context: asymmetry of information, volunteer or part-time boards, and limited resources.<sup>343</sup> Given these circumstances, the environment is conducive to an overvaluation of the outrage reflected by Code Section 4960 but an undervaluation of the need for caution and process that it might counsel.

Traditional concerns regarding agent monitoring may lead nonprofit organizations, especially those that have a high percentage of volunteer board members, to overvalue the outrage constraints because they intrinsically understand it, while they do not have a deeper understanding of the technicalities of the compensation process. One study categorized board self-assessments from the governing bodies of nonprofit

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340. In response to outrage, one would expect to see the nonprofit deploy some camouflage techniques. *See* I.R.C. § 11.

341. *Treas. Reg. § 53.4958-4(b)(1)(ii)*. (2024)

342. *See* Fama & Jensen, *supra* note 248, at 301 (“We argue that the separation of decision and risk-bearing functions observed in large corporations is common to other organization such as . . . nonprofits”). That being said, the most popular of the monitory mechanisms—*incentive compensation*—is largely unavailable in the nonprofit context. True equity compensation is unavailable, so some other metric for performance is necessary. It is often difficult in the nonprofit sector to identify specific and measurable outcomes for accomplishing a nonprofit mission. *See* Oster, *supra* note 289, at 208 (“But measures of performance that can be used to judge or create incentives for those chief executives are harder to find.”).

343. *See* Galle & Walker, *supra* note 297, at 789–90 (“Directors, however, commit limited time to oversight and receive limited information, have little or no direct economic stake in outcomes, and are influenced by a culture of deference to senior management.”); Rogal, *supra* note 157, at 465.

performing arts organizations.<sup>344</sup> The study group was asked to evaluate its performance in certain activities, with the available responses as either the board felt it was doing well, doing poorly or the category was “not applicable or don’t know.” Among the highest responses for “not applicable or don’t know” were the following: approving the executive’s compensation as a full board; formally assessing the chief executive’s performance; and ensuring that the chief executive is appropriately compensated.<sup>345</sup>

If under agency theory the board is charged with overseeing agent-managers, this study demonstrates that directors have self-assessed that they don’t think they have the technical capacity to do so, at least when it comes to compensation.<sup>346</sup> It does, however, limit the ability of even competent boards to provide competitive executive pay packages.

This all assumes that the nonprofit and its agents are acting in good faith, even if incompetently. Congress and the media, however, continue to assume that excessive compensation is the result of criminally incompetent monitoring rather than honest incompetence.<sup>347</sup> In designing Code Section 4960, Congress was clear that its intent was stop top executives from “inappropriately divert[ing] organizational resources into excessive compensation.<sup>348</sup> Willful, even intentional, excessive compensation happens—the *Ononjuju* case, discussed earlier, is evidence of that.<sup>349</sup> If an organization’s board is completely absent<sup>350</sup> or captured and its managers are willing to engage in excessive compensation practices that are so blatant as to rise to the level of an

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344. Judith L. Millesen & Joanne G. Carman, *Building Capacity in Nonprofit Boards: Learning from Board Self-Assessments*, 5 J. PUB. & NONPROFIT AFFS. 74, 74 (2019).

345. *Id.* at 81.

346. J. L. Miller & B. M. Lakey, *The Nonprofit Board Self-Assessment Process: Lessons from the Field*, NAT’L ASSOC’N FOR NONPROFIT & VOLUNTARY ACTION CONF. (1999)

347. Compare Joseph Health, *The Uses and Abuses of Agency Theory*, 19 BUS. ETHICS Q. 497, 498 (2009) (“[D]eception and misappropriation of funds by the agent represent perfect examples of the type of moral hazard problems that are an endemic feature of principal-agent relations.”); and Phillip E. Davis et al., *Agency Theory Utility and Social Entrepreneurship: Issues of Identity and Role Conflict*, 15 REV. OF MANAGERIAL SCI. 2299, 2307 (2021) (“In other words, they take advantage of the contract since they will not bear the cost.”), with John Hendry, *The Principals’ Other Problems: Honest Incompetence and the Specification of Objectives*, 27 ACAD. OF MGMT. REV. 98, 98, 110 (2002) (“At the same time, standard agency theory also ignores a raft of issues that are central to management and organizational life, including those of power, complexity, bounded rationality, and the limited competence of managers to achieve desired outcomes.”).

