BDO KNOWLEDGE

2019 COMPLIMENTARY NONPROFIT
AND EDUCATION WEBINAR SERIES

NEW VIEWS ON NONPROFIT'S COMPENSATION & BENEFITS

February 20, 2019

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AGENDA

- New UBTI for employer-provide parking and/or transit benefits
  - IRS Notice 2018-99
- New Code Section 4960 Excise Tax on "Excess" Compensation
  - IRS Notice 2019-09
  - Examples, Trends and Mitigation Strategies
- Anticipating and preparing for leadership changes
  - Retiring or exiting executives

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New UBTI Increases

Due to employer-provided employee parking and/or transit benefits

TCJA amended Code Section 512(a)(7) to increase UBTI for employee parking/transit costs

- Effective Jan. 1, 2018, EOs must increase UBTI for 132(f) "qualified" employee parking, transit and van pool costs
  - Employees still exclude those benefits from taxable income

- **Notice 2018-100** - IRS provided relief from 2018 estimated tax penalties for entities that were not previously required to file a Form 990-T or that did not exceed the $1,000 threshold below which an EO is not required to file a Form 990-T or pay UBTI

- **IRS Notice 2018-99** - IRS explained how to calculate parking costs
  - Limited retroactive transition relief if reserved employee parking spaces eliminated by March 31, 2019

Does employer pay third party for employee parking or own/lease parking location?

If employer pays a third party – it's easy; include in UBTI the lesser of:

- What employer paid to the third party; or
- IRS monthly limit ($260 for 2018; $265 for 2019)

If employer paid more than IRS limit, excess is wages - do not include in UBTI

If employer owns/leases – it's complicated; based on employer cost

- Cost ≠ FMV
- Can use any reasonable method to determine cost
- IRS 4-step safe harbor = a reasonable method

IRS safe harbor for calculating cost of employer qualified parking to include in UBIT

- **Step 1**: Calculate UBIT increase for reserved employee spots
  - *Note: until 3/31/19, employers can eliminate these retroactive to 1/1/18*

- **Step 2**: Determine primary use of remaining spots
  - *If more than 50% available to public, don't include those costs in UBTI*
  - *If less than 50% available to public, go to Step 3*

- **Step 3**: Calculate any reserved nonemployee spots
  - *Determine % of such spots in relation to the remaining total # of spots*
  -

- **Step 4**: Determine remaining use and allocable expenses
  - *Allocate expenses based on reasonable determination of employee usage of parking during typical business day*

What counts as employee parking expense? Employer **cost**; not FMV of the benefit to employee

Excludes:

(so **no** UBTI increase for these)

- Depreciation
- Amounts paid for items outside of the parking facility
  - Landscaping, lighting, cleaning, snow/leaf/trash removal, etc.

Includes:

(so increase UBTI for these)

- Rent or lease payments
- Insurance
- Property taxes
- Utilities
- Repairs and maintenance, cleaning, removal of snow/leaves/trash
- Parking lot attendant/security expenses

New Code Section 4960

IRS Notice 2019-09

TCJA created new Code Section 4960; Imposes excise tax on "excess" compensation

- Effective Jan. 1, 2018, EOs may owe new 21% tax on annual "remuneration" over $1 million **<u>and</u>** on "excess parachute payments"
  - Employers who never pay ≥ $1 million/year could still owe tax
  - Employers who never pay ≥ $125,000/year may not owe tax
  - Employers of all sizes must track "covered employees"

- Once a covered employee, always a covered employee
  - 5 highest paid employees for the current or any prior year starting with 2017 (so will likely include more than 5 over time)
  - Must make a list starting in *<u>2017</u>*, because remuneration paid to those individuals in 2018 or later could trigger the 4960 tax

IRS Notice 2019-09: answers many questions

- Who pays the 4960 tax?
  - Common-law employer pays the tax; not withheld from pay
  - Related for-profit entities may also owe the tax
    - *The amount of 4960 tax owed could change if the related entities restructure their employment relationships*
    - *4960 uses the same definition of "related organization" as is used for Form 990 executive compensation disclosure*
- What is the 4960 "taxable year"?
  - 4960 tax is calculated for calendar year ending with or within employer's taxable year
    - *Calendar year employers need to pay 2018 tax (if any) by May 15, 2019 using Form 4720 (due 5 ½ months after FYE)*
    - *If FYE is June 30, 2019 and employer owes tax on remuneration paid between Jan 1 and Dec 31, 2018, employer should file Form 4720 on or before Dec 15, 2019*

