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Exempt Organizations

Insights Into Tax Reform's Radical New Game Plan for Tax Exempt Organizations

M.J. Asensio of Baker Hostetler and Greta Cowart of Winstead analyze the new excise tax on executive compensation in excess of $1 million and on certain parachute payments paid by tax-exempt organizations. The authors write that affected organizations include public universities, state and local government entities, charitable organizations, public utilities, and farmers' cooperatives.

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The new tax law brought an unpleasant surprise for many tax-exempt organizations by imposing a 21 percent excise tax on compensation in excess of $1 million and on certain ''parachute payments.'' Organizations, including public universities, state and local government entities, charitable organizations, public utilities, farmers' cooperatives, and other organizations operated without an expectation of retaining profits may now find themselves subject to either complying with the new compensation limit or paying the tax. While the changes to the compensation limit for companies with publicly traded securities included a transition rule, surprisingly, the addition of this compensation limit to entities—that had not faced this type of hard line limit—did not provide for any transition for existing contracts.

Section 13602 of Pub. L. No. 115-97, enacted Dec. 22, 2017 (2017 tax act), added tax code Section 4960, which imposes a tax on what it deems to be excess executive compensation in tax-exempt organizations. Section 4960 borrowed concepts from restrictions applicable to companies such as the compensation limit under Section 162(m), the golden parachute limitations under Section 280G, and the related tax under Section 4999. However, these rules differ in many respects, and the penalties are revised to fit exempt organizations with an excise tax applicable to the entity for either a limit violation or excess departure payments. The tax falls on excess compensation paid in any tax year above $1 million, plus it can also apply to any of what is called an ''excess parachute payment'' paid to a covered employee.

The individuals impacted by the 2017 tax act may differ from the Section 162(m) employees (as revised by the 2017 tax act). Section 162(m) has its own aggregation rules for entities subject to its provision solely as the result of their issuance of publicly traded securities by looking to the definition of affiliated groups under Section 1504 (determined without reference to subsection (b)). Separate aggregation rules apply to entities subject to the Troubled Asset Relief Program and cer-

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tain health insurance providers. Individuals whose compensation is subject to Section 162(m) may not be the same individuals subject to the excise tax.

Organizations Subject to the Compensation Limit and Excise Tax

Tax-Exempt Charitable Organizations and Certain Employee Benefit Plan Trusts The new limit applies to many different types of organizations. It applies to all tax-exempt entities under Section 501(a), which includes all 501(c) and (d) tax-exempt entities and all qualified retirement plans under Section 401(a). The new limit also applies to all voluntary employee beneficiary associations (VEBA) funding employee benefits and to all multi-employer plans.

Farmers' Cooperatives The new law also applies to farmers' cooperatives under Section 521(b)(1), which includes organizations of farmers, such as dairy farmers, fruit growers and like associations that are operated on a cooperative basis for purposes of marketing the products of the members or other producers and returning to those farmers or producers the proceeds of the sales less necessary marketing expenses based on either the quantity or value of the products furnished by the respective farmers and fruit growers. A farmer's cooperative may also cooperate for the purpose of purchasing supplies and equipment for the use of its members at cost plus necessary expenses.

Political Organizations It also applies to political organizations, including every political organization under Section 527(b)(1) without any exclusions. In a political organization context, it applies to a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of, directly or indirectly, accepting contributions or making expenditures, or both, for the purposes of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office, and to a political organization selecting presidential or vice-presidential electors.

Potentially Applies to Certain Governmental Organizations with Income Excludable from Federal Income Tax The law also purports to apply to any governmental organization under Section 115(i), which would include a public utility or an entity that exercises any essential governmental function, including a state or any public political subdivision thereof or the District of Columbia. State immunity from federal taxation has been recognized where the state function being performed is an activity that is essential to the preservation of the state government (*Helvering v. Gerhardt*). However, the immunity has limits. To the extent a state university or college is organized as a political subdivision of the state, immunity might apply if the 2017 tax act's application is challenged under the doctrine of implied statutory immunity.

