

Intermediate Sanctions and The New IRS Form 990: *HR's Role in Executive Compensation*

InsideNGO

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“Intermediate Sanctions” Legislation

Section 4958 of the Internal Revenue Code:

- Addresses “excess benefit transactions” for non-profit and association executives in 501(c)3’s and 501(c) 4’s
- Requires reporting of compensation to officers and key executives known as “disqualified persons”
- Establishes “intermediate sanctions” penalties for excessive compensation
- Provides guidelines for “rebuttable presumption” defense
 - Board approves transaction in advance
 - Board relies on appropriate data with respect to comparability
 - Board documents basis for decision
 - Board relies on reasoned opinion of professionals

Definition of Key Employee

- “Key Employee” meets all three of following tests:
 - Has responsibilities, powers or influence over the organization as a whole, similar to officer, director or trustee;
 - Manages a discrete segment or activity representing **10%** or more of the organization’s activities, assets, income or expenses; and
 - Has authority to control or determine **10%** or more of capital expenditures, operating budget or compensation for employees.

“Independent” Members

- Governing Board - No conflicts of interest
 - Family Relationship
 - Business Relationship

- Compensation Committee - “Arm’s Length” Relationship
 - No family members
 - No persons who have a material financial interest affected by the decision
 - No persons in an employment relationship subject to direction or control of the disqualified person
 - No persons who receive compensation or other payment subject to approval of the disqualified person
 - No persons who have a reciprocal arrangement with the disqualified person

“Comparability Data”

- Benchmarking of executive positions to determine their comparability with market norms to substantiate “reasonableness”
- Verify role, responsibilities and qualifications of executive relative to market-comparable positions
- Market “norms” established on basis of
 - Geographic location
 - Organization type
 - Revenue size (1/2x to 2x)
- Data sources
 - Published salary surveys
 - IRS Forms 990 for peers
 - Consultant client database

Total Compensation Comparison

- IS regulations require look at all elements of compensation:
 - Base salary
 - Incentive or bonus pay
 - Standard ERISA-qualified health/welfare plans
 - Standard ERISA-qualified retirement plan(s)
 - Non-qualified supplemental plans
 - Taxable allowances
 - Non-taxable allowances reportable if they exceed \$10,000
 - Other benefits and perquisites
- Statutory benefits **not** reportable

“Contemporaneous” Substantiation

- Actions taken within 60 days of decision.
- Provide summary of discussion with reference to materials on which decisions are based. If necessary, append copies of materials.
- Include sufficient information to allow Board to make informed decision consistent with its role as “organizational manager”.

Why a New 990?

- Last redesigned in 1979 – **before** Intermediate Sanctions legislation
- Intended to:
 - Promote transparency
 - Assure compliance
 - Strengthen governance

How New 990 Promotes Compliance

- Verifies that processes are in place to assure regular review of compensation of CEO, officers and key employees
- Establishes steps to be included in compensation review process
- Requires reporting of compensation for:
 - Directors, officers and trustees
 - All key employees (up to 20) earning more than \$150,000 in reportable compensation
 - Top five highest paid employees receiving more than \$100,000
 - Former officers, key employees or highest-compensated employees who received more than \$100,000 in current tax year
 - Former directors and trustees who received more than \$10,000

Sections of 990 Affecting Comp Practices

- Part VI – Governance, Management, and Disclosure
 - Section A. Governing Body and Management
 - 1b. # of voting members that are “independent”
 - 8 a and b. “Contemporaneous” documentation by governing body and “each committee with authority to act on behalf of the governing body”
 - Section B. Policies
 - 15. Process for determining compensation including review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision
- Part VII – Compensation Reporting
 - Section A – aggregates compensation received from the organization and related organizations
- Schedule J
 - Part II – More detailed breakdown of elements of compensation and reporting of compensation from prior filing.

Why a Separate Compensation Committee?

- Specific responsibility for safeguarding the organization in relation to compensation-related issues
- Smaller subset of board or Executive Committee eases scheduling and promotes focused discussion

Compensation Committee:

Typical Responsibilities

- Establish the overall compensation philosophy for the organization
 - Relation of base salaries and total compensation to market
 - Components of total compensation (benefits, perquisites, etc.)
 - Currently, “to provide compensation that is competitive, yet judicious, in relation to stakeholder expectations and available financial resources”.
- Establish organizational and individual performance goals and measures for the chief executive officer.
- Review the performance of the chief executive officer and recommend any compensation changes.
- Oversee all aspects of compensation provided to other executives to ensure compliance with intermediate sanctions provisions of the Internal Revenue Code.
- Prepare regular reports disclosing Committee actions and recommendations to the full Board of Directors.

Compensation Committee:

Compensation Philosophy

- Important to proactively establish a philosophy and strategy that supports recruitment and retention of staff and executive talent and promotes consistency in pay decision-making.
- Determine basis for comparisons to the market:
 - Geographic
 - Budget/revenue
 - Organization type
- Where to set salary ranges relative to the market:
 - Review issues of recruitment, turnover and retention
 - Identify specialized skills that may influence pay decisions
- Components and mix of the compensation package:
 - Benefits/perquisites
 - Incentive/bonus pay
 - Supplemental executive benefits and perquisites
- Determine if philosophy is applied consistently to all staff, or if there are differences between levels.

Compensation Committee:

Role in Relation to Executives' Compensation

- **Reviews and approves** compensation package provided to Chief Executive Officer to ensure base salary and total compensation meet standard of “reasonableness” under Intermediate Sanctions, in accordance with role as “organization managers”.
- Compensation Committee **reviews and monitors** actions proposed by Chief Executive Officer for his/her direct reports:
 - **“Monitor”** = assess aggregate information regarding proposed increases and additional cash compensation relative to market norms; assess how supplemental executive benefits or perquisites compare to those provided in the competitive market.

Questions?

- For further information, please contact:

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