

# Incentive Compensation: Another Option in a Staffing Strategy



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Updated August 2024

Many Community Action Agencies (CAAs) routinely review the perks they provide to help retain experienced staff and hire new talent. One way 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.<sup>1</sup>

Federal tax and grant rules permit nonprofit CAAs to pay incentive compensation. While CAAs must pay careful attention to avoid federal grant disallowances and IRS penalties, the need for new approaches to recruit and retain quality staff is motivating some funding sources to take a more favorable view of incentive compensation. 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) if 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 operate 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.<sup>2</sup> Under these rules, no individual may receive excess benefit from a tax-exempt organization, an issue that often arises in relation to the payment of compensation to employees.

The Uniform Guidance applies to costs charged to federal awards. 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, efficient performance, suggestion awards, or safety awards is allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued according to an agreement entered into in good faith between the recipient or subrecipient and the employees before the services were rendered, or according to an established plan followed by the recipient or subrecipient 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. If a disallowance is upheld and a grantee is unable to pay what is owed, it must negotiate an arrangement with HHS to pay back the disallowed funds.<sup>3</sup>

CAAs must also review funding source requirements when considering the use of program funds for incentive compensation and work with an attorney licensed in its state if the CAA intends to use state funding to pay for incentive compensation.

### Writing an Incentive Compensation Policy

To pay incentive compensation, a CAA must first adopt an incentive compensation policy or prove that an established practice of providing incentive compensation to employees exists. A CAA may not retroactively adopt a plan or practice. Funding sources and the DAB have disallowed incentive payments simply because a grantee failed to have an incentive compensation policy or established practice prior to making payments to employees.<sup>4</sup>

A well-drafted incentive compensation policy clearly sets forth the actions that will result in incentive pay as well as the criteria employees must meet to receive such payments. A CAA must strike a balance between the level of detail needed to establish a process and set criteria with the CAA's capacity to facilitate the process and evaluate the criteria in a fair and consistent manner. Being realistic at the drafting stage about the CAA's ability to administer the policy will support consistent application.

Considering the following factors taken from IRS rulings and DAB decisions when drafting an incentive compensation policy will help a CAA develop and facilitate a policy as well as respond to scrutiny of its policy and practices.

- **Purpose.** The policy should include an appropriate purpose for incentive pay. The IRS emphasizes that an organization must demonstrate 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.<sup>5</sup> According to the Uniform Guidance, allowable purposes for incentive compensation paid for with federal funds include cost reduction, efficient performance, suggestion awards, and safety awards.<sup>6</sup>

Historically, the DAB has closely adhered to the allowable purposes for incentive compensation as set forth in the Uniform Guidance.<sup>7</sup> The decisions allowed organizations to use federal funds to pay incentive compensation for purposes such as above average performance and successful cost-cutting efforts.<sup>8</sup> The DAB disallowed incentive compensation paid for purposes outside the scope of those referenced in the Uniform Guidance, including incentives to make up for



historically low salaries; recognize job seniority or length of service; and spend down unexpended grant funds at year end.<sup>9</sup>

During the COVID-19 pandemic, however, funding sources adopted a broader view of allowable purposes for incentive compensation as a way to address staff recruitment and retention challenges exacerbated by the pandemic. After the pandemic subsided, some funding sources maintained a more favorable view of the purposes for which a grantee may issue incentive compensation. The Office of Head Start (OHS), for example, issued a Program Instruction that explicitly directed Head Start programs to consider using “base Head Start funds” to provide bonuses, short-term pay increases, and other financial incentives to recruit and retain staff.<sup>10</sup> OHS promoted prioritizing bonuses or incentives for staff with established tenure and to improve a grantee’s ability to compete with other employers in their geographic locations. As a result, OHS now considers it allowable to use Head Start funds for incentive compensation that recognizes job seniority or length of service, and raises historically low compensation up to competitive levels.

CAAs should determine how their other funding sources interpret allowable purposes of incentive compensation post-pandemic. CAAs may consider using OHS’s guidance to help influence the approaches of those funding sources with respect to incentive compensation. For example, CAAs in some states used OHS’s guidance to successfully convince state administering agencies for Weatherization to allow CAAs to use those to pay retention bonuses for Weatherization program staff.

