Compensation Strategies and Best Practices for Nonprofits

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Pro Bono Partnership of Atlanta:

To maximize the impact of pro bono engagement by connecting a network of attorneys with nonprofits in need of free business legal services.

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- In order to be a client of Pro Bono Partnership of Atlanta, an organization must:
  - ✓ Be a 501(c)(3) nonprofit.
  - ✓ Be located in or serve the greater Atlanta area.
  - ✓ Serve low-income or disadvantaged individuals.
  - ✓ Be unable to afford legal services.
- *Visit us on the web at* www.pbpatl.org
- We host free monthly webinars on legal topics for nonprofits
  - ✓ To view upcoming webinars or workshops, visit the Workshops Page on our website
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Legal Information:

✓ This webinar presents general guidelines for Georgia nonprofit organizations and should not be construed as legal advice. Always consult an attorney to address your particular situation.

Overview of Today's Topics

- What is compensation?
- How should compensation be determined?
- What are the penalties for certain compensation?
- What new tax laws affect compensation?

What is compensation?

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Compensation

- Compensation includes essentially all items of value given to the employee
  - salary or wages
  - retirement plan
  - unpaid deferred compensation
  - payment of personal expenses
  - rents
  - royalties
  - personal use of an organization’s property or facilities

Compensation Example

- The CEO of Nonprofit makes $75,000/year in salary. She is also provided with housing on the Nonprofit grounds at no cost to the CEO. The fair market value of the housing is $1,000 per month. The CEO also accrues deferred compensation of $5,000 per year.
- The total compensation paid is the salary, fair market value of housing, and deferred compensation.
- Total Compensation equals $92,000 for the year.

Rule Against Private Inurement

- Code Section 501(c)(3) prohibits inurement of the net income of any organization to any private shareholder or individual.
- The tax-exempt organization is not operating exclusively for tax-exempt purposes if its net earnings benefit, in whole or in part, to private individuals.
- Any persons having a personal and private interest in the activities of the nonprofit is a “private shareholder or individual” for this purpose.
- Inurement can arise with officers, directors, founders, and their families.
- <u>Inurement is found where compensation to an executive is excessive and unreasonable.</u>

Three Prong Test for Inurement

- The IRS has identified the following as inurement:
  - whether the total compensation package is merely a device to distribute profits to principals or transform the organization's activities into a for-profit joint venture;
  - whether the compensation package is the result of arm's length bargaining; AND
  - whether the compensation constitutes reasonable compensation under the circumstances.

Reasonable Compensation

- The IRS regulations define "reasonable compensation" as the amount that would ordinarily be paid for like services by like organizations in like circumstances.
- The IRS uses two tests to determine reasonableness:

1. "Amount Test" focuses on the reasonableness of the total amount paid, AND
2. "Purpose Test" focuses on the services for which the compensation is paid.

IRS Reasonable Compensation Factors

- whether there were arm’s length negotiations
- the level of control by the founder (or founder’s family) over the organization
- availability of comparable services from a third party at a lower cost
- nature of the employee’s duties, roles, responsibilities
- employee’s background and experience
- employee’s salary history and whether there is a sharp increase in compensation with little or no rationale for the decision
- the employee’s contribution to the organization’s success
- time devoted to the job

Private Benefit

- Private benefit is a separate issue from inurement
- Private benefit is found when the entire benefit structure of an organization provides for excessive and unreasonable compensation
- IRS Factors:
  - size of organization
  - salary scale of others in the same line of business
  - salary scale for employees
  - the amount of the organization’s income devoted to compensation

Noncompliance Consequences

- Public perception and mistrust
- Potential revocation of tax-exempt status
- Disqualified person can be subjected to a penalty equal to 25% of the portion of compensation that is unreasonable and excessive under Code Section 4958(a).
- If any portion is not corrected within the taxable period, the disqualified person can be liable for a 200% tax imposed on the uncorrected portion of the excess benefit.
- A 10% penalty, capped at $20,000, levied on any organization manager who participates in the transaction and is found to have acted willfully, unreasonably, and with the knowledge that the transaction was excessive and unreasonable.

Best Practices for Compensation

- There are no standard formula for determining fair and reasonable compensation
- Determine appropriate salary and benefits package based on the market
- Consider what someone in a similar position would earn at an organization of a similar size with a similar mission or field of activity
- Consider compensation paid by for-profit entities for comparable size, jobs, etc.
- Boards establish procedures for approving executive compensation to establish a rebuttable presumption of reasonableness

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Best Practices for Compensation

- Compensation approved by an independent board or committee
- Do not allow participation in the compensation decision by anyone who has a conflict of interest
- Find and review comparability data obtained before the compensation is approved
- Look at annual returns filed by peers or compensation studies
- Document the decision making process at the time the compensation is approved

What is the New Tax Bill?

