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Current Trends and Hot Buttons in Nonprofit Executive Contracts and Compensation

Speakers

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Session Objectives

- Understand key elements of executive employment contracts from both individual and organizational perspectives

- Become familiar with trends in executive contracts and compensation

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Contracts

- Should you or your organization have one?
- Offer letter vs. formal contract
  - Formal contracts provide security to both the executive and the organization
  - **Trend:** Formal contracts are becoming increasingly common for CEOs. Typical length is 3 to 5 years for the initial term. Extensions may be same or successive one-year terms.
  - **Tip:** Be careful with "evergreen" provisions.

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Key Compensation Elements

- The following compensation elements should be addressed in detail in an offer letter or formal agreement:
  - Base salary
  - Incentive compensation/bonus
  - Deferred compensation
  - Perks

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Key Elements: Base Salary

- Not just initial year salary, but also how salary adjustments will be addressed in future years
  - Automatic increases (cost of living, etc.)
  - Market based (public surveys, compensation consultant, etc.)
  - Discretion of Board

- **Trend:** Common for Boards to state that salary will be reviewed annually and adjusted based on performance (organizational and individual) and market movement
- **Tip:** Review compensation information and salary for prior incumbent (Form 990s) over several years to get a sense of salary levels and annual adjustments

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Key Elements: Bonus

- Agreement should detail both the “target” and “maximum” bonus opportunity
  - Critical for setting expectations
  - With Board turnover it is also important for the understanding to be memorialized/documented for consistency
- **Trend:** With CEO compensation levels rising, association Boards want to tie compensation directly to performance
- **Tip:** Make sure there is an established performance evaluation process and that you are involved in setting goals and metrics

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Key Elements: Deferred Comp

- Goal for executive is to secure adequate savings to offset retirement costs
  - Start early rather than waiting until short employment horizon exists (difficult to accrue ample savings in the last few years)
  - Try and keep the arrangement simple
- **Trend:** 457(b) and 457(f) arrangements (detailed on the following slides) are the most common vehicles. Often include some type of vesting
- **Tip:** Executive should focus the Board on the annual dollar amount desired in deferred comp rather than getting it to commit to a specific income replacement ratio

“Nonqualified” Deferred Compensation

- **Section 457(b) Plan or Agreement**
  - Employee elective deferrals, employer contribution, or combination of both
  - Contributions limited annually to $18,000 (2017) (indexed for inflation)
    - No age 50 catch-up contributions available for nongovernmental 457(b) plans
    - IRS initiative on Form W-2 reporting of 457(b) contributions / plan examinations
    - May be fully vested
  - Taxed when distributed to participant
  - Minimum distribution rules apply beginning at age 70½
  - May be transferred to 457(b) plan of subsequent, tax-exempt employer

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“Nonqualified” Deferred Compensation

- **Section 457(f) Plan or Agreement**
  - Contributions—no limit/generally employer contributions
    - Benchmark with total executive compensation against similar organizations for reasonableness for Intermediate Sanction considerations
  - Contributions and earnings must be subject to a “substantial risk of forfeiture” and to the organization’s creditors
    - “Substantial risk of forfeiture” usually means a requirement to perform substantial services until the “substantial risk” lapses (i.e., the vesting date)
    - “Substantial risk” rule not violated if employment terminates before vesting date other than by voluntary resignation (e.g., death, disability, termination by employer)

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“Nonqualified” Deferred Compensation

- **Section 457(f) Plan or Agreement (cont’d)**
  - Vesting date is usually end of the contract or anticipated retirement date or may vest in accordance to a schedule
  - Income taxed and subject to FICA/Medicare/withholding when vested vs. at distribution
  - No rollover or transfer to further defer tax
  - Subject to 409A compliance

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“Nonqualified” Deferred Compensation

- **Proposed 457 Deferred Compensation Plan Regulations**
  - Proposed regulations (REG-147196-07) issued in June 2016. Once finalized, changes will be implemented in the following calendar year and will apply to amounts deferred after the effective date and unvested amounts deferred prior to the finalized date
  - Opportunity for tax-exempt and government employers to evaluate existing arrangements to consider plan changes that could enhance the organization’s offerings
  - Mainly redefining 457(f) plans, such as:
    - The opportunity to delay the immediate taxation on deferred benefits under 457(f) when the substantial risk of forfeiture is removed
    - Clarification and exception provided on rolling risk of forfeiture (previous guidance disallowed)
    - Other notable clarifications that align many 457(f) plan concepts with IRC 409A, which provides additional certainty to plan design, administration, and reporting
  - New guidance defining leave and severance pay:
    - Prior guidance did not define a bona fide severance pay plan exempt from IRC 457
    - Proposed regulations provide that a bona fide sick or vacation leave plan must demonstrate that the primary purpose of the plan is to provide for paid time off from work because of sickness, vacation, or other personal reasons

