DISCUSSION TOPICS

• Legal Framework
• Objectives and Design
• Goal Selection and Target Setting
**APPLICABLE FEDERAL TAX RULES**

- **Two sets of rules**
- **Section 501(c)(3) and (c)(4): prohibition against private inurement**
  - Private inurement includes payment of excessive compensation to “insiders”
  - Result: revocation of tax-exempt status of organization
- **Section 4958: excess benefit transactions**
  - Excess benefit transactions include excessive compensation to “disqualified persons”
  - Result: DP must pay back excessive amount and 25% excise tax; organization managers, e.g., directors and trustees may be subject to 10% excise tax if knowingly approve excess benefit transaction
INTERSECTION OF PRIVATE INUREMENT AND EXCESS BENEFIT TRANSACTIONS

- **Revenue sharing arrangements**
  - **Definition:** compensation depends in whole or in part on revenues of one or more activities of organization
  - **EBT includes any revenue sharing transaction:**
    - To extent provided in Treasury regulations;
    - But only if such transaction results in private inurement.
  - **Excess benefit is amount of inurement not permitted.**
- **IRC § 4958(c)(4).**
INTERSECTION OF PRIVATE INUREMENT AND EXCESS BENEFIT TRANSACTIONS (CONT’D)

• Final 4958 regulations
  • Reserved section for revenue sharing arrangements
  • Provide general valuation rules apply to all transactions including revenue sharing transactions
  • Is any revenue sharing arrangement permissible if reasonable in amount?
  • Preamble to final regulations states
    • Inurement may exist even though DP receives reasonable amount
    • Most situations that constitute inurement will also exceed reasonable compensation
When is reasonable compensation private inurement?

Treas. Reg. § 1.501(c)(3)-1(f): Service may revoke exempt status in case of EBT

Relevant factors:

1. The size and scope of exempt activities;
2. The size and scope of EBT(s) in relation to the size and scope of the organization’s exempt activities;
3. Multiple EBTs with one or more DPs vs. isolated EBT;
4. Implementation of safeguards to prevent EBTs; and
5. Whether EBT corrected; whether EO has made good faith efforts to seek correction from DP.
When is reasonable compensation private inurement?

General Information Letter 2002-21: Factors

- Reasonableness of total compensation
- Arms’ length bargaining
- Independent governing body
- Comparables
- Ceiling or cap on amount of compensation
- Furthering exempt purposes
- Real and discernable business purpose
- Reward based on performance
- Arrangement not a joint venture
- Not a device to distribute all or a portion of profits to persons in control of EO
- Arrangement does not have potential to reduce charitable services or benefits that organization would otherwise provide
- In operation plan does not result in abuse or unwarranted benefits
EXCESS BENEFIT TRANSACTIONS: TIMING OF REASONABLE DETERMINATION

- Fixed payment
  - Facts and circumstances as of date of employee’s contract
- Non-fixed payments
  - Facts and circumstances up to date of payments
- Treas. Reg. § 53.4958-4(b)(2)
EXCESS BENEFIT TRANSACTIONS:
TIMING OF REASONABLE DETERMINATION

- **What is a fixed payment?**
  - Amount of cash or other property specified in contract; or
  - Determined by fixed formula
    - May incorporate amount that depends upon future specified events or contingencies
    - As long as no person has discretion over making payment or the amount of payment
  - May be subject to a substantial risk of forfeiture
  - Examples:
    - 2% of subscription sales for theatre over $100x;
    - Stock option in taxable subsidiary?

- **What is a non-fixed payment?**
  - Any payment that is not a fixed payment
  - Example:
    - Board determines bonus up to $50,000 based on its evaluation of executive’s performance
LONG-TERM INCENTIVE COMPENSATION PLANS

• Complex rules apply under Sections 409A and 457(f); consult benefits counsel

• Section 409A
  • Applies to certain non-qualified deferred compensation plans, often with very harsh tax results for non-compliance
  • Deferred compensation generally means compensation paid in a year later than it is earned
    • Exception: compensation paid within 2-1/2 months after end of year in which no longer subject to substantial risk of forfeiture (so called “short-term deferral” exception)
  • Most long-term incentive plans can be structured to meet the short-term deferral exception from Section 409A (e.g., by requiring employment on the date plan payments are made)

• Interplay between Section 409A and Section 457(f) regimes can be confusing (hopefully clarified by upcoming Section 457(f) regulations)
• If 409A applies
  • Payments may only be made within a short time after narrowly defined events (such as termination of employment, death or disability)
  • Participants cannot accelerate receipt of benefits
• Penalties for failure to comply
  • Participant taxable on all prior deferrals retroactive to the date of deferral with interest and penalties
  • Additional 20% penalty on the amount included
• Beware
  • 409A has its own definition of substantial risk of forfeiture
SUMMARY OF LEGAL PRINCIPLES

