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# Executive Compensation within Nonprofits: Rewarding Excellence and Ensuring Governance



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The fervor over excessive executive compensation has become a major issue in organizations from coast to coast. Organizations are changing executive compensation advisors, and board members are either learning more about the executive compensation programs they are asked to approve or, in some cases, “retiring” from boards to avoid the potential liability and embarrassment. The egregious for-profit examples of WorldCom and Enron demonstrate that board members may be called upon to personally pay to settle claims despite the relative protection provided to them via indemnification provisions and D&O insurance. The issue of corporate governance relating to executive compensation is critical for all organizations. It is in the mind’s eye of leaders, board members, shareholders, the investment community and the business press.

This article provides guidance on the performance issue and how nonprofit and other tax-exempt organizations such as hospitals and charitable and social welfare organizations (collectively referred to hereafter as “nonprofits”) can manage executive compensation when performance counts and intermediate sanctions are a reality. (“Intermediate sanctions” refers to the excise tax penalties associated with excess-benefit transactions. These penalties potentially apply only

to those IRC 501(c)(3) and 501(c)(4) organizations described in the U.S. Code of Federal Regulation, Title 26, Section 53.4958-2(a) (or 26 C.F.R. 53.4958-2(a)) et seq. Similar excise-tax penalties apply to private foundations via IRC 4941).

Our theme is one of the importance of the board's role in developing executive compensation solutions that make how executives are paid a "win" for all stakeholders — customers, the community, investors, contributors, sponsors, employees and executives. The fact is that organizations that honestly pay for performance outperform those that don't, so the business case for creating a high-performance executive reward solution is solid (Zingheim and Schuster 2000).

Nonprofit groups are universally interested in improving performance. While measures relating to performance differ between and among nonprofits, the search for excellence continues to be widespread. However, nonprofits have been slower than other types of organizations to embrace the need to more closely align the senior executive team's rewards with the organization's performance. Often, nonprofits are concerned about the visibility and potential bad publicity regarding excessive compensation packages

paid to their executives. But in addition to aligning executive and organizational performance and maintaining a positive public image, applicable nonprofits must now assess the compensation arrangements for certain organizational members to avoid potential federal and state regulation.

### **Intermediate Sanctions**

The business case for changing how executive compensation is managed and designed in charitable organizations has therefore been strengthened by the Internal Revenue Service cracking down on perceived and real abuses of excessive compensation. Intermediate sanctions provide a way for the IRS to address excessive compensation without taking away a tax-exempt organization's tax exemption because of inurement or personal gain. Intermediate sanctions include excise taxes for both the disqualified person (commonly the executive but also others) and the organization manager who participated in the compensation decision (commonly board members). Taking away an organization's tax-exempt status will likely hurt the beneficiaries whom the organization serves; intermediate sanctions penalize the responsible parties.

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## What is a nonprofit?

Tax-exempt organizations take on many different forms. Rules governing the various forms can be found in the Internal Revenue Code's Title 26, Section 501(c)(1) to 501(c)(28). A copy of this document can be obtained at [www.worldatwork.org/worldatworkjournal](http://www.worldatwork.org/worldatworkjournal).

The penalty for the executive (disqualified person) found to have excessive compensation is to pay the excess benefit back to the organization; pay interest on the excess benefit; pay an excise tax equaling 25 percent of the excess benefit on each excess-benefit transaction; and pay a 200-percent excise tax on the excess benefit if the executive has not paid within the 90-day correction period after the date the IRS mails a notice of deficiency.

The Exempt Organizations Division of the IRS created new offices to focus, in part, on compensation abuses in charitable organizations. One of these offices, the Exempt Organizations Electronic Initiatives Office ("IRS EO-EIO"), is responsible for acquiring data sources that will aid the IRS in more easily comparing executive compensation paid by tax-exempt organizations. The IRS also hired many additional EO specialists and examination agents in 2004 and set a target of 2,000 correspondence-type audits of the executive compensation in tax-exempt organizations by September 2005.

