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Rewarding and Retaining Nonprofit Executives through Incentive Plans: Practical and Legal Considerations

By Veronika Bordas and Simon Quint[*]

The use of incentive plans to reward and drive executive performance and to retain strong performers has risen over the past decades. In this article, we highlight current trends as well as practical and legal considerations regarding the use of incentive plans. We discuss the prevalence and function of incentive plans, considerations for establishing and managing plans, applicable legal standards to keep in mind when establishing such plans, and key considerations regarding 457(f) plans (common vehicles for longer-term incentive awards). We then address two related topics that nonprofits often ask about: whether it is appropriate to incorporate financial metrics into incentive plans, and how the recent 2017 tax act's (Pub. L. No. 115-97) 21% excise tax on nonprofit compensation may affect incentive awards.

INCENTIVE PLANS AND THEIR INCREASED PREVALENCE AMONG NONPROFITS

Incentives (used interchangeably with ''bonuses'' in this article) are monetary awards used to reward short- or long-term performance (see ''Overview of Types of Nonprofit Incentive Plans,'' below).

Incentive plans at nonprofit organizations were once uncommon and controversial. In 1988, only 7% of nonprofits had bonus systems, according to a staff writer for The Chronicle of Philanthropy; by 1993, a Hay Group survey reported an uptick to 20%.[1] Today, approximately half of nonprofits have formal bonus or incentive programs in place,[2] which tracks an increase documented in the general marketplace (which also includes for-profit organizations).[3]

However, there is wide variation depending on nonprofit type in both the prevalence and percentage of pay that is at-risk. Trade associations (with §501(c)(6) tax status because of their lobbying functions) and health care nonprofits have the highest prevalence of incentive plans (over 80%). Their board members are often from for-profit organizations, they have generous funding sources, and of all nonprofits, they are more likely to compete with for-profits for talent. Foundations and higher education nonprofits are more conservative with incentives.

Table 1. Prevalence of Executive Incentive Plans by Nonprofit Sector[4]

Prevalence of Executive Incentive Plans by Nonprofit Sector	
Arts & Cultural	30% - 40%
Foundations	30% - 40%
Health Care	> 85%
Higher Education	20% - 30%
Professional Societies	~50%

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[1] Lester A. Picker, *Bonus plan needs goals, inclusion of all employees*, The Baltimore Sun (July 19, 1993).

[2] Quatt's Salary Planning Survey for 2017-18 reports 54% of nonprofits as having formal incentive plans and/or regular spot bonuses for one or more staff levels. According to WorldatWork's 2016 survey, Bonus Programs and Practices, 54% of nonprofit or public sector organizations have spot bonus programs and 48% have retention bonus programs.

[3] According to the WorldatWork survey (p. 6, n. 3), ''the use of bonus programs continues to increase as organizations seek other forms of cash compensation to reward employees.'' In particular, the survey cites a spike in bonuses from 2010 to 2014, with the upward trend continuing.

[4] Prevalence and incentive targets are derived from Quatt's proprietary compensation surveys and from our experience with nonprofit client sectors.

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Trade Associations	> 80%

Among nonprofits that provide incentives, trade associations and health care nonprofits tend to provide the largest incentive, while incentives in foundations and higher education organizations tend to be the most modest. For example, among trade associations, typical incentive targets for CEOs can be 15-35% of base salary and for executives, 10-20%. For foundations, CEOs receiving bonuses are more likely to have targets closer to 5-15% of base salary and for executives, <10% of salary. In general, within each nonprofit sector, incentive level and prevalence are more common for large organizations than small organizations.

Incentives as a Tool to Drive Performance

Incentive plans—if managed properly—can be a powerful tool for an organization to drive individual and organizational performance.

An incentive plan can have the following advantages:

- Motivate and recognize top performance;
- Focus employees' efforts on tasks that further the organization's most important mission or operational goals;
- Serve as retention mechanisms for key talent through long-term incentive vehicles;
- Manage the organization's fixed salary costs through awards that are at risk (which is often dependent not only on individual performance, but also on organizational financial performance);
- Support total remuneration at a higher market level because such higher pay is linked to success factors.

After describing the types of incentive plans in more detail in the next section, we discuss key considerations for assessing whether an incentive plan may be appropriate for a given organization. We also provide practical tips for developing and managing incentive plans.

OVERVIEW OF TYPES OF NONPROFIT INCENTIVE PLANS

An organization may employ one or more of the following incentives (in addition to salary adjustments based on merit) to reward and retain individuals.

Short-term incentives are typically assessed or paid out annually (although they may be more frequent) to reward individual and/or organizational performance. Common types include the following:

- **Spot Bonuses**. Awarded on an ad-hoc basis to reward, for example, outstanding achievement on a particular project; such awards are not a regular part of an individual's compensation. Some organizations may budget separately for spot awards.
- **Formal Incentive Plans.** Have a structure (typically a minimum, target, and/or maximum) for each employee based on individual and/or organizational performance metrics. Such bonuses are a regular part of the employee's compensation package.