- **Incentive Criteria.** An organization must use objective and realistic incentive criteria that is linked to the accomplishment of the organization’s exempt purposes.<sup>11</sup> An organization can apply the criteria to individual employees or, under limited circumstances, on an organization-wide basis.

When applying the criteria to individual employees, an organization must tie its assessment of whether an individual employee met the criteria to that specific employee’s accomplishments—a CAA should not determine if an employee in one department earned incentive compensation by looking at outcomes met in a different department.<sup>12</sup> The DAB upheld using federal funds for incentive compensation awarded under a policy that used a five-point performance rating scale, from 1 (“Low”) to 5 (“Outstanding”). When additional funding was available, the CAA awarded one-time salary supplements to employees with above average performance, and sometimes distributed additional merit bonuses for excellent or outstanding performances or major contributions to the agency.<sup>13</sup>

An organization may also issue incentive compensation awards using federal funds on an organization-wide basis under certain, limited circumstances. The DAB upheld a one-time bonus payment made to all full-time staff for their successful effort in reducing program costs after federal budget cuts. Since the award was based on the “staff’s overall performance” and the grantee followed its policies, the organization did not need to provide individual performance evaluations.<sup>14</sup>



- **Reasonable Compensation.** The IRS and the DAB require organizations to pay reasonable amounts under an incentive compensation policy. The general standard of reasonableness is what a prudent person would usually pay for similar services under similar circumstances.<sup>15</sup> DAB decisions establish that factors an organization may consider in determining reasonableness include 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.<sup>16</sup>
- **Safeguards.** The policy should include safeguards to prevent abuse of the arrangement. Incentive compensation must not diminish funds designated for program-related activities. Before paying bonuses, a CAA should ensure it is on track to provide all services outlined in its annual program budgets and instruct program managers to not set aside funds intended for programs to establish a bonus pool.

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

**Board Oversight.** A policy should specify that the board has sole discretion to cancel or reduce awards if paying the incentive compensation would violate any law or regulation; jeopardize the CAA's ability to meet its obligations to funders or carry out its tax-exempt purposes; or is not otherwise in the organization's best interest. CAAs should consult an employment attorney on how to structure and facilitate the policy, since some state laws may treat 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. Keep the following actions in mind when applying an incentive compensation policy:

- **Obtain Required Approvals.** An independent board of directors must adopt the policy and any subsequent changes. Only independent directors should participate in the vote. An arms-length relationship must exist between the board and any employees receiving incentive compensation.<sup>17</sup> When adopting or amending the incentive compensation policy, refer to it with as much specificity as possible in board minutes. In a 2018 case involving a Head Start agency, the DAB refused to infer that the board approved an increase in the payment available under the incentive compensation policy because the board failed to mention the incentive compensation policy changes in its minutes.<sup>18</sup> Some funding sources may also require a grantee to obtain



additional approvals before issuing incentive compensation. In the case of Head Start grantees, the policy council must approve policies and procedures establishing compensation for Head Start staff.<sup>19</sup>