IRS Notice 2019-09 answers many questions

- What is an “excess parachute payment”?
  - ≥ 3x employee’s 5-year average wages (Box 1, Form W-2) if payment is contingent on involuntary termination, but only if employee makes ≥ qualified retirement plan HCE limit ($125,000 for 2019)
  - Notice outlines 6 steps to calculate excess parachute tax
  - Tax applies to excess over *one* times base amount

- How does vesting affect 4960 tax?
  - Amounts vested before separation are excluded from 4960 but increase in value after vesting is subject to 4960
  - If termination accelerates vesting, value is subject to 4960

IRS Notice 2019-09 answers many questions

- What is "remuneration"?
  - Different from any other way employers calculate compensation
  - Looks at when amounts are vested under 457(f) special timing rule (not when the amounts are paid)
  - Starts with 3401(a) "wages" and
    - Excludes: Roth contributions, retirement plan contributions and payments, and wages for certain medical services; but
    - Includes: payments conditioned on a release of claims, damages for employment agreement breaches, payments under early retirement or other "window" programs, payments for non-compete/non-disclosure agreements, and value due to acceleration of vesting upon termination of employment

IRS Notice 2019-09 answers many questions

- What about governmental employers?
  - Despite publicity about public university sports team coaches being subject to tax on ≥ $1 million, some schools may avoid it unless Congress enacts a technical correction
  - Government entities that rely on "implied sovereign immunity" for tax-exempt status are not subject to 4960
  - Government units (including state colleges or universities) that received IRS tax exempt approval may relinquish that status (which may exempt them from 4960)

Some accounting considerations

- Booking a contingent liability
  - EOs may need to book a contingent tax liability if they are reasonably certain that they will incur a 4960 excise tax
    - And may need to adjust it ratably between 2018 and when the tax is expected to be paid
  - Many EOs may not be used to booking contingent tax liabilities

- Book/tax differences
  - EOs may need to track a book/tax difference due to the timing of when the liability is accrued for financial statement purposes and when the amounts are subject to 4960 excise taxes (i.e., when the amounts are vested)

New Code Section 4960

Examples, trends and mitigation strategies

No "Tax Cut" Benefits for Not-for-Profit Employers

- General view of Tax Cut and Jobs Act sets expectations of net tax decrease, however
- There is no mechanism to provide similar benefit to Not-for-Profit employers
- In fact, there is an increased tax burden when new excise tax applies to executive compensation
- Twenty one percent excise tax rate is substantial when compared to rate reductions implemented for taxable entities
- Rules for reasonable and defensible compensation remain
- Cost of paying the excise tax is now a factor in setting salaries

Implications

- Brings more scrutiny to executive compensation plan design
- Total cost of compensation must consider the additional 21% excise tax when applicable
- More challenging to compete for talent with for-profit counterparts/competitors
- Unlikely to change or reduce the amount paid to top executives
- Challenge is to minimize the tax burden, while maximizing the ability to attract, retain, and motivate its workforce while remaining competitive with for-profit entitles in this new economic environment

Question – Can your organization justify its pay for performance plan?

Action Plan – Overall Compensation Plan Design

- Scrutinize Overall Compensation Plan Design
  - What elements of compensation can you modify?
  - What can be changed that will be perceived as a positive response to the new regulations?
  - Can the Annual Incentive Plan ("AIP") be designed to improve organizational performance and thus become self-funding?
  - Should plans with future payments be implemented or restructured?
  - Can succession plans be reviewed (or established) now to allow for future tax savings?
  - How can you address total remuneration from the Applicable Tax Exempt Organization (ATEO) and related organizations?