In June 2005, the report of the Panel on the Nonprofit Sector to the U.S. Senate Finance Committee recommended that the IRS more actively enforce its regulation of intermediate sanctions and the IRS should be provided the funds to do so. If good governance and resource management were not enough reason for boards and CEOs to accelerate the journey to become a high-performance nonprofit tax-exempt organization, the IRS is providing new impetus to taking this initiative.

One data source to demonstrate reasonable executive compensation in both the for-profit and

tax-exempt arenas is ERI's Compensation Comparables Assessor and Tax-Exempt Survey. This compensation survey product allows tax-exempt organizations to demonstrate reasonableness by using compensation data from Form 990s and Form 990PFs. Tax-exempt organizations also can compare themselves to similar for-profit companies using ERI's Executive Compensation Assessor. Each of the authors has worked closely with ERI over the past few years, so we are coming at the topic from the standpoint of understanding how reasonable compensation is measured within nonprofits and with knowledge of what is needed to adequately retain and motivate executives within nonprofit organizations.

## Consequences of Intermediate Sanctions to Board Members

Clearly, board members within charitable organizations owe fiduciary duties of care, loyalty and obedience. As part of the duty of care, the board must implement a process to prudently evaluate the overall reasonableness of executive compensation. Boards also must establish reasonable rewards that reflect the organization's performance and that are consistent with what other similar organizations would pay for a similar executive role and outcomes generated. Because the IRS is currently very active in the study of reasonable compensation, the likelihood of existing problems being uncovered is significantly increased. But whether or not board members face scrutiny from the state or federal government, it is critical that the incentive compensation paid to charities' executives appropriately rewards the executive based upon transparent and clearly established performance-based metrics.

Here's what active IRS enforcement means to board members.

- ▶ Board members for applicable organizations potentially face up to \$10,000 in penalties for each excess-benefit transaction if they are found to have

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knowingly, willfully and without reasonable cause participated in the excess-benefit transaction (according to 26 C.F.R. 53.4958-1(d)).

- ▶ Board members must take the time to become knowledgeable about executive compensation and follow an appropriate process for determining executive compensation. For example, technically, an automatic excess-benefit transaction occurs each time money or property passes to a “disqualified person” and there is an absence of written contemporaneous substantiation regarding the transaction according to the IRS EO CPE Text for FY 2004. This is true even if the economic benefit and total compensation conferred are reasonable.
- ▶ Board members, or the appointed committee of the board charged with determining compensation, must

“obtain and rely” upon appropriate comparability data for purposes of establishing the rebuttable presumption of reasonableness for the underlying compensation arrangement (according to 26 C.F.R. 53.4958-6(c)(2)).

The rebuttable presumption (as explained in 26 C.F.R. 53.4958-6) is the organization’s proactive response to the IRS’s claim that compensation is excessive; the burden shifts to the IRS to prove its claim. The burden of challenging the compensation comparability data shifts to the IRS if the board follows an appropriate process to make executive compensation decisions, obtains and relies upon appropriate comparability data, and possesses a minimal amount of knowledge and expertise about executive compensation. A reasonableness opinion from an appropriate qualified, independent professional makes the rebuttable presumption even stronger.

Unlike reasonable compensation cases in the for-profit arena, and according to 26 C.F.R. 53.4958-1(d), intermediate sanctions involve potentially significant personal liability for both the disqualified person receiving the excess benefit as well as the organizational manager who allowed it to happen.

According to 26 C.F.R. 53.4958-6(c)(2), to establish the rebuttable presumption of reasonableness, among other requirements, the committee of the board charged with establishing the compensation package for the executive must not only obtain and rely upon appropriate comparability data, but must also possess a minimal amount of knowledge and expertise to properly interpret the data.

