Compensation Committees:
Does Your Organization Need a Compensation Committee?

Eileen Morgan Johnson
Whiteford, Taylor & Preston LLP
1025 Connecticut Avenue, N.W, Suite 400
Washington, DC 20036
202-659-6780 (office)
202-327-6180 (fax)
emjohnson@wtplaw.com

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Does your organization need a compensation committee?

With all of the recent efforts to improve the governance of nonprofit organizations, some nonprofit boards have been reconsidering how they set compensation, particularly for the organization's executive staff. A committee dedicated to reviewing and setting compensation can help the board to focus on this aspect of their operations and ensure that the organization's compensation program is reasonable and meets the expectations of the government and the organization's members or donors.

In order to avoid intermediate sanctions under Internal Revenue Code § 4958, organizations that are exempt from taxation under Internal Revenue Code Section 501(c)(3) or (c)(4) must not pay more to their staff or board members for their services than the value of those services to the organization. A compensation committee is one way for all nonprofit associations to provide oversight of this function.

Typically a board will decide on the salary and benefits of the senior staff as a committee of the whole or charge the executive committee with reviewing and setting compensation. However, with the increased scrutiny by government agencies and donors of expenditures for compensation and the increased complexity of some benefit programs, the use of a compensation committee is gaining popularity. A compensation committee can ensure that the board fulfills its fiduciary obligations in establishing and overseeing a compensation program.

A compensation committee is usually a small committee that is tasked with setting the policies for total compensation of the staff and then reviewing and setting compensation on an annual basis. The compensation committee may also work with the audit committee to review expense reports in order to identify potential abuses in compensation arrangements. Unlike an executive committee or finance committee that has other duties to perform, the attention of the compensation committee is focused solely on compensation issues. This gives the committee members the opportunity to learn more about this complex issue and to develop relationships with the consultants who help them fulfill their charge.

The board should provide oversight of executive compensation on a regular basis. Compensation committees are often standing committees for that reason. However, an organization may decide to form an ad hoc compensation committee or task force to perform a periodic review of compensation or whenever there is a change in management or other circumstance indicating a need for a thorough review of the organization's compensation.

Some compensation committees also provide advice and oversight to the employee benefits committee or oversee the benefits provided to board members. Those duties can also be shared with or handled by the finance committee or audit committee.

Composition of the compensation committee

Most compensation committees are small and are comprised of disinterested board members. A disinterested board member is one who does not receive compensation and thus has no personal interest in the work of the committee. Senior staff who serve as directors should not be on the compensation committee. There is nothing more likely to attract negative attention than having the organization's chief executive officer setting his or her own compensation. Other staff such as a compensation or benefits specialist on the human resources staff may serve as advisors to the compensation committee but they should not themselves serve on the committee.

Since the compensation committee may work with the audit committee, the chair of the audit committee should not be on the compensation committee. This gives the audit committee impartiality when reviewing the administration of the compensation program.

Good candidates for the compensation committee are board members who understand compensation, the complexity of employee benefits and the need for independent analysis and advice about executive compensation.

Charge to the committee

In smaller organizations, the compensation committee may set the compensation ranges for all employees. More often the committee approves compensation ranges for executive staff only and the board authorizes the chief executive officer to handle compensation for the rest of the staff. Some organizations have the compensation committee review only the salary and benefits package for the chief executive officer (the executive director or president). A better practice is to have the compensation committee review the compensation of all the senior staff. In rare cases, the president or executive director may not be the highest paid staff member of the organization.

If the compensation committee sets the compensation ranges for staff, the chief executive officer should set the actual compensation paid to staff. This preserves the distinction between the oversight provided by the board and the management of the organization by the chief executive officer.

Special rules for California

Organizations that solicit charitable contributions from the general public in California must comply with that state's Nonprofit Integrity Act of 2004 even if they are not located in California. The board must review and approve the compensation of the chief executive officer or president and the chief financial officer or treasurer to ensure that it is just and reasonable. The California law requires all board members to review and approve executive compensation at the time of initial hiring, when the term of employment is renewed or extended, and when the compensation is modified. The Act specifies that compensation includes benefits. The board's review of compensation may be performed by the entire board or by an authorized committee. The use of a compensation committee for this function complies with the California law.

Review total compensation

The compensation committee should consider all elements of the compensation package. They should not only review and benchmark salaries; they should also look at the entire benefits package, particularly any benefits that are only available to executives or the chief executive officer. The committee should work with a benefits consultant who can assist the committee in benchmarking salary and benefits based on the geographic area, the organization's competitors, and the staff's level of responsibility and experience. In addition to a compensation consultant, the committee should work with an employee benefits law specialist to ensure that the organization's benefit plans do not fail discrimination testing by providing favorable benefits to senior staff.

The IRS is currently reviewing the scope of benefits paid to staff in some organizations with a special focus on loans. It is not uncommon for organizations to provide loans to new senior staff to enable them to relocate to their new place of business. If the terms of these loans are favorable to the employee and they are not at regular commercial rates, there could be a problem.

Other benefits that should be considered in evaluating the compensation package are various insurance policies (medical, dental, disability, life), commuting assistance, meal allowance, travel allowance, entertainment allowance, membership in a gym or club, and the use of a company car, cell phone or computer. Services provided to the employee at home to set up or maintain a home office should also be considered such as internet service, telephone service, furnishings and similar items. The employee may need to allocate between personal and business use of these items.