348. H.R. REP. NO. 104-506, at 53 (1996), reprinted in 1996 U.S.C.C.A.N. 1143, 1179.

349. *Ononjuju v. Commissioner*, 122 T.C.M. (CCH) 109 (2021).

350. See Judith Miller, *The Board as Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards*, 12 NONPROFIT MGMT. & LEADERSHIP 429, 429 (2002) (suggesting that one of the reasons board members do not know how to assess CEO performance is because they simply do not think it is necessary).

unreasonable diversion of assets from charitable purposes, it is hard to believe that the imposition of an additional excise tax will change their hearts and minds. In such a case, the economic cost of the penalty clearly is of no matter, and the organization and its managers are otherwise immune to outrage.<sup>351</sup> Code Section 4960 will play little role in preventing outrageously negligent or outright fraudulent behavior, regardless of the size of the compensation package.

*C. The Third Fallacy: Code Section 4960 is about “Excessive” Compensation at All*

If Code Section 4960 will not accomplish that stated goal of regulating and preventing excessive nonprofit compensation because the “diversion” of resources is, arguably, not inappropriate or because the “inappropriate diversion” will happen regardless, then what was Congress attempting to accomplish? Was Code Section 4960 just misguided in its efforts to regulate compensation? Or is it just a way to reinforce negative stereotypes and manifest of hostility toward the nonprofit sector, specifically higher education, coupled with a significant need for revenue generation?

*Reinforcing Negative Stereotypes: Donative Labor Theory.* Unlike the intermediate sanctions provisions of Code Section 4958, Code Section 4960 affirmatively adopts the notion of donative labor theory to the detriment of the entire charitable sector. Rather than actually preventing harmful excessive compensation, Code Section 4960 is rooted in re-enforcing the application of donative labor theory and shaming nonprofits for its noncompliance.

As a whole, nonprofit organizations tend to pay their workers at lower salaries than their business firm counterparts.<sup>352</sup> The theory is that nonprofit employees accept lower pay in order to do work that furthers a charitable mission.<sup>353</sup> “Donative labor theory” posits that nonprofit workers are willing—and should be willing—to take less in wages

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351. See Margaret Gibleman, Sheldon Gelman & Daniel Pollack, *The Credibility of Nonprofit Boards: A View from the 1990s and Beyond*, 21 ADMIN. SOC. WORK 21, 32 (1997) (examining board performance in various well known charity scandals).

352. See Frumkin & Keating, *supra* note 311, at 271 (discussing how nonprofit organizations pay their employees lower wages compared to similar for-profit roles and providing theories that explain this phenomenon); see also Tracy Shicun Cui, *Donative Labor Effect of the Nonprofit Pay: A Multilevel Explanation*, 31 NONPROFIT MGMT. & LEADERSHIP 57, 57 (2020) (finding “that nonprofit workers earn 4.3% less than comparable for-profit workers net of industry and occupation effects.”).

353. But see Christian King & Gregory B. Lewis, *Nonprofit Pay in a Competitive Market: Wage Penalty or Premium?*, 46 NONPROFIT & VOLUNTARY SECTOR Q. 1073, 1087 (2017) (finding no support for donative labor theory in nonprofit hospital nursing due to higher skilled nursing needs but acknowledging that nursing may be a difficult case).

because of nature of their employer and the good works that they do.<sup>354</sup> In essence, they donate their labor to the nonprofit in the form of being underpaid. Frumkin and Keating<sup>355</sup> note several theories as to why nonprofit employees accept lower wages. Some employees may prefer “altruistic and other non-pecuniary benefits to monetary rewards.”<sup>356</sup> Low wages may act as a filter, “attracting only those managers willing to restrain their desire for profit.”<sup>357</sup> But need it be this way? Alternatively, consider that “the donative labor narrative should be understood as a result of social expectations for sacrifice of nonprofit employees, rather than a simple outcome of supply and demand in the labor market.”<sup>358</sup> “Underpaid and overworked has become the norm,”<sup>359</sup> resulting in a “culture of self-sacrifice.”<sup>360</sup> In the short run, donative labor theory supports the suppression of wages that is endemic to the nonprofit starvation cycle.

