Tips for Setting Non-profit Executive Compensation in a Time of Congressional Outrage and Media Scrutiny

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As evidenced by the recent media coverage of the salaries paid to CEOs of four non-profits that contract with the government to deliver U.S. foreign aid, non-profit executive compensation continues to be an area of keen interest for the media and for key members of Congress. Each of the four executives earned over $500,000 in 2007 according to the organization's tax filings (Form 990). Both Sen. Chuck Grassley and Sen. Patrick Leahy made comments that the pay is excessive:

> "It seems to me that these are salaries that are outrageous, particularly if they're government contractors," said Sen. Chuck Grassley of Iowa, the ranking Republican on the Finance Committee, which has jurisdiction over non-profit compensation.
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> "It conflicts with most people's notion of what a non-profit organization is about when they're paying themselves salaries that are several times higher than what a U.S. Cabinet secretary would earn," said Sen. Patrick Leahy, D-Vt., who chairs the subcommittee that funds foreign aid.

While it is true that these salaries are in excess of what a U.S. Cabinet secretary earns, that is not the standard. The standard is reasonable compensation in the amount that would ordinarily be paid for similar services by similar enterprises, whether taxable or tax-exempt, under similar circumstances. Based on this standard, it’s not clear whether these executives are earning excessive compensation.

Running a large and diverse non-profit organization with a multi-million dollar budget and operations spread out across the globe does not require less skill because the organization is a non-profit. Non-profits compete with for-profits for executive talent, yet the Senators’ comments imply that executives who choose to run non-profit organizations should forgo a significant portion of their earning potential for the privilege.

In my experience, most non-profits do pay reasonable salaries according to the reasonable compensation standard. Where many are coming up short is in adequately documenting the process in a manner that will substantiate and explain the compensation decision if questioned.

To ensure its decisions will stand up to the scrutiny of the media, regulators, and donors, and to protect the employee as well as the board from personal liability, non-profits that employ executive staff should consider implementing practices and procedures that ensure its executive compensation procedures are thorough, well-documented, and conflict-free. Recommendations include the following:

1. Use the Rebuttable Presumption Procedures. Tax-exempt organizations must pay reasonable compensation. The Treasury Regulations outline a process for public charities and social welfare organizations that, if followed, shifts the burden of proof to the I.R.S. to prove that compensation is unreasonable. The I.R.S. has published a checklist that can be used for this purpose.

2. Create a Compensation Committee. A dedicated committee is often better able to devote the time and attention that executive compensation matters require. If a compensation committee is formed, it should operate pursuant to a formal delegation of authority from the board.

3. Adopt Comprehensive Conflicts of Interest Policy. A conflict of interest policy is strongly encouraged by the I.R.S. and is a legal requirement in some states. If followed, it can help protect directors and officers from liability stemming from transactions between the organizations and insiders.

4. Adopt a Compensation Policy. A compensation policy helps to create internal consistency by specifying comparable peer groups, target market position with respect to salary, long and short-term incentives that the foundation offers, total cash compensation, standard benefits, and any executive benefits and perquisites.

5. Use Appropriate Comparability Data. Reasonable compensation is the amount that would ordinarily be paid for similar services by similar enterprises, whether taxable or tax-exempt, under similar circumstances. To qualify for the rebuttable presumption, non-profits with annual gross receipts under $1 million must rely on at least 3 comparables. No threshold has been set for larger non-profits; however, the higher the proposed compensation, the more data the board should generally consider.

6. Assess All Components of Executive Compensation Relative to Comparable Organizations. It is important to ensure that total compensation is reasonable rather than comparing salary and various perquisites in isolation. All financial benefits (other than de minimus fringe benefits) must be included in the analysis and reported as compensation.

7. Have Full Board Approve Chief Executive's Compensation. It is prudent to have the full board of directors approve the chief executive's compensation package. Some boards approve other key executive's compensation. Others delegate that task to the compensation committee or to the chief executive (within pre-established limits).

8. Have Full Board Approve Directors' Compensation. The full board of directors should approve any compensation paid to directors or trustees. This is a requirement

under some state non-profit corporation laws. Due to the inherent conflict of interest, the board should base its decision on the certified opinion of an independent compensation consultant or recommendations from an independent ad hoc committee.

9. Adopt a Travel and Expense Reimbursement Policy. To ensure that travel and expense reimbursements are reasonable and necessary, non-profits should adopt a travel and expense reimbursement policy. This is a good place to memorialize the organization's practices in areas of I.R.S. interest such as luxury travel and spousal travel.

10. Where The Stakes Are High, Obtain a Reasoned Opinion. A reasoned opinion from a lawyer, certified public accountant, or compensation expert protects the board from incurring penalties for "knowingly" paying unreasonable compensation to a key employee or other insider. The review can also serve as a valuable mechanism to discover and correct weaknesses in the analysis or documentation of the compensation process.

If these recommendations are carefully followed, the board will be able to justify its executive compensation decisions. Regulators and the media still may not like the result, but if it is based on solid data and the decision is well-researched and conflict free, the board will be in an excellent position to defend its compensation decisions.