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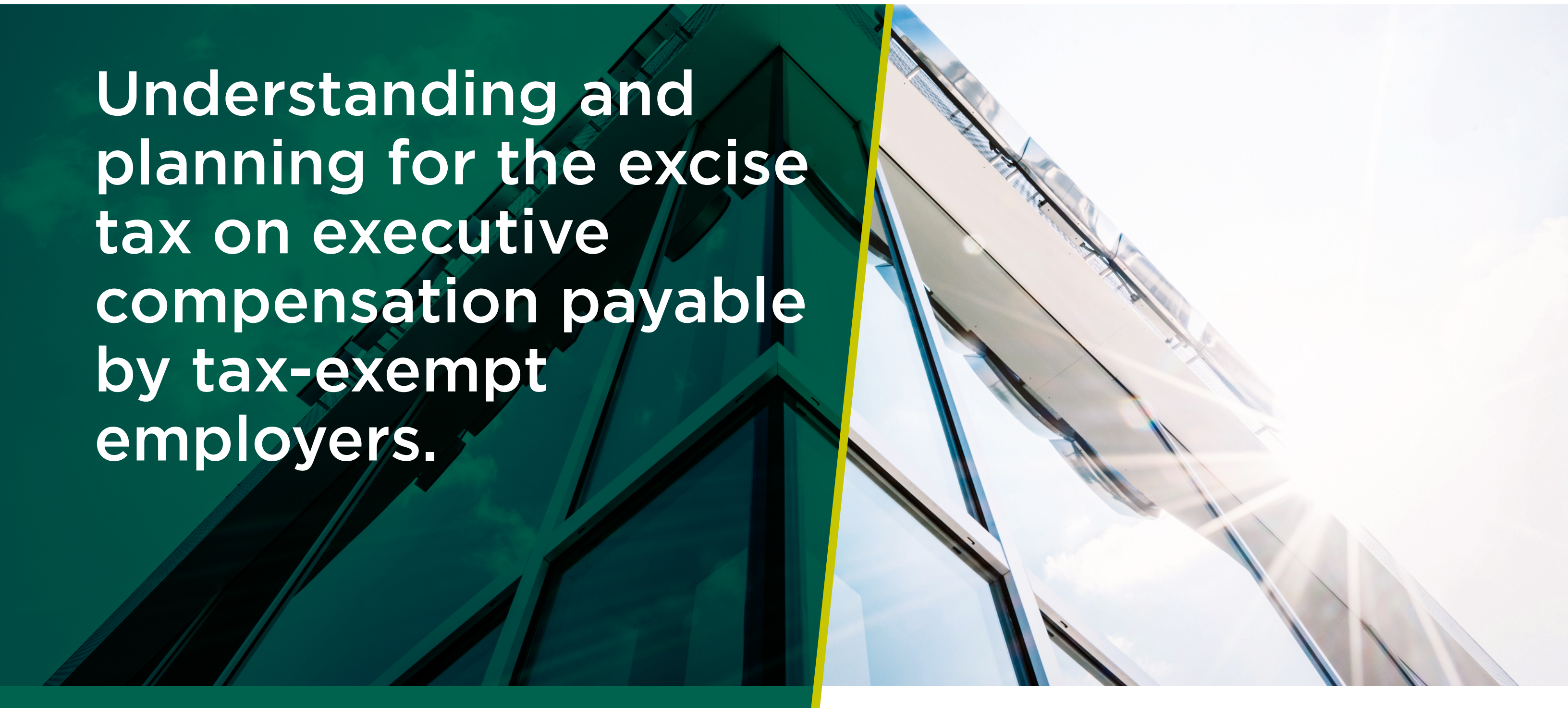

Understanding and planning for the excise tax on executive compensation payable by tax-exempt employers.

By Douglas M. Mancino, Thomas P. Flannery, PhD. and James Otto

Introduction

In the past decade or so, the competition for executive leadership talent in the tax-exempt sector of the United States economy has increased. Executives seldom begin and end their careers with the same organization any longer and there is increased competition for executive talent with the for-profit sector of the economy. Consequently, compensation levels paid to executives of tax-exempt organizations have steadily increased.