The reach of this new limit and excise tax is significant not only with respect to the organizations impacted, but also with respect to the definition of which employees are impacted. Colleges and universities may need to look at the coaching staff to determine which of the coaches may become subject to these rules or if there is an applicable exemption. If state-run universities are exempted, this could mean certain coaching staff of private universities may be more expensive to maintain than similarly compensated coaching staff at state universities.

High Five—Current Employees Subject to Limit and Once in the High Five, Always In

The employees who are potentially subject to this new tax are the five highest compensated employees of the organization (High Five) in the current taxable year. The 2017 tax act does not require these to be executives or officers of the organization. It only requires them to be one of the five most highly compensated employees of the organization for the year. Unlike testing for retirement plans—which looks to the compensation in the prior year for a more easily administered test—the 2017 tax act imposes the limit on individuals who are in the High Five at the end of the tax year (presumably the entity's tax year), thus, making planning to address it more challenging.

An individual can also be subject to the tax if the individual was a covered employee of that organization or a predecessor of that organization for any preceding taxable year that begins after Dec. 31, 2016. So, an individual who terminated in 2017 could still be treated as a covered employee if they were still receiving pay in 2018 from the organization or if they were an individual who was a High Five individual in 2017. While compensation paid by all related organization is aggregated to determine the tax, it is unclear if related organizations' compensation is also aggregated to determine which individuals fall within the High Five for the tax year.

Once in the High Five, Always Subject to Section 4960 If an employee or former employee of the entity is part of the High Five group any time after Dec. 31, 2016, for the entity or a "predecessor entity"—then that individual is always subject to the excise tax and compensation limit under Section 4960(c)(2)(B). In acquisition or mergers of exempt organizations subject to this limit, due diligence checklists or the transition checklists should include obtaining such entity's list of persons subject to the High Five limit. "Predecessor entity" is not defined.

Compensation Counted Toward New Limit

While the new limitation pulls in all covered employees, not all employees' pay is used to define the five most highly paid individuals, and it does not necessarily pull in all amounts paid. The actual pay subject to the new excise tax excludes pay to a licensed medical professional, including a veterinarian, provided it is for the performance of medical or veterinary services by such individual under Section 4960(c)(3)(B). (References herein to medical services should be read to also include veterinarian services.) Does this mean a hospital can exclude pay to a doctor for services as the medical director for pediatric, surgery, or pulmonology services can be excluded? For a healthcare system, the most highly paid doctors employed by the healthcare system would not be subject to the limitation and excise

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tax with respect to pay for "medical services." What compensation is pay for medical services needs to be defined. It may take time for payroll systems to be programmed to separate pay for "medical services" from other pay.

All pay that is treated as wages is included in the compensation calculated toward the new limit. The pay subject to the new $1 million limit excludes designated Roth account contributions (which are taxed to the individual and included as compensation paid on a Form W-2, but which are deposited in a qualified retirement plan). The compensation subject to the limit includes all non-qualified deferred compensation paid to such individuals or that is required to be included in the individual's income under Section 457(f) when it vests and is no longer subject to a substantial risk of forfeiture.

The total pay that an individual receives from the tax exempt entity and that is tested against the $1 million limit includes not only the pay that comes from the primary employer, but also includes the pay from any related organizations. However, what constitutes a "related organization" raises a number of questions. Thus, which entities are considered related organizations must be determined under Section 4960(c)(4)(B). Instead of borrowing from existing definitions of controlled groups or related parties already contained in the tax code, the new limitation and excise tax instead set up a new definition of a "related organization."

Related Organizations Aggregated to Determine 'Remuneration Subject to Limit' Related organizations include any organization that controls or is controlled by the organization paying the compensation (*e.g.*, a hospital that is the sole member of a subsidiary that provides nursing home services). The related organization includes an organization which is controlled by one or more persons that also control the organization paying the individual (*e.g.*, a local chapter of a charity that is controlled by the national charity who appoints all of its board members). A related organization includes an organization that is a supported organization (as defined in Section 509(f)(3) during the taxable year with respect to the organization paying the compensation), *e.g.*, a foundation for a healthcare system or a foundation for a university. The pay from a foundation supporting a university would have its pay to such individual aggregated with the pay paid by the university it supports. A related organization includes a supporting organization during the year under Section 509(a)(3) with respect to the organization paying the compensation (*e.g.*, the foundation for a church that supports the church which employs the individual).

