The Executive Compensation Puzzle: Putting the Pieces Together for Nonprofits

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Harry Atlas
Partner | +1 410.528.2848 | hiatlas@Venable.com

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About the Speaker

- **Harry I. Atlas**, Partner, Venable LLP (410.528.2848, hiatlas@Venable.com)
- **Practice focus:** Executive compensation and employee benefits for tax-exempt and for-profit organizations
- **Representative experience:** Employment agreements, 457(b)/457(f) plans, intermediate sanctions, and §4960 planning

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Today's Agenda

- **Setting the Stage:** Reasonableness, intermediate sanctions, §4960, and Form 990
- **Executive Employment Agreements:** Key provisions and the issues they raise
- **Case Study 1:** The New CEO Hire
- **Nonqualified Deferred Compensation:** 457(b), 457(f), and Section 409A
- **Case Study 2:** The Retention SERP
- **Other Benefits:** Fringe benefits and severance basics
- **Case Study 3:** One Executive, Ten Years
- **Key Takeaways and Q&A**

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Setting the Stage: Reasonable Compensation

- Tax-exempt organizations may pay executives competitively, but compensation must be **reasonable**.
- "Reasonable" generally means what similar organizations would pay for similar services under similar circumstances.
- Reasonableness is judged on the **total package**, not salary alone:
  - Base salary, bonuses, and incentive pay
  - Retirement and deferred compensation
  - Insurance, fringe benefits, and perquisites
  - Severance and other contractual promises
- The board's **process** for setting pay is often as important as the dollar amount.

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Intermediate Sanctions (Section 4958)

- Applies to public charities and social welfare organizations (private foundations are subject to separate self-dealing rules).
  - While §4958 doesn't apply to 501(c)(6) organizations, such organizations should follow similar procedures to avoid inurement.
- Targets **excess benefit transactions** with **disqualified persons**: people in a position to exercise substantial influence (e.g., officers, directors, and their family members).
- If compensation exceeds reasonable value:
  - The executive owes an excise tax and must repay the excess.
  - Board members who knowingly approve may face a separate excise tax.
- **Rebuttable presumption safe harbor:** Independent approval, reliance on comparability data, and contemporaneous documentation shift the burden to the IRS.
- We will walk through the safe harbor in Case Study 1.

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Section 4960 and Form 990 Disclosure

- **Section 4960:** An excise tax paid by the **organization** on:
  - Compensation above $1,000,000 paid to a covered employee
  - Excise tax on excess at corporate tax rate (currently 21%)
  - Excess parachute payments made on separation
- **New for 2026:** Covered employees now include **all** current and former employees paid above the threshold, not just the five highest paid.
- **Form 990 transparency:** Compensation of officers, directors, key employees, and the highest paid is publicly reported (Part VII and Schedule J).
- Form 990 also asks about the process used to approve executive pay; donors, media, and regulators read it.

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Employment Agreements: Term and Duties

- **Why a written agreement?** Clarity for both sides, a record for the board, and a foundation for the rest of the package.
- **Term:** Fixed term, rolling renewal, or at-will with severance protection
  - Automatic renewals and extensions are decision points; build in board review
- **Duties and reporting:** Reports to the board; scope of authority; outside board service and activities, subject to the conflict-of-interest policy
- **Tax angle:** Fixed payments under an initial agreement with a new hire can fall outside §4958, but a material change or renewal is treated as a new contract. Therefore, as a practical matter, §4958 needs to be followed from the outset.