New Tax Bill

- Final Tax Cuts and Job Act (the "2017 Tax Bill") passed by the House on December 19 (but due to a procedural issue was voted on again and passed on December 20)
- Passed by the Senate on December 20
- President Trump signed the 2017 Tax Bill on December 22
- <u>Many changes effective beginning in 2018 </u>and set to expire beginning in 2026

New Tax Bill Affects Tax-Exempt Organizations

- Tax-exempt organizations are subject to TWO new taxes on compensation paid to covered employees.
  - "Parachute Tax": 21% excise tax contingent upon a termination of employment
  - "Excess Compensation Tax": 21% excise tax on compensation paid to an active employee in a tax year
- Even a relatively small entity can be subject to the Parachute Tax
- Common retirement and severance arrangements are created to accommodate special timing rules applicable to compensation paid by a tax-exempt organization and can trigger the Excess Compensation Tax

Types of Entities Subject to New Tax Bill

- Most charities and organizations are subject to the New Tax Bill, including the following:
  - Entities exempt under Code Section 501(c), 501(d), and 401(a).
  - Any farmers' cooperative organization described in Code Section 521(b)(1).
  - Entities that have income excluded from taxation under code Section 115(l) (which provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or political subdivision).
  - Any political organization described in Code Section 527(e)(1).

Employees Impacted by New Tax Bill

- Who is a covered employee?
- The term “covered employee” means the five highest compensated employees (including former employees) of the organization for the taxable year.
- once a covered employee then always a covered employee

Parachute Tax

- Parachute Tax is a 21% excise tax that is triggered when amounts in excess of 3 times a covered employee’s base amount are paid upon separation from service.
- The amount of tax is calculated on the parachute payment in excess of the covered employee’s base amount (not three times the base amount).
- The covered employee’s base amount = average of the last five years of Form W-2 compensation

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Parachute Tax Example

- John’s Compensation reported on Form W-2:
    - 2018 – Expected to be $125,000
    - 2017 - $125,000
    - 2016 - $100,000
    - 2015 - $100,000
    - 2014 - $90,000
    - 2013 - $85,000
- John’s “Base Amount” = $100,000 (average of 2013-2017)
- John is paid a lump sum upon his retirement with a present value of $350,000.
- The Parachute Tax is triggered because $350,000 in more than 3 times $100,000 or $300,000
- The 21% excise tax is calculated on the amount in excess of John’s base amount, which is $350,000 minus $100,000 or $250,000
- The excise tax owed by the tax-exempt organization is 21% of $250,000 or **$52,500**

Parachute Tax Exclusions

- There are exclusions to what is considered to be a the Parachute Payment.
  - Payments to a licensed medical professional for the performance of medical or veterinary services
  - Compensation NOT considered Parachute Payments:
    - amounts paid to or from a qualified retirement plan (such as a 401(k) plan)
    - amounts paid to or under an annuity contract described in Code Section 403(b)
    - amounts paid to or from a plan described in Code Section 457(b)
    - Amounts paid to an individual who is not a highly compensated employee as defined in Code Section 414(q). For 2018, the threshold is $120,000

Excess Compensation Tax

- Excess Compensation Tax is a 21% excise tax that is triggered when a covered employee’s remuneration is more than $1 million in a taxable year.
- Remunerations include wages that are no longer subject to a “substantial risk of forfeiture” but excludes:
  - designated Roth contributions and
  - amounts paid to a medical professional for medical and veterinarian services

Substantial Risk of Forfeiture for Excess Compensation Tax

- A “substantial risk of forfeiture” is defined under Code Section 457(f) rules.
  - “Substantial risk of forfeiture” means there is no further requirement to provide substantial future services
- Examples of compensation subject to a substantial risk of forfeiture:
  - Service related awards vesting in a SERP and/or LTIP can impose a substantial risk of forfeiture
  - Bona fide non-compete can impose a substantial risk of forfeiture
  - Elective deferrals under a Section 457(f) plan are subject to a substantial risk of forfeiture

What Should Nonprofits Do Now?

Steps to Address the New Tax Bill

- Identify which employees are covered employees
- Evaluate existing compensation arrangements
- Evaluate when large amounts will become vested if there is an arrangement with a vesting schedule

Questions?

For More Information:

If you would like more information about the services of Pro Bono Partnership of Atlanta, contact us at:

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