This means that the related organizations concept picks up many affiliated organizations. For a VEBA the "related organization" concept could include all of the sponsoring employers with respect to the VEBA. For instance, a VEBA for a multi-employer plan sponsored by a union (also known as a Taft Hartley Plan) would include all of the employers making contributions to such VEBA. However, the contributing employers may change over time. So, when the related status is determined and for how long it controls the status will need to be defined.

Liability for Tax If the pay comes from more than one entity, then the tax that is imposed under the new Section 4960 is to be allocated amongst the employers who participate in paying such covered employee in proportion to how their respective compensation compares to the total amount of compensation paid by all employers of such employee. For example, if one employer paid $500,000 of the $1.2 million of compensation for a member of the High Five, such employee's allocation would be 5/12ths of the $200,000 of excess compensation, or $83,333.33 of compensation.

Excise Tax Also Applies to 'Excess Parachute Payments'

Not only is compensation above $1 million in a taxable year paid to one of the High Five subject to the excise tax, excess parachute payments are also subject to the new excise tax. While a parachute payment sounds very similar to golden parachute payments under Section 280G in Section 4960, the trigger is pay that is paid upon separation from employment, not a "change in control" as under Section 280G. It is unclear if "separation from employment" will be defined as it is for purposes of Section 401(k), or if a different definition will be used such as separation from service under Section 409A.

What is an Excess Parachute Payment? An excess parachute payment starts with a parachute payment. A parachute payment is a payment to an individual that is contingent on the employee's separation from employment with the employer and includes the present value of future payments in the nature of compensation to (or for the benefit of) such individual that are contingent on such separation. A parachute payment is an "excess parachute payment" to the extent it exceeds an amount equal to three times the base amount under Section 4960(c)(5)(B)(i) and (ii). While the statute is not perfectly clear, it appears that both all current payments contingent on a separation from employment and the present value of all future payments contingent on a separation from employment are added together with the sum tested against three times the "base amount." It also appears that the three times the base amount is not tested solely against the present value of future payments contingent upon the separation from employment—with that amount added to amounts paid currently for the same contingency.

The general definition of a "parachute payment" does not include any payment that is a payment from a qualified retirement plan, any payment made under an annuity that is a tax-sheltered annuity under Section 403(b), or a payment made by a qualified deferred compensation plan under Section 457(b). The parachute payment does not include any payment to an individual who is not a highly compensated employee under Section 414(q) (individuals whose pay was less than $120,000).

If an individual is amongst the High Five for the taxable year or a prior year after 2016, it is possible that they could be subject to the excise tax solely on an excess parachute payment, because the tax is assessed on excess parachute payments even if current compensation does not exceed $1 million. This means this excise tax could apply to one of the High Five of any of the organizations subject to the new limitation if the compensation triggered by the High Five employee's departure exceeds three times the "base amount," constituting an excess parachute payment.

How is the Base Amount Used to Calculate an Excess Parachute Payment Calculated? The ''base amount'' is used to determine whether or not a parachute payment is an excess parachute payment and subject to the excise tax. The excess parachute payment is determined by calculating the sum of all of the compensation currently paid due to separation from employment and adding the present value of the amount paid in the future by virtue of the termination of employment, and subtracting from that number a ''base amount'' which has been multiplied by three. The ''base amount'' concept is defined by the statute as being ''similar'' to the concept in Section 280G(b)(3).

The ''base amount'' defined in Section 280G(b)(3) is the individual's annualized includable compensation for the base period. The base period specified in Section 280G(d)(2) is the five taxable years of the individual ending prior to the year in which the change in control occurs (separation of employment for Section 4960). It is not clear if all aspects of the Section 280G calculation will apply.