The consequences for board members serving on applicable organizations are stronger than in the for-profit sector regarding IRS regulation. IRS reasonable compensation determinations in the for-profit arena typically involve issues relating to “disguised dividends” of corporate profits. In such cases, there are no statutory tax penalties for the board members and management

that approve the issuance of the compensation that is not found reasonable. Contrast this with the penalties associated with intermediate sanctions (see: 26 C.F.R. 53.4958-1(d)) and it's easy to see that corporate governance of charitable organizations can be a much more serious proposition.

### **Involvement of States in Reasonable Compensation for Nonprofits**

In addition to the IRS, state regulatory agencies are becoming more involved. California's *Nonprofit Integrity Act of 2004* requires that the board must review and approve compensation of the CEO/president and CFO/treasurer of California nonprofits to ensure payment is "just and reasonable." New York's Not-For-Profit Law requires that executive compensation paid be "reasonable and commensurate with the personal services provided" (White 2004). The Charities Division of the Minnesota Attorney General's Office in a case involving the organization HealthPartners suggests that boards have the fiduciary duty to set reasonable compensation for services rendered and not permit unreasonable levels of compensation. (The Attorney General's report can be viewed at [www.ag.state.mn.us/consumer/health/Law\\_Legis.htm](http://www.ag.state.mn.us/consumer/health/Law_Legis.htm).) Minnesota's business compliance reviews of executive

compensation focus on flawed methodology and disengagement of the board. Given these examples, applicable organizations must be wary of state law and regulators.

### **Reasons for Paying for Performance**

In many instances organizations have statements of the intent to "pay for performance." However, many are more likely to pay based on length of service than upon actually measured differences in performance. Experience suggests, however, that organizations that pay for performance consistently outperform those that pay only for service. So the business case for creating a high-performance culture is powerful (Zingheim and Schuster 1996). The reasons for paying for performance in addition to complying with intermediate sanctions are as follows:

- ▶ Reinforce the organization's mission, vision and goals. Often nonprofits have statements of mission, vision and goals that are worded in terms that do not translate into metrics that can measure executive performance. The test of the viability of vision, mission and goals is the board's ability to define these in terms that can be used to develop performance metrics for executive compensation. So governance comes from a mission statement that can

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be measured in terms of accomplishment in the short and longer term.

- ▶ Align the executive's success with the organization's success. High-performance organizations recognize and reward success. As the organization achieves goals, the executive team should be rewarded. Executives should be paid more in years when the organization meets or exceeds goals than in years when goals are missed. It gives credibility to the goal-setting process and attracts executives who believe that their economic success and that of the organization and board they serve are closely associated.
- ▶ Enable the organization to attract and retain executive talent. Executives who are willing to have the board evaluate their performance will seek organizations that reward performance. Boards that are interested in executive compensation programs that reward performance will establish an executive compensation strategy and associated rewards for the executive team and then seek executives who fit the mode of helping create and sustain a performance culture. Executives who themselves are role models of paying for performance will establish similar programs for all employees. Thus the goals of the organization become part of the job of everyone in that group.
- ▶ Provide a vehicle to discuss the organization's goals and progress in achieving goals. Performance management is a key communications tool when associated with a viable program of paying for performance. The board's role is to coach and facilitate chief executive performance by periodic and objective performance reviews. At this time, performance is evaluated against established goals. When room for improvement is noted, this becomes part of the board's counseling and coaching process to make sure goals are consistently achieved and that performance is recognized and rewarded accordingly.

## Protecting Tax-Exempt Boards and Organizations

Effective governance of the executive compensation program for nonprofits is clearly the answer to resolving the pay-for-performance problem.

