GUIDESTAR VENABLE® LLP

Top Trends and Traps in Nonprofit Executive Compensation

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Venable LLP, Washington, DC

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Upcoming Venable Nonprofit Events

Register Now

- **July 15, 2015** – Mental Health Issues in the Nonprofit Workplace: Questions Raised by the *Germanwings* Air Disaster

- **August 6, 2015** – Top Ten "Must Have" Provisions for Nonprofit Meeting Contracts

Purpose

- Explain the consequences of excessive and inadequate compensation
- Explain how organizations can protect themselves
  - Rebuttable Presumption of Reasonableness
  - Incentive Compensation
- Explain and interpret trends in IRS enforcement

Consequences of Excessive and Inadequate Compensation

Current Social Regulatory Perception

- Who cares?
- Is anyone paying attention?
- What are the risks of excessive compensation?
- What are the risks of inadequate compensation?

Who Cares?

- **IRS** – Protects against tax abuse
- **State Regulators** – Consumer Protection
- **Donors** – Concerned that appropriate portion of contribution is used in accordance with donative intent
- **Members** – Concerned that dues are used in accordance with member intent
- **Media** – Excessive compensation makes great news in current economic environment
- **Competitor Organizations** – The pool of available member and donor funds is smaller than ever, creating competition for those funds
- **Competing Interests** – More than ever, nonprofit entities are seen as tools of political and social reform, and potential adversaries are looking at executive compensation as a means to tarnish public image
- Your **Employees**, **Executives**, and **Target Executives**!

Is Anyone Paying Attention?

- Regulators
  - Professionally educated with low income
  - Tend to believe that all nonprofits (especially charities) should be run by people with altruistic purposes
- Donors/Members
  - Looking for greatest return on investment or donation
- Media
  - Looking for a story, reporting is inconsistent
- Employees
  - Comparing executive salary to their own
- Executives and Target Executives
  - Comparing their salaries with those of peers and other offers

Is Anyone Paying Attention?

- IRS
  - IRS Area Manager Peter Lorenzetti recently identified executive compensation as "far and away the most common risk area for nonprofits" and as an issue that the IRS will "look at on every audit we do"
  - Executive compensation was discussed as a significant issue in the Report for the IRS College and University Compliance Project
  - We have seen the IRS assess more intermediate sanctions penalties in each of the last five years than in the entire prior decade combined
  - During a recent conversation with an attorney from the IRS Office of Chief Counsel, we were told that the IRS would aggressively pursue these cases in court

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Is Anyone Paying Attention?

- Competing Interests and Media
  - Exempt organizations are more frequently being used to obtain very specific goals and even to attack other exempt organizations
  - *Playoff PAC v. the Bowl Championship Series*
    - Playoff PAC is developing information from publicly available IRS forms
    - Executive compensation is a major issue in media reports about problems with BCS
    - Issue has been highlighted on HBO and ESPN, in *Sports Illustrated* and *Non-Profit Times*, etc.
  - Fiesta Bowl's CEO, John Junker, is the subject of media scrutiny
    - CEO fired
    - Sentenced to 8 months in prison
    - IRS has not weighed in on the issue

Risk of Overcompensation?

- Donors/Members/Competitors
  - Competitors that pay executives less compensation will use this information to attract your donors and members
- Media
  - Sensational articles get a lot of focus, and even when misleading, incorrect, or based on incomplete information, retractions are rare and rarely publicized
- Employees
  - Incongruent pay may lead to discontent and turnover
- Organization Executives
  - May be individually liable for IRS penalties
  - The organization may attract the wrong type of executive

Risk of Overcompensation?

- IRS
  - Revocation of tax-exempt status for private benefit or private inurement
  - Monetary penalties imposed on individual executives who receive excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Monetary penalties imposed on board members and executives who approve the payment of an excessive benefit (only Code sec. 501(c)(3) and 501(c)(4) organizations)
  - Loss of goodwill

Enforcement Issues

- Private Inurement
  - Code generally provides that no part of organization's net earnings can inure to the benefit of any private individual or shareholder
  - Focused on pecuniary benefits in excess of fair market value
  - Only applicable to benefits conferred on insiders
  - Applies to organizations exempt under multiple sections of the Code, including but not limited to 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
  - Inurement is grounds for revocation

Exemption Issues

- Impermissible Private Benefit
  - Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
  - A nonexempt purpose is generally a purpose that serves a private rather than a public benefit, and as such is generally called a "private benefit"
  - Provision of an impermissible private benefit is grounds for revocation
  - The private benefit prohibition is imposed on a more limited group of exempt organizations than is private inurement, and may not be applicable to organizations exempt under 501(c)(6) or 501(c)(7)

