Pearl Meyer

ARTICLE | JAN 2026

Executive Compensation 101 for Tax-Exempt Organizations

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Following our Pearl Meyer series covering Executive Compensation Essentials, this is the first in a series of related articles that are specific to tax-exempt entities.

Executive compensation in tax-exempt organizations is not just a technical exercise—it is a governance responsibility. Compensation-related decisions must balance regulatory compliance, market competitiveness, mission alignment, and public trust. Achieving that balance requires rigorous discipline, a clear process, and role clarity.

The first article in a new series focused on tax-exempt organizations, this **Executive Compensation 101** overview provides boards and senior management with the foundational framework for understanding the key elements of tax-exempt executive compensation design and oversight, establishing a framework into which we will delve deeper as the series continues over time.

The Regulatory Starting Point

Any discussion of executive compensation in a tax-exempt organization must start with Internal Revenue Code Section 4958, which focuses on whether compensation paid to executives is reasonable and free from "excess benefit transactions." This provision governing excess benefit transactions applies to compensation paid to "disqualified persons," including senior executives and others with substantial influence. In summary, the IRS monitors tax-exempt organizations to prevent excessive executive compensation.

At a high level, compliance depends on a clear and consistently applied three-step process:

1. Independent review of all compensation programs and approval by the Board or a delegated committee.
2. Use of appropriate market comparability data.
3. Contemporaneous documentation of decisions, including rationale.

When these steps are followed, organizations may rely on the *rebuttable presumption of reasonableness*, as defined by the IRS, which shifts the burden of proof away from the organization if compensation is later questioned. Miss one of these steps, and that presumption disappears. Importantly, compliance is the baseline—not the strategy. Meeting regulatory requirements alone does not ensure compensation is competitive, effective, or aligned with long-term goals.

This series will address not just what the rules say, as well as leading practices, but how boards and committees can design effective programs infused with appropriate *flexibility without drifting into management*—a line that is crossed more often than many realize.

Governance: Oversight, Not Management

Strong governance is essential to defensible and thoughtful compensation decisions. Boards typically delegate oversight to an independent compensation or executive committee to manage conflicts of interest and regulatory risk.

That committee's role is to review, approve, and document compensation decisions to govern—not to operate as management. The distinction matters. Committees that drift into setting pay in isolation or managing executives can undermine both governance and compliance. Good process protects the organization and clarifies accountability.

Compensation Philosophy Sets the Tone

A comprehensive compensation philosophy provides the guiding principles used to make pay decisions. It clarifies how the organization intends to compete for executive talent and how compensation aligns with an organization's mission, performance expectations, and financial capacity.

Without a clear philosophy, decisions have the potential to become reactive, inconsistent, influenced by history, or overly driven by an individual's own experiences with compensation. With a compensation philosophy, boards gain a framework that supports continuity and defensibility over time and allows for history and individual approaches to be considered within the proper context and application.

How best to develop, express, gain buy-in, and apply a compensation philosophy will be addressed in a future article.

Understanding the Market

Market benchmarking is a critical input but not a conclusion unto itself. Peer groups and survey data must reflect the organization's true competitive market for leadership talent, not aspirational comparisons without meaningful and relevant rationale.

Poor peer group design and/or survey selection is a common weakness and a frequent source of regulatory exposure. It is critically important for companies to develop comparable, appropriate peer groups and use market data responsibly.

Performance, Incentives, and Evaluation

Increasingly, tax-exempt organizations are incorporating pay-for-performance elements into their executive compensation programs, most commonly through annual incentive or bonus plans and, in some cases, through longer-term incentive or deferred compensation arrangements. While the design of these programs varies widely, their purpose is generally consistent: to align executive effort with organizational priorities and results.

At a high level, incentive programs raise several fundamental governance questions:

- What outcomes matter most to the organization at this stage of its evolution?
- How is performance defined, measured, and evaluated?
- How do incentives reinforce mission and stewardship rather than encourage short-term or misaligned behavior?

Effective performance evaluation typically combines quantitative measures—financial, operational, strategic, or programmatic—with qualitative input, such as structured surveys or interviews to understand employee and/or customer satisfaction. When used thoughtfully, these tools provide context that metrics alone cannot, helping boards assess not only what was achieved, but how leadership was exercised. Collectively, they support a more complete and balanced view of executive performance.

Companies must carefully plan their annual incentives, long-term incentives, and performance evaluation practices in great detail.

Executive Benefits, Retention, and Talent Development

Executive benefits, employment agreements, and deferred compensation arrangements can attract heightened scrutiny in tax-exempt organizations. However, when appropriately designed, they serve legitimate purposes related to retention, leadership continuity, organizational success and risk management.

Competitive and flexible benefits programs—particularly those that allow executives to tailor certain elements based on evolving personal and professional circumstances—can strengthen retention without increasing short-term compensation levels. Similarly, well-structured employment agreements help clarify expectations and provide stability during periods of transition.

Boards must also look beyond current executives to consider future business continuity strategies. Identifying, developing, and retaining future leaders is a governance responsibility, not an operational afterthought. Effective compensation and straightforward development programs can play a constructive role in supporting succession planning and long-term talent development. These topics will be explored further in forthcoming articles focused on executive benefits, retention strategies, and talent development.

Looking Ahead: Deep Dives in Forthcoming Articles

This Executive Compensation 101 overview establishes the foundation for a deeper discussion of executive compensation in tax-exempt organizations. The articles that follow will examine:

- Understanding key compliance issues
- Developing a compensation philosophy
- Developing a peer group
- Evaluating the use of annual incentives
- Evaluating the use of long-term incentives
- Evaluating performance and the linkage with compensation levels
- Evaluating the use of executive benefits
- Understanding the role of retention and talent development

Executive compensation does not need to be complicated—but it does need to be deliberate. Organizations that approach it with discipline and sound governance are better positioned to attract, retain, and hold leaders accountable over the long term.

Considered together, these topics form a comprehensive guide to executive compensation—one that emphasizes discipline, clarity, and alignment rather than complexity for its own sake.

About the Authors

Alexander is a managing director at Pearl Meyer. The former president and CEO of Yaffe & Company, he is a second-generation expert in executive compensation and has two decades' experience in the field. As the leader of Yaffe & Company, he oversaw its geographic expansion from 10 to 37 states, development of complimentary service lines, and worked with clients whose net revenues ranged from $10M to greater than $1B, allowing for a varied perspective in similarities and differences based on geography, size, and organizational design.

Jim Hudner is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. He consults in the areas of total compensation strategy, executive compensation, compensation planning, base salary management, incentive plan design, and performance management. Jim brings more than 30 years of consulting experience to his position and has consulted with organizations in a wide range of industries including technology, higher education, healthcare, research organizations, financial services, and manufacturing.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.