

What Not-for-Profit Boards Need to Know About Executive Compensation

Introduction

Not-for-Profit Board members have their calendars full with a myriad of issues to address, including the organization's financials, along with all sorts of regulations and concerns. One of the most onerous tasks the Boards must face is their need to recruit and manage a highly-qualified professional staff, including the Executive Director and his/her senior management staff. Unlike privately owned and operated companies which can pretty much establish executive compensation with few government constraints, NFPs must adhere to some fairly punitive federal and state regulations, as well as being open to public scrutiny and criticism, as well as adverse media attention. The on-going public criticism about excesses in executive compensation have in turn led to a further tightening of regulations affecting how the NFP Boards set executive compensation, and have resulted in greater disclosure and transparency, as well as increased scrutiny on governance practices.

Executive compensation at NFP organizations is more directly affected by the organization's finances, since their revenue is often dependent on external sources and charitable contributions, in which negative publicity about executive compensation can impact a nonprofit organization's image and ability to obtain funding. In addition to different financial constraints, NFPs are prohibited by IRS regulatory constraints from using equity compensation as part of the package for attracting or paying executives. Executive compensation for nonprofits is also limited by IRS regulations and in some instances by various state limitations. Unfortunately, there is a widely held belief that employees of a NFP should be paid less than their counterparts in the for-profit sector; most Boards are seeking the best-qualified candidates, not the lowest paid individuals.

Compensation Philosophy

We believe that the starting point in the design of executive compensation, is for the Board or its Compensation Committee to clarify the organization's Compensation Philosophy. This is a written statement which states the What, How and Why of executive compensation, and becomes the basis for development of the executive compensation package. The Philosophy must provide the direction for the organization and be consistent with the organization's mission, as well as articulate the Board's thoughts on compensation in general, while being in compliance with governmental regulations. It identifies the parameters used for selecting peers for comparison purposes, identifies the components of the compensation package, the mix of pay and benefits, as well as fixed and variable pay elements. Once the Compensation Philosophy has been carefully reviewed and approved, it will become the baseline for development of the entire compensation package.

Establishing Rebuttable Presumption

The Intermediate Sanction regulations contained in IRS Section 4985, addresses 501(c)3 and 501(c)4 organizations (which make up the majority of NFPs) and prescribes penalties for violations of these regulations. Even though the regulations specifically address select NFPs, the IRS has repeatedly indicated that *all* NFPs should use the "Rebuttable Presumption" contained in the Intermediate Sanction regulations, as "Best Practices". The Rebuttable Presumption provides that compensation is reasonable if the organization's board of directors has met the following three (3) conditions:

1. The Independent Requirement: The transaction is approved by an authorized body of the organization which is composed of individuals who are independent and do not have a conflict of interest,
2. Comparable Peer Data: Before making its determination, the authorized body obtained and relied on appropriate data from comparable organizations, and
3. Written Documentation: The authorized body adequately documents the basis for making its determination and all components of compensation are fully identified. This includes full

documentation, including the terms and dates of approved transactions; who voted to approve the transaction, as well as any who voted against it; the comparability data relied upon; and documentation is made contemporaneously or within 60 days after the final actions are taken.

Under the IRS regulations, relying upon peer data for setting compensation means that the board examined compensation levels paid by comparable organizations of similar size, geographic location and related activities. Currently, data for comparable positions among for-profits, and other NFP organizations can be used for comparison data, as well as compensation surveys compiled by independent consulting firms and similar sources. If the board determines that reasonable compensation should be higher or lower than peer data, it should document its justification. The regulations provide that in some situations it may be warranted to provide compensation that is above the 50th percentile; however, this could be a problematic decision and should be subject to advice of legal counsel and/or compensation consultants.

Establishing a Rebuttable Presumption that compensation is reasonable puts the "burden of proof" on the IRS to prove otherwise, and requires the government to show sufficient evidence to challenge the value of the data relied upon. (Note: Senator Grassly has indicated that he would like the provision of the regulations to be cancelled.) The IRS has focused their audits on those organizations that have not satisfied the Rebuttable Presumption. It should be noted, that the regulations provide a "Safe Harbor" in which boards authorizing the transaction will not be penalized if they met the Rebuttable Presumption.

IRS Penalties

Intermediate Sanctions legislation was introduced to provide a mechanism for reviewing executive compensation, and has subsequently been tightened and clarified on a number of occasions, most recently in 2009. Under these regulations, the IRS may impose tax penalties on executives who receive "excess benefit transactions", as well as the board members who authorize such transactions. In addition to having to repay the amount of the overpayment (referred to as "disgorgement"), there is a penalty excise tax of 25% of the transaction, which can jump to 200% if not corrected with a specified time frame. Board members who authorize the Individual fines of equal to the lower of 10% or \$20,000, for each transaction, can also be imposed on those board members who approved the transaction. As mentioned previously, boards who have met the Rebuttable Presumption are protected by the Safe Harbor rules, even if the compensation is determined to be excessive.

Form 990 and Market Consensus

The Form 990 and Schedules J and O provide require that the compensation of highly-compensated executives and directors and other employees be identified. All elements of compensation received (salaries, incentives/bonuses, severance, benefits, insurance payments, and retirement contributions, as well as non-taxable employee benefits and deferred compensation) are included and considered to be the "Total Compensation Package" and are subject to penalties unless the compensation is considered "reasonable".

From a compensation planning standpoint, the calculated average based on the average of peer data and published survey information is referred to as the "Market Consensus" and a range of reasonableness has typically been calculated that is +/- 10% of the Base Salary, and +/- 20% of the Total Cash Compensation (consisting of Base Salary and Bonus/Incentive), as well as +/- 20% of the Total Compensation Package (consisting of Total Cash Compensation, other reportable income, deferred compensation and taxable and non-taxable benefits). These terms coincide with the data required columns in Schedule J of Form, 990: Base Salary is B(i); Bonus/Incentive is B(ii), Total Cash Compensation is B(i), B(ii) and B(iii); while the Total Compensation Package includes the former(Bi, ii, and iii), as well as columns C (Retirement and other deferred compensation) and column D Nontaxable benefits), and is shown as column E (Total of columns B(i)-D).

A thoughtful process must be undertaken in order to balance providing competitive compensations to CEOs and Executive Directors of NFPs, as well as being mindful of comply with Intermediate Sactions regulations.

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