

**CEO COMPENSATION PACKAGE DETERMINATIONS
MADE BY
UNITED STATES NAVAL ACADEMY ALUMNI ASSOCIATION AND
FOUNDATION**

The Naval Academy Alumni Association and Foundation determine the compensation package of the CEO by following very carefully the process specified by the Internal Revenue Service under Internal Revenue Code Section 4958.

Specifically, the independent Compensation Committee of the Boards of the Association and the Foundation acquires, from an independent, professional compensation consultant, a market survey to determine the appropriate range for the compensation package of the CEO. The Committee then evaluates, in detail, the performance of the CEO as determined by the Chairman of the respective organizations, comparing that performance to the compensation package range reflected in the report of the consultant.

The Committee then determines where, within the range reflected in the consultant's report, the CEO's actual compensation package will fall. The median (50%tile) is considered the "market" for the position. The most recent market survey (May 2007) indicates that the CEO's base salary and total cash compensation are 83% & 90% of the market respectively. These levels are well within what the IRS determines to be reasonable. The compensation is allocated (45/55) to the Alumni Association and the Foundation.

After making and documenting its determination, but before announcing its determination to the CEO, the Committee acquires an opinion from its counsel confirming that the process followed by the Committee in determining the CEO's compensation package meets the requirements of Internal Revenue Code Section 4958.

The Association and the Foundation then report the CEO's compensation package on their annual Form 990 reports to the IRS, portraying that compensation in the manner required by the instructions to the Form 990.

Finally, at least annually, and sometimes more often, the Committee consults with its counsel to ensure that it is taking all the steps necessary or appropriate to comply with the IRS rules concerning the determination of compensation packages for CEOs of 501(c)(3) organizations.

An issue paper follows that describes the executive compensation process, an overview of the intermediate sanctions rules, and the charter of the Joint Investment Committee.

The United States Naval Academy Alumni Association, Inc
United States Naval Academy Foundation, Inc.
Joint Compensation Committee
Issue Paper

Subject: Senior Executive Compensation

Purpose: To outline the process by which the Alumni Association and Foundation monitors and determines the compensation for the President & CEO, other officers, and key executives.

Background:

- To obtain and retain federal tax-exempt status under Sections 501(c) (3), an organization must be organized and operated so that no part of its net earnings inures or benefits any private individual.
- Tax-exempt organizations are prohibited from engaging in private inurement transactions. This means that no private individual can obtain the organization's funds **except as reasonable compensation** for goods or services provided.
- The rules apply to an organization's "insiders", which generally includes its trustees, directors, officers, members, and key employees.
- If the IRS determines that private inurement has occurred, then the organization's exempt status can be revoked.
- As an alternative penalty to revocation of the tax-exempt status, the IRS enacted the so called "Intermediate Sanctions Rules"¹ (Section 4958) which provides for penalties in the form of excise taxes on "excess benefit transactions."
 - An "excess benefit transaction" includes any transaction between the tax-exempt organization and a "disqualified person" that is not based on **fair market value**.
 - A "disqualified person" includes, among others, an individual who (within 5 years of the transaction) was in a position to exercise "substantial influence" over the organization's affairs. Persons who have "substantial influence" include: Trustees or directors, President and CEO, COO, CFO, and others with significant influence within the organization.

Process:

- The Alumni Association & Foundation in order to comply with IRS rules has formed the "Joint Compensation Committee"². The committee is formed with members of the Alumni Association's Board of Trustees and the Foundation's Board of Directors.