Following a normal business-focused process so that compensation varies with the organization's performance based on concrete and pre-established metrics is a key way boards can add value to the organization and protect it and themselves from embarrassment. At a minimum, the process should include the following steps:

- ▶ Select the metrics of organizational performance best reflecting the executive team's responsibilities for the success and future of the organization.
- ▶ Consistently evaluate the executive's performance based on these clearly defined metrics.
- ▶ Develop executive rewards that compensate based on transparent, clearly established and predetermined changes in these metrics. Executives should earn more when the organization meets goals and less when it doesn't. HealthPartners represents an important example of the pitfalls associated with rewarding executives who fall short of predetermined goals. Moreover, the board must stick to these predetermined guidelines.
- ▶ Include regular review of the compensation arrangement to avoid excess-benefit transactions. Particularly, review any contracts that seek to take advantage of the "initial contract exception" to determine whether the contract has been materially modified or enhanced or whether the executive has failed to substantially perform her contractual obligations. If an applicable 501(c)(3) hires a new CEO with no connection to the organization, then the initial compensation arrangement paid to her may not have to satisfy this test. However, the compensation arrangement must be clearly defined and followed; otherwise the organization may run afoul of the regulations later on, should

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there be a material modification to the agreement (e.g., a large bonus paid out contrary to a clearly defined formula).

- ▶ Carefully review the compensation arrangement not only with the executive but also with all board members outside of the committee charged with forming the compensation package. While a subcommittee is allowed to establish the rebuttable presumption of reasonableness per the Treasury Regulations (26 C.F.R. 53.4958-6(c)(1)), each board member should be brought up to speed as to why an executive is being paid what she is being paid.
- ▶ Ensure compensation reasonableness by using data sources that the IRS will accept as appropriate, and include unbiased measures of competitive compensation.

The issue of defining the compensation opportunity is an objective one. It is the platform for paying for executive performance and provides the baseline from which executive compensation is established. Each board, or designated committee, should at

the very least measure compensation reasonableness as follows.

- ▶ Define the competitive market and the market value of the job using a source of information that does not create a conflict of interest and is completely independent of bias or conflict toward organization management and the organization's auditors.
- ▶ Consistently apply the compensation data from the independent source to determine the competitive worth of the executive jobs in question. Make compensation decisions based on unbiased data that can be defended to the state or federal regulator if the compensation arrangement is brought into question.
- ▶ Use an independent "appropriate professional," as defined in 26 C.F.R. 53.4958-1(d)(4)(iii), to recommend compensation levels and systematically follow these recommendations.
- ▶ Have the independent compensation professional compare each facet of executive compensation to the competitive market. Review total compensation, cash compensation, deferred compensation, benefits, perquisites, allowances and all forms of executive compensation to be paid now or in the future. Require the independent compensation professional to provide data that includes at least the following:
  - Compensation levels paid by similarly situated organizations, both taxable and nontaxable, for functionally comparable positions
  - The availability of similar services in the geographic area of the applicable tax-exempt organization and
  - Current compensation surveys compiled by independent firms.

According to 26 C.F.R. 53-4958-6(c)(2)(i), the IRS considers these factors when analyzing comparability data:

- ▶ Whether a reputable firm, having knowledge and expertise in the same industry as the applicable organization, provided the information

- ▶ Whether the firm was independent of both the organization and the executives whose compensation is in question
- ▶ Whether the survey covered the period subject to the IRS examination
- ▶ Whether the organizations surveyed were similar
- ▶ Whether the positions considered in the surveys were comparable and
- ▶ The number of compensation surveys and the number of different organizations the firms included in their surveys.

### Example of Intermediate Sanctions

The IRS recently published a technical advice memoranda (TAM) providing an example of intermediate sanctions penalties imposed on a nonprofit health-care group. It is TAM 200244028. Although TAMs describe only a specific, unidentified taxpayer's situation and cannot be used or cited as precedent, the TAM is certainly informative.

In the situation at issue, the IRS imposed excise tax penalties on the CEO and the wife of a health-care group for the CEO's employment contract and post-employment "consulting agreement." In seeking to establish the rebuttable presumption, the three-step procedure that shifts the burden to the IRS to rebut the probative weight of the comparability data (26 C.F.R 53.4958(6)(b)), the health-care group retained the services of an executive compensation consulting firm and delegated the decision making to the board's personnel committee.

