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Is Long-Term Incentive Compensation Right for Your Tax-Exempt Organization?

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This is the seventh installment in our Tax-Exempt Executive Compensation Essentials series—a resource for boards, compensation committees, and management teams of tax-exempt organizations.

While long-term incentives are a powerful tool for retaining senior leadership and reinforcing alignment with organizational strategy, they are not the right tool for every organization. In the tax-exempt sector, the decision to adopt a long-term incentive (LTI) program merits careful consideration, not assumption. The conditions that make LTI appropriate vary considerably, and poor design can create significant regulatory, governance, and reputational risk.

For tax-exempt organizations that decide an LTI program is appropriate, the familiar public company LTI equity vehicles are unavailable, including stock options, restricted stock units, and performance shares. Tax-exempt organizations typically do not have equity to grant or shareholder returns to anchor incentive design. Instead, they often must choose from cash-based and deferred compensation arrangements governed by a distinct regulatory framework.

Compensation committee members and HR professionals must consider these three questions: Does LTI make sense for the organization? Which alternatives are available?

What design and governance practices will support an effective and defensible program?

Who Should Be Considering LTI—and Why

The use of long-term incentives in the tax-exempt sector has grown steadily over the past several years, driven by increasing organizational complexity and intensifying competition for senior leadership talent. Large health systems, university foundations, national advocacy organizations, and complex social enterprises now routinely compete with investor-owned companies for C-suite executives. In the current environment, a compensation program with no long-term performance or retention component can create a real competitive disadvantage when it comes to attracting, motivating, and retaining the executive-level talent needed to successfully run a complex organization.

But LTI programs are not universally appropriate, and boards should carefully evaluate their own circumstances before moving forward. The organizations best positioned to benefit from an LTI program generally share several characteristics:

- Talent market exposure. The organization competes for senior leadership with employers—for-profit or otherwise—that offer meaningful long-term incentives as part of their overall executive compensation program. If executives can find comparable roles at organizations with equity or LTI programs, retention risk is real.
- Organizational scale and complexity. Long-term incentives are most appropriate at the senior executive level in organizations large and complex enough that leadership continuity has material strategic consequences. Smaller organizations may find that a well-designed annual incentive program, coupled with a competitive base salary, is more cost-effective and appropriate for retention.
- Governance infrastructure. An LTI program requires an independent compensation committee, access to reliable and relevant comparability data, and the administrative capacity to manage multi-year award tracking and documentation. Organizations without that infrastructure face both legal and operational risk.
- Stakeholder sustainability. Form 990 disclosures make executive pay at a tax-exempt organization available to the public. An LTI payout that appears disproportionate—relative to the organization’s financial performance, mission outcomes, or the broader community context—can create reputational damage that outlasts the governance benefit. Boards should be prepared to explain and defend any potential payout before adopting a program that could generate this type of risk.

A Distinct Regulatory Framework

Once an organization determines that LTI is appropriate, the design process begins with the regulatory framework governing tax-exempt compensation. Three elements are particularly important.

1. The private benefit and inurement rules embedded in IRC Section 501(c)(3) prohibit organizational earnings from flowing to private individuals in ways that are not

   commensurate with services provided. Executive compensation, including long-term incentives, must be defensible as reasonable in relation to the value the executive delivers.
2. IRC Section 4958 establishes intermediate sanctions for “excess benefit transactions.” These are compensation arrangements with disqualified persons (generally executives and board members with substantial organizational influence) where awarded pay exceeds what is reasonable. Violations can trigger significant excise taxes on both the individual and the approving managers.
3. The rebuttable presumption of reasonableness is the primary tool for managing that exposure. Establishing it requires an independent body to approve compensation in advance, supported by appropriate comparability data, and contemporaneously documented. This process does not guarantee that compensation is reasonable—but it shifts the burden of proof in any IRS challenge. Committee process is more than just good governance; it is a legal safeguard.

The Available Tools

Tax-exempt organizations can use several vehicles to create long-term retention and performance alignment without the use of real equity. The right choice depends on whether the primary goal is retention, performance alignment, or both.

457(f) Deferred Compensation

The 457(f) plan is the workhorse of nonprofit LTI design. Unlike a 401(k) or 457(b), it has no annual dollar cap and can therefore deliver meaningful value for senior executives.

The mechanics are straightforward: the organization promises a future cash benefit contingent on the executive remaining employed through a specified date or achieving defined performance goals. This vesting requirement is called a substantial risk of forfeiture (SROF). 457(f) plans are commonly designed with service-based cliff vesting schedules, often over three to five years, although longer vesting periods and rolling grant structures are also frequently used depending on the organization's retention objectives.

Until the amounts vest and the SROF lapses, the benefit is not taxable. Once it lapses, the full accrued value becomes taxable as ordinary income, regardless of payment timing. Organizations typically coordinate payment timing with vesting so executives can more easily cover the resulting tax liability.