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Employment Agreements: The Pay Provisions

- **Base salary:** Set within a range supported by comparability data; describe how increases are determined
- **Bonus and incentive pay:** Tie to mission-related and operational goals, with board discretion and caps
  - Revenue-sharing arrangements draw scrutiny; avoid open-ended formulas
  - Specify payment timing to avoid creating unintended deferred compensation
- **Benefits and perquisites:** Vehicles, housing, spousal travel, club dues
  - Treat and report them as compensation when provided; otherwise they can be automatic excess benefits regardless of reasonableness

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Employment Agreements: Separation and Transitions

- **Severance triggers:** Termination without cause or resignation for good reason; define both carefully
- **Conditions:** Release of claims, return of property, ongoing compliance with covenants
  - Release timing language matters under Section 409A
- **Mergers, affiliations, and leadership transitions:** The nonprofit version of a change in control
  - Combinations with a health system or larger affiliate, or a restructured board
  - Single-trigger vs. double-trigger protection
- **Tax angle:** Large separation payments can trigger the §4960 excess parachute tax, and some severance is deferred compensation

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Employment Agreements: Restrictive Covenants

- **Common covenants:** Noncompetition, nonsolicitation of employees and donors, confidentiality, nondisparagement
- **State law is changing quickly:** A growing number of states ban or limit noncompetes, often based on pay level or industry
  - Enforceability varies by state; review the law where the executive works
- **Draft for enforceability:** Reasonable scope, duration, and geography; consider nonsolicitation as an alternative
- **Tax angle:** A covenant may affect when deferred compensation is taxed (more in the 457(f) discussion)

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Employment Agreements: Issue Spotting

Provision	Watch For	Practical Tip
Term and renewal	Renewals or material changes treated as new contracts under §4958	Refresh comparability data at each renewal
Base and bonus	Unsupported pay levels; open-ended formulas; unclear payment timing	Document metrics, caps, and payment dates
Benefits and perquisites	Personal benefits not reported as compensation	Report on Form W-2 and approve as part of the package
Severance and transitions	409A release timing; §4960 parachute exposure	Use double triggers; model severance cost in advance
Restrictive covenants	State-law enforceability; interaction with 457(f)	Tailor to the state; prefer narrow covenants

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Case Study 1: The New CEO Hire – The Facts

- A national trade association (a 501(c)(6)) and its affiliated research and education foundation (a 501(c)(3)) recruit a new CEO from industry to lead both organizations.
- The board chair, a longtime acquaintance of the candidate, negotiates the deal alone, using the candidate's prior corporate pay as the benchmark.
- The package: salary well above the predecessor's, a signing bonus, guaranteed annual raises, club dues, and spousal travel.
- The foundation pays a share of the CEO's compensation, but there is no written cost-sharing arrangement.
- The full board approves by email, with no minutes; club dues and spousal travel are not reported as compensation.
- With the signing bonus, first-year pay exceeds the §4960 threshold.

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Case Study 1: The Issues

- **Which rules apply?** Section 4958 does not apply to the 501(c)(6) association, but it does apply to the 501(c)(3) foundation's payments; the association remains subject to the prohibition on private inurement.
- **No rebuttable presumption:** A single corporate benchmark is weak comparability data, and an email approval is not contemporaneous documentation.
- **Automatic excess benefits:** Unreported club dues and spousal travel can be excess benefits regardless of whether total pay is reasonable.
- **Section 4960:** Pay from related organizations is aggregated, and each organization bears its share of the excise tax.
- **Governance and reputation:** Form 990 reporting for both entities will make the package public to members and donors.

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Case Study 1: Practical Lessons

- **Use an independent body:** A compensation committee of members without conflicts, not a single board member
- **Get real comparability data:** Similarly sized associations and nonprofits, ideally through an independent consultant
- **Document contemporaneously:** Minutes showing the data relied on and the basis for the decision
- **Report every benefit:** Treat perquisites as compensation on Form W-2 when provided
- **Put cost sharing in writing:** Allocate pay between affiliated entities based on services
- **Model §4960 before making the offer:** Consider spreading sign-on payments or adjusting structure
- For the 501(c)(6), follow the same process as a best practice, even though §4958 does not apply.