Long-term bonuses or deferred payments accrue or pay out over a multi-year timeframe. The following are examples:

- **Future Payout Tied to Short-Term Performance.** Effectively a short-term incentive with a deferred payment. It may serve as a retention mechanism because payout may be contingent on the executive being with the organization when the payment is due.
- **Future Payout Tied to Long-Term Performance.** This is an incentive (or set of incentives) tied to a multi-year performance period or multi-year objective. Such an objective may, for example, be an executive's performance on a multi-year project (e.g., three-year organizational strategic plan) or staying through a contract term. The award may be determined upon completion of the multi-year period as a whole, or may be accrued at interim intervals or milestones measuring progress towards the ultimate goal.

Short-term incentives have an "instant gratification" element and are typically paid out in cash. Long-term incentive plan awards may be paid in cash but, to provide executives with an added tax benefit and to "hold back" the compensation as a part of retaining the executive, are often put in 457(f) plans, which we discuss in more detail in the section titled "Incentive Plan Vehicles: 457(f) Plans."

Short-term incentives are most common among large tax-exempt organizations and trade associations. Outside of the health care sector, future payouts tied to long-term performance are uncommon among nonprofits. When we do see such arrangements, they tend to be for executives in prominent, high-paying nonprofits, designed to retain extraordinary talent or to drive specific high-priority initiatives.

SHOULD YOU ESTABLISH AN INCENTIVE PLAN AND AT WHAT LEVEL?

When deciding whether to establish an incentive plan, ultimately, nonprofits should consider the objectives of the plan, market practice among comparable organizations, the organization's finances and culture, as well as what type of plan and process the Board and senior management can commit to supporting.

Because the considerations for whether to have an incentive plan are similar to the considerations for de-

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termining the award levels, we address both together through a series of questions organizations should ask themselves:

- **Are stakeholders comfortable with at-risk pay and are incentives common in similar organizations?** Some stakeholders continue to believe that bonuses are inappropriate for nonprofits. Others, for example Board members, may be uncomfortable with incentives if incentives are not part of their own compensation plans. Donors—especially for public charities—may perceive their donations as funding bonuses rather than program work. An organization should also consider not just whether, but how much at-risk pay stakeholders are comfortable with.

- **Can you defend bonuses to the public and other staff?** Acknowledge that bonus payments may be made public. Eventually, compensation for highly-paid executives will be publicly available on the organization's IRS Form 990s.

- **Can you defend compensation levels against relevant legal standards?** Ensure that total compensation, including any bonuses, will be defensible if the incentive plan pays out at maximum for each participant (see discussion of legal standards in the section titled ''Implications of Applicable Legal Standards,'' below).

- **Does an incentive plan align with your compensation philosophy?** Consider how an incentive plan (and what levels) will fit within your compensation philosophy. Incentive amounts will need to be large enough to be meaningful to influence behaviors.

- **Will incentives support your desired culture?** Consider the impact of introducing an incentive plan on the organization's culture and gauge employee comfort with the ultimate plan design and whether employees will perceive the plan as a positive. Some employees may not like the introduction of an ''at-risk'' element to their compensation, especially if they believe their compensation may decrease.

- **Have you fully vetted the plan prior to implementation?** Commit to fully vetting the incentive plan before implementation, and to an annual process once implemented. Ill-conceived or mismanaged incentive plans can lead to perceptions of unfair bonus awards or of automatic awards (which do not proportionately reward performance).

- **Do you have the resources to manage the plan effectively?** Be aware of the administrative costs of managing an incentive plan. Incentive plans require human resources time to maintain (effective, customized goal-setting and performance tracking, staff communications, etc.); other plans, such as 457(f) plans, may cost the organization money through fees to external accounting or legal firms to set up and maintain.

Considerations for Establishing and Administering a New Incentive Plan

If your organization has decided it wants an incentive plan, it should consider the following steps before implementation:

Determine Plan Objectives. Successful plans are tailored to the organization's needs—the needs drive the structure of the incentive plan. For example, if the goal is to reinforce and reward teamwork and collaboration, the incentive plan should not be based entirely on the accomplishment of individual goals. Objectives can include: Focusing employees on key annual goals; retaining top performers; following the practice of similar organizations in having an incentive structure; or, making pay more defensible by tying it to performance goals.

Determine Plan Participants. Should only the CEO be eligible for the incentive plan? Executives only? All staff?

Determine Incentive Opportunity/Award Levels. If multiple levels of employees will be eligible for the incentive plan, the incentive opportunity (typically, a percentage of salary) needs to be determined for each position level. Here are some considerations, in addition to those noted in the previous section:

- The opportunity may be tiered by level (most common), with positions at higher levels eligible for higher incentive opportunities, or all participants may have the same bonus opportunity.

