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Client Alert

Understanding and Planning for the Excise Tax on Executive Compensation Paid by Tax-Exempt Employers

By Douglas M. Mancino and Ofer Lion

Introduction

In the past decade or so, the competition for executive talent in the tax-exempt sector of the United States economy has increased. Executives seldom begin and end their careers with the same organization and there is increased competition for executive talent with the for profit sector of the economy. As a consequence, compensation levels paid to executives of tax-exempt organizations have steadily increased while, at the same time, an increasing percentage of that compensation has been made contingent on the operational performance of the organization, including bonuses for the attainment of both mission-related and financial goals.

As levels of compensation have escalated in the tax-exempt sector, so has the level of Congressional scrutiny. 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. Bear in mind that the $1 million threshold is not adjusted for inflation, so more and more tax-exempt organizations will become subject to the excise tax as wages increase over time.

From a tax policy perspective, the excise tax appears intended to create a sort of parity between tax-exempt organizations and publicly held corporations. Under section 162(m),[1] publicly held corporations generally cannot deduct compensation in excess of $1 million per year with respect to certain employees. Effectively, this increases the tax owed by publicly held corporations by the product of those excess amounts and the corporate tax rate, currently 21%, the same rate as the excise tax now applied to tax-exempt organizations.

The purpose of this article is to explain how the new excise tax is determined, and identify some planning options available to mitigate its effects on current and deferred compensation paid to highly-compensated employees. For example, and as further detailed below:

- Certain state universities, colleges, and hospitals may wish to explore whether to give up their 501(c)(3) exemptions and, instead, rely on their status as a "political subdivision" or as "an integral part of a state or local government" in order to remain exempt from both federal income tax and this new excise tax.
- Tax-exempt organizations may seek to utilize "split dollar loan arrangements," an alternative to traditional unfunded deferred compensation arrangements, because the loans utilized to provide the employee with a deferred benefit do not constitute "remuneration" for purposes of the $1 million threshold.

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

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- If portions of an employee's compensation could appropriately be paid by an affiliate which is not a related organization for this purpose, such as an unrelated management company, tax-exempt organizations may consider bifurcating that compensation between those entities in order to reduce or avoid the excise tax.
- For tax-exempt organizations that become subject to the excise tax, establishing the "rebuttable presumption of reasonableness" with respect to the payment of more than $1 million in annual "remuneration" will become even more important.

In General

Prior to the 2017 enactment of the new excise tax, tax-exempt organizations were not subject to taxation on any compensation or benefits paid to their executives, so as long as the amounts paid were considered reasonable in relation to the services provided to the organization. It was only in situations where some element or all of the compensation or benefits was unreasonable that the organization's tax-exempt status could be in jeopardy because the excessive amount could result in a violation of the prohibition against the private inurement of net earnings. In addition, in the case of section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations, the recipient of the unreasonable compensation and those who knowingly approved it could be subject to the excise taxes imposed by section 4958, the so-called "intermediate sanctions" provision.

Section 4960 now imposes an excise tax on tax-exempt organization executive compensation equal to 21 percent[2] of: (i) "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 (ii) any "excess parachute payment" paid by an applicable tax-exempt organization to a covered employee other than an employee who is not "highly compensated."[3] The 21% excise tax is imposed on excess parachute payments even if the covered employee's total remuneration does not exceed the $1 million threshold. Remuneration paid by a "related" entity is added to the calculation of total remuneration.

Tax-exempt organizations can expect to continue to have to pay market rates for recruiting and retention purposes, and still compete with for-profits for talent. The authors expect that the new provision may put added pressure on compensation determinations in any case where the excise tax will or could become payable (compensation in excess of $1 million or golden parachute severance arrangements). In those cases, it may be even more important to meet the requirements to establish the "rebuttable presumption of reasonableness" and procure opinions from compensation and tax counsel as to the reasonableness of the overall compensation package in each such case (with updates as appropriate).

Particularly in the case of compensation owed under employment agreements already in effect, the obligation to make these excise tax payments when paying reasonable compensation (or a reasonable separation payment pursuant to a "golden parachute" arrangement) should not amount to an automatic excess benefit transaction, private inurement or a violation of the limitation on private benefit.

Affected tax-exempt organizations should maintain and regularly update a roster of their covered employees and related entities, and track the total amount of remuneration being paid. If compensation could appropriately be paid by an affiliate which is not a related organization for this purpose, as further described below, tax-exempt organizations may wish to consider bifurcating a covered employee's compensation to reduce or avoid the excise tax.

"Covered Employees"

For purposes of this provision, a "covered employee" means an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or 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. Importantly, once an employee becomes a "covered employee," he or she will remain a covered employee for purposes of this provision.

[2] 21% 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.

[3] For 2018, a "highly-compensated" employee is one who earns in excess of $120,000.

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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.

"Applicable Tax-Exempt Organizations" - Which 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), entities that have income excluded from gross income under section 115(1), and section 527 political organizations.

