

It's Beginning to Look a Lot Like... Bonus Season?

Managing Disallowance Risk in Incentive Compensation Policies and Practices

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Many Community Action Agencies (CAAs) routinely review the perks they provide to help retain experienced staff and hire new talent. One of the ways in which CAAs may choose to reward productive employees is by adopting and implementing an incentive compensation plan. Incentive compensation is a one-time payment to employees above and beyond their regular salary as a reward for good performance.¹

Federal tax and grant rules permit nonprofit CAAs to pay incentive compensation. However, careful attention must be paid to both the content and the implementation of incentive compensation policies, since improper incentive compensation practices have led to significant disallowances, penalties, and even the revocation of tax-exempt status. This article reviews the incentive compensation rules applicable to CAAs, discusses issues to consider when drafting an incentive compensation policy, and describes how to implement a policy to mitigate the risk of disallowance.

What are the Rules?

There are two primary sources of federal law applicable to the payment of incentive compensation at nonprofit CAAs: (1) the Internal Revenue Code (the Code), as interpreted by Internal Revenue Service (IRS) rulings; and, (2) when incentive compensation is paid using federal funds, the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (the Uniform Guidance). As stewards of charitable funds, CAAs must also consider their organization's mission, values, and public perception when making compensation decisions.

The IRS requires that section 501(c)(3) tax-exempt organizations be operated exclusively for one or more exempt purposes contained in the Code and that no part of such organizations' total earnings flow to the benefit of any private individual.² The rules about impermissible private benefits often arise in relation to the payment of compensation to employees.

The Uniform Guidance applies to costs charged to federal awards, so it determines whether a CAA's federal funds may be used to pay incentive compensation. The rules on incentive

compensation are found in Subpart E—Cost Principles, at [2 C.F.R. § 200.430\(f\)](#), which states:

Incentive compensation to employees based on cost reduction, or efficient performance, suggestion awards, safety awards, etc., is allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the non-Federal entity and the employees before the services were rendered, or pursuant to an established plan followed by the non-Federal entity so consistently as to imply, in effect, an agreement to make such payment.

The Departmental Appeals Board (DAB) of the U.S. Department of Health and Human Services (HHS) is the administrative body that reviews disallowances of costs, like incentive payments, by a federal agency pursuant to the Uniform Guidance and applicable funding source requirements. The DAB strictly interprets the Uniform Guidance with respect to incentive compensation payments. If a disallowance is upheld and a grantee is unable to pay what is owed, it must negotiate an arrangement to pay back the disallowed funds with HHS.³

In addition to the sources mentioned above, CAAs should review program-specific requirements when considering the use of program funds for incentive compensation. It is also important to work with an attorney licensed in your state if any funds from state funding sources will be used to pay for incentive compensation.