Board member benefits

While most members of nonprofit boards do not receive compensation for their services in the form of salary, many do receive reimbursement for expenses incurred in fulfilling their volunteer duties. Others may receive free admission to programs hosted by their organization or benefit from the use of nonprofit property such as cell phones and computers. Some may enjoy traveling to resort locations for board meetings or the organization may pay for their spouse or other guest to accompany them to board meetings and functions. Benefits provided to the board may be considered compensation. If that compensation is deemed excessive, the organization has a potential problem with the IRS, funders, watchdog groups and others.

Typical reimbursement policies allow board members to be reimbursed for minimal out-of-pocket expenses such as long distance telephone charges and postage. An organization may reimburse mileage, tolls and parking for local travel. These reimbursement policies are usually fine since they do not cover excessive spending. Problems can arise when an organization pays for entertainment or travel expenses for its board or provides what may be considered to be personal services for the board members. Free attendance at a social event such as a concert or party hosted by the organization does not usually create problems since the board member is often there to meet prospective donors or otherwise further the work of the organization. Sending the board on an all expense paid trip to a resort with only minimal board duties to perform while there could be a problem. Expense accounts can also pose problems unless the organization has a clear policy on what expenses can be paid out of these accounts and there is an audit or other check on the expenditures to ensure that they are appropriate.

Volunteer stipends

Some nonprofit associations pay stipends to their volunteers in recognition for their service to the organization. Stipends may be paid to the entire board, limited to the executive committee or given only to the board chair or president. To the extent that a stipend constitutes payment for services rendered, the compensation committee should review the organization's policies and procedures for paying stipends and ensure that there are no problems with this practice.

Spouse travel

Some nonprofit organizations place a premium on the social interactions of their board members and senior staff with members of the funding community, their major donors and the community they serve. Senior staff and board members who frequently travel on behalf of the organization or attend social functions to further the work of the organization may ask to take their spouse or guest along at the organization's expense. The Compensation Committee should establish policies for spouse and guest travel or event attendance and work with the audit committee to monitor compliance with the policy.

Under current tax law, the expense of a spouse or guest to attend a social function or travel on behalf of the organization should only be paid by the organization if the spouse or guest's attendance meets a bona fide business purpose of the organization. For example, the spouse may be hosting a program or special event and participating in the detailed planning and execution of the event. Or the guest may be involved in fundraising activities and provide detailed reports to the development staff on donor cultivation efforts. If no service is provided to the organization or if the cost of the travel or event participation outweighs the value provided in return to the organization, then some or all of the expense would be considered taxable income to the spouse or guest and should be reported on a Form 1099.

The role of the employee benefits committee

Some organizations use an employee benefits committee to manage the organization's benefit programs. This committee is typically comprised of staff from the human resources and finance departments although it may include some board members. The chief executive officer or another senior member of the management team may also serve on the committee. Typically these committees will review utilization and cost of various benefits and determine which ones will be offered to the staff each year. They may also address issues concerning the management of the benefits program.

While it is possible for an employee benefits committee that is comprised of staff to oversee the management of the organization's employee benefits program, the board shares responsibility for ensuring that the benefits are not excessive and that the program is managed fairly and without discrimination. The board should exercise oversight of the employee benefits program. Although it may not be practical to include members of the board on the employee benefits committee, the work of the employee benefits committee should be overseen by the board or one of its committees. A good working relationship is to have a board committee establish the benefits offered to employees with a budget approved by the board and management of the benefits program delegated to the staff.

Intermediate sanctions safe harbor

Organizations that are tax-exempt under Internal Revenue Code (IRC) Sections 501(c)(3) or (c)(4) have an additional challenge. Those organizations can be subject to intermediate sanctions under IRC Section 4958 in the form of excise taxes if the IRS determines that any compensation arrangements for the staff or board results in private inurement. In order to take advantage of the rebuttable presumption safe harbor provided by the IRS in 26 CFR § 53.4958-6, organizations should ensure that their compensation arrangements are: 1) reviewed and approved by the board of directors or a committee authorized by the board; 2) supported by appropriate data as to comparable compensation; and 3) documented with a contemporaneous record. The regulations provide detailed instructions on taking advantage of the safe harbor provision and should be consulted by any Section 501(c)(3) or (c)(4) organization establishing or reviewing its compensation approval process.

Reporting back to the board

The compensation committee should report to the board whenever it sets or changes compensation. It should also provide periodic reports on the work of the staff in managing the compensation program. These reports can be given to the full board in executive session so as to maintain the confidentiality of the employees who are involved.

The process for setting executive compensation can be difficult for some boards. The board is responsible for overseeing executive performance and compensation. Every board member should be involved in the process of submitting information to the committee that is charged with evaluating the executive's performance. That is part of their obligation to supervise the CEO. Likewise, the compensation committee should inform the entire board of the compensation that is being paid to the executive staff. Sometimes concerns about maintaining confidentiality prevent the board leadership from sharing compensation information with their fellow board members. While their concerns may be understandable, this is not a good practice. The board members should be informed of the need to keep compensation information confidential and their fiduciary obligation to act in the best interest of the organization. Then they should be given information on the compensation the organization pays to its senior staff and trusted to act appropriately. One of the lessons learned in recent years is that organizations that hide compensation arrangements from their boards often have larger issues than privacy concerns. Boards have fractured over secret compensation arrangements that are made public and organizations have lost credibility with their members, donors and the general public as a result.

Conclusion

A compensation committee may not be right for every organization. The use of a compensation committee should be evaluated in connection with the entire committee structure of an organization. If the work that could be delegated to a compensation committee is currently being handled well by other committees, then it is likely that the organization has no need of a compensation committee. But if the organization is struggling with how to set and oversee compensation, a compensation committee might be just what the organization needs to get this important board duty under control.