

**ADVANCED MARKETS**

# Nonprofit Employers: Building an Effective Key Employee Compensation Strategy

Chances are the success of your nonprofit organization relies, at least in part, on the talents and performance of your employees. And while each employee is important, there may be a few that are key to attaining your organization's mission and objectives. The total compensation package you offer key employees is part of your value proposition to them. There are many different forms of compensation and benefits an employer may offer to retain, recruit, and motivate the talent they need to succeed. As with any other business decision that requires an allocation of financial and human resources, it is important to take a strategic approach.



**Start with good people, lay out the rules, communicate with your employees, motivate them, and reward them. If you do all those things effectively, you can't miss." – Lee Iacocca**

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# Steps in building an effective key employee compensation strategy

## Understand the federal limits and transparency requirements

In order to retain your status as a tax-exempt employer, it is important to understand the federal limitations and transparency requirements around compensation. For example:

- **IRC Sec. 4960** – levies a 21% excise tax on remuneration in excess of \$1,000,000 paid by an applicable tax-exempt organization. The limit applies to any “covered employee,” which includes the top five highest paid employees (starting January 1, 2017) regardless of their income.
- **Private Inurement** – To qualify as tax-exempt, a corporation may not have earnings that “inure to the benefit of any private shareholder or individual.” A common way organizations run afoul of this rule is by paying excessive compensation.
- **Transparency** – Compensation of all officers, directors, trustees, key employees, and the five highest paid employees who received more than \$100,000 in compensation must be disclosed on the organization’s federal 990 form.

## Define and prioritize goals

Before committing financial resources, it is important to determine exactly what your goals are. Is your organization a startup that needs to quickly attract top talent? Is it an established organization concerned with retaining employees who would be difficult to replace? Or are you looking for an effective means of motivating key employees toward certain financial or mission-based goals? If you have multiple goals, which one has the highest priority? The more specific you are about those goals the better. For example:

- “We are starting a five-year capital campaign. Our fundraising/development officer has strong relationships with key donors and is being recruited by other organizations. We would like to implement a compensation plan that provides financial incentives to remain with our organization at least for the next five years.”
- “The health care needs within our community are growing and we need a compensation plan to attract medical professionals to our organization to meet that demand.”
- “We are a religious organization that has grown substantially due to the efforts of one or two individuals, and we need a compensation plan that will create an incentive for them to continue working for our organization well into the future.”

## Decide who is “key”

Before allocating financial resources to a key employee compensation package, take the time to determine which employees truly are key to the ongoing success of your business.

- Do they have long-term, trusted relationships that are important to the success of your organization and would take many years for their replacement to develop?
- Do they have unique knowledge or skills specific to achieving your organization’s mission?
- If they were to terminate their employment, would there be a negative impact on fundraising results?
- If they were to terminate their employment, would other talented employees choose to leave with them due to a close relationship?



## Tailor the plan to the individual employee

What motivates one employee may not motivate another. A married 35-year-old making \$80,000 per year who just had a third child will be much more appreciative of employer-provided cash value life insurance than a single 60-year-old employee with no children who earns \$400,000 per year. An employee making \$120,000 per year with a total household income of \$150,000 may not appreciate the tax advantages of a deferred compensation plan, but another employee making the same amount with a total household income of \$400,000 may greatly appreciate such a plan. If the compensation doesn't motivate or incentivize a particular employee, you risk wasting financial resources as well as losing the services of the employee.

## Communicate

A common mistake made by employers of all types is assuming their employees fully understand and appreciate the different forms of compensation the employer provides. As with any financial outlay, you should expect a return on your investment. In the case of key employee compensation, the expected return is more effective, better performing, harder working, and loyal employees. To maximize your return, it is important that your key employees fully understand what these additional forms of compensation are, how they work, and what benefits they receive from them.

**There are many reasons why employees may choose to dedicate their time, talents, and energy to your organization.** It could be the culture, the challenges the job presents, the potential for advancement, the people they'll work with, or the mission the organization is working to achieve. But employers who develop a compensation strategy that balances an employee's need for financial rewards with the organization's need for high-performing, motivated, loyal employees should have a leg up on their competitors.