In the long term, however, adopting donative labor theory as a guiding principle for nonprofit staffing is affirmatively harmful. On the executive level, it becomes difficult to develop compensation packages that attract (and retain) qualified leadership candidates. But the crisis is even more significant on the non-executive level: “Charities that pay so far below market rate relative to the skills, education, and experience needed for the job can have trouble retaining staff and waste a lot of money by repeatedly recruiting and training new crops of employees, losing valuable institutional knowledge in the process.”<sup>361</sup> Kim & Charbonneau, in their study of nonprofit wages, found that “the social

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354. Oster, *supra* note 289; Mirae Kim & Etienne Charbonneau, *Caught Between Volunteerism and Professionalism: Support by Nonprofit Leaders for the Donative Labor Hypothesis*, 40 REV. PUB. PERS. ADMIN. 327, 327 (2020).

355. Frumkin & Keating, *supra* note 352.

356. *Id.* (first citing Anne E. Preston, *The Nonprofit Worker in a For-Profit World*, 7 J. LAB. ECON. 438 (1989); and then citing Susan Rose-Ackerman, *Charitable Giving and Excessive Fundraising*, in SUSAN ROSE-ACKERMAN, *THE ECONOMICS OF NON-PROFIT INSTITUTIONS* (1986)).

357. *Id.* (citing Hansmann, *supra* note 230); *see also* King & Lewis, *supra* note 353, at 1074 (“Nonprofits may even choose to pay below-market rates to help them select the most motivated workers.”) (citations omitted).

358. Kim & Charbonneau, *supra* note 354.

359. Caitlin Kearney, *The Price of Doing Good: Measuring the Nonprofit Pay Cut*, PAYSACLE.COM (Nov. 27, 2018), <https://www.payscale.com/data/nonprofit-pay-cut> [<https://perma.cc/N6N4-YJBV>].

360. Kim & Charbonneau, *supra* note 354, at 328.

361. CHARITYWATCH, *supra* note 313; *see also* King & Lewis, *supra* note 353, at 1047 (“[T]he nonprofit sector has high turnover rates with low pay being one of the most common reasons employees cite for leaving.” (citations omitted); *and* Kim & Charbonneau, *supra* note 354, at 328–29 (“[O]ne of the consistently cited reason for high turnover rates in the nonprofit sector is the ‘inability to pay competitively.’” (citations omitted)).

expectation for sacrifice from nonprofit workers in the pursuit of efficiency restrains nonprofits from treating their employees fairly through proper compensation for their contributions.”<sup>362</sup> With Congress, donors, charity watchdogs, and even nonprofits boards focusing on overhead and accepting the narrative that the payment of compensation to skilled workers is a “diversion” of assets, charities are shamed for attempting to invest appropriately and equitably in the personnel who are critical to accomplishing their missions.

Code Section 4960 codifies donative labor theory in a way that Treasury refused to do in the intermediate sanctions regulations.<sup>363</sup> Even in a case where over \$1 million in compensation is the market rate, Congress has signaled that is it de facto excessive. It’s easy conceptually to get behind that notion when thinking about very highly compensated individuals, and we can easily say they have “enough” so they should stop taking “more.” But in the long haul, the narrative that working for nonprofit means to be underpaid and that’s normatively a good thing is extraordinarily damaging to the nonprofit sector overall.

Given the success of outrage and shaming nonprofits on compensation issues, Congress was handed an easy target. Once you adopt the narrative that nonprofits are wasteful, it is a simple political matter to extract resources from an already disfavored sector.

The TCJA<sup>364</sup> had a significant number of business tax breaks in it, including the 21 percent flat rate for corporations and the Code Section 199A deduction for small business income. In addition, the TCJA looked to raise the standard deduction and the child tax credit.<sup>365</sup> As a result, the TCJA was expensive. The Congressional Budget Office and the Joint Committee on Taxation’s revenue estimate for the TCJA found that it would “reduce revenues by about \$1,649 billion and decrease outlays by

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362. Kim & Charbonneau, *supra* note 354, at 330.

363. See Troyer, *supra* note 70 (discussing Congressional and regulatory allowance of for-profit and nonprofit comparisons for purposes of the rebuttable presumption).

