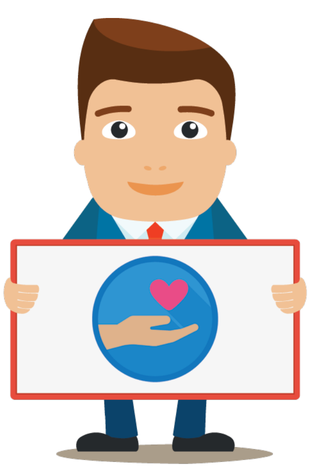
ECONOMIC RESEARCH INSTITUTE

Guide to Setting Nonprofit Executive Compensation



There always seems to be plenty of interest in levels of nonprofit executive compensation – not only from federal and state government regulators, and even Congress on occasion, but also the media. The threat of financial penalties has heightened, but the loss of public support and credibility for charities is also a major factor. This is the time for tax-exempt organizations to increase the time and attention devoted to investigating, deliberating, documenting, and reporting executive compensation.

While nonprofit executives may be very focused on the mission of their organizations, they still have themselves and their families to support. Regardless of size or tax status, all organizations need to attract, motivate, and retain the right employees to ensure their continued success. That means setting compensation at market rates that are also in accordance with IRS rules and regulations for those with tax-exempt status.

Organizational Steps to Take

There are some steps that need to be taken before salaries are determined in any organization with employees.

Establish a Compensation Committee

A dedicated committee is in a better position than the full board of directors to devote the time and attention that executive compensation matters require. The Committee should also have a charter adopted by the full Board of Directors that establishes its legal authority and provides guidance in the task of setting compensation. Management should not control the process of compensation setting, even indirectly. Ideally, the Compensation Committee's Charter should authorize the Committee to select, hire, and work with advisors directly, outside the presence of management.

Enact and Enforce a Conflict of Interest Policy

Although not strictly a requirement, the IRS does include a question on the Form 990 asking if the organization has a conflict of interest policy. An explanation is required for those who reply no. Such a policy requires disclosure of any situation in which a person or organization is involved in multiple interests, financial or otherwise, one of which could possibly corrupt the motivation or decision-making of that individual or organization. For example, this would include a CEO who, as a Board member, has a voice in setting his own compensation, or a board member who is a lawyer and approves a contract with his firm for services to the organization.

If there is a conflict reported, here are some options:

- No participation by the member with the conflict in any decision-making (such as leaving the meeting room during discussions and votes).
- Resign from the governing body.
- End a business relationship with a business which the member has a conflict or, alternatively, obtain bids from outside vendors or hire a consultant to confirm that the compensation arrangement is fair and reasonable.
- Document any steps taken in the minutes of the organization.

Create a Compensation Philosophy

This is a statement intended to give insight into the organization's philosophy towards compensation for its employees and helps guide the Compensation Committee or other group tasked with setting the salaries. Here is an example:

> "Our policy is to pay at the 50th percentile of human service nonprofits of our size in the Washington, D.C., market."

Detailed job descriptions should identify responsibilities and accountabilities, as well as any experience, certifications, or education required to competently fill that job. The major tasks, and amount of time allocated to each task, should also be included to provide a basis for market pricing.

Market pricing is a formal process for determining the external value of jobs. This is used in conjunction with the compensation philosophy; in the example above, that is "paying at 50th percentile of human service nonprofits of our size in the Washington, D.C., market." After the comparative market is defined and the jobs matched, then the data from comparable organizations can be used to develop a target pay rate for each job. Then the market rate can be used to set the salaries, or a more formal pay range system can be developed, if needed.

In a formal salary structure, jobs are grouped by pay levels and pay ranges with midpoints representing the "competitive market rate" for the group of jobs established. A typical pay range is +/- 20% of the midpoint. Then the compa-ratio, a measure that expresses current pay rate as a percentage of range midpoint, can show how the organization is paying in relationship to the market. An organization with a stable employee population would target an overall compa-ratio of 100%, indicating it pays at market levels that attract and retain the employees it needs to function.