Writing an Incentive Compensation Policy

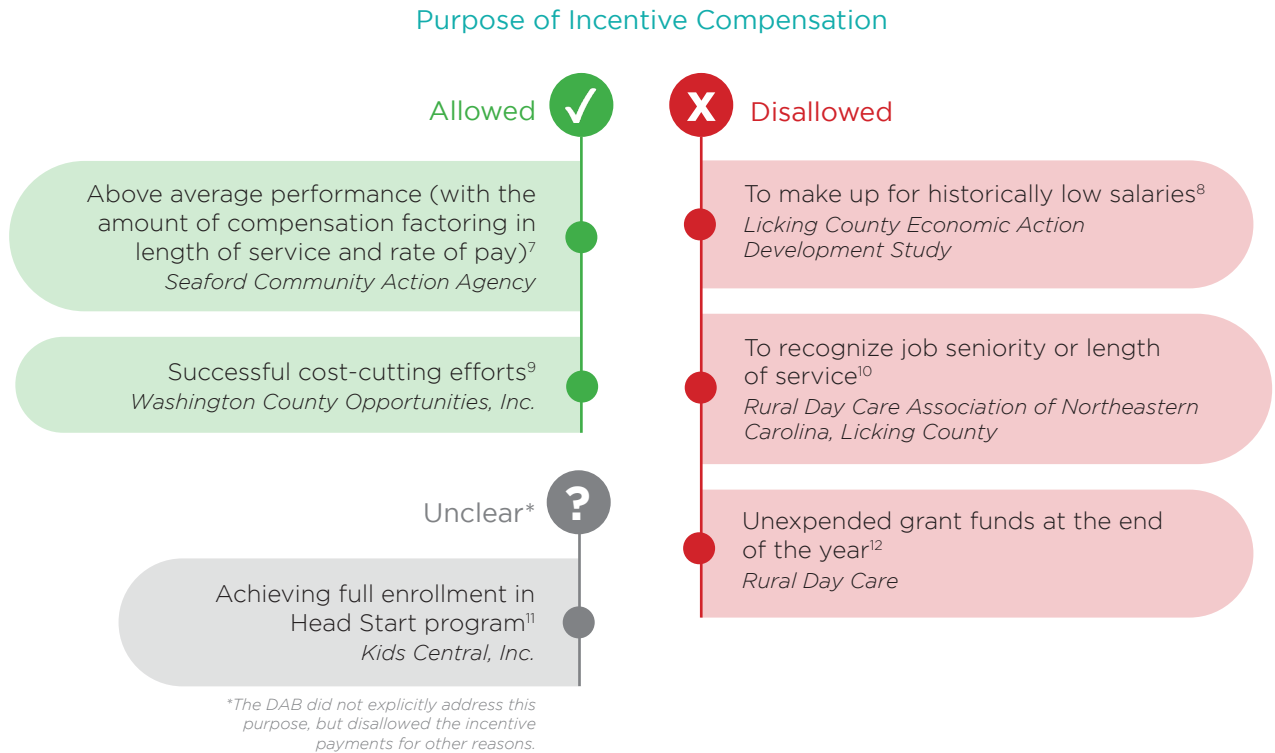
To pay incentive compensation, a CAA must first adopt an incentive compensation policy or enter into an agreement with employees regarding incentive compensation. This cannot be done retroactively—you must have a policy in place for employees to start earning incentive compensation. Numerous incentive payments have been disallowed simply because the grantee failed to have an incentive compensation policy in place prior to making payments to employees.⁴

An incentive compensation policy should set forth the option for an employee to receive incentive pay as well as the criteria that must be met for payments to be made. Try to be as detailed as you can, but only to the extent that you can actually comply with the policy. Being realistic at the drafting stage about your CAA's ability to administer the policy will support consistent application down the road.

The bullets below discuss how various factors have contributed to the allowability of incentive payments in IRS and DAB rulings and decisions. You should consider these factors when writing the policy so that if the IRS or a funding source later challenges it, you are prepared to defend it.

- **Purpose.** The policy should include an appropriate purpose for the incentive pay. The IRS has emphasized that there must be a “real and discernable business purpose” for incentive pay, such that it is not simply a device to distribute profits to directors or officers of a tax-exempt organization.⁵ According to the Uniform Guidance, allowable purposes for incentive compensation include cost reduction, efficient performance, suggestion awards, and safety awards.⁶ The policy and purpose of the incentive pay must be designated before the criteria are met and the incentives are paid.

Below is a table showing how the DAB has ruled with regard to certain purposes grantees have set forth as the basis for their incentive compensation:



- **Incentive Criteria.** The criteria for earning incentive compensation should be objective, realistic, and linked to the CAA's accomplishment of its exempt purpose.¹³ The criteria can be applied to individual employees or, under limited circumstances, on an organization-wide basis.

