



Complying with Executive Compensation Limits under NYS Executive Order #38

by JER HR Group LLC

In January 2012, New York State's Governor Andrew Cuomo issued Executive Order #38 ("EO38"), the latest in a series of regulatory actions to curb the use of public funds for excessive administrative expenses or executive compensation in exempt organizations. Final guidelines to implement EO38 were promulgated by thirteen state funding agencies effective for reporting periods beginning July 1, 2013. In this article, we review some key points of the regulations and their effect on exempt organizations in relation to executive compensation. We will also review steps to be taken to ensure compliance with the regulations.

Executive Order #38 "prevent(s) public funds from being diverted to excessive compensation and unnecessary administrative costs, and...ensure(s) that taxpayer dollars are being used to help New Yorkers in need".

- Governor Andrew Cuomo,
Executive Order #38

Key Features of Executive Order 38

EO38 imposes additional reporting requirements and limitations on covered providers¹ for the use of State funds or State-authorized payments:

- In addition to usual consolidated financial report or other required report(s), covered providers must complete and submit an annual EO38 Disclosure Form. This includes information regarding program services and administrative expenses, in addition to executive compensation provided to covered executives during the reporting period.
- At least 75% of covered operating expenses must be used for program service expenses, rather than administrative expenses. *That limit will increase to 80% in 2014 and 85% in 2015 and thereafter.*
- No more than \$199,000 may be paid in executive compensation to a covered executive.

If a covered provider exceeds, or anticipates it will exceed, the limits for either administrative expenses or executive compensation within a given reporting period, an application for waiver must be submitted no later than 180 days following the close of the reporting period – concurrent with the EO38 disclosure form submission.

¹ "Covered Providers" are entities or individuals that have received during the annual reporting period **and** the prior year an average annual amount of greater than \$500,000 in State funds or State-authorized payments to render services to the public; and at least 30% of whose annual New York State revenues during both the annual reporting period and the prior year were from State funds or State-authorized payments.

Covered Executives and Executive Compensation

Limits on executive compensation apply to “covered executives” who are, by definition:

- compensated directors, trustees, managing partners, officers or key employees² of a covered provider;
- whose salary and/or benefits are administrative expenses in whole or in part; and
- whose overall compensation exceeded \$199,000 during the reporting period.

Under EO38, “executive compensation” includes salary; bonus or incentive pay; executive deferred compensation arrangements; housing, personal vehicle or other executive allowances; personal use of organization property; below-market loans; and payment for personal/family travel. Similar to IRC Section 4958, mandated benefits such as Social Security, Unemployment Insurance, Workers’ Compensation and New York State short-term disability, are excluded from executive compensation. However, unlike IRC Section 4958, NYS EO38 excludes the value of benefits that are consistent with those provided to other employees, such as health/life insurance premiums and standard retirement plan contributions.

For purpose of complying with EO38, clinical and program personnel providing program services, including the heads of departments who fulfill administrative functions that are “directly attributable to and comprise program services”, are not considered covered executives.

Accordingly, the primary executives affected by EO38 executive compensation limits are chief executive officers, chief financial or administrative officers, and other executives whose responsibilities are primarily related to administrative and operational functions.

EO38 Limits on Executive Compensation

Under EO38, a covered executive may not receive more than \$199,000³ in State funds or State-authorized payments in a reporting period without a waiver. Executive compensation may exceed \$199,000 from all revenue sources if it satisfies a safe harbor provision:

- Executive compensation is below the 75th percentile reported for comparable executives in similar organizations, as demonstrated by a valid compensation survey; and
- Compensation has been reviewed and approved by the board of directors or specified governing body (with decision ratified by the board), with such review including an assessment of appropriate comparability data.

As noted earlier, covered providers must annually submit an EO38 Disclosure Form which includes a worksheet for calculating and reporting executive compensation for each covered executive. The worksheet delineates the component elements of executive compensation (salary and wages, bonus

² The definitions of director, trustee, officer and key employee are the same as those described in the instructions for IRS Form 990. However, if there are more than 10 key employees, only the top 10 are counted for EO38.

³ Funding agencies may review and adjust the cap on executive compensation in following years.

compensation, personal vehicles, housing, etc.) with the total dollar value (All Funds) and the amount allocable to State funds or State-authorized payments (SF/SAP). The total may be adjusted by excluding any portion of compensation that is paid to a covered executive for the provision of program services. Such positions as chief executive officers, who may dedicate a portion of their time and effort

to program services, may have their total compensation reduced by that portion. A covered provider should be prepared to substantiate any adjustment to compensation claimed as allocable to program services through time and effort records, in case of audit.

To ensure compliance with EO38, the covered provider must demonstrate that:

- No executives were paid executive compensation in excess of \$199,000 from any source of revenue. In such case, there would be no covered executives to report.
- More than \$199,000 in executive compensation was provided to a covered executive(s), but it complied with the safe harbor provision (below the 75th percentile reported among comparable executives and approved or ratified by the board of directors); or
- A waiver was approved to authorize payment of executive compensation in excess of \$199,000 to a covered executive.