- A good plan will have a defined incentive range—a threshold and maximum opportunity, with a target in between. For example, a CEO's bonus target may be 20% of base salary, with a threshold of 10% and a maximum of 30%. The minimum is typically 0%, because most organizations do not guarantee a bonus.

- Defined incentives are crucial because they align expectations for the incentive recipients and those determining the award. In addition, maximums can help curb large bonus determinations that may run up against applicable legal standards (i.e., will you be able to defend compensation if the plan pays out at maximum?).

- Often, plan payouts are contingent on the organization meeting certain financial or strategic metrics, in addition to the individual meeting established minimum levels of performance. If the organizational financial or strategic goals are not met, then the incentive plan may not pay out at all

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or may be scaled back. This mechanism helps to ensure that payouts are reasonable to external stakeholders (e.g., no full payouts if the organization has a "bad year") and also supports the incentive plan's affordability.

With respect to the mechanics of the plan, the organization should:

- Tie goals to achievable metrics and review them regularly to ensure that they further the organization's strategic priorities.
- Document performance for each pre-defined metric as well as the bonus decision.
- Make the process transparent and communicate it clearly to ensure that it is understood by participants. We often advise nonprofits with incentive plans to provide regular refreshers to all staff, especially when hiring many new employees.
- Consider the vehicle(s) that will be used for the incentive plan (e.g., cash payout or 457 plan, described further in the section titled "Incentive Plan Vehicles: 457 Plans" below)

Implications of Applicable Legal Standards in Establishing Incentive Plans

There are primarily three largely overlapping legal standards that apply to nonprofit compensation—the private inurement doctrine, the rules against self-dealing, and the intermediate sanctions regulations. One or more may apply to a particular nonprofit depending on organization type, but nearly all nonprofits are covered by at least one. Here, we focus primarily on the implications of these standards for incentive plans, rather than on the details of the standards.[5]

Overall, the goal of each legal standard is to ensure that compensation paid to a nonprofit employee is "reasonable"—that is, proportionate to the benefit the organization receives from the employee.

Total remuneration as measure of reasonableness of pay. Ultimately, total remuneration (base salary, all bonuses, and non-cash compensation including benefits, retirement contributions, and perquisites) determines the competitiveness of an individual's compensation relative to the market as well as whether compensation is "reasonable." How the organization allocates base salary versus bonus or deferred compensation is less important than the total amount that the executive may be paid, reinforcing the importance of having a maximum or cap for an incentive plan to ensure that total remuneration, including payout at plan maximum, will be reasonable.

Prorating incentive plans with future payout tied to long-term performance and optics of such plans. Because such plans award an amount for performance over more than one year, for purposes of determining reasonableness of compensation, such a payment can be prorated over the length of the performance period. For example, if a three-year incentive plan pays out $150,000 in 2020 for performance in 2018-2020, to assess the reasonableness of an executive's total remuneration in 2020, it is reasonable to count $50,000 towards the executive's compensation that year (one-third of the three-year plan payout amount).

Nonetheless, the organization should consider the optics of a large payout, even if it is for performance over multiple years. Given the nonprofit's mandatory IRS Form 990 reporting requirements, the compensation amounts will eventually be made public for officers, key employees, and other highly-paid employees.[6] Incentive awards bridging multiple years in accrual/payment are typically reported both in years during which the incentive is accrued, as well as one large amount when paid. The organization should consider the optics of such payouts because donors, the media, the general public, or other stakeholders who may not understand the reporting intricacies of long-term plans can readily access the Form 990 within a year or two after its filing. Board members as well as the organization's communications team should be prepared with talking points if a Form 990 is about to be published with a large multi-year payout that may raise questions.

Incentive Plan Vehicles: 457(f) Plans

A 457(f) plan is a common vehicle for long-term incentives. Contributions to a 457(f) plan on behalf of the recipient, rather than as cash, can provide the executive and the organization with tax savings, and can also help retain the executive through the delayed payment of awards.

Key features 457(f) plans:

- No annual limit on contributions.
- Tax-deferred as long as the employee faces a legally defined substantial risk of forfeiture, which generally takes the form of a vesting schedule. The entire accumulated sum is paid out and taxed at vesting; should the executive leave before vesting, all amounts are forfeited.
- Payments must also be reported on the annual IRS Form 990 twice—when accrued, and when the payment vests. Organizations will footnote the

[5] For more details, see Brian H. Vogel, James F. Wynn II, and Veronika Bordas, *A 'Reasonable' Investment – Compensating Executives within Legal Bounds*, Taxation of Exempts (September/October 2015).