Action Plan – Remuneration from Related Orgs

- Scrutinize Total Remuneration Package
  - No simple answer – depends on number of related orgs, tax status, etc.
  - Determine if covered employee's earnings can be shifted to for-profit entities that can take a deduction
  - Gain clarity on current state/situation and tax implications
    - Step 1: Calculate total remuneration to be paid to covered employee, including remuneration from any related organizations
    - Step 2: Calculate the share of liability for each employer as a fraction of the total excise liability that bears the same ratio
    - Step 3: Perform hypothetical financial modeling increasing base pay at ATEO and increasing incentive compensation target/opportunity levels at for-profit organizations under different performance scenarios
    - Step 4: Reevaluate arrangements with future payouts at each organization
    - Step 5: Determine if it makes sense (and is defensible) to decrease remuneration at ATEO while increasing it at for-profit organization to obtain a tax benefit that offsets applicable excise tax

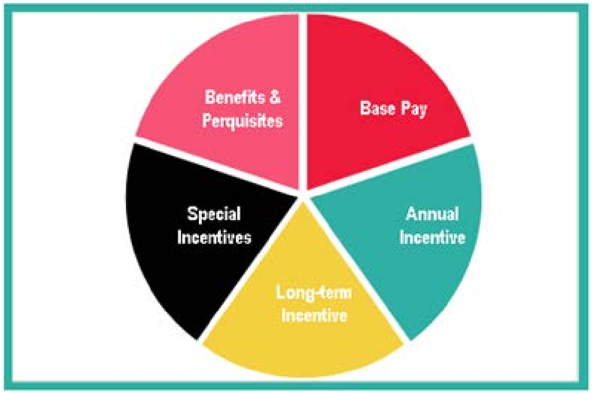
Recommendations

- Develop Executive Compensation Philosophy/Strategy
- Conduct Market Benchmarking/Market Analysis Study
- Develop Formal, Performance-Based Annual Incentive Plan
- Review/Implement Deferred Compensation Arrangements
- Review/Implement Succession Plan

Executive Compensation Strategy

- Provides the foundation for a number of key compensation decisions.
- Helps define how the organization will attract, motivate, and retain members of the executive leadership team.

Elements of the Executive Compensation Strategy



Executive Compensation Strategy

Questions to answer when developing the organization's compensation strategy:

- Who does the organization compete with for executive talent?
- How will compensation be aligned with the organization's long-term business goals and strategic objectives?
- Where will the organization target executive pay relative to the external marketplace?
- What is the appropriate mix of pay (base salary vs. short-term incentives vs. deferred compensation)?
- What will be the alignment between pay and performance?
- What role will deferred compensation play in the total compensation package, if any?

Market Benchmarking / Market Analysis

- Perform an independent total compensation benchmarking analysis in 2019
  - Confirm reasonableness of executive pay levels
  - Ensure total compensation position is within market competitive range
  - Published compensation survey data or peer group study (Form 990 analysis)
    - Market competitive at the 50th percentile
      - Base pay
      - Bonus and incentive compensation
      - Other reportable comp
      - Retirement and other deferred comp
      - Nontaxable benefits
      - Estimated amount of other comp from related orgs
  - Review again in 2-3 years (2021 or 2022)

Annual Incentive Plan (AIP)

- Additional scrutiny leads to more pressure for organizations to justify/prove AIP plan design and linkage between pay and performance
- Not-for-Profits have not utilized incentive plans like their for-profit counterparts
  - Don’t want to compromise mission
  - Didn’t start out with an incentive plan, continue with the status quo
  - Peers don’t offer incentive plans
  - Requires additional resources for tracking/administration

Annual Incentive Plan (AIP)

- Benefit to implementing a performance-based AIP
  - Use of incentive plans correlated to better performing organizations.
  - Ties compensation expenses to financial results.
  - Enhances the competitiveness of compensation programs without increasing fixed costs.
  - Focuses executives on the goals of the organization.
  - Attracts top performers.

Annual Incentive Plan (AIP)

- Guidelines and best practices in AIP design
  - Incentives should be tied to the achievement of key, annual strategic goals (support the mission) and organization-related metrics.
    - Financial, strategic, operations/quality
    - Quantitative and qualitative
    - Recognize need for discretion
  - Limit number of performance metrics to 3 to 5 clearly stated goals.
    - Not one, but not too many
    - Measurable
  - Payout annually for the executive leadership team.
  - Include review by the board of directors or compensation committee members.