Multi-Year Cash LTI Plans (LTIPs)

A cash LTIP is the tax-exempt analog to a performance stock unit (PSU) and is seen regularly in large for-profit companies. A target award is established at the start of a performance period, typically three years, with target awards usually expressed as a percentage of base salary. LTIP payouts are determined based on actual performance results against pre-established goals, with threshold, target, and maximum levels defined in advance. Unlike a PSU plan, the award’s value does not change with movement in the underlying stock price. Cash LTI plans are most often standalone but can be wrapped inside a 457(f) structure depending on the organization's objectives and tax considerations.

Defining Performance Without a Stock Price

For organizations designing a cash LTI plan or incorporating performance conditions into a 457(f) arrangement, metric selection is one of the most consequential design decisions. The measures that anchor for-profit incentive plans (e.g., earnings per share, total shareholder return, return on equity) are either inapplicable or inappropriate in the tax-exempt context.

Effective plans balance financial sustainability with mission-driven outcomes. Financial sustainability metrics, including operating margin, days cash on hand, debt service coverage and net asset growth, can reflect the organization's capacity to sustain and invest in its mission over time. Mission outcome metrics vary by sector but might include program reach, patient outcomes, housing placements, student completion rates, or fundraising performance. Strategic milestones may be appropriate when the organization is executing significant change.

A few considerations are worth keeping in mind:

- Sector context matters. Health systems and large academic medical centers tend to use sophisticated multi-year frameworks that closely mirror for-profit LTIP design. Community-based nonprofits may have more limited financial visibility and rely more heavily on strategic, mission-based, or qualitative goals.
- Goal-setting visibility is a real constraint. Organizations in volatile funding environments may find it difficult to set credible multi-year financial targets. Wider performance ranges or milestone-based goals are often more appropriate.
- Measurability is non-negotiable. A metric the committee cannot objectively evaluate at the end of the performance period creates governance risk. If the organization cannot confidently determine whether a goal was achieved, it should not be included.

Governance, Payout Leverage, and the Reasonableness Standard

Sound LTI governance in the tax-exempt sector requires attention to several considerations that carry more weight than in the for-profit world.

Calibrating Payout Leverage

Target opportunity levels and payout ranges deserve careful calibration—and the reasonableness analysis must happen at the design stage, not just at payout. This is particularly important for 457(f) arrangements, where the promised benefit creates a defined expectation from the moment it is granted. A committee that approves a 457(f) benefit without stress-testing the maximum potential payout against total compensation benchmarks has created a compliance risk before the first dollar is earned.

Several principles apply regardless of vehicle:

- Evaluate total compensation. An LTI opportunity that appears modest as a standalone figure can push total compensation well outside the market range when combined with base salary, annual incentives, and retirement benefits. The reasonableness standard applies to the aggregate, not the components.
- Maximum payouts warrant particular scrutiny. Leverage structures common in for-profit plans, which typically include maximum payouts of 150–200% of target, can produce headline numbers on the Form 990 that are difficult to defend in the tax-exempt context, particularly in years of financial difficulty or organizational stress. Maximum opportunity should be calibrated to what the board can credibly explain to external stakeholders.
- Build in an affordability override. Even when performance goals are fully achieved, a funding shortfall, liquidity challenge, reputational event, or shift in donor sentiment may make paying an LTI imprudent. Board-level discretion to reduce or eliminate a payout should be built into the plan design from the outset, not invoked as an ad hoc exception.

990 Transparency and Comparability

Deferred compensation balances and LTI payouts appear on Form 990 and are publicly visible. A significant payout during financial difficulty or community controversy will attract scrutiny well beyond what any technical compliance argument can neutralize. Plan design should account for how the public will perceive payouts, not only whether they are defensible on paper.

The reasonableness standard also requires benchmarking against similarly situated organizations that are comparable in revenue, complexity, mission type, and geography. For long-term incentives, that means drawing peer groups from the tax-exempt sector rather than defaulting to for-profit data. When for-profit benchmarks are used, the rationale should be deliberate, documented, and grounded in the organization’s actual talent market.

Conclusion: Every Organization May Have a Different Answer

Long-term incentives can strengthen executive retention and alignment in tax-exempt organizations, but only when supported by a clear retention need, adequate governance infrastructure, defensible economics, and stakeholder awareness.

Organizations that meet those conditions can use 457(f) arrangements, cash LTIPs, or a combination of vehicles to create meaningful long-term value without equity. The absence of equity is a design constraint, not a barrier. When thoughtfully structured, appropriately benchmarked, and rigorously governed, the available vehicles can deliver meaningful retention and performance alignment.

Organizations working through these questions should start with whether LTI is right for the organization, not which vehicle to use or what the payout opportunity should be. Getting that foundational question right makes everything that follows more straightforward.

About the Authors

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About Pearl Meyer

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