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Should a Nonprofit Organization Compensate Board Members?

The board of directors plays a critical role in nonprofit organizations, from making strategic decisions to providing financial oversight. Normally, staff members of nonprofits are paid salaries while the governing board consists of unpaid volunteers. Paying board members for their service on the board remains controversial but some nonprofit organizations are starting to do so, since it is allowed by law and can be an equitable approach.

This Legal Alert answers common questions that a nonprofit organization may have when thinking about compensating its board members. Because this Legal Alert focuses on the New York State Not-for-Profit Corporation Law ("N-PCL"), nonprofit organizations incorporated in other states or in New York under other laws are encouraged to consult local counsel or counsel with expertise in such other laws.

Does the law allow a New York nonprofit corporation to compensate Board Members?

There is neither federal law nor any provision in the N-PCL that prohibits nonprofits¹ from compensating their board members. In fact, the N-PCL states that "the board shall have authority to fix the compensation of directors for services in any capacity," unless such compensation is barred by the certificate of incorporation or bylaws.² However, there may be industry-specific laws or licensing requirements that prohibit board compensation.³

What should nonprofits consider when deciding whether to compensate Board Members?

There are two main arguments in favor of nonprofit board compensation. First, compensation may help attract talented directors who are motivated to devote time and energy to the board. Second, it may help promote more equitable access and inclusiveness on nonprofit boards. Compensation helps enable low-income individuals to serve on nonprofit boards, which can be time consuming and would ordinarily take those individuals away from work or family care. Nonprofit organizations particularly benefit from the participation of individuals that share the experiences of those served by the nonprofit. It is therefore especially important that nonprofit boards are not limited to those who can afford to volunteer their time.

¹ This legal alert is generally focused on public charities, but note that 501(c)(3) corporations classified as private foundations have strict limits on the types of services for which they can compensate board members. IRC 4941.

² N-PCL 715(d).

³ For instance, the Board of Regents warns that "To help ensure effectiveness, trustees/board members need to ensure boards address the following, consistent with statute...Not compensate their members for services in their role as trustee or board member." NY State Education Department, Board of Regents, "Statement on the Governance Role of a Trustee or Board Member," (2010), available at https://www.regents.nysed.gov/about/statement_governance

The main drawbacks to nonprofit board compensation are the potential legal risks to the board members and the organization, increased administrative burden and the potential reputational risk. While there is no legal restriction on the amount or proportion of board members who are compensated, charity monitoring organization BBB Wise Giving Alliance advises that per their standards no more than one or 10% of the member(s) of the board (whichever is greater) should be directly or indirectly compensated, and that compensated members should not serve as the board's chair or treasurer.⁴

In assessing reputational risks, 501(c)(3) organizations should bear in mind that they must disclose board compensation publicly on the IRS Form 990, which will be reviewed by current or prospective funders.⁵

What are the tax considerations associated with deciding to pay board members?

The tax implications of board member compensation depend on the organization's tax-exempt status. Organizations with 501(c)(3) status must avoid inurement, meaning that they cannot operate to benefit the private interests of their board members or other insiders.⁶ An organization can have its 501(c)(3) status revoked if the IRS finds that it has engaged in prohibited inurement. For this reason, it is important to ensure that any compensation paid to board members is reasonable, in light of the services provided.

A 501(c)(3) organization classified as a public charity⁷ should assess reasonableness for another reason, too: to avoid incurring excise taxes for entering into an "excess benefit transaction" with an insider.⁸ Compensation paid to a board member will constitute an excess benefit transaction "if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."⁹

What process should the organization follow before deciding to compensate Board Members?

Step 1: Check organizational restrictions

To start, nonprofit organizations should check their bylaws, certificate of incorporation or any other organizational documents for any provisions that would prohibit compensating board members. It is

⁴ BBB Wise Giving Alliance, "BBB Standards for Charity Accountability" Standard 4, <https://give.org/charity-landing-page/bbb-standards-for-charity-accountability>.

⁵ 26 USC 501(c)(3) ("no part of the net earnings of which inures to the benefit of any private shareholder or individual."). See Part VII, Section A of [Form 990; Schedule J of Form 990](#)

⁶ IRC 501(c)(3).