**The following pages highlight a few of the more common forms of key employee compensation strategies available to nonprofit employers.**

# Selecting a key employee compensation plan

## Bonus plan

A simple and flexible form of incentive compensation that requires minimal administrative costs and time commitment from human resources is an annual cash bonus. There are very few limitations on the amount, timing, performance measures, or number of employees included in the plan. The employee will recognize the bonus as taxable income in the year received.

One common way to design a bonus plan is to make contributions (i.e., premium payments) to a cash value life insurance policy owned by the employee. Such policies typically have built-in surrender charges in the early years and require ongoing premium payments in order to help increase accumulation value and to help ensure the policy remains in force.

The employer may make the plan more appealing to the employee by paying an additional bonus (above the amount of the life insurance premium) to cover the employee's income taxes on the initial bonus. This type of plan is often referred to as a "double bonus." The formula for determining the employer's total annual outlay for a double bonus plan is: ANNUAL PREMIUM divided by (1 minus EMPLOYEE'S TAX RATE). For example, if the annual premium is \$20,000 and the key employee is in the 30% tax bracket, the total bonus paid by the employer would be \$28,571 ( $\$20,000 / (1 - .30)$ ).

## Restricted bonus plan

A restricted bonus plan provides the organization with a more effective plan to retain key employees. The plan involves the combination of three separate components: an employment contract, bonus arrangement (discussed above), and a restrictive endorsement. The employee receives bonuses that are paid into a cash value life insurance policy owned by the employee. The employment contract requires the employee to pay "damages" if they violate the terms of the agreement (i.e., terminate their employment prior to a defined time period). Damages are typically equal to the amount of the bonuses paid by the employer. The restrictive endorsement limits the employee's ability to gain access to the insurance policy cash value through policy loans and withdrawals<sup>1</sup> without the approval of the employer.

When combined, these three agreements provide the employee with a tax-efficient supplemental retirement benefit (in addition to tax-free death benefit protection for their family). But they must meet their obligations under the employment contract to enjoy those benefits.

<sup>1</sup> Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.



## Nonqualified deferred compensation (NQDC) plan

Qualified retirement plans such as 401(k) plans provide employees an opportunity to defer taxation on their income until retirement. However, qualified plans limit the amount of income an employee may defer and prohibit the employer from discriminating in favor of highly compensated employees. Nonqualified deferred compensation plans (NQDC) are designed to provide similar tax deferral benefits to key employees without the participation requirements of qualified plans.

Nonprofit employers may provide their key employees with a NQDC plan as well, but there are limitations and guidelines. There are two alternatives, “eligible” 457(b) plans, and “ineligible” 457(f) plans. The primary differences between the two are the amount that may be contributed to each plan and the timing of the employee’s recognition of income taxes.

The NQDC plan may be established to allow a key employee to defer existing salary, the employer may contribute amounts in addition to an employee’s salary, or the plan may include both options.

In order to avoid many of the burdensome requirements of the Employee Retirement Incomes Security Act (ERISA), nonqualified plans are actually required to limit participation to a select group of highly compensated employees or management.

The employer may consider purchasing a cash value life insurance policy on the life of the key employee. The employer/nonprofit organization would be the owner and beneficiary of the policy and may use policy cash values (via withdrawals and/or policy loans<sup>2</sup>) to meet their obligations under the NQDC plan.

Feature	457(b) plan	457(f) plan
Maximum annual deferral	\$23,000 (2024)	No limit
“Catch-up” deferral amount	Over age 50 – \$7,500 (2024) Double if within 3 years of plan “normal retirement age”	N/A
Recognition of taxable income – timing	When paid	When there is no “substantial risk of forfeiture” – i.e., entire amount in year vested

## Split-dollar arrangement

Beyond a bonus plan or deferred compensation plan, a third option for nonprofit employers is a split-dollar arrangement. A split-dollar arrangement is an agreement between the employer and employee in which they split rights to a life insurance policy's accumulation values and death benefit. There are a number of different ways to design a split-dollar arrangement, but the most common is the collateral assignment split-dollar (CASD).

**Collateral assignment split-dollar (CASD):** The best way to understand a CASD is to think of it as a zero-interest loan from the employer to the employee where the loans are paid into a cash value life insurance policy.