If the criteria is applied to individual employees, it should be tied to an employee's actual performance—a CAA should not determine whether an employee in one department has earned incentive compensation by looking at outcomes met in a different department.¹⁴ In *Seaford Community Action Agency*, the DAB upheld incentive compensation awarded pursuant to an incentive compensation policy found in the grantee's personnel policies manual. Awards made under the policy were based on a five-point performance rating scale, from 1 ("Low") to 5 ("Outstanding"). When additional funding was available, one-time salary supplements were awarded to employees with above average performance, and additional merit bonuses were sometimes distributed for excellent or outstanding performances or major contributions to the agency.¹⁵

Incentive compensation awards may also be made organization-wide under certain limited circumstances. In *Washington County Opportunities, Inc.*, the DAB upheld a one-time bonus payment made to all full-time staff for their successful effort to reduce program costs after federal budget cuts. Since the award was based on the "staff's overall performance" and the grantee followed its personnel policies, the organization did not need to provide individual performance evaluations.¹⁶ Regardless of whether its incentive compensation criteria is applied to an individual or group of employees,

a CAA must be able to show that each recipient of incentive compensation met the appropriate incentive criteria.

- **Reasonable Compensation.** Amounts paid under the incentive compensation plan, and each employee's total compensation, must be reasonable. The general standard of reasonableness is what would usually be paid for similar services by a prudent person under similar circumstances.¹⁷ DAB decisions have established that an organization's compensation levels, the compensation levels of comparable workers in the same geographic area, bonuses of similarly situated organizations and other bonuses paid to employees should be considered when determining whether the amount of an incentive award is reasonable.¹⁸
- **Safeguards.** The policy should include safeguards to prevent abuse of the arrangement. Incentive compensation should not take away from the funds that are available for program-related activities, so a CAA should ensure it is on track to provide all of the services it committed to in its annual program budgets before paying bonuses. It should also make sure that its program managers do not set aside funds for the bonus pool that should be used for programs.

Another important safeguard is a cap on the amount that employees may earn (e.g., a certain percentage of their regular salary) under the incentive compensation policy. This will help CAAs determine in advance the reasonableness of an employee's total compensation and budget for incentive payments made under the policy.

- **Board Oversight.** The incentive compensation plan should specify that the board has sole discretion to cancel or reduce awards under the plan if paying the incentive compensation would violate any law or regulation, would jeopardize the CAA's ability to meet its obligations to funders or carry out its tax-exempt purposes, or would otherwise not be in its best interest. CAAs should consult an employment attorney on how to structure and operate the plan, since state law may interpret an incentive compensation policy as a promise of wages, which would restrict the CAA's ability to cancel the award.

Implementing Incentive Compensation at Your CAA

While adopting a written incentive compensation policy is critical, appropriate and consistent enforcement is just as important. The DAB closely scrutinizes how policies were applied when reviewing disallowances under the Uniform Guidance. So, keep the following actions in mind when applying an incentive compensation policy:

- **Get Board Approval.** Ensure that an independent board of directors adopts the policy and any subsequent changes, and comply with funding source requirements for any additional approvals needed. In the case of Head Start agencies, this means the policy must also be approved by the CAA's policy council.¹⁹ Only independent directors should participate in the vote. There must be an arms-length transaction between the board and any employees receiving incentive compensation.²⁰ When adopting or amending the incentive compensation policy, refer to it with as much specificity as possible in board minutes. In a recent case involving a Head Start agency, *Kids Central, Inc.*, the DAB refused to infer that the board had approved an increase in the payment available under the incentive compensation policy because the board had not mentioned the incentive compensation policy changes in its minutes.²¹