At the same time, an increasing percentage of that compensation has been made contingent on the operational performance of the organization, including the attainment of both mission-related and financial goals. In addition, many tax-exempt organizations are exploring the use of equity and equity-like compensation approaches in selective situations. For example, a few tax-exempt health systems have spun off discrete product lines or businesses as well as investment management and real estate development activities into newly-formed subsidiaries (typically C corporations or limited liability companies) and have awarded nonqualified stock options or restricted stock or profits interests to incentivize the management of those companies. Even private foundations are incentivizing managers of program-related investments by awarding similar types of equity and equity-like incentives.

As levels of compensation have escalated in the tax-exempt sector so has the level of Congressional scrutiny. Thus, in December 2017, Congress, as part of broader tax legislation, enacted a new excise tax on annual compensation paid by all tax-exempt organizations in excess of $1 million and on excess parachute payments.

The purpose of this article is to explain how the new excise tax works and identify several planning options available to mitigate its effects on current and deferred compensation paid by tax-exempt employers to highly-compensated employees.

In general

Prior to the enactment of section 4960[2] in 2017, tax-exempt organizations were not subject to taxation on any compensation or benefits paid or provided to their executives, so as long as the amounts paid or provided were considered reasonable in relation to the services provided to the organization. It was only in situations when some element or all of the compensation or benefits was unreasonable that the organization's tax-exempt status could be in jeopardy. In addition, in the case of section 501(c)(3) and section 501(c)(4) organizations, the recipient of the unreasonable compensation and those who approved it could be subject to the excise taxes imposed by section 4958, the so-called "intermediate sanctions" provision. Similarly, in the case of section 501(c)(3) private foundations, excessive compensation paid for personal services constitutes an act of self-dealing.

Section 4960 now imposes an excise tax on tax-exempt organization executive compensation equal to 21 percent[3] of: (1) remuneration (other than any excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a tax year, plus (2) any excess parachute payment paid by an applicable tax-exempt organization to a covered employee other than an employee who is not highly compensated. This provision imposes the 21 percent excise tax on an excess parachute payment, even if the covered employee's total remuneration does not exceed the $1 million threshold amount. The $1 million threshold is not adjusted for inflation.

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Covered employees

For purposes of this provision, a "covered employee" means an employee (including any former employee) of an applicable tax-exempt organization if (a) the employee is one of the five highest compensated employees of the organization for the taxable year or (b) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016. This determination is made each taxable year, so the five "covered employees" may change from year to year. Once an employee becomes a "covered employee," he or she will remain a covered employee until the employee leaves the organization and post-termination payouts such as deferred compensation or severance could be large enough to be subject to the 21 percent excise tax. Consequently, an applicable tax-exempt organization may over time have significantly more than five covered employees whose compensation is subject to the excise tax, as the number of covered employees grows year-over-year.

Of critical importance is the fact that the determination of who is a covered entity is made on an organization-by-organization basis. This means that within a group of affiliated tax-exempt organizations such as a health system comprised of a parent corporation and multiple operating subsidiaries, the affiliated group could have considerably more than five covered employees in any given tax year.

What types of tax-exempt organizations are subject to the tax?

Virtually all tax-exempt organizations are subject to the excise tax because the term "applicable tax-exempt organization" is broadly defined to include all organizations exempt from taxation under section 501(a), but there are a few exceptions.

Organizations subject to the tax.

The excise tax applies to an "applicable tax-exempt organization," and that term is defined to mean any organization that for the year is exempt from taxation under section 501(a). Importantly, this definition encompasses all types of tax-exempt organizations, including hospitals, colleges, and universities exempt under section 501(c)(3), health maintenance organizations and other social welfare organizations exempt under section 501(c)(4), trade associations exempt under section 501(c)(6), and labor organizations and professional football, baseball and other types of sports leagues exempt under section 501(c)(5).