• Section 4958 tends to be dominant but private inurement doctrine cannot be ignored
• General Information Letter 2002-21 factors provides good guide for private inurement considerations:
  • Cap
  • No discretion as to amount or payment
  • Business purpose; furthers exempt purposes
  • Payment dependent on individual’s performance, not organizational performance alone
  • Based on revenue, not profits
OBJECTIVES AND DESIGN
# Typical Purpose of Each Compensation Element

<table>
<thead>
<tr>
<th>Compensation Element</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Salary</td>
<td>Reward for performance of daily activities set at appropriate levels to attract, retain and motivate</td>
</tr>
<tr>
<td>Annual Incentive Plan</td>
<td>Reward for achieving defined objectives that align with the organization’s mission, designed to attract candidates but later for motivational and some retention effect</td>
</tr>
<tr>
<td>Long-Term Incentive Plan</td>
<td>Reward for performance over an extended period (more than one year, often three plus years) depending on design, can focus on motivation, retention or a combination of motivation and retention. Having a plan can enhance the attractiveness of the organization</td>
</tr>
<tr>
<td>Benefits</td>
<td>Provides a level of security by supporting the health and welfare of employees and helping to provide for retirement</td>
</tr>
</tbody>
</table>
# Main Objectives for Incentive Plans

<table>
<thead>
<tr>
<th>Alignment</th>
<th>Attraction/Retention</th>
<th>Line-of-Sight</th>
</tr>
</thead>
</table>
| - Compensation that is directly aligned with stakeholder value creation  
- Allow participants to share in the successes and failures of the organization  
- Encourage desired behaviors | - Provide competitive total compensation opportunities  
- Provide compensation that the participant perceives as having value  
- Provide greater flexibility to substantially reward “star” performers  
- Complement other reward programs (salary, learning and development, work environment) to attract and retain key employees | - A clear path between the company’s strategic objectives and the ability for the participant to play a role in achieving them  
- Extent to which participants perceive that the performance metrics that determine pay outcomes are within their control to influence |
# AIP Design Elements

<table>
<thead>
<tr>
<th>Elements</th>
<th>Common Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan Type</td>
<td>Should plan reward individual performance or organization-wide performance only?</td>
</tr>
<tr>
<td></td>
<td>Should there be more than one plan?</td>
</tr>
<tr>
<td>Eligibility</td>
<td>Who should be included in this plan?</td>
</tr>
<tr>
<td></td>
<td>What are the competitiveness considerations and cost constraints?</td>
</tr>
<tr>
<td>Target Bonus Opportunities</td>
<td>Are current target awards competitive? Where is the company targeting its target total cash philosophy? What is its pay mix philosophy?</td>
</tr>
<tr>
<td>Performance Measures</td>
<td>What behaviors should the incentive plan drive?</td>
</tr>
<tr>
<td></td>
<td>How do these measures complement the overall business?</td>
</tr>
<tr>
<td>Measurement Levels &amp; Weights</td>
<td>At what levels should performance be measured?</td>
</tr>
<tr>
<td></td>
<td>How should these factors be combined for different employee groups?</td>
</tr>
<tr>
<td>Goal Setting</td>
<td>At what levels should performance be measured?</td>
</tr>
<tr>
<td></td>
<td>How should these factors be combined for different employee groups?</td>
</tr>
<tr>
<td>Performance &amp; Payout Standards</td>
<td>What’s a reasonable range of expected performance?</td>
</tr>
<tr>
<td></td>
<td>What are appropriate award levels to associate with that range?</td>
</tr>
<tr>
<td>Funding</td>
<td>Should the plan be funded through financial performance or through a qualitative approach?</td>
</tr>
</tbody>
</table>
## ANNUAL INCENTIVE PLAN TYPES

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organization-wide</td>
<td>Funding and performance measure(s) are organization-wide, employee payout determined by proportional share of incentive pool (e.g., profit sharing plans)</td>
</tr>
<tr>
<td>Tiered Incentive</td>
<td>Several performance tiers used to measure organization, business unit/team and/or individual performance</td>
</tr>
<tr>
<td>Individual Incentive</td>
<td>Payouts based only on individual’s performance against goals</td>
</tr>
<tr>
<td>Team Incentive</td>
<td>Payouts for ongoing, established teams based on performance against team goals</td>
</tr>
<tr>
<td>Project Incentive</td>
<td>Payouts based on performance against project-specific goals within a finite time frame</td>
</tr>
<tr>
<td>Gain Sharing</td>
<td>Self-funded plan shares a percentage of savings or earnings generated</td>
</tr>
</tbody>
</table>

- Senior management oriented incentive plans are most typically tiered incentives
### ANNUAL INCENTIVE DESIGN