364. The TCJA had its genesis in the Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014), developed by then House Ways and Means Chairman David Camp (R-MI). The Tax Reform Act of 2014 contained the initial version the excess executive compensation tax at a 25% rate, the excise tax on college and university endowments, as well as many other items that made it into the TCJA. See Tax Reform Act of 2014 §§ 3803, 5205; See also the comparative chart contained in *House Ways and Means Committee Releases Comprehensive Tax Reform Bill*, AKIN GUMP STRAUSS HAUER & FELD LLP (Nov. 2, 2017), <https://www.politico.com/f/?id=0000015f-8126-d4fa-abdf-a1bfada40000> [<https://perma.cc/267M-XN4L>] (showing the genesis of the university endowment tax, the proposal to repeal the student loan interest deduction, and the increase in the standard deduction).

365. Samuel A. Donaldson, *Understanding the Tax Cuts and Jobs Act*, GA. ST. UNIV. COLL. L. 1, 12 (2018); Jennifer Bird-Pollan, *Revising the Tax Law: The TCJA and its Place in the History of Tax Reform*, 45 OHIO N. U. L. REV. 501, 516 (2019).

about \$194 billion over the period from 2018 to 2027, leading to an increase in the deficit of \$1,455 billion over the next ten years.”<sup>366</sup> Congress needed revenue sources to support the significant individual and business tax revisions. Charities, and very specifically higher education,<sup>367</sup> were already in the crosshairs from the Tax Reform Act of 2014.<sup>368</sup> TCJA’s changes to the standard deduction were expected to negatively impact charities generally, as fewer taxpayers would be eligible to take the charitable deduction.<sup>369</sup> Many commentators felt that the structure of many of the TCJA’s provisions were specifically designed to hurt Democratically-leaning “blue states,” especially the changes to the state and local tax deduction.<sup>370</sup> One commentator noted:

My claim is not that Republicans composed this bill in a smoke-filled room to purposefully screw over public universities and college

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366. CONG. BUDGET OFF., COST ESTIMATE FOR H.R. 1 CONF. AGREEMENT (Dec. 15, 2017), <https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/53415-hr1conferenceagreement.pdf> [<https://perma.cc/5CGK-9FE6>]; J. COMM. ON TAX’N, 115TH CONG., ESTIMATED REVENUE EFFECTS OF H.R. 1 (Comm. Print 2017).

367. See Melanie McCoskey & Doron Narotzki, *Education Has Been ‘Dumbed Down’ in Tax Reform*, 22 FLA. TAX REV. 677, 677 (2019).

368. Tax Reform Act of 2014, H.R. 1, 113th Cong. §§ 1201–1210 (2014) is entitled “Simplification of Education Incentives.” The original proposal from the Ways and Means Committee contained a 7.5% excise tax on private foundation investment income, which reharkened back to the “deep distrust and displeasure with private foundations” that was clearly demonstrated in the discussions surrounding the private foundation excise taxes in 1969. See Fishman, *supra* note 58, at 271. The political climate around the TCJA was similar in many ways to that of 1969 although for different reasons: a distrust of philanthropy as well as elite college and university as bastions of elitism. *Id.* at 272–73 (“Most members of Congress were not part of that establishment and were less than impressed by individuals who were.”)

369. William G. Gale et al., *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis*, TAX POL’Y CENTER 11, 21–22 (Jun. 13, 2018), [https://www.brookings.edu/wp-content/uploads/2018/06/es\\_20180608\\_tcja\\_summary\\_paper\\_final.pdf](https://www.brookings.edu/wp-content/uploads/2018/06/es_20180608_tcja_summary_paper_final.pdf) [<https://perma.cc/MZW9-PCM9>]. These predictions appear to have been partially accurate but difficult to isolate, given the impact of the COVID pandemic in the interim; see, e.g., Howard Husock, *The Tax Cuts and Jobs Act*

and *Charitable Giving by Select High-Income Households*, AM. ENTER. INST. (2002), <https://www.aei.org/wp-content/uploads/2022/04/The-Tax-Cuts-and-Jobs-Act-and-Charitable-Giving-by-Select-High-Income-Households.pdf> [<https://perma.cc/99NC-MFVD>] (“[H]igh-income taxpayers in high-tax states actually reduced their charitable giving following the TCJA.”); but see Scott Hodge, *Latest Data Shows That the Tax Cuts and Jobs Act Did Not Dampen Charitable Giving*, TAX FOUND. (Jun. 22, 2020), <https://taxfoundation.org/blog/tax-cuts-jobs-act-affect-charitable-giving/> [<https://perma.cc/U8M8-Z5M9>] (finding an increase in non-income tax motivated giving).

