# COMPENSATION PLANNING FOR EXECUTIVE DEPARTURES

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*Nonprofit boards navigating the departure of a long-tenured executive director face the challenge to develop a mutually satisfactory exit agreement between the executive and the board, often in a limited time horizon (e.g., less than two years). Long-tenured executives who have dedicated years to their role - oftentimes as founders themselves or those who have been there since the organization's founding – may have accepted below-market salary rates and retirement contribution opportunities. Over time, the ability to accrue deferred compensation for retirement diminishes, creating a misalignment between compensation paid to the departing executive and the incoming leader.*

*When evaluating the appropriate amount of pay to recognize a departing executive's service to the organization, boards should take into consideration the following factors:*

- *Timeframe: what is the planned departure/retirement date?*
- *Market Assessment: how does the executive's current compensation compare to other executives in the marketplace, among similar roles?*
- *Transition Planning: what do the board and the executive wish to accomplish before the planned departure date?*
- *Step-Down Role for Departing Executive: what role does the board want the departing executive to hold after stepping down from their leadership role, if at all? How will this relationship impact the onboarding of a new executive?*
- *Onboarding of New Executive: how can the board implement a governance process to ensure the new executive leader's compensation is reviewed in a timely manner by the board?*

## ASSESSMENT OF CURRENT TOTAL COMPENSATION ARRANGEMENT AND PAY ADJUSTMENTS

*An independent assessment of the executive's current compensation can determine if any market equity adjustments to pay are needed to bring compensation closer to market pay levels during the executive's remaining tenure with the organization. The evaluation should take all pay elements into consideration. This includes base salary, bonuses earned, retirement contributions, other forms of deferred compensation, benefits and supplemental cash compensation. External market comparability data can be gathered from published compensation surveys from national or regional survey vendors or working directly with a compensation consultant (to be engaged by the board – not management - to conduct the independent compensation study). The external market data is best supported by a robust sample size of organizations that are comparable in size, operational complexity, etc. (i.e., reflects the market in which the board will recruit from for its next executive director). Obtaining reliable market comparability data will give board members a reasonable market pay range to help guide pay decisions commensurate with the organization's and executive's performance to date .[1]*

*Organizations with a shorter time frame (less than two years) until the executive's departure date may find this step to be limiting in providing incremental compensation for its seasoned leader. However, this process secures the board with relevant market comparability data to support pay adjustments for its departing executive (if any) for the remaining pay periods and the expected compensation range for its next phase of leadership.*

## TRANSITION PLANNING FOR OUTGOING EXECUTIVE

*Boards should discuss with the executive director their transition plan during their remaining time with the organization:*

- *What long-term goals do the board and the executive director wish to mutually attain during this time period? Can these goals be translated into objectives or key milestones to be accomplished by the executive?*
- *Does the executive wish to remain full-time with the organization during this time, or is there a desire to reduce their time commitment to pursue other opportunities prior to departing the organization?*
- *What is the action plan for the transition of new leadership? This may include and not be limited to: sharing of institutional knowledge, identifying key employees for retention and professional development opportunities, hand-off of key relationships, and other operational transitions to set up the organization for future success.*

*Board members may wish to consider a one-time retention award if it is determined that the retention of the incumbent executive is vital to the successful execution of key strategic initiatives and/or the implementation of its leadership transition plan:*

- *Retention Award Example: The current executive director intends to depart the organization at the end of 2024. The board determined that it is critical to retain the executive for an additional year (to the end of 2025) to complete its five-year strategic plan and implement an effective transition plan. The board proposes a one-time retention award of $50,000 [2] to be paid to the executive director at the end of 2025 (three years), subject to the incumbent remaining in their current role and meeting the board's performance expectations.*

  *Note that in this example, the retention award is structured as deferred compensation. The executive will not earn the award until the end of 2025 and as such, if correctly structured, the award should not need to be reported as taxable income to the executive until the three-year retention period is over. Organizations should work with their outside tax counsel to understand the implications of providing deferred compensation and Form 990 reporting requirements.*

## POST-TRANSITION PLANNING WITH OUTGOING EXECUTIVE (STRATEGIC ADVISORY SERVICES)

*In addition to transitioning to new leadership, boards should also consider if there is a need to retain the prior executive director on a part-time basis as an employee or a strategic advisor. Following the appointment of a new executive director, some boards may find it beneficial to retain the prior executive director as an advisor through the leadership transition process. The advisory relationship can help maintain employee morale and support the retention and professional development of the senior staff. This strategic advisor role is usually most effective over a short-term duration (no more than six to eight months) to not conflict with the new executive director's planned strategy for the organization.*

