

LAW MEMO

Compensating Fund Raisers

Should development professionals (staff, independent proposal writers or consultants) be paid a percentage of the money they raise? Industry ethics say no, and the Internal Revenue Service disfavors revenue-sharing payment arrangements.

This issue of *Arts Law Memo* summarizes the Association of Fundraising Professional positions on both commission-based compensation and performance bonuses. It also explains the "excess benefit prohibition" contained in the Intermediate Sanctions regulations issued by the IRS last month. Finally, it presents the findings of a study conducted by Missourian Matt Beem, which found a significant gap between professional practice and preference with regard to fund raiser compensation.

CODE OF ETHICS

In 1992, the National Society of Fundraising Executives (NSFRE), now the Association of Fundraising Professionals (AFP), adopted standards for the compensation of its 17,000 members. The organization is a professional association of fund raisers that seeks to advance philanthropy through advocacy, research, education and certification programs.

Simply put, the AFP Code of Ethical Principles states that members should work for salaries or fees, not percentage-based compensation or commissions. The AFP code does, however, allow incentive compensation (such as bonuses) if it is based on the accomplishment of mutually agreed upon, pre-established overall goals related to fund raisers' responsibilities within their organizations.

FINDERS' FEES

AFP Standard No. 16 forbids compensation that is based on a percentage of charitable contributions and prohibits finders' fees, which are defined as payments for bringing a donor or a charitable contribution to a nonprofit organization. The National Committee on Planned Giving and the American Council of Gift Annuities also forbid their members to pay or accept finders' fees.

UNACCEPTABLE PRACTICES

According to the AFP, unacceptable compensation practices include:

- Accepting percentage-based compensation because an organization lacks sufficient funds;
- Disguising compensation as salary, fee, or a bonus when it is, in truth, a percentage of funds raised; and/or
- Accepting a compensation package in which a part is salary or a fee and the balance is to be made up of a percentage of the funds to be raised.

AFP members are expected to comply with their code or resign from the association. Similar statements prohibiting percentage-based compensation appear in the code of ethics of the National Committee on Planned Giving, Association for Healthcare Philanthropy and the American Association of Fundraising Counsel, which publishes *Giving USA*.

LONG-TERM RELATIONSHIPS

Despite the unequivocal stand against contingent-pay propagated by professional associations, the practice is prevalent and, some say, growing. Why? Sales commissions are common in the for-profit arena and nonprofits are constantly encouraged to be more business-like. If the promise of additional compensation, based on the amount of money raised, helps an organization recruit and retain successful fund raisers, why make a fuss about percentages and ethics?

The answer is that such arrangements may damage the relationship between the donor and the nonprofit and can be detrimental to the long-term financial health of the organization.

Marilyn Fischer, author of *Ethical Decision Making in Fund Raising*, frames her argument against commission-based pay in terms of conflict of interest. According to Fischer, "the conflict of interest is that if fund raisers' own personal income is correlated with the size of the gift, it takes their attention off of the organizational mission and refocuses it onto

Published by the St. Louis Volunteer Lawyers and Accountants for the Arts (VLAA), *Arts Law Memo* is mailed, free of charge, to more than 850 Missouri and Southwestern Illinois arts organizations, VLAA volunteers and corporate sponsors.

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This issue was written by Sue Greenberg, VLAA's executive director. Special thanks to Matt Beem, Scot W. Boulton and Nola Ruth.

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their own personal financial well-being. Fund raisers' ability to exercise good judgment on behalf of the nonprofit's mission may be compromised."

Fischer justifies her position by examining commission-based pay from three perspectives:

Mission. Fund raisers who are being paid on commission might be tempted to focus their attention on writing proposals or soliciting donors based on the amount of money that would be raised rather than on how closely the donors share the organization's mission.

(Of course, an organization can run adrift of its mission even when the fund raiser is not receiving a commission. A notable example is the Smithsonian's acceptance of an earmarked \$38 million gift, which would have been used to create an exhibit honoring American over achievers such as Martha Stewart and Steven Spielberg. The gift was recently withdrawn after the museum staff complained that its curatorial independence was being compromised.)

A commission-based structure could tempt fund raisers to seek gifts that are immediately forthcoming rather than cultivating a wide donor base. This approach would put the fund raisers' short-term gain in conflict with the organization's long-term financial stability.