- **Charge to the Proper Grant Period.** Incentive compensation must be charged to the grant year during which the incentive criteria were met. In *Kids Central, Inc.*, the DAB upheld a disallowance of incentive compensation due to the fact that the grantee used funds from one grant period to pay incentive compensation that had been incurred in another, prior grant period.²²
- **Apply the Plan or Agreement Consistently.** The incentive compensation plan must be applied in accordance with its terms to be enforceable.²³ The DAB has consistently disallowed incentive payments when the grantee fails to follow its established plan or agreement, including failing to apply the incentive criteria set forth in the policy. Examples of such disallowances include:
 - A CAA paying all non-management employees the same level of incentive compensation, when its incentive compensation policy required it to evaluate employees individually and award greater incentives to those with superior performance.²⁴
 - A CAA disregarding its policy and awarding more highly-rated employees with less incentive compensation than lower-rated employees.²⁵
 - A grantee awarding incentive compensation despite failing to achieve full enrollment in its Head Start program, as required by its policy.²⁶
- **Call It Like It Is.** Whether or not you call it “incentive compensation” or a “bonus”, if your CAA awards employees a temporary, discretionary increase in pay, the IRS and federal funding sources are likely to view it as incentive compensation. In *Licking County Economic Action Development Study*, the grantee insisted that the funds it had awarded were a “one time lump sum payment”, not incentive compensation. However, since it could not offer any evidence of how the costs might otherwise be allowable, and since there was no substantive difference between the one time lump sum payment and a bonus, the DAB upheld the disallowance.²⁷
- **Document, Document, Document.** Keep records showing how the criteria for incentive compensation were met and when. The DAB recently upheld a disallowance of merit-based incentive compensation paid pursuant to an established policy, even though the grantee provided a copy of its policy, because there was no evidence that (1) the policy was in place during the charged grant period, (2) the bonuses had been paid in accordance with the policy’s criteria, (3) the employee recipients’ overall compensation was reasonable and (4) the grantee had appropriately calculated the portion of the incentive compensation allocable to the federal award.²⁸ Your incentive compensation policy is more likely to be upheld if you can provide evidence of all four points.

Finally, we strongly recommend that you reach out to a qualified tax attorney or accountant before implementing a new policy or amending an existing one.

¹ CAAs may also provide incentives in the form of fringe benefits, which the Uniform Guidance defines as “allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages” (2 C.F.R. § 200.431). This article does not discuss fringe benefits.

² 26 U.S.C. § 501(c)(3).

³ See *Licking County Economic Action Development Study, DAB No. 1159 (1990)*.

- ⁴ See [Licking County Economic Action Development Study](#); Rural Day Care Association of Northeastern Carolina, DAB No. 1384 (1993).
- ⁵ See IRS Information Letter 2002-0021 (Jan. 9, 2002).
- ⁶ 2 C.F.R. § 200.430(f).
- ⁷ See [Seaford Community Action Agency](#), DAB No. 1433 (1993).
- ⁸ See [Licking County Economic Action Development Study](#).
- ⁹ See [Washington County Opportunities, Inc.](#), DAB No. 1464 (1994).
- ¹⁰ See [Rural Day Care Association of Northeastern Carolina](#); [Licking County Economic Action Development Study](#).
- ¹¹ See [Kids Central, Inc.](#), DAB No. 2897 (2018).
- ¹² See [Rural Day Care Association of Northeastern Carolina](#).
- ¹³ See IRS Information Letter 2002-0021 (Jan. 9, 2002).
- ¹⁴ *Id.*
- ¹⁵ See [Seaford Community Action Agency](#). Note that *Seaford Community Action Agency's* policy stated that the purpose of the program was "to offer incentives for above average performance." Thus, the DAB overturned the disallowances of the bonuses paid to employees with a 4 or 5 performance rating, but upheld the disallowances of bonuses paid to employees with a 3 - "Average" rating or lower.
- ¹⁶ See [Washington County Opportunities, Inc.](#)
- ¹⁷ See IRS Information Letter 2002-0021 (Jan. 9, 2002) and 2 C.F.R. § 200.404. For disqualified persons, CAAs should also try to establish a rebuttable presumption under the IRS's intermediate sanctions rules. More information is available on the IRS's website: <https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions>.
- ¹⁸ See [Washington County Opportunities, Inc.](#)
- ¹⁹ See 42 U.S.C. § 9837(c)(1)(E)(iv), (c)(2)(D)(vi); 45 C.F.R. § 1302.90(a).
- ²⁰ See <https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions>.
- ²¹ See [Kids Central, Inc.](#)
- ²² See [Kids Central, Inc.](#)
- ²³ See 2 C.F.R. § 200.430(f).
- ²⁴ See [Texas Neighborhood Services, Inc.](#), DAB No. 2571 (2014).
- ²⁵ *Id.*
- ²⁶ See [Kids Central, Inc.](#)
- ²⁷ See [Licking County Economic Action Development Study](#).
- ²⁸ See [Maryland Disability Law Center](#), DAB No. 2843 (2018).

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