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Excess Benefit Transactions

- Transaction in which an economic benefit is provided, directly or indirectly, by a 501(c)(3) or 501(c)(4) tax-exempt organization, to or for the use of a disqualified person, where the value of the benefit provided exceeds the value of the consideration received by the organization
- Disqualified person is one in a position to exercise substantial influence over the organization's affairs (includes directors, officers, and key employees)
- Compensation arrangements to disqualified persons must be presumed reasonable and not providing excess benefits

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Excess Benefit Transactions

- Reasonableness of compensation for purposes of determining excess benefits – all compensation provided by a 501(c)(3) or 501(c)(4) organization to a disqualified person in exchange for the performance of services is taken into account:
  - Salary, bonuses, severance, deferred compensation, insurance premium payments, fringe benefits, all non-cash compensation
- Excess benefit transactions may result in:
  - Severe sanctions imposed by IRS
  - Revocation of an organization's tax-exempt status
  - Excise taxes (IRC section 4958)

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Excess Benefit Transactions

- Presumption of reasonableness of compensation:
  - Compensation arrangement must be approved in advance by an authorized body of the tax-exempt organization, composed of individuals who do not have a conflict of interest concerning the transaction,
  - Prior to making its decision, the authorized body obtained and relied upon appropriate data as to comparability, and
  - The authorized body adequately and timely documented the basis for its determination concurrently with making that determination
  - IRS can always refute
  - Recommend organization retains all supporting documentation, including transaction terms, approval date, authorized body members present during debate and approval, the comparability data relied upon, the basis for determination

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Key Elements: Perks

- Common perks and benefits for CEOs:
  - Supplemental insurance
  - Memberships in professional organizations
  - Car/phone allowances
  - Travel arrangements

- **Trend:** With increased scrutiny, the prevalence of CEO perks has been declining (e.g., housing, car leases, sabbaticals, social clubs)
- **Tip:** Executives should focus on perks that are important to them (i.e., long-term care or business class travel) – otherwise it might be better to negotiate a higher salary

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Other Key Contractual Elements

- Severance
- Restrictive covenants
- Executive authority and reporting
- Term and termination

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Other Elements: Severance

- Discuss severance provision up front while the relationship is strong; understand relationship with "cause" terminations
- **Trend:** Typically 6 to 12 months of salary
- **Tip:** Ensure severance payment is tied to execution of a release agreement
- **Tip:** Consider making the severance length at least as long as any non-compete period, and clarify whether severance is just based on base salary or base plus target/pro-rated bonus

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Restrictive Covenants

- Confidentiality
- Non-solicitation
  - Employees
  - Members, customers
- “Do not compete”
- Limits on outside activities

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Executive Authority and Reporting

- "Full time and attention"
- Description of responsibilities *(a.k.a. The Job Description)*
- Authority over staff
- Report to Board or committee
- Annual reviews

Term and Termination

- Term, renewal, effect of non-renewal
- Rights to terminate, "cause"
  - Right of executive to terminate for "good reason"
  - **Tip:** Pay close attention to definition of cause
- Payments upon termination
  - Accrued obligations
  - Severance
  - Liability release as a pre-condition
- Return of records and association property
- Dispute resolution – arbitration vs. courts

Misclassification of Employees

- According to the U.S. Department of Labor, misclassification of employees as independent contractors presents one of the most serious problems facing affected workers, employers, and the entire economy
- Misclassified employees often are denied access to benefits and protections they are entitled to by law, such as minimum wage, overtime compensation, family and medical leave, unemployment insurance, safe workplaces, retirement, and health/welfare benefits
- Employee misclassification generates substantial losses to the federal government and state governments in the form of lower tax revenues, and to state unemployment insurance and workers' compensation funds, and has potential tax consequences
- U.S. Department of Labor Misclassification Initiative
  - The Wage and Hour Division is working with the IRS and many states to combat employee misclassification and to ensure that workers get the wages, benefits, and protections to which they are entitled

Questions?