⁷ A 501(c)(3) organization classified as a private foundation can pay a board member to provide personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation, so long as the compensation is not excessive. Additional restrictions may apply if the board member is a government official. For these reasons, a private foundation should consult with counsel before deciding to compensate board members.

⁸ If the IRS determines that an excess benefit transaction has occurred, it will impose a 25 percent excise tax on the person who received the benefit. In certain circumstances, the IRS can also impose a 10 percent excise tax on any board member or other manager who approved the compensation. If the excess benefit is not corrected during the tax year in which it occurred, the IRS can impose additional taxes on both the person who received the benefit (200 percent of the excess benefit) and any board members or other managers who approved the compensation (up to 10% of the excess benefit, capped at \$20,000). IRC 4958.

⁹ IRC 4958.

common for bylaws to state that directors may only be compensated for performing services to the organization other than serving as a director. At the same time, nonprofit organizations should consult government contracts to see if there are any direct or indirect restrictions. Nonprofits may also want to start exploratory discussions with funders and donors to understand their view of board compensation.

Step 2: Carefully assess the reasonableness of the compensation

For a 501(c)(3) public charity, the IRS will presume that board compensation is reasonable, and is not an excess benefit transaction subject to excise taxes, if the organization takes these steps:

- a) the compensation arrangement must be approved in advance by the board, without the involvement of any board member who stands to benefit,¹⁰
- b) the board must first obtain and rely upon appropriate data as to comparability – this can be tricky because so few public charities compensate their board members, and
- c) the board must adequately and timely document the basis for its determination concurrently with making that determination.¹¹

If an organization takes and documents all the steps above, then the burden of proof shifts to the IRS to demonstrate that the compensation was unreasonable.

If you are considering compensating your board, it is also wise for your organization to ensure it complies with the N-PCL and implements best board practices. For example, New York not-for-profit corporations must have a conflict of interest policy that meets requirements outlined in the N-PCL,¹² and directors must provide an annual disclosure statement to the organization's designated compliance officer listing any conflicts of interest.

Step 3: Follow proper voting procedure and document the entire process

Board member compensation must be approved by the board itself; this cannot be delegated to a committee.¹³ Note that the N-PCL requires that directors recuse themselves from the meeting during deliberations and the vote on their compensation arrangement. Federal law penalizes organizations that

¹⁰ If an organization plans to compensate every board member, it is difficult to meet this criterion. In the case of a private foundation seeking to compensate all its board members, the IRS has issued a non-precedential ruling that uniform salaries are deemed to be exceptions which do not constitute self-dealing. The organization must be able to demonstrate that the proposed salary is compensation for each member's board service and must be "comparable to amounts paid by similar charitable organizations for similar services." Internal Revenue Service, Private Letter Ruling 200007039 (Nov. 1999).

¹¹ Treas. Reg. 4958-6.

¹² N-PCL 715-A(b). The minimum requirements include: a) a definition of circumstances that constitute a conflict of interest; b) procedures for disclosing potential conflicts of interest to the board or committee and determining whether a conflict exists; c) a requirement that the person with the conflict of interest not participate or be present during board or committee deliberations or voting (though the board and committee may solicit background information from the person prior to deliberations); d) a prohibition against any attempt by the person with the conflict to influence the deliberation or voting on the matter; e) a requirement that the process for addressing the conflict be documented within the organization's records, including meeting minutes; and, f) procedures for disclosing, addressing, and documenting related party transactions. This is discussed further here: https://lawyersalliance.org/userFiles/uploads/legal_alerts/Conflict_of_Interest_Policies_Legal_Alert_June_2019_FINAL.pdf

¹³ NPCL 712(a)(3).

do not follow such procedures by providing greater protections for organizations who document best practices.¹⁴ Organizations should also be sure to document the conflicted director's recusal in the meeting minutes.

Ultimately, the decision to compensate board members encompasses numerous considerations as well as specific processes and their documentation. Nonetheless, it is an excellent opportunity to review your organization's procedures to ensure compliance regardless of the decision to compensate members of the board.

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Rafi Stern at rstern@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

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¹⁴ [N-PCL 715-A\(b\)](#); [26 CFR § 53.4958-6](#).