Relationships and Trust. Knowing that a percentage of their donation goes directly into the fund raiser's pocket could diminish donors' trust in both the fund raiser and the organization.

Internal considerations include jeopardizing relationships with staff and board members. Co-workers may feel that they also deserve a commission. And who gets the commission on a surprise bequest?

Paying staff members commission also could give board members yet one more excuse for shirking their fund raising responsibilities.

Personal Integrity. Commission-based pay could compromise a fund raiser's dignity: The subtext of the pitch becomes "please increase your gift this year so I can afford winter clothes for my children."

CONTINGENCY ARRANGEMENTS

In small organizations, a more common scenario involves hiring a grant writer on contingency basis. This practice could be unethical or even illegal if the grantmaker expects the money to be used to pay for the project, not hiring the grantwriter.

A better approach is to budget for the cost of proposal writing. After all, it is a legitimate cost of doing business and experienced grantwriters are entitled to reasonable compensation.

PRIVATE INUREMENT

The Internal Revenue Service discourages but does not absolutely forbid what it calls "revenue-sharing arrangements."

The IRS position is based on the private inurement doctrine, which is what distinguishes nonprofit organizations from for-profit ones.

In fact, to be eligible for tax-exempt status, a nonprofit's Articles of Incorporation must include language, like the following, prohibiting private inurement: "No part of the net earnings

of the corporation shall inure to the benefit of or be distributable to any of its directors, officers, members (if any) or other private individuals; provided however, the corporation shall be authorized and empowered to pay reasonable compensation for services rendered."

What does reasonable mean? Generally, the standard is based on the market rate. In other words, how do similar organizations operate under similar circumstances?

For example, according to AFP's recently released annual salary survey, the average pay of fund raisers who worked for arts and cultural organizations was \$51,708.

Overall, the average salary for fund raisers surveyed was \$61,223. At the high end were those working for consulting agencies (\$85,414) and for public broadcasting organizations (\$64,254).

Another study, conducted by the *Art*

Fund Raiser Compensation: the AFP Survey

- The average salary for U.S. fund raisers was \$61,223. Those working for arts and cultural organizations were paid an average of \$51,708, the lowest among 16 categories.
- The AFP study revealed a stark difference in compensation between males and females. The average salary of male fund raisers in the U.S. was \$77,978, while female fund raisers earned an average of \$53,593. The AFP called this finding "disheartening."
- There was a very strong correlation between experience and compensation. Fund raisers with up to three years' experience reported salaries of \$44,312 while their counterparts with 10 to 14 years of experience reported an average salary of \$59,895.
- Expected strong positive correlations were noted between average compensation and the size of an organization's staff, its budget and the amount of money raised.
- There also was a strong positive correlation between average compensation and level of education.
- Ninety percent of respondents reported that their organizations provided medical insurance.

Source: Association of Fundraising Professionals
2000-2001 Compensation and Benefits Survey

Newspaper, compared salaries, benefits and other allowances for selected art museum directors. In 2001, salaries ranged from a high of \$505,797 (Kimbell Art Museum in Fort Worth) to \$133,040 (Fine Art Museum of San Francisco).

Directors' pay usually corresponded to the institution's operating budget — the higher the budget, the higher the pay — rather than the institution's attendance or national reputation.

According to the *Art Newspaper* report, the Houston Museum of Fine Arts rewarded its director with nearly \$1.7 million (in addition to \$325,000 in salary and nearly \$100,000 in benefits and other compensation) for completing a major capital campaign without hiring a consultant.

Was this unusually generous bonus a private inurement transaction? Does the museum run the risk of losing its tax-exempt status? Probably not, assuming that "disinterested" members of the board devised the plan after careful consideration.

INTERMEDIATE SANCTIONS

Historically, the IRS was reluctant to punish a charitable organization for making improper financial transactions because its only option was to revoke tax-exempt status.

In 1996, Congress enacted the so-called Intermediate Sanction law, which gives the IRS the option of fining those who receive or authorize others to receive inappropriately excessive salaries or perquisites.

The final version of the Intermediate Sanction regulations were issued last month; they are nearly identical to the version that was published a year ago.