The IRS determined that the personnel committee failed to establish the rebuttable presumption because: (1) the comparability data was analyzed subsequent to the approval of the compensation arrangement; (2) the board minutes failed to reflect the compensation report prepared by the executive compensation consulting firm or other relevant data and (3) the personnel committee failed to establish that it

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possessed particular knowledge or expertise relating to the compensation paid.

The memo's implications are startling with regard to the exacting compliance that the IRS demands with regard to intermediate sanctions. The memo implies that even if a properly delegated board subcommittee properly retains the services of a qualified compensation consultant who properly prepares a timely, comprehensive comparability report, the board may still fail to establish the second step of the rebuttable presumption of reasonableness unless it provides some evidence that it possesses sufficient knowledge and expertise that will render it capable of reasonably assessing the comparability data in question.

Here, the board's assumption regarding pay for performance was made on a "bedrock of sand" rather than of substance. The total compensation was viewed as excessive, and the board came short of establishing a valid method for determining executive compensation.

### Example of Paying for Performance with Reasonable Compensation at a Hospital

The hospital's objective is to pay for performance and pay reasonable compensation. It compensates executives based on a combination of the labor market and performance. With the aid of an outside independent compensation professional, it uses the

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average as its competitive compensation position in the labor market for similar organizations.

Performance metrics and goals cascade from the organization's mission, vision and business plan. Some metrics are qualitative and others are quantitative, but all are documented and measurable. Metrics include patient satisfaction, quality of care, cost management and excess of revenue over expenses. The board evaluates the CEO annually based on goal achievement and also approves new goals on an annual basis.

Base pay adjustments are primarily based on market, provided performance expectations are met and living the organization's values and competencies are demonstrated. Performance is rewarded through a variable pay plan that still provides reasonable compensation if all goals are achieved (average total cash compensation in the labor market) and if stretch goals are all significantly exceeded (around 1 standard deviation above average). This enables pay to vary based on performance without increasing fixed pay costs. Over time, the organization refined its goal-

setting process to ensure alignment of the organization and executives in executive compensation.


### **Conclusions and Suggestions**

What should an organization do to protect itself?

Here are the three critical steps.

- ▶ The compensation committee should be educated on executive compensation and its responsibilities under IRS regulation and, if applicable, state regulation. It should decide on a process for determining executive compensation. Ignorance is no longer an alternative.
- ▶ The organization should require a competitive compensation analysis and written opinion by an appropriate qualified independent professional. Compensation is considered reasonable if the amount paid is what would be ordinarily paid for like services (duties and responsibilities) by like organizations (industry, size, nature) under like circumstances (location). Consideration can be given to the individual's special skills and experience; the particular nature of the individual's duties and nature of the individual; the amount of time the individual devotes to the position; and measurable performance.
- ▶ The compensation committee should make an informed decision on reasonable executive compensation, document the decision adequately and approve it in advance of payment. There should be no conflict of interest. The committee must make a reasonable attempt to ascertain if compensation is excessive and must act if it is aware of an excess-benefit transaction. Silence or inaction is not viable — the board member must dissent on the record regarding excessive compensation.  
This is just exercising good business judgment. It is the job of the board of nonprofits, as it is in all organizations, to establish executive compensation programs that are reasonable, competitive and reward executive performance. The U.S. Congress for one

believes this is not the case in many nonprofits since it passed IRC 4958 and has determined to set this right in both the short and longer term. Where does your executive compensation program stand compared to objective measures of reasonableness under intermediate sanctions? If the IRS challenges your organization's compensation determination, what will it find?

Corporate governance is an important issue. Because of the visible and public nature of many nonprofits, it is important to diagnose your board and organizational liability and vulnerability relative to pay for performance under intermediate sanctions. It may be too late when the IRS is at the door asking questions you are unable to answer. But the timing may be right to review all executive compensation practices as early as practicable. 

## Resources Plus

For more information related to this article:

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- nonprofit and executive compensation.

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