BENEFITS LAW ALERT
JANUARY 24, 2018

Legislation adds significant new tax on exempt organizations' executive compensation

By Dennis Bouxsein, Anita Pelletier, Claire P. Rowland and Jenny Holmes

On December 22, 2017, the president signed the Tax Cut and Jobs Act (the "Act") into law. The Act continues the federal government's attempts to influence the amount and form of executive compensation paid by private employers through tax policy. Reportedly, those efforts have had a limited effect in diminishing total executive compensation. For example, amendments to the Internal Revenue Code (the "Code") in 1993 to disallow the deductibility of certain non-performance-related compensation resulted in a shift of executive compensation toward performance-related bonuses and stock options, but apparently achieved little else.

Despite that failure, Congress saw fit to graft the core of that same scheme onto an unlikely host: tax-exempt organizations. Newly fashioned Code Section 4960, entitled "Tax on Excess Tax-Exempt Organization Executive Compensation," applies to compensation that is neither excessive nor necessarily paid to executives. It claims to create some level of equivalence so tax-exempt organizations do not have a tax advantage in attracting highly compensated employees who might otherwise be hired by publicly traded companies. It attempts to accomplish this by imposing a corporate-level tax on the exempt organization on compensation in excess of $1 million, as well as on certain "excess" parachute payments.

The new tax is effective for taxable years beginning after December 31, 2017. The legislation is not explicit on whether "taxable year" refers to an organization's fiscal year or the calendar year. Future regulatory guidance may make clear whether there is a deferred effective date for organizations with a non-calendar fiscal year.

Exempt organizations and executive compensation

A basic understanding of the decades-old exempt organization compensation regime is necessary to appreciate the disruptive effects of Code Section 4960. To begin, nonprofit corporate status is pretty much a prerequisite to securing tax-exempt status. State corporate laws generally prohibit payment of excessive compensation — amounts beyond those reasonable and necessary to achieve nonprofit purposes — and bar a nonprofit from paying what amounts to dividends. Failure to comply with those limitations could constitute a breach of fiduciary duty and result in an action for recoupment of excessive compensation.

Federal tax law borrows from these state law limitations. In particular, exemption under Code Section 501(c)(3) prohibits the inurement of charitable income or assets to the benefit of corporate insiders, except as payment of reasonable compensation for necessary services rendered. Failure to comply has resulted in the revocation of an organization's tax-exempt status in numerous published cases.

Concerned that the burdens of revocation disadvantaged the public more than the offending insiders and those fiduciaries who approved the excessive compensation, Congress adopted Code Section 4958 in 1996. That statute imposed "intermediate sanctions" penalty excise taxes on individuals that became confiscatory in the second tier, where excessive compensation was not repaid. The reach of the new law advanced past charities to include civic organizations and qualified nonprofit health insurance issuers.

What did the Act change?

The Act added new Code Section 4960, which imposes a 21% excise tax on any tax-exempt organization that pays remuneration to an employee that exceeds $1 million in a tax year ("4960 Tax"). Excess parachute payments are separately subject to the 4960 Tax. Moving forward, organizations must determine the following:

Is my organization subject to the 4960 Tax?

The organizations subject to these rules include:

- any organization exempt from taxation under Code Section 501(a) (this includes tax-exempt organizations under Code Sections 501(c) and 501(d), as well as Code Section 401(a));
- farmers' cooperative organizations under Code Section 521(b)(1);
- political organizations described in Code Section 527(e)(1); and
- governmental entities with income excluded under Code Section 115(1).

Thus, unlike the intermediate sanctions rules described above, the 4960 Tax will apply to other tax-exempt organizations such as trade associations, business leagues and fraternal benefit societies.

Which employees does the 4960 Tax affect?

A "covered employee" is any current or former employee who is one of the five (5) highest-compensated employees for the current year or any prior tax year beginning after December 31, 2016. Unlike Code Section 162(m), which limits the definition of covered employee to corporate officers, the 4960 Tax applies to any employee, even if the employee is not an officer.

Interestingly, once an employee is a covered employee, the employee will always be a covered employee, meaning that the covered employee group can include more than five individuals.

If your organization is subject to Code Section 4960, you will need to identify the five highest-compensated employees starting with your first year beginning after December 31, 2016, and maintain a cumulative list of all such employees for each year thereafter.

How do I calculate remuneration for purposes of the 4960 Tax?

Code Section 4960 defines remuneration to mean wages within the meaning of Code Section 3401(a), excluding designated Roth contributions and any excess parachute payments. In other words, remuneration is the employee's wages reported in Box 1 on Form W-2. Remuneration also includes deferred compensation awards that vest in a taxable year and are includible in income under Code Section 457(f).

Remuneration is treated as paid when there is not a substantial risk of forfeiture of the right to payment. Because Code Section 457(f)(3)(B) applies to ineligible deferred compensation subject to Code Section 457(f), the excise tax applies to the value of remuneration that is vested (and any increases in that value or vested remuneration), even if the remuneration has not yet been received. Deferred compensation amounts that vested and were included in income before January 1, 2018, but have not yet been paid, will be "grandfathered" and will not be subject to the excise tax when they are ultimately paid in the future. However, it is not yet clear whether earnings on the unpaid vested deferred amounts will also be grandfathered.

For purposes of determining who is a covered employee, remuneration does not include the portion of any remuneration paid to a licensed medical professional (including a doctor, nurse or veterinarian) for the performance of medical or veterinary services. However, it is not clear to what extent compensation for other services provided by these individuals (e.g., administrative) is included.

