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Tax Implications for Executive Compensation in Nonprofit Organizations

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Attracting and retaining the right talent to provide leadership can have a significant impact on how dynamically a nonprofit organization is able to meet the needs of its community. While there are many methods for providing benefits to executives, one primary focus for attracting talent is designing attractive compensation packages. However, compensation for employees of nonprofit organizations, and in particular executives, is subject to special restrictions under the Internal Revenue Code (the “**Code**”). This article will provide guidance for organizations to help navigate some of these restrictions.

Topics covered in this article include: (1) What is reasonable compensation? (2) What is a private inurement? (3) How does the new tax bill affect compensation for nonprofit executives? (4) Guidance for structuring an incentive compensation policy.

1. What is reasonable compensation?

Any compensation arrangement a nonprofit organization provides must comply with relevant federal law and regulations. Guidance provided by the Internal Revenue Service (“**IRS**”) and Office of Management and Budget requires nonprofit organizations to provide compensation that is: a) “reasonable” and b) paid and accrued either: i) under an arrangement between the nonprofit organization and the employee that was entered into in good faith before any services are provided or ii) pursuant to an established compensation plan consistently followed by the nonprofit organization (e.g., a bonus plan).

To determine the reasonableness of compensation, look to the amount ordinarily paid for similar services, by a similar organization, in similar circumstances. To test whether compensation is reasonable, the IRS has established a two-part test, as follows: 1) an amount test, that focuses on the reasonableness of the total amount of

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compensation paid, and (2) a purpose test, that focuses on examining the services for which compensation was paid. The factors under the tests are assessed in their totality. To ensure compensation is reasonable, nonprofits should maintain structured methods to evaluate executive compensation and compare it to compensation for executives in similar positions, fields, locations and similarly-sized organizations.

A. A Structured Method for Determining Compensation

Nonprofit organizations should implement a formal structure for creating executive compensation arrangements, including base salary and bonus arrangements. Administrators of a nonprofit organization should take the following steps to ensure that compensation is reasonable:

1. Create a Board Committee that consists of independent directors (i.e., a “Compensation Committee”) to conduct a “comparability review” and provide a recommendation to the full Board of Directors.
2. Perform a comparability review to determine reasonable compensation for an executive.
3. The Committee should provide documentation of: a) who was involved in the review, b) the process used to conduct the review, c) the full reviewing body’s recommended decision to approve executive compensation, and d) a demonstration of the reviewing body’s consideration of comparable compensation data.

In all compensation arrangements, plans and policies, the Compensation Committee should retain the authority to cancel compensation arrangements at any time if it is determined that such cancellation is in the best interest of the nonprofit organization. Nonprofit organizations should also perform regular reviews of compensation arrangements and policies to ensure continued reflection of the best interests of the organization and compliance with applicable law and regulations.

B. Comparability Review Factors

When performing a comparability review, a nonprofit should examine compensation for similarly situated executives, based upon their geographic location, the purpose and/or business of the comparable organizations, and similarly sized and structured organizations. This examination may include both nonprofit and for-profit organizations, but if the purpose or business of the organization is not comparable between a for-profit and nonprofit, then they are not readily comparable. When performing such a comparability review, consider the following factors:

Comparable Compensation

The amount of compensation for individuals in comparable positions and comparable organizations.

Comparable Services

The performance of comparable services. A review of comparable services should include consideration of the following factors:

- The type of work and skills involved in the position;
- Whether the job is full-time or part-time;
- The size and scope of the organization;
- The number of employees managed;
- The budget or assets managed; and
- The responsibility of the individual for singular or multiple functions.

Comparable Enterprises

The comparability review should look to enterprises that are similar to the nonprofit. To determine if an enterprise is comparable, the reviewing body should consider:

- The size of the organization, including the budget, revenues, number of employees and people serviced; and
- The organizational purpose and/or mission.

Comparable Circumstances

To determine whether the circumstances are comparable, the reviewing body should consider:

- Similarity of the location and/or geographic area; and
- Economic conditions.

Additional Factors

The reviewing body may also balance the following factors:

- The duties for the position and performance history of the individual;
- The individual's background, skill, education and experience; and
- The availability of similar services in the organization's geographic area.

For smaller nonprofit organizations, the most feasible way to perform a comparability study may be to review Form 990s filed by similar nonprofit organizations, which are accessible on GuideStar, www.guidestar.org. As a "rule of thumb," it is acceptable to use three comparable institutions with similar annual revenues for a satisfactory comparability study.

2. What is a private inurement?

Under the Code, a §501(c)(3) nonprofit organization only maintains its tax-exempt status if it is organized and operated exclusively for a religious, charitable, scientific or other exempt purpose. Therefore, nonprofit organizations are prohibited from allowing their money or assets to accrue for the benefit of “insiders” to the organization (“private inurement”). Insiders include individuals and their immediate family members who either 1) have a financial interest in the organization or 2) are in a position to exercise substantial influence over the organization’s affairs or both. Some common insider roles include: a) board members, b) trustees, c) officers, d) key employees, e) members and f) significant donors. Insiders remain in that position for five years after they no longer have direct involvement or influence over the organization.

A common form of an excess benefit constituting private inurement is excessive compensation for executives of a nonprofit organization. As nonprofit organizations attempt to create more incentives in their compensation structures, they must make sure that private inurement does not occur. It is important to understand that compensation includes not only the actual salary paid to an executive but also all other forms of compensation such as benefits accrued under a retirement plan and deferred compensation plans. Further, it may include fringe benefits such as payments for personal expenses, rent or the use of the organizations’ property or facilities.