370. David Altig et al., *Did the 2017 Tax Reform Discriminate Against Blue-State Votes?*, 73 NAT’L TAX J. 1087, 1087 (2020); see also John Hickey, *GOP’s 2017 Tax Plan Came Down Hardest on California, Researchers Say*, BERKELEY NEWS (Apr. 24, 2019), <https://news.berkeley.edu/2019/04/24/gops-2017-tax-plan-came-down-hardest-on-california-researchers-say> [<https://perma.cc/K7TC-FEAQ>]; *GOP Tax Cuts Were Designed to Hurt Blue States, Lawsuit Alleges*, CBS NEWS (July 17, 2018), <https://www.cbsnews.com/news/gop-tax-cuts-were-designed-to-hurt-blue-states-lawsuit-alleges/> [<https://perma.cc/44E7-NZAB>].

students. But it's no coincidence that these bills were written by a party that increasingly relies on non-college-educated whites, as young college graduates have voted for Democrats at a historically high margin.<sup>371</sup>

A number of cuts that were hostile to education specifically were passed, including an excise tax on private university endowments,<sup>372</sup> repeal of above-the-line higher education deductions,<sup>373</sup> and changes to Section 529 plans that made them available for non-higher education purposes.<sup>374</sup> That being said, many of the provisions did not actually raise that much revenue; the highest revenue impacts were from the excise tax on endowments and the excise tax on excessive compensation, each of which was estimated to raise \$1.8 billion over ten years.<sup>375</sup> Additionally, the House version of the TCJA included repealing the exclusion from income of graduate tuition waivers, the student loan interest deduction, and the exclusion of employer-provided educational assistance, all of which would have had profound impacts on students with little budget impact but did not raise significant revenue.<sup>376</sup> In the face of these serious cuts to education, higher education and student groups sprang into action.<sup>377</sup> Happily, many of the changes that would have been most detrimental to students ultimately did not make it into the final bill.

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371. Derek Thompson, *The Republican War on College*, THE ATL., (Nov. 20, 2017), <https://www.theatlantic.com/business/archive/2017/11/republican-college/546308/> [<https://perma.cc/4NF3-K7G8>]; see also McCoskey & Narotzki, *supra* note 367, at 684.

372. I.R.C. § 4968.

373. McCoskey & Narotzki, *supra* note 367, at 691–92.

374. See *id.* at 690–91 (detailing changes to Section 529 plan that allowed the use of funds for private elementary school costs and allow rollovers to ABLE accounts for individuals with disabilities).

375. *Id.* at 689.

376. See *id.* at 693–99 (referencing details in section V. Proposed Changes that Were Not Enacted).

377. Colleen Flaherty, *'Taxing a Coupon'*, INSIDER HIGHER ED, (Nov. 6, 2017) (citing Letter from The American Council on Education, to the House Ways and Means Committee (Nov. 6, 2017), <https://www.acenet.edu/Documents/Letter-on-House-Tax-Cuts-and-Jobs-Act.pdf> [<https://perma.cc/VQY6-HD4X>] (regarding TCJA education changes)) <https://www.insidehighered.com/news/2017/11/07/grad-students-and-policy-experts-say-taxing-graduate-students-tuition-waivers-would> [<https://perma.cc/V4W3-J6G8>].

But Code Section 4960 remained. Who was going to step forward and vocally defend highly compensated nonprofit executives as a victim of tax reform?<sup>378</sup> The answer was no one.<sup>379</sup>

### III. RECOMMENDATIONS FOR FUTURE EXAMINATION

Academics, policy makers, and legislators can and will continue to debate the question of what is wrong (if anything) with labor markets with respect to nonprofit compensation. And that debate should continue. Clearly, the relative valuation of services between top earners and the lower income earners is problematic in both the nonprofit and the for-profit sectors and needs to be examined. One could argue that the Code Section 4960 excise tax is designed to do just that—change the labor market. If the decision to hire a coach is swayed repeatedly by the increase in economic burden of the excise tax, it could theoretically change the market—but not all nonprofits will make that decision. Not all nonprofits will even be required to do so.<sup>380</sup> The structure of the tax involves voluntary decision making, not prohibition, which means it will likely not compel enough market uniformity to create new norms or cause collective action. If one is truly concerned about the level of executive compensation at nonprofits specifically, potential reforms need to focus on the underlying the problems, which could include the following suggestions: Nonprofit Capacity Building, Donor Attitudes and the Nonprofit Starvation Cycle, Revising the Rebuttable Presumption of Reasonableness, and Funding for Enforcement.