The excise tax also applies to farmers' cooperatives described in section 521(b)(1) and political organizations described in section 527(e)(1). These types of organizations are not discussed in this article.

Public hospitals, colleges and universities.

Many public hospitals, colleges and universities are operated under state laws that authorize their formation and funding but do not grant them any governmental powers, such as the power of eminent domain, the power to tax or the police power. In the absence of any of these powers, these organizations can still be recognized as tax-exempt charitable organizations described in section 501(c)(3). Even if these types of organizations choose not to file an exemption application, these organizations can claim that their income is excluded from gross income under section 115(1) and thus not subject to income tax because they perform an essential governmental function (e.g., operate a hospital, college or university) and their income ultimately will accrue to the state or a political subdivision of the state upon their dissolution. In either case, these hospitals, colleges and universities will be subject to the excise tax on executive compensation in excess of $1 million.

On the other hand, many state laws authorize the formation and funding of hospitals, colleges and universities and grant governmental powers that include the power to use eminent domain to acquire property for their use, the power to tax (such as the ability to issue general obligation bonds that are funded by assessed real and personal property taxes), and limited police powers to establish their own police forces (such as a university's campus police force). In general, these types of hospitals, colleges and universities are not subject to the excise tax on executive compensation in excess of $1 million unless they also apply and receive tax-exempt status as charitable organizations described in section 501(c)(3).

Many public hospitals applied for and received section 501(c)(3) exemption in order to be eligible to make section 403(b) tax-sheltered annuities available to their employees. These hospitals may wish to consider relinquishing those exemptions in order to avoid remaining subject to the excise tax if an appropriate retirement-funding alternative is available.

What types of compensation are subject to the 21 percent excise tax and what types are not?

Wages in general.

Remuneration to an employee that is subject to the excise tax means "wages" as defined in section 3401(a) and as a result includes all cash and compensation in any medium other than cash, except for payments to a tax-qualified pension or profit-sharing plan or other amounts that are excludable from the employee's gross income.[4] Remuneration also includes amounts paid with respect to the employment of the employee by a person or governmental entity that is related to the applicable tax-exempt organization. As an example, a health system with multiple tax-exempt subsidiaries will be exposed to the excise tax for both the parent corporation as well as each tax-exempt subsidiary, and the use of a common paymaster does not avoid the tax exposure.

An important issue is the time period over which wages are measured for purposes of determining whether the $1 million-dollar threshold is measured. This issue arises because tax-exempt organizations are required to have an annual accounting period that is either the calendar year ending on December 31st or a fiscal year that ends on the last day of a month other than December. Individuals who are employees of a tax-exempt organization, on the other hand, are required to use the calendar year as their annual accounting period. These annual accounting periods are referred to as the taxpayers' taxable years.[5]

The reporting of wages paid by a tax-exempt organization to its employees, including highly-compensated employees, is straight-forward if the organization uses the calendar year as its taxable year because Form W-2, Wage and Tax Statements, issued to employees are based on the employees' taxable year as well, and the organization files its annual Form 990, Return of Organization Exempt From Income Tax, based on the same calendar year.

Confusion has arisen when the tax-exempt organization uses a fiscal year (such as a June 30 year-end), as do many colleges, universities and health care organizations. The organization is required to report compensation for current officers and key employees on its Form 990 in Part IX, Statement of Functional Expenses, Line 5, using the total compensation paid to such individuals for the organization's fiscal year.[6] However, for purposes of completing Part VII of the Form 990, Section A, and Schedule J, Compensation Information, Part II, the organization is required to use compensation that was paid during the calendar year

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that ends within the organization's fiscal year and that was reported on the employees' Forms W-2.

Given that the organization is the party subject to the tax, and not the employee, the authors believe that wages paid in the organization's taxable year, and not those reflected on an employee's Form W-2, should be used to determine whether a covered employee's wages exceeded $1 million and as a consequence whether the organization will be subject to the excise tax on the excess.