[6] For more on which employees' compensation must be reported on Form 990s as well as detailed reporting rules, see "Part VII. Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors" starting on page 26 of the draft instructions for completing the 2018 IRS Form 990.

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payments to explain the double-counting.[7] Still, the optics issues cited previously remain.

- Legally belong to the organization and are subject to the claims of creditors. Therefore, the organization has the option of explicitly funding the 457(f) plan, or simply promising to pay the amounts at some point in the future.

To ensure that the plan meets the substantial risk of forfeiture requirements and to navigate logistical complexities, the organization should consult with legal counsel and accountants when establishing a 457(f) plan.

We note that 457(f) plans are distinct from 457(b) plans, which supplement qualified retirement plan contributions and are limited to $19,000 in tax deferral per employee in 2019 ($18,500 in 2018). Also, 457(b) plans are not contingent on a substantial risk of forfeiture.[8]

Special Considerations for Nonprofit Incentive Plans: Incorporating Financial Metrics

We are often asked by nonprofits whether it is appropriate to determine incentives based on financial metrics. For example, can a Chief Development Officer's incentive be based primarily on the incumbent raising a certain amount of money in a given year?

While there is little formal IRS guidance on the matter, it is best to avoid a commission structure for an incentive (that is, where an incentive determination is directly linked to a percentage of contributions the individual raises). In a position paper, the Association of Fundraising Professionals (AFP) ''prohibits members from working for percentage-based compensation'' because the ''charitable mission can become secondary to self-gain'' and ''there is incentive for self-dealing to prevail over donors' best interests'' (which would violate one or more of the legal standards applicable to nonprofits).[9]

As an additional point that applies to our earlier discussion of how incentives should be structured to reward performance, the AFP position paper notes that ''percentage-based compensation can provide reward without merit'' because ''contributions that materialize at a given moment are often the culmination of the efforts of many people. . .over long periods of time.'' Having a commission structure can also unintentionally motivate the employee to act against the organization's best interest in other ways, such as by damaging donor relations ''in reaction to undue pressure and the awareness that a commission will be paid to a fundraiser.''

The takeaway is that financial metrics are permissible as part of the incentive determination but should not be the primary measure. In addition, the amount of incentive that can be earned based on financial metrics should be capped both to avoid commission structure and to ensure that the maximum potential compensation for the employee remains reasonable under the applicable legal standards.

Special Considerations for Nonprofit Incentive Plans: The 2017 Tax Act's 21% Excise Tax

Another important consideration when establishing an incentive plan for executives is the potential implications of the 2017 tax act, as it relates to nonprofit compensation. The 2017 tax act imposes a 21% excise tax on compensation paid by a tax-exempt organization in excess of $1 million to any covered employee for tax years beginning after December 31, 2017.[10] The tax applies to all compensation, with a few exceptions such as Roth elective deferrals, but does include 457(f) deferred compensation, including any amounts vested, even if not yet received.[11] This provision applies in any given year to current and former employees who are among the five highest paid for the taxable year, or were covered employees for any preceding taxable years beginning after December 31, 2016 (even if no longer among the five highest paid in a later year).[12]

The organization should review expected total compensation for all employees each year to see for which, if any, employees' compensation it will have to pay the excise tax, because the organization—rather than the employee—is liable for the tax. It should also consider whether any new employees are among the five highest paid. The list of covered employees under the 2017 tax act is cumulative, meaning that once an employee is covered, that employee will be covered in future years as well, so the organization may potentially be liable to pay the excise tax on more than five employees.

The organization should also be mindful of the fact that the 2017 tax act excise tax will apply to compensation paid or vested in a calendar year for an individual. For this reason, the timing of bonus vesting/payment may be important—even for short-term bonuses. If vesting/payment is timed so that it falls in a year when an executive's compensation is less, the organization's tax burden may be reduced.

As a related note, although single bonus payments tied to performance over multiple years may be prorated when determining the reasonableness of compensation for an executive in a given year (as described above in the section titled ''Implications of Applicable Legal Standards''), the excise payment applies to amounts paid out in a given year that are above $1 million—regardless of whether parts of the compensation package were earned in different calen-

[7] *See* IRS, Instructions for Schedule J (Form 990) (2017).

[8] Notice 2018-83.

[9] AFP, *Position Paper: Percentage Based Compensation* (1992).

[10] §4960, added by 2017 tax act, §13602.

[11] §4960(c)(3).

[12] §4960(c)(2).

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dar years. Hence, the organization should also weigh whether and how the excise tax may be triggered when timing incentive payments.

CONCLUSION

Nonprofits have increasingly turned to incentive plans to reward, motivate, and retain key talent, and to drive the accomplishment of key organizational priorities. While there are various legal and practical considerations as we have described in this article that a nonprofit should keep in mind when establishing and managing an incentive plan, a well-managed plan can be a powerful tool to energize and focus employees on organizational performance.

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