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378. *Contra* Jake Novak, *How Tax Reform Will End the Nonprofit Executive Pay Scam*, CNBC, (Dec. 20, 2017) (“No one should cheer new taxes. But for-profit companies with much higher tax burdens have found a way to pay high salaries and retain top executives in competitive markets for decades. Meanwhile, nonprofit companies make big money without those tax burdens and then shovel those profits to their top executives. That’s an uneven playing field they enjoy no matter what the IRS calls them.”) <https://www.cnbc.com/2017/12/20/tax-reform-smacks-down-excessive-nonprofit-executive-pay-commentary.html> [<https://perma.cc/EF7D-3DZB>].

379. *See* Letter from The American Council on Education, *supra* at note 377 (objecting to a long list of TCJA provisions that would impact higher education; noticeably absent from the list was excessive compensation excise tax of Section 4960).

380. Under current law, a Code Section 501(c)(3) organization is deemed to be a private foundation unless it demonstrates that it is entitled to public charity status. I.R.C. § 509(a). Generally, public charity status is currently afforded to churches, schools, hospitals, medical research organizations, state university foundations, governmental entities, charities substantially supported by donations from the public, charities substantially supported by fees for charitable services, and supporting organizations. *See* I.R.C. 509(a)(1)–(3); *see also* I.R.C. 170(b)(i)–(vi). Broadly speaking, Code Section 503 would have applied to what we currently consider to be private foundations, as well as state university foundations, fee for service charities, and supporting organizations. Troyer, *supra* note 70; Aprill, *supra* note 71.

### A. Nonprofit Capacity Building

Excessive compensation is often a by-product of an over-reliance on staff, a misunderstanding of the rules, a lack of organizational capacity, or simply non-feasance regarding process. While these all constitute inappropriate diversions, Code Section 4960 is not likely to help in these situations. As indicated by the compliance research cited earlier,<sup>381</sup> many of these issues occur in smaller nonprofit organizations. Smaller organizations—those with no dedicated staff, a volunteer board, and pro bono attorneys and accountants that may not be specialists in nonprofits—are not subject to Code Section 4960.

Not all failures of governance are in smaller organizations. “Failures of governance—such as when a board is largely absent, unclear about their role, and delegate authority improperly to the CEO—have been implicated in the emergence of scandal.”<sup>382</sup> Any meaningful attempt to address executive compensation excesses must start with governance for organizations of all sizes and in all sectors. Unfortunately, capacity building is yet another type of administrative expense that charities have cut over time.<sup>383</sup>

### B. Donor Attitudes and the Nonprofit Starvation Cycle

Donors, grant makers, charity watchdogs,<sup>384</sup> and regulators need to understand the damage done to the sector by blindly accepting the donative labor narrative. High-end compensation packages are, of course, the hard case.<sup>385</sup> It is difficult to support multi-million-dollar salaries for coaches while student tuition is raised.

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381. See Fishman, *supra* note 58, at 253 (noting that Wright Patman was a bombastic figure that had limited influence with his colleagues, but the output of his hearings no doubt set in motion the process then ended with the Tax Reform Act of 1969 and the private foundation excise taxes); see also Fishman, *supra* note 58, at 262–63 (describing Patman’s testimony at the hearings in advance of the Tax Reform Act of 1969).

382. Cassandra M. Chapman et al., *Nonprofit Scandals: A Systematic Review and Conceptual Framework*, 52 *NONPROFIT & VOLUNTARY SECTOR Q.* 278S, 290S (2023).

383. Grace L. Chikoto & Daniel Gordon Neely, *Building Nonprofit Financial Capacity: The Impact of Revenue Concentration and Overhead Costs*, 43 *NONPROFIT & VOLUNTARY SECTOR Q.* 570, 571 (“[A]dministrative expenses can provide organizations with resource flexibility necessary to take advantage of capacity building opportunities.”).

384. *Id.* at 573–74 (“Generally, nonprofit watchdogs view high overhead costs and nonprogrammatic expenses as indicators of inefficiency and waste.”).