The IRS considers the following factors in a three-prong test when determining whether compensation by a nonprofit organization results in a private inurement:

- Whether the total compensation package is merely a device permitting the distribution of profits to insiders, or results in the transformation of the organization’s activities into a for-profit joint venture;
- Whether the compensation package results from arm’s length bargaining; and
- Whether the compensation is reasonable under the circumstances.

If the IRS determines that compensation is private inurement, it may impose the following penalties on the employee who received the excessive compensation and the managers who approved the transaction: a) a 25% excise tax on the amount of the excess benefit and the excess benefit must be repaid by the employee in the same tax year it is provided, b) a 10% penalty on the excess benefit provided must be paid by any organization manager who knowingly participated in the transaction, and 3) if the excess benefit and 25% penalty are not paid in the same tax year, an additional tax of equal to 200% of the excess benefit is imposed on the insider who received the compensation. The employees and organizations are required to report the taxes on Form 4729. Further, the IRS also has the option to revoke the tax-exempt status of the nonprofit organization because of private inurement. Nonprofit organizations should be aware that the IRS has made an effort to penalize private inurement, no matter how small.

Nonprofit organizations should use their structured methods and comparability review factors, indicated above, to avoid private inurement. Documentation of an organization’s

analysis of these factors, using such methods and a proper comparability review will provide some safe harbor protections for the nonprofit organization.

3. How Will the Tax Cuts and Jobs Act Impact Nonprofit Compensation?

On January 1, 2018, the Tax Cuts and Jobs Act (the “**TCJA**”) became effective. The TCJA included changes that have significant implications for compensation and termination payments for executives of large nonprofit organizations.

Under the TCJA, a nonprofit will be subject to a new 21% excise tax on “covered employees.” A covered employee is one of the top five highest paid employees for that tax year and any preceding tax years (with the earliest tax year being 2016) who receives (1) compensation exceeding \$1 million annually and/or (2) excess parachute payments. Thus, for example, in 2019, the tax will apply to the current five highest paid employees who meet (1) and/or (2) above but also anyone who met (1) and/or (2) above in the preceding years beginning in 2016 and meets (1) and/or (2) in 2019. In other words, this list of “covered employees” grows over time. Compensation in this context includes: wages, deferred compensation that has vested, and payments from related organizations but does not include excess parachute/severance payments. Compensation does not include compensation paid to a licensed medical professional (e.g., doctor, nurse, or veterinarian) for the performance of medical or veterinary services.

Additionally, certain payments made as the result of a termination of employment (“severance/parachute payments”) to highly compensated employees (individuals receiving more than \$120,000 in severance/parachute payments as of 2018) will also be subject to a 21% excise tax. Such severance/parachute payments will be subject to the excise tax if they are greater than three times the average W-2 compensation paid to the employee for the five years prior to the year of termination. For the purposes of the calculation of severance/parachute payments, it is important to understand that all remuneration and excess parachute payments paid to the covered employees, including incentive compensation payments or plans, separation payments and non-cash benefits, will count towards the limit. However, amounts contributed into a tax-qualified retirement plan will not be included within the calculation of the limit. Further, it is important to note that the 21% excise tax may increase in conjunction with increases in general tax rates.

All nonprofit organizations should consider the impact of these changes prior to determining compensation for executives and structuring severance payments. This is important because it will not be enough to consider the wages paid to such an executive only. Nonprofit organizations must also consider the manner in which incentive compensation benefits are structured, which, based upon design, can be unpredictable. Because of these changes, competition to recruit executive talent will increase, along with the cost to nonprofits. Therefore, it is important for nonprofit organizations to consider creative ways to build compensation packages for executives simultaneously with structuring sustainable compensation structures.

4. Guidance for Structuring Incentive Compensation Policies

Nonprofit organizations must take particular care to implement a structure that bases all compensation (including bonuses) on permissible performance factors. Exempt organizations should avoid design structures that reward executives based on the dollar amount of funds raised by the nonprofit organization during an executive's tenure (e.g., where a bonus amount is expressed as a percentage of funds raised without a cap which would ensure the overall compensation is reasonable) to avoid providing an excess benefit or private inurement to an executive.

Possible alternatives for consideration with regard to bonus structures include:

- Adopting metrics that measure and reward membership, donor or stakeholder engagement during the executive's tenure, including increases in total membership or donors, retention or reactivation of previous members or donors, and the number of gifts made by donors (not the dollar amount donated);
- Adopting metrics for specific projects undertaken by the nonprofit organization and the percentage of completion or satisfaction reached at the end of each fiscal year, or;
- Adopting metrics to measure engagement in the communities or groups served by the nonprofit organization, and rewarding the executive in correspondence with such engagement.

However, in all cases, the Compensation Committee should do a comparability review and analysis to determine what is a reasonable amount of total compensation and determine the compensation structure including using the parameters of the benchmarks above. Such compensation structure and benchmarks should be determined and provided to the executive prior to the commencement of the executive's term of service. Further, because of the changes to the taxation of nonprofit organizations under the TCJA, it will be important to consider whether new and existing compensation structures could subject the nonprofit organization to the 21% excise tax, and include provisions in compensation agreements that allow the cancellation of compensation amounts that would result in tax to the nonprofit organization.

5. Where Do We Go From Here?

As the landscape for nonprofit organizations continues to change, it will be important to adopt compensation structures that will attract talented executives, while preventing a nonprofit organization from diverting from its purpose, or untenable tax penalties. As such, nonprofit organizations should carefully structure compensation guidelines and adhere to them while designing compensation for executives. Further, nonprofit organizations should carefully review all compensation provided to executives to ensure that no private inurement/excess benefit occurs.