ARTICLE | JAN 2026

Examining Long-Term Incentive (LTI) Plan Design Within Nonprofits' For-Profit Subsidiaries

Large nonprofit organizations whose missions require ongoing funding to sustain and advance their charitable purpose are, with increasing frequency, establishing for-profit subsidiaries to diversify and bolster revenue streams and the balance sheet.

This practice is taking hold in industries such as healthcare, technology, and higher education, as well as other areas of specialization such as research and development, testing and certification, and economic development and entrepreneurship. It can take many forms that blend and balance societal benefit with profitability.

For-profit subsidiaries of nonprofit organizations seeking to recruit, retain, and motivate top talent can face unique challenges when it comes to designing effective long-term incentive (LTI) plans. These entities need to align their long-term business performance with the incentives provided to their executives while maintaining their tax-exempt status and addressing the specific needs of their organization.

This article discusses various LTI design alternatives, their advantages and disadvantages, and emphasizes how such plans can drive the commercial success of for-profit subsidiaries.

Introduction to LTI Plans for Nonprofit Subsidiaries

Tax-exempt organizations that operate for-profit subsidiaries, like their for-profit counterparts, seek to incentivize their senior executives to drive growth, improve performance, and achieve strategic objectives. However, the methods by which they can reward their executives differ due to regulatory constraints and the need to align with their mission-driven goals. LTI plans offer a way to provide meaningful rewards and enhance retention while steering the organization toward long-term success.

Cash-Based "Traditional" LTI Programs

Cash-based programs, which essentially function as multi-year bonus plans, are the most prevalent type of LTI program at tax-exempt organizations and their subsidiaries. These

plans are straightforward and familiar, making them easy to implement and understand. They often align incentives with annual earnings, revenue growth, strategic goals, and other key metrics, providing clear and predictable reward mechanisms.

Advantages:

- Simplicity and ease of implementation.
- Predictable expenses and cash flow control.
- Adaptable and flexible, allowing changes and refinement from year-to-year.
- Widely understood and common in tax-exempt organizations and private companies.

Disadvantages:

- May not align perfectly with long-term business performance.
- Lacks the sense of ownership provided by equity-based plans.

Phantom Equity

Phantom equity programs use notional shares or appreciation rights, providing value based on book or formula values. These plans are common in companies where ownership remains narrow. Payouts are made in cash and taxed as ordinary income.

Advantages:

- Strong retention value with design flexibility.
- Company tax deduction and predictable cash flow.
- Strong alignment between participant rewards and company value creation.

Disadvantages:

- Complexity in changing payouts and potential misalignment with company monetization.
- Valuation challenges and complexity.
- Value creation may not be the primary measure of success for the company.
- Complexity creates a communications challenge to participants.

Pearl Meyer

Case Study: Designing a Cash-Based LTI Plan for a Tax-Exempt Organization's Subsidiary

Context and Objective

A tax-exempt organization specializing in testing and certification sought to establish a competitive executive compensation program for its new, for-profit subsidiary. With a need to attract and retain top talent while supporting strategic growth, the subsidiary engaged Pearl Meyer to design an LTI plan. Equity-based awards were not viable due to their complexity and the reluctance of the organization to establish the requisite ownership structure; instead, a cash-based LTI framework was recommended.

Key Decision Points

1. Form of LTI Vehicle—The Board weighed equity and equity-like "phantom" structures against cash-based awards. To maintain alignment with market practice while minimizing complexity, a cash-based approach with overlapping multi-year performance periods was selected.

2. Performance Periods—The Board evaluated whether to use end-to-end 3-year cycles or rolling/overlapping cycles. They opted for overlapping 3-year cycles, creating continuous retention hooks while reinforcing accountability for sustained performance. An overlapping performance period structure also offers the opportunity to reset goals every year based on evolving business priorities and performance levels.

3. Transition Design ("Bridge Cycle")—To ensure smooth implementation and maintain regular payout opportunities, the subsidiary approved an initial 2-year bridge cycle, followed by standard 3-year cycles.

4. Performance Metrics—After discussion of options such as revenue, EBITDA, and ROI, the subsidiary prioritized revenue growth and profitability as the cornerstone measures, ensuring goals were directly linked to financial sustainability.

5. Payout Leverage—The plan incorporated threshold, target, and maximum performance levels, with payout ranges from 50 to 150 percent of target, using straight-line interpolation. This design balanced risk and reward while aligning with competitive market practices.

Proposed LTI Design

The resulting plan features:

- Cash-Based Awards: No equity grants; all incentives paid in cash.

Equity-Based LTI Programs

Equity-based LTI programs can be more complex but offer greater alignment and real “skin in the game” with the organization's long-term success. These plans can be categorized into capital interests, profits interests, and carried interest plans.

Real Equity: Capital Interest

Capital interest, which is similar to owning a share of stock in a company, provides equity interest in a partnership (e.g., a limited liability company). It provides immediate ownership rights and a share of the proceeds if the organization's assets are liquidated.

Advantages:

- Immediate alignment with organizational performance.
- Strong retention value.
- Tax-friendly capital gains treatment.

Disadvantages:

- Potential dilution of equity.
- Complex administrative and tax implications.