385. Charles Quatt, founder and president of Quatt Associates, a consulting firm that specializes in compensation for nonprofit executives, said the excise tax may slow the level of salary increases going forward, but organizations still must compete for talent that demands higher levels of pay. *Seven-Figure Pay in Nonprofit Groups Gets a New Tax*, CEO UPDATE (Dec. 21, 2017), <https://www.ceoupdate.com/seven-figure-pay-in-nonprofit-groups-gets-a-new-tax#:~:text=Going%20into%20effect%20for%202018,paid%20of%20of%20nonprofit%20organizations> [https://perma.cc/M4X9-APRY].

And yet, the narrative embedded in Code Section 4960—that we need to underpay employees of nonprofits simply because they work at nonprofits—is seriously problematic. So long as stakeholders demand lower salaries, nonprofits will respond, even to their long-term detriment, as studies show a positive relationship between “growth in nonprofit financial capacity . . . and administrative support and fundraising expenses.”<sup>386</sup>

### C. Revising the Rebuttable Presumption of Reasonableness

If one were to repeal Code Section 4960, what would take its place? Nonprofit compensation of over \$1 million may be, at times, excessive and an inappropriate diversion. It also may not be. Because compensation packages in these ranges generally occur at larger institutions, it may be appropriate to demand a higher level of fiduciary scrutiny of organizations that should have the institutional capacity to comply.

One way this could occur would be to repeal the rebuttable presumption of reasonableness under Code Section 4958, the intermediate sanctions rules, for compensation packages in excess of a given amount. It should be incumbent on a governing body to be able to affirmatively demonstrate and defend that it fulfilled its duties of care and loyalty in good faith.<sup>387</sup>

### D. Funding for Enforcement

Investing in capacity building, working with donors and grant makers, and overseeing actual malfeasance costs money—money that the IRS and the state Attorneys General don’t currently have. The budgetary woes of the IRS are well documented; tax-exempt organization enforcement is just another area of the tax law where the law on the books (such as Code Section 4958 and 4941), if actually enforced, might address some of the issues presented.<sup>388</sup>

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386. Chikoto & Neely, *supra* note 383, at 578.

387. For example, Galle and Walker, *supra* note 297, at 801, recommend that:

[S]imple, comparative information provided in a relatively salient way by a credible intermediary can be more effective. But of course, it might be difficult to extend a “top 10” model to a larger group of firms. Therefore, other governance options, such as more demanding regulatory processes, lower judicial deference to the board’s decisions, or private alternatives such as paid third-party monitoring likely deserve closer consideration.

388. Alan Rappeport, *I.R.S. Commissioner Warns Budget Cuts Would Add to Deficit*, N.Y. TIMES, (Feb. 15, 2024), <https://www.nytimes.com/2024/02/15/us/politics/internal-revenue-service-budget-cuts-hearing.html> [<https://perma.cc/2362-2CWT>].

It is easy to get caught up in the latest scandal involving nonprofit compensation. The recent downfall of Wayne LaPierre as the CEO of the National Rifle Association due, in part, to excess compensation in excess of \$1 million is attention grabbing and infuriating and leads inexorably to calls for reform. But Wayne LaPierre is the exception, not the rule. The outcry over cases like his masks the very real issues of setting reasonable compensation in all pay ranges and the need for appropriate overhead expenditures that are far more prevalent across the board in the nonprofit sector. In a case with no demonstrable agency failure, compensation over \$1 million may be high but it is not necessarily unreasonable.

In such a case, our unease is really about whether the labor market for executives should be in that range at all. That unease doesn't mean we need to artificially regulate nonprofit compensation through a mechanical excise tax devoid of any real evaluation of the compensation process—regulation that has the pernicious effects of unduly punishing organizations that are actually making appropriate decisions, inappropriately influencing boards to make short term staffing cuts at the expense of long-term organizational capacity and reinforcing damaging stereotypes about the nonprofit labor force.

#### CONCLUSION

In conclusion, Code Section 4960 does nothing to advance the conversation regarding the appropriate amount and process for setting executive compensation in a nonprofit (or any other) setting. Because the underlying issues causing the compensation problems remain unaddressed, many nonprofits that find themselves in the high end of the labor market may simply choose to pay the excise tax, raising administrative costs at the cost of other priorities. Cynically, Code Section 4960 is merely a step to show action in the face of public outcry—even if counterproductive, ineffectual, and damaging—and to raise tax revenue out of perceived bad actor that Congress could use for its other priorities.



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