Intermediate Sanctions

- Code section 4958 allows the IRS to impose penalties on “disqualified persons” who participate in or approve “excess benefit transactions”
- These penalties are commonly referred to as intermediate sanctions
- Similar to “private inurement” concept

Intermediate Sanctions–Penalties

- Penalty for receipt of an excessive benefit
  - Return the value of the excessive benefit to the organization; and
  - An excise tax of either:
    - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service, or
    - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

Intermediate Sanctions–Penalties

- Penalty on organization managers for approval of an excessive benefit transaction
  - Section 4958(a)(2) imposes a 10% tax on any organization manager who knowingly approves an excess benefit transaction
  - Liability under Section 4958(a)(2) is joint and several and is capped at $20,000 per transaction

The Risks of Undercompensating Nonprofit Executives

- Undercompensating
  - Demotivation
  - Retention risk
  - Hiring risk
  - Loss of executive value/standing relative to stakeholders
  - Cap on compensation that can create motivational problems for executive staff and hiring challenges
  - Compression when recruiting talent at the next level

Protecting Yourself

What Can You Do to Protect Your Organization?

- Use caution when entering into transactions with disqualified persons
- Develop and implement effective governance policies
- Establish the rebuttable presumption of reasonability

Effective Governance Models in Compensation Determination

- Board or Committee Charter
  - Annual cycle established
  - Manageable number of committee members
  - Designated process and responsibilities between board and management for:
    - Annual performance goal setting and assessment
    - Compensation planning and decisions systematically organized
    - Organization compensation philosophy
    - Organization compensation budget
    - Responsibilities of Committee versus Board designated
- Processes in place for addressing intermediate sanctions, the rebuttable presumption of reasonableness

The Rebuttable Presumption of Reasonableness

- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value

- To establish the rebuttable presumption:
  1. The transaction must be approved in advance by disinterested members of the organization's governing body
  2. The governing body must obtain and rely on valid comparability data in approving the transaction
  3. The governing body must contemporaneously document its decision and the reason for its decision

The Rebuttable Presumption of Reasonableness

- Benefits of establishing the “rebuttable presumption”
  1. We have never seen the IRS attempt to rebut the presumption
  2. Provides board members with near-absolute protection from excise tax on participation
  3. The very nature of the process, independent members using objective data, significantly mitigates the risk of overcompensation
  4. Provides organization with a clear and easy explanation of compensation decisions
  5. Allows the organization to affirmatively answer all Form 990 questions relating to the policies and procedures that the IRS deems to be most desirable

The Rebuttable Presumption of Reasonableness

- Section 53.4958-6(e) of the regulations provides that an organization's failure to establish the rebuttable presumption does not create any inference that a transaction is an excess benefit transaction. However, our experience in representing organizations has shown us that this is clearly not the case. Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
- The effect of failing to establish the rebuttable presumption
  - In recent litigation and examinations, the IRS based its entire position on the fact that an organization failed to establish the rebuttable presumption of reasonableness
  - The IRS will prepare its own valuation, often using noncomparable organizations

Professional Resources Available

Professional Resources Available

- When we see this issue raised by clients—*TOO LATE*
- Executive compensation is not an HR issue, it is not an accounting issue, and it is not a purely legal issue
- Do not rely solely on advice of your:
  - Legal counsel
  - Compensation/valuation expert
  - Tax accountant or independent auditor
  - HR director

The Role of Outside Advisers

- Compensation Consultant
  - Working directly with the board on CEO compensation and possibly that of disqualified persons
  - Identifying the appropriate marketplace and data
  - Market analysis
  - Pay philosophy and strategy
  - Compensation plan design
  - Intermediate sanctions opinion
  - Expert testimony and opinions
- Legal Counsel
  - Legal and tax research and opinions
  - Plan drafting, including deferred compensation, severance and employment contracts
  - Partner in detailed plan design
  - Situations requiring attorney-client privilege
- Executive Search Consultants
  - Ensuring that the organization has appropriately considered its compensation philosophy and developed plans in conjunction with compensation experts and legal counsel—before an offer is given

Strategies for Advising the Board and Management and the Role of Outside Advisers

It may be helpful to provide the Board with decision factors that Board members can use in determining the adequate range for executive salary. These may include:

- What is the *market* for the position?
- What are *compensation trends* among peer organizations, and in the geographical area?
- What are relevant *contract terms* and principles in the organization's established *compensation philosophy and compensation system*, including the pay-for-performance system?
- How is the *performance* of the organization, including its financial performance?
- How should *stakeholder opinion* be weighed and managed? Key stakeholders may include:
  - The board
  - Membership
  - The public
- What is the staff compensation practice, for example, the differential between executive compensation and staff compensation?