Deferred amounts and earnings or losses in a nonqualified deferred compensation plan subject to section 457(f) are included in income and wages at the time these amounts become vested or otherwise are no longer subject to a substantial risk of forfeiture. Consequently, the taxable year in which that happens should be the taxable year in which these amounts are added to other wages for purposes of determining whether the organization will be subject to the excise tax.

Non-taxable fringe benefits.

Section 3401(a) uses an expansive definition of "wages," which is defined as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." However, there are many statutory exclusions from income that are not subject to the excise tax because they are also excluded from the definition of wages: these exclusions include certain employer-provided meals and lodging (section 119) and non-taxable fringe benefits (section 132).

Expense reimbursement and allowance arrangements.

Another potential source of "wages" is from expense reimbursement and allowance arrangements. If an expense reimbursement and allowance arrangement meet three requirements – there is an appropriate business connection, proper substantiation, and the employee returns amounts advanced in excess of expenses – the arrangement will qualify as an

accountable plan. Amounts treated as paid under an accountable plan are excluded from an employee's gross income and are not reported as wages or other compensation on the employee's Form W-2.

On the other hand, amounts treated as paid under a nonaccountable plan are included in the employee's gross income and are reported as wages on the employee's Form W-2. As a result, these amounts will also count toward remuneration subject to the excise tax if, when added to other compensation, the $1 million-dollar threshold is exceeded.

Wages paid to certain professionals.

Remuneration does not include the portion of any remuneration paid to a licensed medical professional, including nurses and veterinarians, for the performance of their professional services.[7] This exception would not apply to the portion of remuneration for the performance of administrative services, such as those of a physician serving as an executive or medical director of a health care provider. But this is not an all or nothing exception.

Guidance is needed concerning the scope of this professional services exception. For example, many physicians today serve as chief executive officers or medical directors of health systems or health plans, and while functioning as a chief executive officer may not require a medical degree per se, making medical necessity decisions does. Similarly, medical and veterinary professionals often provide services that depend on their professional expertise that do not involve direct patient or animal care, such as teaching and proctoring medical or veterinary students and residents and conducting peer review and quality assurance activities as a member of a medical staff.

Payments to independent contractors and risks of reclassification.

Many organizations attempt to bypass the requirement to withhold income, and withhold and pay employment and Medicare taxes by classifying a service provider, such as a physician acting as a part-time medical director of a hospital who also has a private practice, as an independent contractor rather than as an employee. In many cases this is a completely legitimate position. However, it also is a position the Internal Revenue Service (IRS) routinely challenges on audit. As a consequence, tax-exempt organizations such as hospitals should review their independent contractor-employee classifications carefully, in particular if the individual classified as an independent contractor is highly compensated.

Also, it should be noted that Congress has directed the IRS to prescribe regulations to prevent avoidance of the 21 percent excise tax by performing services other than as an employee or by providing compensation through a pass-through entity such as a partnership, limited liability company, or S corporation. It is likely the IRS will take the position that performing services through a single-member limited liability company that is a disregarded entity for tax purposes should be treated as performing services directly to the tax-exempt organization and is subject to the 21 percent excise tax if the compensation for the services exceeds $1 million.

However, the IRS will have a much more difficult issue if the service provider is an employee of a professional service corporation or a partner of a professional partnership or limited liability company.

Split dollar loan arrangements.

Increasingly, tax-exempt organizations are using split dollar loan arrangements as replacements for traditional non-qualified deferred compensation arrangements subject to section 457(f) or in addition to those arrangements.

Basically, under a split dollar loan arrangement, the employer agrees to make loans to the executive to pay the premiums for a universal life insurance policy that is owned by the employee and that has a significant death benefit. A private placement policy also may be issued instead of a traditional policy issued by a traditional life insurance company. The employee typically is the owner of the policy, and the employee agrees to a collateral assignment of the death benefit to the employer to secure the repayment of the loan and any accrued but unpaid interest.

Upon the employee's retirement, and assuming the employee has met all vesting requirements, the employee is permitted to borrow accumulated cash value from the insurance company that issued the policy within agreed upon limits that assure that the employer ultimately will be repaid the amounts it loaned to the employee along with accrued interest.