*If the prior executive director is retained as an advisor, the board should clearly outline the responsibilities and expectations for this role, duration in role, time commitment and the compensation structure:*

- *Discuss if the advisory will be retained as a part-time employee or a contractor.*

  *—If a part-time employee, determine if they will be eligible for health and welfare benefits on the same basis as all other employees, and the pay rate at which they will be compensated.*

  *—If an independent contractor, determine how they will be paid, e.g., at an hourly rate or a fixed stipend (e.g., $5,000 / month) with an agreement that they will be available 3-4 days a week to the board.*

- *There is no direct comparability data for market compensation as a strategic advisor. However, it is important to acknowledge that while the board and/or new executive is leveraging the incumbent's leadership experience, the position is different from an executive director and reflects a diminishing role over the course of the engagement, and compensation should be significantly lower than their prior compensation as a full-time executive.*

- *Organizations are strongly encouraged to discuss with employment counsel the appropriate employee classification for this strategic advisory role, as the consequences of misclassification can be costly.*

## CONSIDERATIONS FOR NEW LEADERSHIP

*A new executive director appointment also presents an opportunity to (re)establish a board governance process to evaluate executive compensation and ensure compensation is competitive and reasonable as compared to analogous roles among organizations similar in size and operations:*

- *Review the executive's total compensation arrangement on a regular basis, ideally no fewer than every three years. Assuming organization and individual performance meet board expectations, make moderate salary adjustments on a regular basis to keep pace with the market.*
- *Establish a qualified retirement plan for organizational staff – offering employer matching contributions can encourage early savings for retirement for all employees.*
- *Create a compensation policy or "calendar of activities" to establish a regular cadence for when the board will review the executive's performance and compensation to avoid unanticipated discussions around pay. Having a set policy by establishing protocols that remain with the organization can also serve as an "instruction manual" to support board chair transitions.*
- *Succession planning should be an active discussion topic between the board and executive leadership. Boards should be kept up to date on internal succession planning and professional development opportunities for high potential employees to proactively address any leadership transition challenges.*

## "JUST AND REASONABLE" COMPENSATION

*The IRS defines reasonable compensation as "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances."[3] In addition, the California Nonprofit Integrity Act states that the governing board of a nonprofit entity must review and approve the compensation of the CEO or President and the CFO or treasurer, to ensure that the payment is "just and reasonable."*

*As such, board members of California tax-exempt organizations should take great care in reviewing any compensation proposal for outgoing and incoming executive leadership to ensure the total compensation arrangement approved constitutes as reasonable compensation paid to the executive for services provided to the organization and obtaining reliable market comparability data from external data sources scoped to organization size, scope of operations, location, program services and other relevant factors. Smaller organizations with lower risk compensation arrangements, i.e., below average salaries and limited deferred compensation arrangements, may not need to conduct assessments annually. Similarly, the governing board does not need to conduct annual studies if the market has not moved significantly, or if minimal pay adjustments are expected.*

*Lastly, in January 2021, the IRS issued its final regulations for Section 4960 of the Internal Revenue Code on certain executive compensation paid by tax-exempt organizations (includes all organizations exempt under Section 501(a)), which imposes a 21% excise tax on remuneration in excess of $1 million or "parachute payments" paid to a covered employee. The "parachute payment" provision is triggered when a separation payment is equal to three times the five-year average annual compensation from the applicable tax-exempt organization. While the details behind Section 4960 are beyond the scope of this memorandum, it is important to consider all pay elements that add up to the definition of "separation pay," which includes any other vested payments as a result of separating from service, e.g., accrued deferred compensation balances or one-time bonus payments, to avoid this incremental cost.*

**NOTES**

1. *Examples of reliable nonprofit compensation surveys include: the Candid Nonprofit Compensation Report; the Equitable Nonprofit Workplace Report published by the Center for Nonprofit Management and Envision Consulting; Total Compensation Solutions (TCS) Not for Profit Compensation Survey; and the 2022 Compensation & Benefits Survey published by Nonprofit Compensation Associates (comprising nonprofits in Southern California)*
2. *The amount of the retention award will vary depending on the size and type of organization, the term of the award and requires a comparison to market findings.*
3. *§ 53.4958-4 Excess benefit transaction.*