Deferred Compensation Arrangements

- Important element of the executive retention strategy
  - Compensation Committee should assist with establishing specific position and objective on level of benefits to be provided
- Develop early and review annually
  - Eligibility – Should additional participants be included?
  - Plan type (SERPs, 457f, etc.) – Determine the most effective vehicle(s) for your organization
  - Retirement age – Confirm the anticipated retirement age of all plan participants as this impacts the annualized value of the award
    - Longer time horizons less likely to trigger excess benefits
  - Confirm the replacement value/amount
  - Vesting provisions – Review time horizon associated award payout
    - Identify proactively or within enough time for corrective action (min 5 years pre-retirement)
    - There will be a point where it is too late to make changes (3 years pre-retirement)

Preparing for Leadership Changes

Strategies for dealing with retiring or exiting executives

Leadership Succession & Retirement Benefits – *Board / Compensation Committee 'Blind Spots'*

- The inevitable transition of numerous 'baby boomers' holding leadership posts in nonprofit organizations has been well-covered in numerous publications for more than a decade.
- The seismic shift that some predicted has failed to materialize. This can be attributed to a variety of factors:
  - delayed retirements out of financial need;
  - resistance to change;
  - belief that "age 75 is the new 65";
  - procrastination / denial of the inevitable… eventually a successor will be needed.

Leadership Succession & Retirement Benefits – *Board / Compensation Committee 'Blind Spots'*

- The delay on the part of these baby boomer executives and the boards to whom they report could increase the likelihood of an unexpected and disruptive leadership crisis. The problems can range from a noticeable decline in performance to an abrupt departure caused by sickness or death.
- Leadership changes under the best of circumstances are not 100 percent successful; thus, in crisis mode, the odds of success are much slimmer.
- Executive retirement arrangements (or lack of same) are another… and related obstacle… facing boards. Confronting the departure of a long-tenured and critically important executive retirement arrangements come to the forefront.
  - Many organizations and executives discover the price that will be paid for failing to address this important issue well in advance. In adequate preparations become an obstacle for smooth succession and may create awkward / expensive situations for all concerned.

Leadership Succession & Retirement Benefits – *Board / Compensation Committee 'Blind Spots'*

- Boards have failed to proactively raise the subject of retirement plans and acknowledge the impact that they will have on an orderly retirement / leadership transition. There are a variety of reasons:
  - financial costs;
  - reluctance to broach the subject of leadership change;
  - mistaken assumptions that arrangements or 'promises' made many years ago will address the needs;
  - embarrassment that arrangements are inadequate or have not been made;
  - Board members have 'day jobs' and many are not familiar with the subject… assuming 'someone else is taking care of this.'

Leadership Succession & Retirement Benefits – *Board / Compensation Committee 'Blind Spots'*

- Scenarios illustrating the situations we discover in "11th hour" reviews of retirement arrangements:
  - **Plan / Document Failures**: Plan documents (e.g., employment contracts, deferred compensation arrangements, life insurance plans, etc.) developed many years ago and / or without the benefit of needed expertise to ensure compliance pose potential problems to the unwary. Problems may result in an unforeseen tax liability and punitive excise tax penalties for recipients.
  - **Plan Administration Failures**: well-drafted plan documents are not adhered to from an administrative standpoint. Contributions, excess contributions, payment amounts and / or payment terms are made (or not) that fail to follow plan requirements causing adverse tax consequences to the executive and the organization.
  - **Improbable / Impossible Catch Up**: there is simply no time and / or financial resources to provide the benefit.

Leadership Succession & Retirement Benefits – *Board / Compensation Committee 'Blind Spots'*

- **The Wake-Up Call** – Board / committee members spend most of their time on decisions about current cash compensation (i.e., salary, bonus and incentive) matters for executives. We are not suggesting the committee members spend any less time on them.
- We are suggesting an immediate and recurring **review of the organization's retirement program** to ensure that all documentation, administration and funding are in accordance with the organization's policy, on track to meet stated objectives and fully compliant with pertinent requirements.
- Finally, schedule and hold a **thoughtful discussion about leadership succession** needs and develop plans to address them.
  - Raise the subject 'no one wants to discuss'
  - Everybody needs a plan….

Questions?

Conclusion

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