Before the enactment of section 4960, these arrangements were attractive alternatives to section 457(f) plans for several reasons. From the employer's standpoint, the employer provides a benefit to the employee from a split dollar loan arrangement and ultimately recovers its "investment" to provide that benefit when the employee dies. In contrast, the employer recovers no amounts from a section 457(f) plan when the amount is paid out fully to the employee upon vesting. From the employee's standpoint, the benefit from the split dollar loan arrangement – the policy loan(s) that the employee takes out – is not taxable currently to the employee and typically is non-recourse; in contrast, a section

457(f) plan benefit is taxable to the employee when there no longer is a substantial risk of forfeiture regardless of whether the benefit is payable in a lump sum or over time.

With the enactment of the 21 percent excise tax in section 4960, split dollar arrangements are more attractive because policy loans are not considered wages: they are loans pursuant to section 7872[8] and therefore are not remuneration subject to the 21 percent excise tax.[9]

Related persons or governmental entities.

In recent years, it has become increasingly common for highly-compensated executives to receive compensation from multiple sources that, in the aggregate, exceeds $1 million. For example, the compensation of a health system chief executive officer may be assessed to each individual, separately-incorporated hospital but paid by the parent organization acting as a common paymaster. Similarly, the compensation of a university president or football coach may be paid in part by the university and in part by a separate fund-raising or booster organization. In order to address these and similar types of situations, a broad definition sweeps in all compensation from related entities to determine whether the $1 million-dollar threshold for taxation is met each year.

"Related to" is based primarily on the concept of "control." A person or governmental entity is treated as related to the applicable tax-exempt organization if that person or governmental entity: (a) controls, or is controlled by, the organization; (b) is controlled by one or more persons that control the organization; (c) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the organization; (d) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the organization; or (e) in the case of an organization that is a voluntary employees' beneficiary association described in section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.[10]

Control of a tax-exempt organization.

One or more persons (whether individuals or organizations) "control" a tax-exempt organization if they have the power to remove and replace a majority of the tax-exempt organization's directors or trustees, or a majority of the members who have the power to elect a majority of the tax-exempt organization's directors or trustees.[11] ("Removal or replacement" also includes the power to appoint, elect, or approve or veto the appointment or election of, if this power includes a continuing power to appoint, elect, or approve or veto the appointment or election of, periodically or in the event of vacancies.) This power can be exercised directly by a (parent) organization through one or more of the (parent) organization's officers, directors, trustees, or agents, when acting in their capacity as officers, directors, trustees, or agents of the (parent) organization.[12] Also, a (parent) organization controls a (subsidiary) tax-exempt organization if a majority of the subsidiary's directors or trustees are trustees, directors, officers, employees or agents of the parent.[13]

Control of a stock corporation.

One or more persons (whether individuals or organizations) control a stock corporation if they own more than 50 percent of the stock (by voting power or value) of the corporation.[14]

Control of a partnership.

One or more persons control a partnership if they own more than 50 percent of the profits interests or capital interests in the partnership (including a limited liability company treated as a partnership or disregarded entity for federal tax purposes).[15] A person also controls a partnership if the person is a managing partner or a managing member of a partnership or limited liability which has three or fewer managing partners or managing members (regardless of which partner or member has the most actual control), or if the person is a general partner in a limited partnership which has three or fewer general partners (regardless of which partner has the most actual control).[16] For this purpose, a "managing partner" is a partner designated as such under the partnership agreement, or regularly engaged in the management of the partnership.

Implications when compensation is received from multiple organizations that are related.

To the extent that any employee receives compensation from multiple tax-exempt organizations that are related, each organization is liable for a portion of the excise tax imposed on the employee's compensation. Specifically, the amount required to be paid by each employer is calculated by multiplying the total excise tax amount by a percentage, which is determined by dividing the amount of remuneration paid by each employer to the employee over the total remuneration paid by all employers to the employee.

Excess parachute payments.