Remuneration also includes compensation paid to a covered employee by a person or governmental entity that:

- controls or is controlled by the employer organization;
- is controlled by one or more persons that control the employer organization;
- is a supported or supporting organization under Code Section 509 with respect to the employer organization; or
- with respect to a Voluntary Employee Beneficiary Association ("VEBA") under Code Section 501(c)(9), establishes, maintains or contributes to the VEBA.

It is unclear whether compensation paid by related taxable businesses when calculating remuneration is included for purposes of the 4960 Tax. The language in the Act seems to contemplate that such compensation may not be included for purposes of the rule, since the underlying purpose of the statute is to impose tax on compensation paid by tax-exempt organizations.

Who is liable for the 4960 Tax?

The employer of the covered employee is liable for the 4960 Tax. Any remuneration for which a deduction is not permitted by Code Section 162(m) is not taken into account for purposes of the 4960 Tax. For example, if an employee is paid remuneration of $1.2 million, the employer would owe a 4960 Tax on $200,000, the amount that exceeds $1 million.

If remuneration from more than one organization is taken into account, the liability for the excise tax is divided proportionately among the organizations.

Note that Code Section 4960 does not include a controlled group rule for determining 4960 Tax liability. For now, it appears that the 4960 Tax applies on an entity-by-entity basis. Larger tax-exempt organizations with multiple entities, such as tax-exempt hospital systems comprising separate exempt organizations for each hospital, will likely find the determination of 4960 Tax liability particularly burdensome.

What is an excess parachute payment?

A 4960 Tax is also assessed on excess parachute payments that include arrangements where:

- the payment is contingent on the employee's separation from employment with the employer and
- the aggregate present value of the payments (to be paid to or for the benefit of the employee) equals or exceeds an amount equal to three (3) times the base amount.

The base amount is the covered employee's average annualized compensation includible in gross income for the five (5) taxable years ending before the year in which the parachute payment was made (or, if less, the portion of such period in which the covered employee performed services for the applicable tax-exempt organization).

The 4960 Tax applies to all payments in the nature of compensation that are contingent on a separation from employment. This may include not only severance pay but also vested deferred compensation awards under Section 457(f), healthcare continuation benefits, outplacement assistance and other benefits triggered by separation from employment.

If a parachute payment equals or exceeds three (3) times the base amount, the entire amount of the parachute payment in excess of the base amount is subject to the 4960 Tax. Unlike the "golden parachute" rules that apply to taxable businesses, a change in control of the employer is not required; an employee need only terminate employment to trigger the excess parachute payment. Also, an employee need not be an officer for the parachute payment tax to apply.

Note that because the 4960 Tax is imposed on the excess over the base amount, the excise tax may apply to an excess parachute payment even if the covered employee's compensation does not exceed $1 million.

Parachute payments do not include:

- payments to licensed medical professionals for medical services;
- payments from Code Section 401(k) and other tax-qualified retirement plans, Code Section 403(b) plans, Code Section 457(b) plans, a SEP under Code Section 408(k), or a SIMPLE IRA under Code Section 408(p).; or
- payments to an individual who is not a "highly compensated employee" (HCE) for purposes of Code Section 414(q) (e.g., an employee who earns more than $120,000 in 2017 is an HCE for 2018).

What should I do now?

- Organizations subject to Code Section 4960 ("4960 Organizations") should identify their five highest-compensated employees based on the 2017 tax year. After December 31, 2017, these employees, and the five highest-compensated employees in 2018, will be the covered employees for the first tax year in which the excise tax applies.
- 4960 Organizations should work with counsel to review compensation arrangements for covered employees to determine if or when the 4960 Tax may apply. In addition to annual base salary and taxable benefits, this review should include employment agreements, annual and long-term incentive programs, deferred compensation plans, severance agreements, and retention or change in control agreements.

- Healthcare 4960 Organizations should identify potential covered employees who are medical professionals and assess how much of their pay is attributable to medical services versus executive, administrative or other non-medical services. We expect to see future guidance on this issue from the IRS.
- After identifying any compensation arrangements that may trigger the 4960 Tax, 4960 Organizations should consult with counsel to determine whether existing employment and other agreements should be amended to address the impact of the 4960 Tax.
- Identify recently terminated covered employees and consult with counsel to determine the impact of the 4960 Tax on payments to such covered employees.

We understand that the Act's excess parachute payment provisions are new for 4960 Organizations. However, these provisions closely track the "golden parachute" provisions that have long applied to taxable businesses. With our extensive experience with such rules, we can help 4960 Organizations get "up to speed" on these concepts and address any actions that may need to be taken now. If you have questions about how the 4960 Tax will affect your organization, please contact your Nixon Peabody benefits attorney or:

- Dennis Bouxsein at **dgbouxsein@nixonpeabody.com** or 312-977-9204
- Anita Pelletier at **apelletier@nixonpeabody.com** or 585-263-1164
- Claire P. Rowland at **crowland@nixonpeabody.com** or 415-984-8338
- Jenny L. Holmes at **jholmes@nixonpeabody.com** or 585-263-1494
- Michael J. Cooney at **mcooney@nixonpeabody.com** or 202-585-8188
- Paul B. Holmes at **pbholmes@nixonpeabody.com** or 312-977-4488
- Eric R. Paley at **epaley@nixonpeabody.com** or 585-263-1012
- Brian Kopp at **bkopp@nixonpeabody.com** or 585-263-1395
- Christian Hancey at **chancey@nixonpeabody.com** or 585-263-1147
- Thomas J. McCord at **tmccord@nixonpeabody.com** or 617-345-1337