States Beginning to Limit Nonprofit Executive Compensation

In response to several high profile cases of questionable pay practices within not-for-profit organizations, Congress in 1996 enacted Internal Revenue Code (IRC) Section 4958—(aka “Intermediate Sanctions”) making executives and board members of these organizations subject to tax penalties “excess benefit transactions.”

Then, six years later, the Internal Revenue Service (IRS) issued landmark regulations under Internal Revenue Code (IRC) Section 4958. The Service’s intent was to bring greater governance and processes to the design of nonprofit executives’ pay. To bring more clarity to the total compensation of nonprofit executives, the IRS revised Form 990 three years ago. The revised form required additional schedules and tables plus governance questions having the nonprofit organization describe the process of how the board determined executives’ compensation. The new Form 990 highlighted the total compensation earned by nonprofit executives including base salary, annual incentives, qualified and nonqualified deferred compensation, contributions, perquisites, and any other type of compensation elements earned by the executive. The enhanced disclosure of the Form has allowed donors, the general public, employees, the press, and peer nonprofit organizations to closely scrutinize executives’ compensation.

More recently, these compensation disclosures have created adverse publicity for some organizations as selected nonprofit executives’ compensation exceeds the general public’s expectation. This, in combination with the government’s limited ability to fund nonprofit organizations because of the current economic headwinds, has led to a closer review of nonprofit executive compensation practices by various legislators and government agencies.

Earlier this year, New York became the first state to require limits on executives’ pay for New York charities that receive greater than $500,000 in state support each year and at least 30% of their annual funding from the state. The compensation limitation is $199,000 and failure to comply can result in various penalties from reduced state funding to revocation of nonprofit status. The rules were passed on May 16, 2012, and were subject to review and comment for a 45-day period starting May 30. This law becomes effective January 1, 2013.

Following the lead of New York, several states are proposing similar statutes. Florida, Illinois, Massachusetts, and New Jersey have or are planning to propose legislation that limits executive pay for nonprofit organizations that receive state funding. The compensation limitations vary and the legislation differs on how to enforce the pay limits. It is clear that nonprofit compensation will continue to be controversial and subject to increased public scrutiny.

Compensation Limits: New York

As stated above, the compensation limit for New York nonprofit executives is limited to $199,000. If executives are earning amounts greater than $199,000, the nonprofit must use other sources of revenue (non-New York State funds) to compensate the executive. However, the organization must not pay the executive an amount greater than the 75th percentile of compensation paid to comparable executives of like organizations as determined by survey data approved by the relevant state agency and Division of the Budget. The agencies have yet to clarify what surveys will be utilized. In addition, the executive’s compensation must be approved by the service provider’s board of director’s including at least two independent directors.
Covered Executives

Any director, trustee, managing partner, or officer of a covered nonprofit or any employee who earns greater than $199,000 during the reporting period.

Compensation Includes

- Regulations apply to “total compensation” that is an administrative expense. Note the New York’s definition of “total compensation” is not the same “total compensation” amount that is reported on IRS Form 990.
- It is intended that any payment or benefits (direct or indirect) to a covered executive will be deemed compensation. This includes wages, bonuses, dividends, housing, discriminatory health insurance premiums, meals, vehicles, travel, entertainment, pension contributions, etc.
- Nondiscriminatory health insurance premiums and mandated benefits such as Social Security benefits, worker’s compensation, and unemployment and disability insurance are excluded.

Reporting

The organization will report annually, using electronic filings, the annual public funds it has received from New York, the total compensation of its covered executives and other highest-paid employees.

Waiver

An organization can apply for a waiver from these rules if it can show good cause. Factors noted in the proposed regulations that will be evaluated by the agencies when reviewing a waiver request include:

- Nature, size, and complexity of the organization’s operations;
- Impact on program services of the waiver is not granted;
- Efforts to hire a comparable executive at a reduced compensation level;
- Ability to fund the “excess” compensation for non-New York State sources;
- The executive’s compensation as compared to the total compensation of comparable executives of like organizations; and
- The organization’s compensation processes and procedures.

Penalties for Noncompliance

If an organization receives notice of noncompliance, they are allowed to cure the infraction.

- Upon receipt of a noncompliance notice, the organization has 15 days to submit a corrective action plan to the appropriate agency.
- In addition, the organization will be granted a deadline by the agency of at least six months to correct the problem.

Failure to cure can result in the state imposing the following sanctions:

- Redirection/reduction of state funding;
- Revocation or suspension of state contracts;
- Revocation or suspension of state licenses; and
- Any other lawful action or penalty deemed appropriate in the sole discretion by the state.

**Going Forward**

New York organizations subject to these rules should immediately review the total compensation paid to its covered employees. If any executive's pay exceeds $199,000, the organization and board of directors should begin to prepare for the new rules:

- Use other funding sources for compensation in excess of $199,000;
- Provide and review survey data to ensure the executive does not exceed the 75th percentile of comparable executives in like organizations; and
- Document all findings and procedures completed to comply with the rules.

The scrutiny and restrictions on executive compensation for New York nonprofits will be unparalleled beginning in 2013. Organizations and all of their related entities need to be prepared for the implementation of these rules. Relevant survey data and the proper interpretation of that data will be critical for the organization to justify executive pay. Organizations are already struggling to find the resources to comply with IRS compensation and governance rules; this is just another burden for organizations whose funds are limited and budgets stretched.

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Aon Hewitt is a leader in advising nonprofit boards in designing executive compensation. In addition, Aon Hewitt is the leading provider of compensation data for profit and nonprofit organizations in the world. Our governance and compensation experts can help your organization prepare for the new regulations effective January 1, 2013. Non-New York organizations should continue to review their compensation and governance practices and be prepared for additional state regulations. For more information, visit [http://www.aonhewitt.com](http://www.aonhewitt.com).