- **Charge to the Proper Grant Period.** A CAA must charge incentive compensation to the grant year during which the incentive criteria were met. The DAB upheld a disallowance of incentive compensation because the grantee used funds from one grant period to pay incentive compensation incurred in another, prior grant period.<sup>20</sup>
- **Apply the Policy or Practice Consistently.** A CAA must apply the incentive compensation policy in accordance with its terms.<sup>21</sup> The DAB consistently disallowed incentive payments when the grantee failed to follow its established plan or practice, including failing to apply the incentive criteria set forth in the policy. Examples of such disallowances include:
  - Paying all non-management employees the same level of incentive compensation when the policy required the CAA to evaluate employees individually and award greater incentives to those with superior performance.<sup>22</sup>
  - Disregarding the policy and awarding more highly-rated employees with less incentive compensation than lower-rated employees.<sup>23</sup>
  - Awarding incentive compensation despite failing to achieve full enrollment in its Head Start program, as required by its policy.<sup>24</sup>
- **Call it Like It Is.** Whether you call it “incentive compensation” or a “bonus”, if a CAA awards employees a temporary, discretionary increase in pay, the IRS and federal funding sources are likely to view it as incentive compensation. In a DAB decision, a grantee insisted that the funds it awarded were a “one-time lump sum payment”, not incentive compensation. However, the DAB upheld the disallowance because the grantee failed to provide evidence establishing a substantive difference between the one-time lump sum payment and a bonus.<sup>25</sup>
- **Document, Document, Document.** Keep records establishing how and when the CAA met the criteria for incentive compensation. The DAB 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 the grantee failed to provide evidence that: (1) the policy was in place during the applicable grant period; (2) payment was made in accordance with the policy’s criteria; (3) overall compensation was reasonable; and, (4) allocations to the federal award were proportional to the benefit received by the award.<sup>26</sup>
- **Work with an Attorney.** A CAA should work with an attorney licensed to practice in its state and familiar with tax and employment law issues when drafting a new policy or amending an existing one.



## ENDNOTES

<sup>1</sup> 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.

<sup>2</sup> 26 U.S.C. § 501(c)(3).

<sup>3</sup> See [Licking County Economic Action Development Study](#), DAB No. 1159 (1990).

<sup>4</sup> See [Licking County Economic Action Development Study; Rural Day Care Association of Northeastern Carolina](#), DAB No. 1384 (1993).

<sup>5</sup> See [IRS Information Letter 2002-0021](#) (Jan. 9, 2002).

<sup>6</sup> 2 C.F.R. § 200.430(f).

<sup>7</sup> DAB decisions issued prior to the 2014 adoption of the Uniform Guidance reference the cost principles from Circular No. A-122. Circular No. A-122 provided guidance on cost allowability of federal awards prior to the Uniform Guidance. The allowable purposes for incentive compensation in the Uniform Guidance mirror those found in Circular No. A-122.

<sup>8</sup> See [Seaford Community Action Agency](#), DAB No. 1433 (1993); [Washington County Opportunities, Inc.](#), DAB No. 1464 (1994).

<sup>9</sup> See [Licking County Economic Action Development Study; Rural Day Care Association of Northeastern Carolina](#).

<sup>10</sup> See [ACF-IM-HS-22-04, Competitive Bonuses for the Head Start Workforce](#).

<sup>11</sup> See [IRS Information Letter 2002-0021](#) (Jan. 9, 2002).

<sup>12</sup> *Id.*

<sup>13</sup> 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.

<sup>14</sup> See [Washington County Opportunities, Inc.](#)

<sup>15</sup> 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>.

<sup>16</sup> See [Washington County Opportunities, Inc.](#)

<sup>17</sup> See <https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions>.

<sup>18</sup> See [Kids Central, Inc.](#), DAB No. 2897 (2018).

<sup>19</sup> See 42 U.S.C. § 9837(c)(1)(E)(iv), (c)(2)(D)(vi); 45 C.F.R. § 1302.90(a).

<sup>20</sup> See [Kids Central, Inc.](#)

<sup>21</sup> See 2 C.F.R. § 200.430(f).

<sup>22</sup> See [Texas Neighborhood Services, Inc.](#), DAB No. 2571 (2014).

<sup>23</sup> See *id.*

<sup>24</sup> See [Kids Central, Inc.](#)

<sup>25</sup> See [Licking County Economic Action Development Study](#).

<sup>26</sup> See [Maryland Disability Law Center](#), DAB No. 2843 (2018).

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*This resource was developed by Community Action Program Legal Services, Inc. ("CAPLAW") in the performance of an award from the U.S. Department of Health and Human Services (HHS), Administration for Children and Families (ACF), Office of Community Services (OCS), Award Number 90ET0505-01. Any opinion, findings, and conclusions, or recommendations expressed in these materials are those of the author(s) and do not necessarily reflect the views of, nor the endorsement by, OCS/ACF/HHS or the U.S. Government. For more information, please visit the ACF website, Administrative and National Policy Requirements.*

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