#### TIERED FRAMEWORK

<table>
<thead>
<tr>
<th>Element</th>
<th>Design Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target Award</strong></td>
<td>• 30% of base salary</td>
</tr>
</tbody>
</table>
| **Performance Measures and Weights** | A. Organization Goals  
  • Mission/Milestone-based Goals (40% weighting)  
  • Financial-based Goals (40% weighting)  
  B. Individual Goals  
  • Individual/Strategic Goals (20% weighting)  
  • 2 to 3 value-added goals  
  • Incorporate strategic/mission measures  
  • Goals need to be scalable (i.e., need to identify threshold, target and maximum levels of performance) |
| **Award Payout Range**       | **Performance Level:** | **Threshold** | **Target** | **Maximum** |
|                              | Payout Level:          | 50% of Target | 100% of Target | 150% of Target |
|                              | Use straight-line interpolation to determine payouts between performance levels  
                              | For example, if performance falls midway between target and maximum, the payout would equal 125% of target |
**LONG-TERM INCENTIVE PLAN DESIGN**  
**GOALS AND TARGET PAYOUTS**

<table>
<thead>
<tr>
<th>Financial trigger</th>
<th>• The LTIP will have a financial trigger and/or operational trigger (measure(s) TBD); the specific trigger(s) to be approved by the Committee; if the financial trigger is not met, participants will not be eligible for awards.</th>
</tr>
</thead>
</table>
| Goals and relative weights are established | • No more than 3-5 goals should be established.  
• No more than 50% of the award should be based on financial goals.  
• Goals need to be measurable and long-term in nature.  
• Weighting of each goal should be no less than 15% each. |
| Performance goals | • Goals could include: student satisfaction, staff retention, academic quality, and financial goals.  
• A list of potential goals is included in the Appendix. |
| Performance targets are set | • Similar to the Annual Incentive Plan, goals need to be calibrated based on difficulty to achieve.  
• Setting of 3-year goals can be extremely challenging and typically we would see a wider range of performance than in the Annual Incentive Plan. |
| Target opportunity established for each participant | • Based on the initial competitive market assessment, consider an opportunity level of 30%-40% of base salary. Opportunity level will be calculated based on annual base salary for each year of the plan and updated to reflect market assessment.  
• We do not see a compelling reason to provide different levels of awards for each executive. |
LONG-TERM INCENTIVE PLAN DESIGN
FRAMEWORK A

<table>
<thead>
<tr>
<th>Framework A: Annual Incentive Plan Deferral</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uses Annual Incentive Plan with deferral (e.g. 2-3 years).</td>
<td>Leverages existing plan structures and measures and does not require forecasting over multiple years.</td>
</tr>
<tr>
<td></td>
<td>Provides ongoing incentive opportunity and aids retention.</td>
</tr>
<tr>
<td></td>
<td>Annual Incentive Plan measures are likely to be short-term in nature.</td>
</tr>
<tr>
<td></td>
<td>May require 990 reporting both in year of accrual and year of payout.</td>
</tr>
<tr>
<td></td>
<td>Deferral must be compliant with IRC Section 409A (e.g. fixed payout schedule).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Award Cycle 1</td>
<td>Performance Period</td>
<td>Deferral Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award Cycle 2</td>
<td>Performance Period</td>
<td>Deferral Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award Cycle 3</td>
<td>Performance Period</td>
<td>Deferral Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# Long-Term Incentive Plan Design

## Framework B: Overlapping Performance Cycles

<table>
<thead>
<tr>
<th>Description</th>
<th>Overlapping performance cycles with three-year performance periods.</th>
</tr>
</thead>
</table>
| Implications | Provides ongoing incentive opportunity and aids retention.  
|             | Focuses on long-term mission alignment and achievement.  
|             | Goals can be recalibrated with each new cycle; however this design requires setting of 3-year performance goals annually.  
|             | Multiple cycles operating simultaneously can be confusing if targets change year-to-year.  
|             | Payouts should occur within two and a half months of vesting in order to qualify for the short-term deferral exemption under IRC Section 409A.  
|             | May simplify 990 reporting if not considered deferred compensation for 990 purposes. |

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Award Cycle 1</td>
<td>Performance Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award Cycle 2</td>
<td>Performance Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award Cycle 3</td>
<td>Performance Period</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
For Form 990 purposes, deferred compensation is compensation earned or accrued in one year and deferred to a future year, regardless of whether it is funded, vested, or subject to substantial risk of forfeiture (including earned but unpaid incentive compensation).

Our understanding of the general requirements is summarized below; specifics will depend on final design and should be confirmed with legal and tax counsel.

