September 18, 2013

TO: Clients and Friends Interested in the Nonprofit Sector

RE: **"Say-On-Pay" for Nonprofit Executive Compensation**

The Dodd-Frank Act of 2010 gave the shareholders of public companies the right to vote on executive compensation, although the vote is non-binding. Nonprofits are subject to far greater scrutiny.

The IRS and state regulators generally have a "say on pay" and it is very binding. In California, if a charity board approves executive compensation that is higher than what is reasonable, based on market data, the board members may be personally subject to federal excise taxes or a suit for restitution brought by the Attorney General.

The best way directors can protect themselves when approving executive compensation is to follow the IRS' safe harbor guidelines:

- The compensation must be approved in advance by the board (not a committee).
- The directors voting for the compensation must be "disinterested," having no financial or other interest in the matter. For example, if the CFO is also a member of the board, the CFO would not be "disinterested" with respect to the compensation of his or her boss.
- The board must have market data supporting the decision. If the organization's revenue is less than $1 million, it is sufficient to have comparable pay data from three other organizations.
- The board must document the basis for the decision. (This is just one more example of the value of well-written minutes.)

This procedure is not required by law; it is a "safe harbor" under IRS regulations. The ultimate standard, whether or not the safe harbor procedures are observed, is whether the approved compensation is fair to the organization.

GuideStar publishes a survey of nonprofit sector compensation based on data from almost 100,000 tax returns filed by nonprofits around the country. For an organization above the $1 million revenue threshold, this might be a valuable resource.

The question of reasonable, market-rate compensation does not just boil down to dollars and cents and surveys. In one case, the Attorney General successfully sued a charity when the board approved a pension benefit after all of the employee services had been performed. (*Queen of Angels Hospital v. Younger*, 66 Cal. App. 3d 359, 371 (Cal. App. 2d Dist. 1977).) The moral is that a board cannot wait until an employee's retirement to approve a retirement benefit, because there is no legal consideration being given for the benefit, it is instead viewed as a private gift of public funds.

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