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Nonqualified Deferred Compensation: Why It Matters

- Qualified plan limits (403(b), 401(k)) cap the retirement benefits a nonprofit can provide its most senior executives.
- Nonprofits cannot offer equity, so deferred compensation is the main tool for **retention and retirement**.
- For tax-exempt employers (other than churches), **Section 457** governs:
  - **457(b):** An eligible plan with an annual deferral limit, fully vested, taxed when paid or made available
  - **457(f):** An ineligible plan with no dollar limit, taxed at vesting
- Section 409A overlays 457(f), and§4960 and Form 990 still apply.

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457(b) Plans for Tax-Exempt Employers

- **Who can participate:** A select group of management or highly compensated employees (a “top hat” group).
- **2026 deferral limit: $24,500** (separate from, and in addition to, the 403(b) limit); 2027 deferral limit: $25,500
  - No age-50 catch-up for tax-exempt (non-government) plans; a special catch-up may apply in the three years before normal retirement age.
- **Fully vested:** As a practical matter, accounts must be fully vested at all times because of how the IRS contribution limits apply, so not a retention tool.
- **Unfunded:** Amounts remain assets of the organization, subject to its general creditors.
- **Taxed when paid or made available**, not when deferred.
- **Limits on portability:** No rollovers to IRAs or 403(b) plans; transfers only to another tax-exempt 457(b) plan.

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457(f) Plans: The Retention Tool

- **No dollar limit:** Commonly used for supplemental executive retirement plans (SERPs) and retention bonuses.
- **Taxed at vesting**, when the benefit is no longer subject to a **substantial risk of forfeiture**, even if payment comes later.
  - Typically requires continued service through a vesting date.
  - FICA taxes also generally apply at vesting.
- **Section 4960:** Vested amounts count as compensation in the year of vesting.
- **Design point:** Most streamlined approach is to pay at or soon after vesting so the executive has cash to pay the tax.

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457(f): The 2016 Proposed Regulations

- **Voluntary Employee Contributions:** Unlikely to meet requirements for tax deferral.
- **Noncompetes:** May create a substantial risk of forfeiture if the covenant is written, enforceable, and actually enforced, and the organization has a bona fide interest in preventing competition.
- **Rolling vesting and elective deferrals:** Permitted only under strict conditions.
  - The deferred benefit must be meaningfully larger than what is given up (125% rule).
  - A minimum extension period and advance written election (2 years/90 days).
- **Bona fide severance pay plans:** Excluded from 457(f) within limits.
- **Status:** Still proposed, not final.

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Section 409A and Funding Considerations

- **Section 409A:** Some 457(f) plans and severance arrangements must also meet 409A rules when payments occur; violations bring income acceleration and additional tax for the executive (details in the appendix).
- **Rabbi trusts:** Set assets aside for the executive in a trust.
  - Protects against a change of heart, such as a new board or leadership.
  - Does **not** protect against insolvency; assets stay subject to creditors.
- **Communicate the creditor risk** to executives in plan documents.

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Comparing the Options

Feature	457(b)	457(f)	Loan Regime Split-Dollar
Dollar limit	Annual limit	None	None
When taxed	When paid or made available	At vesting	Generally not taxed as compensation if loan terms are respected
Executive's risk	Organization's creditors	Forfeiture before vesting; creditors	Policy performance; loan repayment
§4960 impact	When deferred (usually vested immediately)	At vesting	Generally limited to imputed interest
Best suited for	Supplementing 403(b) savings	Retention and larger benefits	Long-tenured executives; more complex

Split-dollar is covered only briefly here; see the appendix for more detail.

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Case Study 2: The Retention SERP – The Facts

- A private university adopts a 457(f) SERP for its president: annual credits, with **cliff vesting after five years** of service.
- Late in year four, the president asks to push vesting out three more years to avoid a large tax bill, and a §4960 hit for the university, in year five.
- The board chair agrees by email about 60 days before the vesting date; the benefit is not increased.
- The original vesting date passes. Nothing is reported on the president's Form W-2.
- In year six, the president leaves for another university. The university treats the SERP as forfeited.
- The president's counsel responds: the extension was invalid, so the benefit vested in year five and is owed.