¹ Summary provided as enclosure (1)

² Charter provided as enclosure(2)

- The committee reviews annually the compensation packages of those key employees determined to be “disqualified persons.”³
- The committee determines whether the compensation packages are reasonable by reviewing credible compensation comparability data provided by an independent compensation consultant⁴, the performance of the key employees, and other information the committee deems relevant.
- In conducting the review of executive compensation the consultant gathers relevant published salary surveys to use in developing the competitive market rates. Each position is matched to a similarly situated position covered in the surveys. A ratio is used to assess the degree to which current position pay levels are competitive with the market. The consultant considers compensation reasonable if this ratio is between 75% and 125% of the market rates.⁵
- The committee seeks the opinion of an independent counsel⁶, as outlined in the IRS’s intermediate sanctions rules, on the process to satisfy the requirements of the regulations.
- The committee keeps detailed minutes of the meetings.
- The committee reports to the respective organizations’ chairmen. The respective chairmen attend committee meetings regularly.

Recommendation: None – for information only.

³ Watt, Johnson, Murray, Sanford, Wallace, Heyworth, Kobosko

⁴ Kennedy & Rand Consulting, Inc.

⁵ In the survey conducted in 2007, the competitive ratio for the key executives was 86% for base salary and 97% for total cash compensation, which are both reasonable and within the competitive norms.

⁶ Henry Smith, Principal – Smith & Downey, LLP

Intermediate Sanctions Overview

GENERAL

The intermediate sanctions rules of the Internal Revenue Code impose penalties on Board members and executives of Code Section 501(c)(3) entities in cases in which the top employees of those entities receive unreasonably high compensation.

EMPLOYER PROTECTION

Fortunately, the intermediate sanctions rules provide that employers enjoy a “presumption of reasonableness” of the compensation packages of their top employees if they determine that compensation packages under the following procedure.

(1) First, the compensation packages must be approved by a Compensation Committee of the Board composed entirely of “outsiders”; that is, individuals who do not have any business or familial relationship with the employees.

(2) The Compensation Committee, before approving the compensation packages, must obtain and rely on credible comparability data.

(3) The Compensation Committee must adequately document the basis for its determination concurrently with making its determination (e.g., in Minutes of the meeting which are approved at the next meeting of the Committee).

(4) The Compensation Committee must obtain and rely on an opinion of counsel stating that they have met the various requirements to enjoy the presumption of reasonableness.

If these steps are followed, intermediate sanctions penalties may be imposed by the IRS only if it is able to develop contrary evidence sufficient to rebut the presumption enjoyed by the employer, a hurdle that will not be easily met.

MECHANICS

Typically, a Section 501(c)(3) employer retains a compensation consultant and ERISA counsel to assist it in ensuring that the requirements are met to enjoy the presumption of reasonableness.

Enclosure (2)

**The United States Naval Academy Alumni Association, Inc.
The United States Naval Academy Foundation, Inc.**

Charter of the Joint Compensation Committee

Mission Statement

The Alumni Association and the Foundation shall maintain a Joint Compensation Committee to determine the compensation packages of the key employees of the Association and the Foundation.

Organization:

The Committee shall be composed of members of the Boards of the Association and the Foundation selected by the Chairmen of the respective Boards, each of whom are "outsiders" with no conflicts of interest, as defined under the IRS's "intermediate sanctions" regulations.

Roles and Responsibilities

The Committee shall:

A. review annually the compensation packages of those key employees of the Association and the Foundation who are determined to be "disqualified persons" under the IRS intermediate sanctions regulations.

Operations and Communications

The Committee shall:

A. report to the respective organizations' chairmen the approved compensation packages for those key employees only if the Committee determines that the proposed packages are reasonable under all of the relevant facts and circumstances. In determining whether a compensation package is reasonable, the Committee will review credible compensation comparability data provided by an independent compensation consultant, will review carefully the qualifications and performance of the key employees, and will review such other information as the Committee determines is relevant.

B. keep detailed minutes of its meetings, and review and approve each meeting's minutes at the next meeting of the Committee.

C. seek an opinion of counsel to the Committee, in the form specified in the IRS's intermediate sanctions regulations, on the process it follows to satisfy the requirements of those regulations.

D. periodically update the Executive Committee of the Boards of its activities and formally report its activities to the respective Chairmen at least annually.