**CASD basic design:** The employee purchases a cash value life insurance contract covering their life and designates the beneficiary, typically their spouse and/or children. The employer pays the premiums and has the right to recover their total outlay from the employee either from the policy's accumulation value during their life or from the death benefits when the insured dies. The policy is assigned to the employer as collateral to secure repayment of the "loan."

For tax purposes, the IRS will treat the arrangement as a loan from the employer to the employee (a zero-interest loan unless the agreement calls for the employee to pay interest on the amounts loaned).

The amount of tax paid each year by the employee is measured by applying an interest rate to the total outstanding "loan" (total premiums paid by the employer). This applicable interest rate is the annual blended rate provided by the Internal Revenue Service.<sup>1</sup> The following chart illustrates an example assuming a \$20,000 annual employer contribution starting in the year 2013 (using historical annual blended rates).

### Example: Collateral assignment split-dollar – annual employee taxable income

Year	Blended annual rate	Annual premium paid by employer	Cumulative premium paid by employer	Annual taxable income to employee
2013	.22%	\$20,000	\$20,000	\$44
2014	.28%	\$20,000	\$40,000	\$112
2015	.45%	\$20,000	\$60,000	\$270
2016	.73%	\$20,000	\$80,000	\$584
2017	1.09%	\$20,000	\$100,000	\$1,090
2018	2.03%	\$20,000	\$120,000	\$2,436
2019	2.42%	\$20,000	\$140,000	\$3,388
2020	.89%	\$20,000	\$160,000	\$1,424
2021	.13%	\$20,000	\$180,000	\$234
2022	1.4%	\$20,000	\$200,000	\$2,800
			\$200,000	\$12,382

This hypothetical example is provided for illustrative purposes only.

<sup>1</sup> IRC §7872(e)(2)

**Advantages for the key employee:** A CASD agreement may provide a number of tax advantages for the employee, such as minimal annual tax outlay when the premiums are paid, tax-deferred growth of policy accumulation values, tax-free withdrawals of cash values, the potential for income-tax-free withdrawals of cash values and/or loans from the policy, and a generally income-tax-free death benefit to beneficiaries.

**Advantages for the employer:** The primary advantage for the employer is that they typically retain the right to receive all of their premium contributions back.

Upon retirement or termination of employment the employer may terminate the agreement and recover their premiums paid via the policy cash values. The employee will retain ownership of the policy and have access to the remaining policy cash values for supplemental retirement income (in addition to the

policy's death benefit protection). The employer may also decide to forgive the total loan balance as additional compensation to the employee. However, the employer must take care not to make any formal commitments or promises to forgive the loan in order to avoid immediate taxation to the employee.

### Combining 457 plans and CASD arrangements:

There may be a number of advantages to providing a key employee with both a 457 NQDC plan and a CASD plan. From the employer's perspective, the 457 NQDC plan provides a strong financial incentive for the employee to continue their employment. From the employee's perspective, the CASD provides the advantage of direct ownership of the funding vehicle (i.e., the life insurance policy).<sup>1</sup>

## A word on noncompete agreements/employment contracts

Many for-profit business owners look to noncompete agreements or restrictive employment contracts as a way to protect intellectual property and trade secrets, define terms of an employee's employment, and restrict certain activities post-employment. The terms of such agreements vary, but generally they limit the employee's ability to provide similar services to other employers during the term of their employment and for a period of time after their employment terminates. The enforceability of such agreements largely depends on state law. Some states restrict or even prohibit the use of noncompete agreements. In general, limitations on the employee's future employment must be narrowly tailored and not overly restrictive to be enforceable.

Nonprofit organizations may also enter into noncompete/employment agreements with key employees, but such agreements may not have the retention or motivational impact on the employee they desire. Any such agreements should be discussed with legal counsel prior to implementation.



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<sup>1</sup> When combining a 457 NQDC plan and a split-dollar arrangement, work with professional legal counsel to execute separate agreements for each. In order to avoid potential negative income tax consequences for the employee, neither agreement should reference the other. See *Miller v. Heller*, 915 F. Supp. 651 (S.D.N.Y. 1996).

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