Once the base compensation on an annualized basis is determined, the sum of the base amounts for each of the base years is divided by the number of years to obtain the ''base amount.'' The base amount is then multiplied by three and such amount is deducted from the parachute payments with any remaining amount being the excess parachute payment. This summary is based on the rules under Section 280G applying in a similar manner.

Calculation of Total Parachute Payment The parachute payment includes the amount paid in the current taxable year contingent upon one of the High Five's or prior years' High Five's separation from employment and the present value of future payments one of the High Five or prior High Five receives contingent upon separation from employment. If there are property transfers in conjunction with the separation from service from the company, then the rules under Section 280G(d)(3) and (4) will apply and transfers of property are to be valued at their fair market value. The present value of future payments under Section 280G is determined using a discount rate equal to 120 percent of the applicable federal rate under Section 1274(d), compounded semiannually.

Tax Calculation

The tax is calculated on two pieces. First, compensation paid to a covered employee in excess of the $1 million limit in any taxable year is calculated, and next the amount of any excess parachute payment paid by the organization to the covered employee is calculated. Those two amounts are then added together, and the resulting sum is subject to the excise tax of 21 percent. This means it could apply to a High Five individual who does not make $1 million but received payments triggered by his or her separation from employment if such payments exceed three times his/her ''base amount.''

Effective Date for New Compensation Related Excise Tax

These new rules apply for taxable years beginning after Dec. 31, 2017. The excise tax provision does not include any transition rule for existing binding contracts for which there is no material modification as was contained in 2017 tax act Section 13601(e)(2) with respect to the changes to Section 162(m). This means every entity subject to Section 4960 needs to be reviewing all employment contracts and compensation arrangements to determine the economic impact of this new excise tax on its budgets and recruitment efforts. This tax should be considered as contracts are renewed and renegotiated and for anyone departing an entity subject to Section 4960 on or after Jan. 1, 2018, and for any High Five member receiving parachute payments on or after Jan. 1, 2018. However, it also applies to persons who were a High Five after Dec. 31, 2016, prior to the section's enactment, and to High Five persons in predecessor entities.

Special Rule for Entities with Publicly Traded Securities and a Charitable Foundation

Companies with publicly traded securities and which are subject to Section 162(m) should still consider the implications of Section 4960 if such company's officers subject to Section 162(m)'s limit are also employed by a charitable foundation which is a ''related organization'' to such company. Section 162(m) applies to compensation paid by entities with publicly traded securities, resulting in nondeductible compensation. Aggregation rules under Section 4960 would, but for new Section 4960(c)(6), also subject such nondeductible amounts to Section 4960's excise tax if the compensation paid by a foundation was aggregated with the compensation paid by the publicly traded entity due to the ''related organization'' concept.

Compensation Committee Considerations

There are several immediate considerations for compensation committees regarding the potential impacts of the new excise tax under the 2017 tax act. Initially, it will be important to identify the High Five whose compensation is potentially subject to the new tax. As part of this process, it will be important to apply exclusions such as those for physicians who are paid for medical services rendered. The compensation committee will then be able to assess the financial impact of the excise tax. Ultimately the compensation committee will need to balance the need to provide market competitive compensation to attract top executive talent against the reality of paying the excise tax on compensation in excess of $1 million. Obviously, capping executive pay at $1 million could result in a talent exodus, because the addition of the excise tax increases the cost of doing business.

Set forth below are several additional considerations that compensation committees will need to address with regard to their executive compensation programs.

1. Determine whether restructuring is an option to consolidate payrolls and limit the number of entities potentially subject to the excise tax.

2. Analyze whether the use of deferred compensation will shelter income from the excise tax, delay taxation, or at least reduce the impact to a one-time tax event.

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3. Identify future departures from the High Five that are still receiving payments triggered by their separation from service.

As a final matter, it will be imperative for compensation committees to be mindful of their continuing compliance obligations under the intermediate sanctions regulations (Treasury Regulations Sections 534958-0 to -8) and their reporting obligations pursuant to Internal Revenue Service Form 990. The fact that a compensation package may be justified under Section 4958 does not protect it from the excise tax under Section 4960. Similarly, compensation subject to the excise tax still must be reasonable under the intermediate sanctions regulations.