Not only is there a need to think about salaries when there is a vacancy or new position, but also each year during the annual budget process when the allocation of salary increases and pay adjustments are considered. The fixed money available can be distributed in several ways:

- **Flat Increase** – All receive a set percentage increase (usually referred to as a general increase or cost-of-living adjustment).
- **Merit Pay** – This increase reflects the level of individual performance, with higher performing employees receiving larger percentage increases. This means a formal performance management system must also be in place.
- **Market Adjustment** – If the compensation philosophy includes a commitment to market competitiveness, there should be money set aside annually for pay adjustments to employees whose salaries are low compared to the market or for increases for jobs which have become more competitive in the market.

Taking these steps will prepare the organization to move on to actually setting compensation.

Requirements for Setting Nonprofit Executive Pay

Executive pay gets reported on Form 990 filings and is reviewed by the IRS for "excess benefit" issues. IRC Section 4958 (intermediate sanctions) does not allow 501(c)(3) organizations to pay more compensation than is "reasonable." Also, insider relationships need to be disclosed (among officers, directors, founders, their families, etc.), and the IRS considers any form of compensation (salaries, pensions, and unpaid deferred compensation). In addition, payments for personal expenses, rents, personal use of organization's property or facilities, or loans or other payments must also be reported and will be reviewed.

Reasonable Compensation

The IRS says that reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax-exempt, under like circumstances. The IRS definitions of those terms follow:

- **Like Services** – That means finding a job match with substantially similar duties and responsibilities, including such factors as the number of employees managed; the size of the budget or assets managed; hours worked; and scope (national or local).
- **Like Enterprises** – Organizations used for comparison must be similar in size, usually measured by budget, assets, number of employees, or number of persons served. Equally important, the organizations must provide similar services, usually classified using the National Taxonomy of Exempt Entities (NTEE). While some for-profit comparables can be used to determine reasonable compensation, the IRS says that exclusive reliance on them will "draw increased scrutiny and may lead to the tax-exempt organization not being able to rely on the rebuttable presumption of reasonableness." If the tax-exempt organization can show that tax-exempt and for-profit entities compete for the same pool of specialized talent, then the for-profit data can be used.
- **Like Circumstances** – All forms of compensation must be included in the comparison. For example, are there expense allowances or housing paid for some jobs and not for others? All financial benefits need to be included in the analysis. Geographic area should also be reviewed. If sufficient comparable data are not available for the geographic area, then a larger geographic might be necessary, in addition to potential cost-of-living adjustments.

The Rebuttable Presumption

The IRS has decided that compensation will be presumed reasonable, unless proven otherwise, if the organization follows a set of standard procedures, creating what is termed a "rebuttable presumption of reasonableness." This presumption means that it is the responsibility of the IRS to prove that a transaction involved excess benefit, not the Form 990 filer.

The IRS has set out these requirements to establish the rebuttable presumption:

- The transaction is approved by an authorized body of the organization, usually the full Board of Directors, but with no participation by anyone who might be affected by the decision on compensation. There might be a compensation committee or an executive committee, or another sub-group or task force of board members, for this purpose.

- The authorized body uses “appropriate data” to determine comparability prior to making a decision. That means looking at what nonprofit employers with similar missions, and similar budget sizes, that are located in the same, or a similar geographic region, pay their executives.
- The authorized body documents the basis for its determination while making its decision – who was involved with reviewing comparable data (and their “independence”), the process used, and the decision to set the executive salary, demonstrating that the board considered the comparable data when approving the compensation.

Finding Comparable Data

For organizations with annual gross receipts of less than $1 million, the IRS has stated that compensation data should be provided for similar positions paid by three comparable organizations. No threshold has been set for larger nonprofits; however, the higher the proposed compensation, the more data the board should generally consider.

So organizations with annual revenues of $1 million or over must do more detailed analysis of comparable compensation. Although some individual surveys are available for purchase, there are some disadvantages to using them as the sole source of data – they may be expensive or limited in scope (too few organizations responding or insufficiently detailed industry breakouts). Often, the additional criteria of size and geographic location significantly reduce the number of relevant observations needed to pass the IRS criteria for comparability. The type also tends to be very important for nonprofits, as executive salaries vary widely among child care centers, art museums, health care clinics, and public policy think tanks, for example.