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Case Study 2: The Issues

- **Was the extension effective?** Under the 2016 proposed regulations, likely not: no enhanced benefit, too little advance notice, and an informal approval.
- **If not, vesting occurred in year five:**
  - The full SERP balance was taxable income to the president in year five.
  - The university missed W-2 reporting, withholding, and FICA.
  - The vested amount counted toward §4960 in year five.
- **The forfeiture claim weakens:** A benefit that has already vested may not be forfeitable on a later departure.
- **Plan terms and approvals matter:** Who had authority to amend, and did the plan permit it?

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Case Study 2: Practical Lessons

- **Design to avoid cliffs for large amounts:** Graded vesting or staggered tranches smooth the tax and §4960 impact.
- **If extending, plan early:** Follow the proposed-regulation conditions, with a written agreement well before vesting and a meaningful enhancement.
  - Best to assume at the design phase that it will not be practical to extend the vesting date due to onerous regulatory requirements.
- **Otherwise, let it vest and pay it** at or soon after vesting.
- **Follow plan formalities:** Amendments approved by the proper body and documented.
- **Coordinate with the employment agreement:** Termination without cause, good reason, and death or disability provisions should align with SERP vesting.
- **Calendar every vesting date** for payroll, §4960, and Form 990 reporting.

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Other Benefits: Fringe Benefits and Perquisites

- **Common executive perquisites:** Vehicles, housing or relocation, spousal or companion travel, club dues, personal use of organization resources.
- **Default rule:** Taxable to the executive unless a specific exclusion applies (e.g., business use that is properly substantiated).
- **Substantiate and report:** Keep business-use records, include taxable amounts on Form W-2, and approve perquisites as part of total compensation.
  - Unreported perquisites risk automatic excess benefit treatment and Form 990 Schedule J disclosure questions.
- **Executive life and disability insurance:** Supplemental coverage is a common, relatively low-cost retention benefit; premiums or imputed income are generally taxable and count toward total compensation.

Other Benefits: Severance Basics

- **Why it matters:** Severance is often the largest single payment in an executive's tenure and the most visible.
- **Tax classification:** A bona fide severance plan can be excluded from 457(f), and many severance payments fit a Section 409A exception, but only within limits on amount, timing, and triggering events.
- **Section 4960 excess parachute payments:** Payments contingent on separation to highly compensated employees can trigger the excise tax if they are large relative to the executive's historical pay.
- **Reasonableness:** Severance counts as compensation for §4958 and must be approved with the same care.
- **Releases and covenants:** Condition payment on a release and on ongoing compliance.

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Case Study 3: One Executive, Ten Years – The Facts

- A national charity hires a CEO; the story unfolds over ten years:
  - **Year 1:** Employment agreement with a three-year term, automatic renewals, and 12 months' severance on termination without cause.
  - **Year 4:** The board adds a 457(f) SERP vesting at year 10, or earlier on termination without cause.
  - **Year 7:** At renewal, severance is increased to 24 months plus a prorated bonus; no new comparability data.
  - **Year 9:** A new board chair arrives, and the board decides on a leadership change.
- The board terminates the CEO without cause. The CEO notes that the SERP and the employment agreement define "cause" differently.

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Case Study 3: The Issues

- **The pieces collide at separation:** 24 months' severance, a prorated bonus, and accelerated SERP vesting all arrive together.
- **Section 4960:** Accelerated vesting and severance may produce **excess parachute payments**, on top of the excise tax on high compensation in the separation year.
- **Section 4958:** The year 7 increase was approved without comparability data, so the total separation package is harder to defend.
- **457(f) and 409A:** The SERP becomes taxable on vesting; the timing of severance and release language must comply with 409A.
- **Inconsistent documents:** Different definitions of "cause" invite a dispute and leverage for the executive.
- **Visibility:** The payments will appear on Form 990 and Schedule J.

