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Executive Compensation Considerations

What executive directors should be paid can definitely be a sticky topic these days. On the one hand, an organization wants to make itself competitive in order to attain the best talent. On the other, you don't want to end up on the front page of Yahoo News with the headline "Nonprofit under investigation". Admittedly, the balance between competitive and excessive is a tough one, with it being easy for one to inadvertently cross the line. But determining executive compensation is definitely one facet of operation you'll want to pay particular attention to. Doing so will not only assist in gaining the trust of your donors, staff and board, but can lead to a happier, aspirational and more competent work-force as well. Not giving it the requisite attention can result in intermediate sanctions, fines, penalties, investigations and damage to your brand.

The key to it all is have a system in place and to ensure this system is not only used, but implemented fairly. Here, a template approach is not recommended. You'll want to audit your organization and determine what may work best for you. To get you on your way, I've outlined a couple of considerations to keep in mind below.

An Appraisal System

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A good way to rebut claims of impropriety is to have some sort of appraisal system in place. Whether you use a point, goal or ranking system, it helps to have some objective system playing an integral role in determining what an executive's (or someone in an executive position's) compensation will be.Perhaps those in executive positions can have goals set for them, depending on where their weaknesses and deficiencies lie, and meeting those goals determines whether or not a raise is appropriate. When initially hiring someone for an executive position determine how important certain competencies, experiences or skills are and compensate accordingly. The important thing is to avoid compensation or raises being determined on an impromptu basis. You'll want some way of documenting how much a particular position is getting paid and why that amount is appropriate.

Compensation Policy

As supplement to an appraisal system you might also want to draft a compensation policy as well. Doesn't have to be 1000 pages or read like a Shakespearean masterpiece. Just something succinct that details how your organization sets compensation and how compensation will be adjusted each year (remember, accounting for a raise is just as important as the base salary). Detail what factors or data the organization use in its determinations, and how they will use it. You'll also want to be clear on what constitutes as "compensation" and detail how each facet of "compensation" will work. So things like benefits, deferred compensation, raises, expense accounts, housing, etc. should all be discussed or at least touched on. For that last touch of "umph" detail what the policy is for, why it is needed, how it will be used and that all compensation must be set with the best interests of the organization in mind. Language covering the IRS' Intermediate Sanctions safe harbor requirements, which are further discussed below, should also be included.

Committees

I won't get too much into this, but depending on the size of the organization it may be beneficial to have an ad hoc compensation committee. They wouldn't really be active until annual reviews came around, other other impromptu events such as hiring, but the task of researching comparable salaries, new legal or ethical developments in compensation as well as ensuring that annual reviews run properly could be tasked to this committee. No need for it to be too large, perhaps someone from the finance/audit committee (who can keep everyone on track with the big financial picture of the organization) as well as 1 or 2 other board members and

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possibly the ED. Of course, when the ED's compensation comes up you will want to gracefully exclude them from that conversation.

Penalties

There are a few "penalties" that you'll want to be aware of. The first, and most often mentioned, are the Intermediate Sanctions the IRS wages on excess benefit transactions. The reasoning is, if someone's salary isn't reasonable there has arguably been an excess benefit gained. The tax is 25% of the excess benefit (the amount exceeding what was reasonable) and can jump up to 200% if left unresolved. Unfortunately, not only the person receiving the benefit but the person (s) paying the excess benefit can be penalized as well. However, the law does have a safe harbor protecting organizations if a there is a "rebuttable presumption of reasonableness" i.e. if the compensation is reasonable. Amongst many things this is determined by:

- Whether the financial arrangement was approved by a committee (board) that is unrelated to, and not subject to, the control of the person receiving the benefit (known as the disqualified person).
- Whether appropriate data was used to determine whether the transaction was comparable with what others have done in similar situations. Examples would be compensation studies done by other organizations, offer letters from organizations in the same geographical location and sector, etc.
- Whether the arrangement and its basis were properly documented. In other words, details of what was relied on in determining compensation, how the arrangement was voted on, etc.

More details about intermediate sanctions can be found on the IRS' website.

Other things that should be kept in mind is that excessive pay can also be interpreted as private inurement in some instances (a concept I discussed in a previous post). Consequently, excessive compensation can not only result in responsibility for extra taxes but risking one's tax-exempt status was well. In addition to these two considerations you will also want to keep in mind other regulations that affect compensation such as the Fair Labor Standards Act (FLSA), Employee Retirement and Income Security Act of 1974 (ERISA), Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) and any applicable state regulations.

Take-Away

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At the end of the day it is all about being reasonable; do you pass the common-sense test. I would venture to say that in most of those egregious cases we read about in the papers (where the small town non-profit with a small budget dedicates itself to advocating for Amazonian frogs and pays its ED over a million dollars) involves people who knew fully well something wasn't quite okay. But to avoid those close-call situations you'll want to ensure you have a way of proving that there is no conflict or favoritism involved with your compensation decisions. The right systems with the right implementation will do just this.

For further research:

- Charity Navigator, The United Way, Guidestar and Non-profit Times conduct survey's on Executive Director pay. These will help tremendously with researching comparable salaries.
- The BoardSource and National Council of Nonprofits have sample policies that can be used a a reference point.
- The IRS has a great page addressing Excess Benefit Transactions.

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