The 21 percent excise tax also applies to both remuneration to a covered employee and any excess parachute payment paid to a covered employee. An excess parachute payment is an amount (1) paid to a covered employee, (2) upon the employee's separation from employment and (3) in an amount with a present value that equals or exceeds three times the employee's "base amount."[17] An employee's base amount is in general the average of the employee's "wages" from the employer for the five years prior to the year of separation from employment. Payments under qualified plans, or any payment under or to an annuity contact described in section 403(b) or an eligible plan described in section 457(b), are not included in the definition of excess parachute payment.[18]

The authors note that even if payments upon a separation of employment do not result in an excess parachute payment, the amounts the covered employee receives upon a separation of employment must still be included in the calculation of whether remuneration exceeds $1 million in the year in which these payments are received.

Coordination with deduction limitation and the excise tax on excess benefit transactions.

Remuneration, the deduction for which is not allowed by reason of section 162(m), is not taken into account for purposes of section 4960.

In addition, there is no coordination between the excise tax on compensation in section 4960 with the excise tax on unreasonable compensation imposed by section 4958 of the Code. This simply means that tax-exempt organizations must still take steps to determine the reasonableness of all cash and other compensation and benefits as they have been doing for many years: there is no presumption that simply because the section 4960 tax applies, that compensation in excess of $1 million is in any way excessive or unreasonable.

Effective date

The provision is effective for a tax-exempt employer's tax years beginning after December 31, 2017. Thus, for tax-exempt organizations with fiscal year-ends, the tax applies to compensation paid beginning with the first tax year beginning after December 31, 2017. For example, if an organization's fiscal year ends September 30, these provisions are effective for the year that begins October 1, 2018.

Other implications

This provision would reflect the limitations on compensation deductibility for certain taxable organizations. Specifically, under section 162(m), publicly-held C corporations are limited to a compensation deduction of $1 million paid to certain executives (subject to applicable exceptions). Additionally, taxable corporations may be subject to an excise tax and deduction limitation for severance and other compensation that is considered an excess "parachute payment." This provision imposes an excise tax on compensation paid by tax-exempt organizations for compensation amounts that exceed the amount that would be deductible for a publicly-held C corporation.

Steps a board of directors of a tax-exempt organization should take today (and tomorrow).

1. For those organizations with fiscal years ending other than on December 31, consider whether any acceleration of compensation into the organization's fiscal year 2018 (e.g., the year ending September 30, 2018) is appropriate and which can "move" dollars out of the first year subject to the excise tax. For example, can annual incentives be estimated and paid for the performance year/fiscal year ending September 30, 2018 prior to this date without violating section 409A?
2. Identify the organization's five highest-compensated employees for the taxable year (which may be based on estimates until the end of the year) and any individuals who were covered employees for any preceding tax year; this will require a detailed understanding of the corporation structure of the enterprise to identify to what extent each entity will have its own group of five highest-employees
3. "Field test" the potential excise tax liability from the compensation arrangements for these covered employees, using 2017 tax year compensation and 2018 projections
4. In particular, review the severance provisions in employment agreements or in severance policies that could apply to the covered employees, and estimate the potential excise tax if these severance provisions are triggered
5. Review each component of pay and confirm its continued viability in the context of the compensation philosophy, the market, and the potential cumulative effect that each component could have on the application of the excise tax.
a. Consider any changes to the timing of payments or alternative vehicles that could be used to deliver
compensation to reduce or eliminate the excise tax liability, for example:

   i. Can the vesting and payment schedule of any current 457(f) arrangements be adjusted to reduce or eliminate the excise tax exposure?

   ii. Are split dollar arrangements a viable alternative to existing 457(f) arrangements either by replacing an existing plan or starting a new plan when an existing plan ends?

   iii. Are current, annual cash payments a viable alternative to continuing employer contributions to existing section 457(f) arrangements?

   b. Certain relocation reimbursements are now subject to income tax and included in the calculation of
the excise tax.

   i. Ensure there is a clear understanding of the tax implications to the relocating employee and to the organization.