<table>
<thead>
<tr>
<th>Incentive compensation is taxable and paid in same year</th>
<th>Report on Core Form, Part VII, Section A, column (D) or (E) and Schedule J, Part II, column B(ii)</th>
<th>Report on Core Form, Part VII, Section A, column (F) and Schedule J, Part II, column C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year in which performance and payment is made</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Compensation is accrued or attributable to one year (e.g. performance criteria has been satisfied) but payout is deferred (e.g. payment in installments)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year in which performance criteria is satisfied</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Year in which incentive compensation is paid</td>
<td>X</td>
<td>(Amounts reported in prior 990s would also be reported in Schedule J, Part II, column F)</td>
</tr>
</tbody>
</table>

LONG-TERM INCENTIVE PLAN
FORM 990 REPORTING
GOAL SELECTION AND TARGET SETTING
IDENTIFYING GOALS FOR THE PLANS

- Performance measures should be support the overall strategic priorities/mission of the organization.
- Value drivers can be used to identify metrics that are appropriate at various levels of the organization.
- The process below illustrates an example of how to translate drivers into performance metrics.

1. Identify drivers most important to the organization’s strategy:
   - Drivers and goals should be tied to the strategy and mission to ensure that goals are aligned with business objectives.
2. Prioritize the identified objectives to ensure focus:
   - Can employees impact the objective/driver?
   - How critical is the objective/driver for improving business performance?
3. Specify metrics that can be used to track performance:
   - Identify quantitative.
   - Identify and ensure balance between metrics.
   - Are there any challenges with measuring or understanding these metrics?
Value driver analysis can ensure alignment of performance goals with business strategy and mission during the objective setting process and can be rolled down the organization.

Executive / department level objectives can be built from prioritized value drivers.

Individual objectives of direct reports established from executive / department goals to ensure strategic alignment.

Should ensure all Objectives are SMART.

**Marketing Services**

**Priority Value Drivers**

- Conduct marketing initiative for XYZ college to increase student applications and selectivity.

**SVP Marketing**

**Executive / Department Objectives**

- Achieve all marketing initiatives related to student applications & selectivity within FY15 marketing strategic plan.

**Individual Objectives of Direct Report**

- Develop and execute ABC marketing initiative to generate xx% of new applications.
# INTERNAL AND EXTERNAL PERSPECTIVES IN SETTING GOALS

<table>
<thead>
<tr>
<th>Perspective</th>
<th>Description</th>
<th>Advantages</th>
<th>Challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year-to-year</td>
<td>Performance target based on improvement over prior year's results</td>
<td>Relatively easy to manage</td>
<td>This year's actions influence next year's performance standards</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More easily understood by participants and shareholders</td>
<td>Recent past is poor predictor of next year's results</td>
</tr>
<tr>
<td>Peer performance</td>
<td>Basing performance expectations on peer group performance — either peer recent performance, projections for peers or both</td>
<td>Helps ensure alignment between incentive plan targets and peer group / industry performance</td>
<td>Timeliness of peer data creates challenge in setting targets early in cycle</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Differences between peers and organization may reduce relevance and comparability of peer performance</td>
</tr>
<tr>
<td>Internal budget</td>
<td>Organizations' annual budgeting process effectively defines the performance targets</td>
<td>Nearly all organizations have an annual budgeting process</td>
<td>Executives can be tempted to negotiate for low goals; Board members can be tempted to negotiate for high goals</td>
</tr>
</tbody>
</table>
GOAL SETTING – SETTING APPROPRIATE “STRETCH”

- Probability-based target and range setting would suggest that performance:
  - Thresholds should be set such that threshold payout can be achieved about 80% of the time
  - Targets should be set such that target payout can be achieved about 50% of the time
  - Maximums should be set such that maximum payout can be achieved about 20% of the time

**Typical Design**
- Threshold (80 - 90%)
- Target (50 - 60%)
- Stretch (10 - 20%)

**Towers Watson Performance Difficulty Scorecard**

<table>
<thead>
<tr>
<th>Probability of Achievement</th>
<th>Performance Difficulty</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;20%</td>
<td>Extremely Challenging</td>
</tr>
<tr>
<td>20% - 40%</td>
<td>Very Challenging</td>
</tr>
<tr>
<td>40% - 60%</td>
<td>Challenging</td>
</tr>
<tr>
<td>60% - 80%</td>
<td>Moderately Challenging</td>
</tr>
<tr>
<td>&gt;80%</td>
<td>Not Challenging</td>
</tr>
</tbody>
</table>

Best Practice: Each measure could have different performance ranges based on the varying probability of hitting certain performance levels above and below target.
Determining Incentive Targets

- **Internal Budget (plan)**
  - Net Income Growth = 18%

- **Judgment based on business climate**
  - Net Income Growth = 20%

- **Historical**
  - Net Income Growth = 20%

- **Peer group performance**
  - Net Income Growth = 22%

Incentive Plan Growth Target: 20%