Real Equity: Profits Interests

Profits interests provide an appreciation-based ownership interest. Profits interests also provide real equity interest in a partnership. They are similar to stock options in that interests gain value only as the organization's value increases above a pre-determined “distribution threshold” (e.g., a price established based on current enterprise value, below which the profits interest has no value). These plans are most prevalent in private equity-owned portfolio companies and may be advisable when an exit opportunity is a potential or likely outcome for the for-profit subsidiary, and in certain investment focused organizations.

Advantages:

- No initial taxation if properly structured.
- Significant retention value while appreciation occurs and through vesting (performance-based, time-based, or both).
- Alignment with the financial success of the organization as measured by value creation.

Disadvantages:

- Long timeframe until payouts may reduce perceived value.
- Value creation may not be the primary measure of success for the company.
- Complex administrative and tax requirements.

Real Equity: Carried Interest

Common among private equity and similar for-profit investment funds, carried interest provides a performance-based share of investment fund profits, payable after investors receive their capital back and a preferred return. In this structure, the carried interest is offered by a for-profit investment subsidiary owned by a nonprofit (501(c)(3)) parent. The program is intended to motivate investment professionals and senior leaders by directly linking rewards to fund performance, while remaining separate from the nonprofit's charitable activities.

Advantages:

- Strong alignment with long-term fund performance and value creation.
- No tax at grant and deferral of taxation until payouts, if structured properly.
- Well understood and competitive incentive in the investment market, enabling the organization to compete for talent.
- Payouts are funded from investment gains rather than operating cash.

Disadvantages:

- Long time horizon to payouts may reduce perceived value.
- Significant added legal, tax, and governance complexity due to the nonprofit ownership structure.
- Returns can be volatile and influenced by market conditions outside management's control.

Pearl Meyer

Case Study: Establishing Competitive Carried Interest Levels in a Venture Fund Subsidiary

Context and Objective

A tax-exempt regional economic development nonprofit's venture capital and venture development subsidiary, committed to fostering sustainable innovation and entrepreneurship across its state, sought to establish a competitive compensation structure for its newly formed for-profit venture fund. The subsidiary was designed to invest in later-stage, high-growth companies with the aim of recycling capital within the region. To attract and retain top-tier investment professionals, the organization engaged Pearl Meyer to conduct a benchmarking project focused on aligning base salary, cash incentives, and carried interest with market standards.

Key Decision Points

1. Balancing Tax-Exempt vs. For-Profit Market Data—The leadership team needed to reconcile compensation expectations for executives serving dual roles across the parent and subsidiary, requiring benchmarking against both tax-exempt leadership roles and venture capital market practices.

2. Carried Interest as a Core Component—Recognizing that carried interest is a defining element of total remuneration in the venture capital industry, the organization evaluated competitive allocations both as a percentage of fund value and in dollar terms.

3. Addressing Pay Gaps—Benchmarking revealed that base salaries and target cash compensation were substantially below venture capital market medians, while carried interest participation was underdeveloped relative to competitive standards.

4. Retention and Market Competitiveness—The company weighed the importance of aligning carried interest levels with market practice to ensure retention of key executives and to signal credibility to external investors.

Proposed Design and Terms

The resulting framework integrated:

- Base and Cash Compensation: Maintained closer alignment with the tax-exempt market for reasonableness standards but adjusted upward where critical to remain competitive.

- Carried Interest Participation: Introduced carried interest allocations at levels benchmarked against venture capital peers, ensuring that managing partners, partners, and principals received meaningful upside potential tied to fund

Design Considerations and Recommendations

When designing an LTI plan for a nonprofit subsidiary, careful planning and consideration are essential. Key factors to consider include:

- Eligibility: Limiting participation to senior executives and high performers.
- Performance Metrics: Focusing on long-term corporate financial, operational, or strategic goals.
- Vesting and Payout: Establishing minimum service periods and clear payout structures.
- Forecasting: Developing reliable long-range financial and operational models.
- Alignment with Not-for-Profit Governance Standards: It is recommended that for-profit subsidiaries of not-for-profit parent organizations follow a similar, board-approved process for establishing and reviewing compensation levels for highly paid executives and employees. For executives who may be considered “disqualified persons” under the IRS’ Internal Revenue Code Section 4958[1] at the not-for-profit parent, adhering to the guidelines described in the regulations is critical.

The Motivational and Alignment Power of LTI Programs

Long-term incentive plans can be a powerful tool for nonprofit subsidiaries to attract, retain, and motivate top talent. By carefully selecting and designing the right LTI program, these organizations can align their executives' incentives with their mission-driven goals and drive long-term success. Whether opting for cash-based or equity-based plans, the key is to ensure that the plan is tailored to the organization's unique needs and circumstances.

---

[1] Section 4958 is a part of the Internal Revenue Code that imposes excise taxes (intermediate sanctions) on "excess benefit transactions" between an "applicable tax-exempt organization" and a "disqualified person." The IRS defines a disqualified person as anyone in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during the lookback period. While the definition includes several types of individuals and entities, as it relates to executives this typically includes CEOs, COOs, CFOs, and board members, among others.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.