   ii. Establish policies that clearly state how relocation will be handled.
6. Adopt a review protocol that will describe how moving expenses will be determined to be reasonable, including the data that will be used to support that determination.
7. Consider consolidating all highly compensated employees into one employer such as the parent corporation or a management company. This would simplify the reporting of compensation and help improve board oversight of the executive compensation program. (The implications to Medicare reimbursement and other issues must be taken into account when considering this approach for tax-exempt hospitals.)
8. Confirm that the current governance process for overseeing executive compensation is consistent with and adequately addresses the new requirements under 4960.

   a. Is the appropriate "authorized body" from the governing board - typically the compensation committee and articulated through a board=adopted "compensation committee charter" – overseeing all of the appropriate executive compensation arrangements?

   b. Is the compensation philosophy up to date? Should it reflect how the organization will address the implications of section 4960?

   c. Is the appropriate market data used for context when making compensation decisions being developed and provided to the authorized body? This should include not only cash compensation data but data on severance and change-in-control arrangements and relocation practices.
9. Adopt the practice of annually reviewing "tally sheets" for all executives, which quantify all elements of compensation, identify those elements included in the definition of "wages," and

include an estimate of the potential excise tax liability resulting from the compensation (both for the current year and in any future year in which a material increase in compensation is anticipated to occur, e.g., when a section 457(f) arrangement vests and is paid). A tally sheet would include all supplemental executive retirement arrangements (regardless of how the benefit is delivered) and all severance terms that would apply to the employee – either via an employment agreement or severance policy.

a. This approach provides a more complete picture of the executive compensation program and potential accrued financial liabilities and tax implications. Given turnover at the board level, having this helps new board members or trustees have a fuller picture of the compensation program

10. Manage the compensation program to support recruiting the level and type of talent required. The potential tax liability should not be a barrier to hiring the quality of talent your organization requires, but it should be managed in a manner that ensures the independent directors are fully aware of the financial implications.

    a. The parent board should also maintain information on all compensation near or above the $1 million level. This includes physician compensation and all compensation of individuals in related entities.

    b. The adoption of clear policies for the parent and all related entities is essential to ensuring the board's proper exercise of its authority under sections 4958 and 4960.

Conclusion

The excise tax on compensation in excess of $1 million represents both a challenge as well as an opportunity for tax-exempt organizations. It is a challenge because it will add to the compensation expense of the organization and even if it is not applicable today, it may become applicable in the future because the $1 million-dollar threshold is not indexed to inflation. In addition, for larger organizations the number of covered employees will likely increase to more than five over time.

It is an opportunity in the sense that it should prompt all tax-exempt organizations to explore compensation strategies such as split dollar loan arrangements as alternatives to traditional arrangements such as ineligible section 457(f) deferred compensation plans.

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Footnotes

[1] Mr. Mancino is a partner with the law firm Seyfarth Shaw LLP. Mr. Flannery is Senior Client Partner, Executive Pay & Governance, and James M. Otto is Associate Client Partner, Executive Pay & Governance, with the consulting firm Korn Ferry. © 2018 Douglas M. Mancino and Thomas P. Flannery, all rights reserved.

[2] All "section" references are to a section of the Internal Revenue Code of 1986, as amended.

[3] 21 percent is the current rate for the corporate income tax. If that rate is increased in the future, the rate imposed by section 4960 would increase as well.

[4] Section 4960(c)(3)(A).

[5] Section 441(b).

[6] 2017 Instructions for Form 990 Return of Organization Exempt From Income Tax,

[7] Section 4960(c)(3)(B).

[8] Treas. Reg. § 1.7872-15.

[9] A full treatment of split dollar arrangements is beyond the scope of this article. The authors recommend carefully reviewing the technical and economic issues involved in designing, implementing and administering these arrangements.

[10] Section 4960(c)(4).

[11] See generally, the 2017 Schedule R Instructions for Form 990.

[12] Id.

[13] Id.

[14] Id.

[15] Id.

[16] Id.

[17] Section 4960(c)(5)(A).

[18] Section 4960(c)(5)(C).