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Case Study 3: Putting the Pieces Together

- **Map the whole package** at hiring, at each renewal, and before any separation.
- **Align the documents:** Use consistent definitions of cause, good reason, and separation across the agreement, SERP, and benefit plans.
- **Model separation cost annually,** including accelerated vesting and §4960 exposure.
- **Refresh comparability data** whenever the package changes materially.
- **Plan for transitions:** Succession planning, release and 409A-compliant payment terms, and board communication.
- **Assign ownership:** One person or committee responsible for the full compensation picture.

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Key Takeaways

- **Reasonableness is judged on the total package,** so look at all of the pieces together.
- **Process protects:** Independent approval, comparability data, and contemporaneous documentation.
- **Know the 2026 §4960 changes** and model the excise tax before it arrives.
- **Design deferred compensation deliberately:** Vesting schedules drive taxes, §4960, and retention.
- **Coordinate the documents** and revisit them at every renewal and transition.

Questions?

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Contact information

Harry I. Atlas, Partner
hiatlas@Venable.com
t 410.528.2848

www.Venable.com

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APPENDIX

Appendix A: Section 409A Mechanics

- **Permitted payment events only:** separation from service, disability, death, a fixed date or schedule, a change in control event, or an unforeseeable emergency
- **Anti-acceleration:** payments generally cannot be accelerated, and subsequent deferrals must delay payment at least five years and be made at least 12 months in advance
- **Short-term deferral exception:** amounts paid by the 15th day of the third month after the year of vesting are generally exempt
- **Separation pay exception:** involuntary severance within dollar and timing limits is generally exempt
- **Releases:** the executive should not be able to choose the tax year of payment by timing the release
- **Consequences of failure:** immediate income inclusion of vested deferred amounts, a 20% additional tax, and interest, all borne by the executive

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Appendix B: Split-Dollar Life Insurance

- **Economic benefit regime:** the organization owns the policy and endorses a death benefit to the executive; the executive is taxed annually on the value of the insurance protection
- **Loan regime:** the executive owns the policy and the organization lends the premiums, secured by a collateral assignment
  - Below-market interest is imputed as compensation
  - Loan forgiveness is compensation when it occurs
- **Why consider it:** can provide substantial retirement or death benefits without 457(f) taxation at vesting, when properly structured
- **Considerations:** policy performance risk, exit strategy and loan repayment, reasonableness of total compensation, §4960 treatment of imputed amounts, and ongoing administration

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Appendix C: Form 990 Schedule J

- **Who is reported:** officers, directors, trustees, key employees, and highest compensated employees whose reportable compensation from the organization and related organizations exceeds $150,000, plus former insiders meeting reporting thresholds
- **Part I questions include:** first-class or charter travel, companion travel, tax gross-ups, discretionary spending accounts, housing, health or social club dues, and personal services
  - Methods used to set the top executive's compensation (committee, consultant, survey, other organizations' Form 990s, written agreement, board approval)
  - Severance or change-in-control payments, SERPs, and revenue- or earnings-based compensation
  - Use of the initial contract exception or rebuttable presumption procedure
- **Part II breakdown:** base, bonus and incentive, other reportable, deferred compensation, nontaxable benefits, and amounts previously reported as deferred
- **Part III:** narrative explanations, an opportunity to tell the story

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Appendix D: §4958 Rebuttable Presumption Steps

- **1. Independent approval:** approved in advance by the board or an authorized committee made up entirely of individuals without a conflict of interest
- **2. Comparability data:** reliance on appropriate data, such as compensation paid by similarly situated organizations (taxable and tax-exempt) for functionally comparable positions, independent surveys, and written offers
  - Small organizations (annual gross receipts under $1 million) may rely on data from three comparable organizations
- **3. Contemporaneous documentation:** minutes recording the terms and date approved, members present and voting, the data relied on and how it was obtained, and any recusals
  - Prepared before the later of the next meeting or 60 days after final action, and approved within a reasonable time
- **Effect:** the IRS must rebut the presumption of reasonableness with sufficient contrary evidence

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