ERI’s Nonprofit Comparables Assessor™ software equips users to calculate average salaries for specific nonprofit executive jobs based on the criteria used by the IRS to assess comparability – type of nonprofit, size, and geographic location. The data used in the software include salaries from all Forms 990, updated every time a new form is filed. This is the most comprehensive data source available, as data from all Form 990 filers are included. The software provides a simple way to find the market salaries for nonprofits based on the criteria that IRS uses to determine comparability of data. It also provides a list of comparable organizations that can be refined to a smaller number targeted for further research.

For example, let’s say a nonprofit adoption center in Chicago, Illinois, with annual revenues of $10 million, is seeking a new executive director, the top paid position in the organization. After checking for and resolving any conflicts of interest among the members of the Board Compensation Committee and setting a compensation philosophy of paying at the average level for its executives, the organization should consider the following information from the Nonprofit Comparables Assessor to set the parameters of pay:

Table 1 - Nonprofit Comparables Assessor: Reportable Compensation for CEO

Revenue	25th Percentile	Mean	75th Percentile
$ 15,000,000	$ 140,767	$ 167,573	$ 211,378
$ 10,000,000	$ 123,721	$ 147,281	$ 185,782
$ 5,000,000	$ 99,223	$ 118,118	$ 148,995

Organization Data - Area: Illinois; Industry: Children’s, Youth Services; Size: $10,000,000

So the compensation for the CEO position would probably be around $147,000 per year based on the Form 990 reported salaries of other Illinois charities providing services to children.

Next, the Nonprofit Comparables Assessor can be used to develop a detailed list of the organizations that provide individual and family social services, based in Illinois, with the specific annual revenue size that is most relevant for comparison (for example, ranging from $5 million to $15 million). In this instance, the Nonprofit Comparables Assessor finds a list of 18 organizations that meet the criteria – providing similar services in Illinois, with annual revenues of $5 million to $15 million. The list provides the name, title, and compensation for the CEO in each comparable organization, plus other financial information. From that list, the organizations could be chosen for further research and analysis, perhaps a list of the 10 most similar entities. The list also includes the IRS Employer Identification Number (EIN) for each comparable organization, so the specific Form 990 can be easily accessed from the ERI Form 990 library. Then the purpose and operation can be reviewed along with any other compensation details included on the Form 990 that are not included on Table 1. For example, there could be more details on compensation reported on an attached schedule or a notation that a salary is for part of the year or includes a deferred compensation payment. It might also be useful to contact these organizations for more detail.

Using the Data for Decision-Making

The combination of Table 1 data with more precise data on the Form 990 covering a more limited group of organizations should be documented in a report, including a recommendation for compensation and the rationale for that decision.

While the IRS says that it is less likely to scrutinize compensation which is at or below the 50th percentile of the average salary paid for that position in comparable organizations, there are no precise rules for a salary level. If the organization wants to pay above the 50th percentile, there should be justification for that level. That might include describing the knowledge, experience, or relationships that would be difficult to replace, or qualifications needed because the organization is recovering from mismanagement or growing into new areas. Also, if the incumbent has received a competing offer, that would also count as a rationale. The IRS seems mainly concerned with confirming that data from comparable organizations were collected and considered in the decision-making process.

Then, to ensure that the organization receives the protection of the rebuttable presumption of reasonableness from IRS, the decision-makers should finish by completing these tasks:

- Document the decisions on compensation in the records at the time it is approved by the full board.
- Note the comparability data obtained, how it was obtained, and the actions taken to ensure that no one with a conflict of interest was involved in the compensation decision.
- If it is decided that reasonable compensation is higher or lower than the range of comparable data received, then the basis for the decision should be recorded.

Summary

Following the steps outlined above results in compensation decisions that will pass review by the IRS and other stakeholders and meet the goal of attracting and retaining the executives needed to sustain the organization. **ERI's Nonprofit Comparables Assessor** provides a simple and cost-effective way to collect and analyze the comparable data needed in that process.

Please email Linda Lampkin at linda.lampkin@erieri.com with questions or comments.

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