The Role of Compensation Studies and Comparability Analyses

- Defining a defensible approach to determining the market value for a position
- Ensuring competitive compensation data needed by the Board and management as they make decisions about compensation levels
- Serving as the basis for developing a compensation system

Common Pitfalls and Best Practices in Compensation Benchmarking

- The hard-to-defend comparator group
  - Rule: compare to similar organizations, identify the criteria used in the report
- The use of for-profit data
  - IRS red flag—in theory, can be used, but frowned on in practice
  - Limit use of for-profit data to cases where for-profit skill set *required* and similar NFPs must also recruit from the for-profit sector
    - Example: In public media organizations, content production jobs will often come from the for-profit sector
    - CEOs should be compared to similar NFP positions

Common Pitfalls and Best Practices in Compensation Benchmarking

- Targeting above the 75th percentile
  - Reasonable range of the 75th is generally defensible if:
    - Documented record of achievement; ideally should be able to point to achieving specific goals
    - Experience, skills, background of the individual
    - Rule of thumb: no more than 10% above the 75th
  - VERY careful documentation by the Board and strong rationale for above 75th
- End-of-career compensation that may be difficult to defend
  - Post-retirement "consulting"
  - Sabbaticals that are really deferred compensation

Common Pitfalls and Best Practices in Compensation Benchmarking

- We love the CEO and want to take care of her:
  - Late redress of low retirement savings
  - The "founders' dilemma": low pay in the beginning and never fully corrected
  - In the past, compensation consultants would "look back" and estimate underpayment
    - Avoid look-backs, especially if more than two to three years—IRS skeptical (and state AGs perhaps even more so—assumption that past pay was a market transaction)
    - Adjust compensation going forward, consistent with market total remuneration (e.g., additional base, bonus or deferred compensation)
    - One-time performance bonus for *recent* performance may be defensible

Common Pitfalls and Best Practices in Compensation Benchmarking

- Other forms of Additional Compensation
  - Housing
    - Generally taxable
    - Special exception for colleges and universities
      - Required to accept
      - On institution premises
      - Provided for benefit of the institution
      - Must be reported on 990
    - Failure to report and included as taxable has been issue
  - Below interest loans
    - Interest difference is taxable
    - Not allowed in some jurisdictions (e.g., DC)

Common Pitfalls and Best Practices in Compensation Benchmarking

- Vacation payout
  - Annual vacation must be consistent with market practice
  - Cap on vacation accrual
- Automobiles

Combining the Executive Search Process with Compensation Determinations

- Often, CEO succession is what makes a Board grapple with executive compensation
- Compensation information can help the search process in the following ways:
  - Understanding what is current market reality at the outset helps set expectations of the search committee—work may need to be done
  - Getting the appropriate market range based on the right comparator groups
  - Providing insight into the appropriate compensation philosophy relative to the board, stakeholders, public perception and the staff
  - Providing insight into the appropriate compensation plan that both reflects market trends and meets the needs of the board and the candidate, including base salary, incentives, deferred compensation, benefits and perquisites

Various Ways to Address Compensation in the Executive Employment Contract

- Employment contracts typically include
  - Base Salary, which may be fixed but is usually provided with annual considerations for adjustment based on performance and market changes
    - Some contracts have guaranteed base salary increases.
    - This is not always advisable
  - Incentive or Bonus Compensation
    - Usually stated as a percentage of base salary, sometimes with a range, based on performance, but usually also cited as discretion of board
    - While it is important to have an annual methodology for making the incentive determination, it is often best to leave the specifics as part of a board-approved annual incentive compensation plan

Various Ways to Address Compensation in the Executive Employment Contract

- Employment contracts typically include:
  - Deferred Compensation
    - Common but not in all contracts
    - Typically tied to a 457(b) or 457(f) plan with terms and vesting date cited
  - Severance
  - Standard Benefits
  - Executive Benefits and Perquisites
    - This can include financial planning, supplemental long-term disability, life insurance, executive medical, clubs and business travel

Incentive Compensation–Examples, How to Structure

- Incentives are a significantly growing practice
- Incentives are typically based on a percentage of base salary
- Incentives can have a range from threshold to target to outstanding
- Incentives are typically tied to organizational goals and leadership with target measures of success
- The measures can be qualitative or quantitative
- Organizational goals are best tied to the strategic priorities and/or the mission goals
  - Some use a balanced score card approach

Incentive Compensation–What Types of Provisions Will Generally Increase the Risk of IRS Scrutiny?

- Incentive bringing compensation beyond market practice
  - Incentives need to be incorporated into the overall value for the position consistent with the marketplace
  - Even for outstanding performance, incentives cannot bring compensation above the market without risk
- Incentive plan design with no cap
- Incentives based percentage of revenues

Questions?

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