In a nutshell, the regulations prohibit "excess benefits transactions" with persons who exercise "substantial influence" over the organization. An excess benefit is defined as one that exceeds the fair market value, which is similar to the "reasonableness" test used to determine whether there is a private inurement problem.

Small and midsize cultural organizations should not be overly concerned about these rules because

Study finds gap between practice and preference

A survey completed by professional fund raisers in Missouri, Kansas and Iowa revealed a substantial gap between professional practice and preference when it comes to compensation arrangements. The study, which was conducted by Matthew J. Beem, executive vice president of Harstook and Associates, a fund raising consulting firm based in Wichita, was published in the May 2001 issue of the *International Journal of Nonprofit and Voluntary Sector Marketing*.

Beem's survey contained 32 questions covering topics such as job descriptions, formal evaluations and rewards. The question that asked whether performance and pay should be connected revealed the strongest disconnect between preference and practice. More than 80 percent of respondents said the two should be connected, while less than a third currently have compensation arrangements that pay them fully or partially for performance.

According to Beem, "fund raisers are largely motivated by the rewards — both tangible and intangible — that follow their work." They expressed desire for appreciation and recognition, and for compensation arrangements that promote success.

Beem believes the competitive marketplace and the ethical codes adopted by the professional fund raising organizations are creating tremendous tension in the field. He said nonprofit leaders need access to tactical guidelines or templates to help them design systems which provide incentives for exceeding expectations.

they were designed to address big money-big abuse situations like the 1992 William Aramony-United Way scandal. Aramony, who was receiving salary and benefits totaling more than \$450,000 and had a pension worth \$4.4 million, was also found to be hiring family members and misusing agency funds.

The Intermediate Sanction regulations are lengthy and the terminology is often confusing. For example, the "influential" employees, founders, directors, contractors, former employees or close family members who are covered by the rules are called "disqualified persons." At the staff level, this refers only to highly-compensated or top-level employees.

However, facts and circumstances can control whether a person has substantial influence. Facts tending to show substantial influence include "a person whose compensation is based primarily on revenues from organization activities controlled by that person."

Although the Intermediate Sanction

regulations are complex, they do not include specific revenue-sharing rules. This means organizations that want to provide incentive compensation can do so, but do not have any precise guidelines or safe harbors. Without firm rules, the chances of an IRS challenge could increase.

BOARD PARTICIPATION IS KEY

Both the IRS and AFP offer some guidance that can help nonprofit leaders act prudently when addressing compensation matters.

The AFP code permits fund raisers to accept performance-based compensation when success is assessed in terms of multiple measures and when the board of directors adopts a policy outlining criteria and procedures.

Similarly, the IRS will assume that compensation is reasonable if decisions are made by board members who have no conflict of interest with the person receiving the compensation. They should examine the plan in advance, investigate the "going rate" and document their findings.

W H I T A K E R F O U N D A T I O N
Publication of *Arts Law Memo* is made possible by grants from the
Whitaker Foundation; Regional Arts Commission; the Illinois Arts
Council, a state agency; and the Missouri Arts Council, a state agency.



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RESOURCES

Association of Fundraising Professionals

More information on salaries, ethics, giving trends and pending legislation can be found on the AFP website (afpnet.org). The organization's annual international conference will be held in St. Louis, April 14-17, 2002. The keynote speakers are James A. Baker, III and Maya Angelou. On April 16, Matt Been will present a session entitled "Using Technology to Enhance Personal Effectiveness."

Internal Revenue Service

The IRS recently redesigned its website (irs.gov). The section for tax-exempt organizations contains forms, easy-to-understand publications and the manuals used by IRS auditors.

Publications

Bruce R. Hopkins, one of the country's leading authorities on tax-exempt organizations, is a lawyer with the Kansas City firm of Polsinelli, Shelton and White. He is the author of ten books including *The First Legal Answer Book for Fund-Raisers* (2000) and *The Law of Fundraising* (2002) as well as a monthly newsletter, *The Nonprofit Counsel*.

Ethical Decision Making in Fundraising (2000) by Marilyn Fischer offers practical solutions to real problems, including donor relations, privacy, conflicts of interest, commission-based pay, cause-related marketing and fostering cultural diversity.

These books and many others on arts law and business practices are available at the **St. Louis Volunteer Lawyers and Accountants for the Arts library** located within the Regional Arts Commission office, 3540 Washington, in Grand Center.