However, if a covered executive receives executive compensation in excess of \$199,000 and the amount is above the 75th percentile reported for comparable positions in similar organizations, the covered provider will be non-compliant, even if the compensation has been reviewed and approved by the governing body of the organization. In such case, the provider will need to enter into a plan of corrective action or be subject to penalties.

Application for Waiver

If a covered executive's total EO38 compensation exceeds \$199,000, the covered provider must submit an application for waiver. Beyond the basic information about the covered executive (name, title, amount of compensation and amount of compensation derived from State funding or State-authorized payments), the waiver application includes the following sections:

- *Comparable Compensation:* how the covered executive's compensation compares to comparable executives in similar organizations. These should be organizations of similar size and scope, the same industry sector, and within the same or comparable geographic area. As a general rule, we recommend that the sample include organizations between ½ to 2 times the size of the covered provider, either in revenues or operating expenses.
- *Essential Executive Description:* describe the extent to which the organization would be unable to provide program services at the same level of quality or availability without providing compensation above the \$199,000 limit. Factors may include unique skills or qualifications required of the position, the organization's record of accomplishments, its leadership within the industry, degree of community involvement, etc.

- *Compensation Review Process:* describe how executive compensation is reviewed and approved. The suggested process is similar to that suggested by IRC Section 4958: compensation is reviewed and approved by the board of directors or other governing board; the governing body includes at least two independent directors or members; comparability data or a compensation survey is reviewed to identify how compensation compares to similarly situated executives; the factors considered in determining comparability; contemporaneous evidence of the governing body's deliberation and decision to approve compensation.
- *Relationship to 75th Percentile:* disclose whether executive compensation exceeds the 75th percentile reported for comparable executives in similar providers of comparable size and scope within the geographic area. If compensation exceeds the 75th percentile, the provider must disclose the amount by which compensation exceeds the 75th percentile, and provide details regarding the comparability data used to determine the calculation, and the rationale for approving the compensation.
- *Qualifications:* the specific qualifications and experience of the covered executive. This may include credentials, tenure, accomplishments or unique qualifications that set the executive apart from others.
- *Recruiting Alternatives:* any efforts to hire executives with comparable levels of experience, expertise and skills at lower levels of compensation. It may be important to note if there are any specialized job requirements for the covered executive that command a market premium.

If and when a waiver is approved, it is valid only for the covered executive(s) for the amount identified in the applications and for the specific time period approved. If the waiver is not approved, the organization must submit a corrective action plan outlining steps it will take to adjust compensation and the time period in which it will do so. If the provider fails to properly implement or complete the corrective action plan and remains non-compliant with the regulatory limits, the State funding agencies may impose penalties⁴.

Good Governance Practices Support Compliance

Following good governance principles espoused by the Internal Revenue Service in establishing its "rebuttable presumption" defense for the reasonableness of compensation under Section 4958 guidelines, EO38 underscores the importance of board accountability for reviewing and approving executive compensation. A few steps exempt organizations can take include:

- **Establish an executive compensation philosophy:** This should be discussed and adopted by the Board of Directors and should identify criteria for determining the peer market in which the organization competes, the desired relationship of executive compensation to the peer market, and a rationale for why that target is appropriate. This may include specialized skills,

⁴ Penalties may include redirection of funding for program services; suspension modification or revocation of the provider's license(s), certification or permission to provide services; suspension, modification, limitation or revocation of contracts or agreements with the provider; and/or other lawful actions or penalties deemed appropriate by the agencies.



credentials or qualifications required for executives; tenure and record of accomplishments; and circumstances that set the organization apart from peers.

- **Implement a regular compensation review process:** Review compensation at least every two years to assess current market comparability in light of current organization revenues and scope of services. If compensation is at or above the 75th percentile, it may be advisable to conduct an annual compensation review.
- **Governing body:** To ensure an “arm’s length” relationship in setting executive compensation, it is important to establish that the governing body is comprised of independent members who have no vested interest in the outcome of its deliberations and actions.
- **Board of Directors review and approval:** Regardless of the group that reviews and recommends or approves compensation (compensation committee or executive committee), it is essential that the recommendation or decision be reported to and ratified by the full Board.
- **Document the approval of compensation decisions:** “Contemporaneous substantiation” of compensation decisions assures that there is a timely paper trail documenting the basis for assessing and determining compensation.

Closing Thoughts

EO38 adds reporting and compliance requirements beyond those previously set under IRC Section 4958, with more stringent limitations on executive compensation. It establishes an annual reporting and waiver application process if compensation exceeds the \$199,000 limit, shifting the onus for determining compliance to the covered provider. Because funding could be jeopardized by non-compliance, it is important that covered providers implement good governance practices. This includes assuring that Boards of Directors are highly aware of the competitive environment, that they regularly review comparability data and the compensation provided to executives, and they are prepared to provide a rationale to support the appropriateness of compensation.

*JER HR Group LLC. (formerly known as James Rocco Associates Inc.) is an independent consulting practice specializing in exempt organization compensation. For further information regarding our services, visit our website: <http://www.jerhrgroup.com> or call **Jim Rocco** at 646-453-7563 or **Larry Beers** at 646-453-7562.*