Organizations Subject to the Tax

The excise tax applies to an "applicable tax-exempt organization." 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), but these 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) 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 the governmental powers including the power to use eminent domain to acquire property for their use, the power to tax (*e.g.*, 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). As a result, these quasi-state entities may wish to consider the disadvantages of voluntarily terminating their 501(c)(3) status,[4] accomplished by a letter to the IRS documenting that the organization is not otherwise subject to income tax, against the advantages of being exempt from this new excise tax (and, in the case of hospitals, perhaps as an added bonus, from section 501(r) and its extensive regulatory regime[5]).

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[4] For example, a public hospital that is no longer described in section 501(c)(3) cannot use section 403(b) annuities to fund employee retirement benefits.

[5] See Mancino, *The Final Section 501(r) Regulations and Section 501(c)(3) Hospitals*, 28:2 Taxation of Exempts (Sept./Oct. 2016).

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“Remuneration” - What Types of Compensation Are Subject to the 21% Excise Tax, and What Types Are Not?

Wages in General

Remuneration subject to the excise tax means wages (as defined in section 3401(a)) and 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.[6] It also includes amounts paid with respect to the employment of such employee by a person or governmental entity that is related to the applicable tax-exempt organization. Importantly, 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 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. These annual accounting periods are referred to as a taxpayer’s “taxable years.”[7] 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.

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’ calendar 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 arises 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.[8] 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 that ends within the organization’s fiscal year and that was reported on the employees’ Forms W-2.

Given that the statute specifically refers to remuneration paid “for the taxable year,” and it is the organization that is subject to the tax, rather than the employee, we 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 “remuneration” exceeded $1 million, subjecting the organization to a 21% 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 at the time such amounts become vested or otherwise are no longer subject to a substantial risk of forfeiture and are treated as remuneration even if such amounts are not treated as wages. Consequently, the taxable year in which that happens should be the taxable year in which such amounts are added to other items treated as 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, such as certain employer-provided meals and lodging (section 119) and non-taxable fringe benefits (section 132).

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[6] IRC § 4960(c)(3)(A).

[7] Section 441(b).

[8] 2017 Instructions for Form 990 Return of Organization Exempt From Income Tax.

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Expense Reimbursement and Allowance Arrangements

Another potential problem area arises in connection with expense reimbursement and allowance arrangements. If an expense reimbursement and allowance arrangement meets three requirements, namely, there is an appropriate business connection and proper substantiation, and the employee returns amounts 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, such amounts will also count toward remuneration subject to the excise tax if, when added to other compensation, the $1 million threshold is exceeded.

The Surgeon Exception?

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.[9] 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. So, this is not an all or nothing exception.

The scope of this professional services exception remains uncertain. For example, many physicians today serve as CEOs or medical directors of health systems or health plans, and while functioning as a CEO 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. It remains unclear whether compensation for these types of services will fall under the exception.

Payments to Independent Contractors and Risks of Reclassification

Many organizations attempt to bypass the requirement to withhold income, 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 that the IRS routinely challenges on audit. As a consequence, tax-exempt organizations such as hospitals should carefully review their independent contractor-employee classifications, especially if the individual classified as an independent contractor is highly compensated as such.

Also, it should be noted that Congress has directed the IRS to prescribe regulations to prevent avoidance of the 21% excise tax through the performance of 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 that the IRS will take the position that the performance of services through a single-member limited liability company that is a disregarded entity for federal income tax purposes should be (i) treated as the performance of services by the sole member of the limited liability company directly to the tax-exempt organization and (ii) subject to the 21% excise tax if the compensation for such services exceeds $1 million.

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 very high death benefit. A private placement policy also may be issued instead of a traditional policy issued by a traditional life insurance company. The employee is the owner of the policy and the employee agrees to a collateral assignment of the death benefit to the employer in an amount sufficient to secure the repayment of the loan and any accrued interest.

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

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Upon the employee's retirement, the employee is permitted to borrow accumulated cash value from the insurance company that issued the policy within agreed upon limits, again to 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 provided a benefit that it ultimately would recover upon the employee's death, unlike a section 457(f) plan where the amount is paid out fully to the employee upon vesting. From the employee's standpoint, unlike a section 457(f) plan where the full amount payable to the employee is taxable when there no longer is a substantial risk of forfeiture regardless of whether the benefit is payable in a lump sum or over time, the policy loan is not taxable currently to the employee and typically is non-recourse.

With the enactment of the 21% excise tax in section 4960, split dollar arrangements are more attractive because policy loans are considered loans pursuant to section 7872[10] and, therefore, are not remuneration subject to the 21% excise tax.

Related Persons or Governmental Entities

In recent years, it has become increasingly common for highly-compensated executives to receive compensation from multiple sources that, perhaps only in the aggregate, exceeds $1 million. For example, the compensation of a health system CEO may be assessed to each individual hospital but paid by the parent company 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 aggregates all compensation paid by related entities to determine whether the $1 million threshold for taxation is met each year.

A person or governmental entity is treated as "related" to the applicable tax-exempt organization if such person or governmental entity: (i) controls, or is controlled by, the organization; (ii) is controlled by one or more persons that control the organization; (iii) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the organization; (iv) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the organization; or (v) 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.[11]

One or more persons (whether individuals or organizations) control a tax-exempt organization if they have the power to remove and replace (or to appoint, elect, or approve or veto the appointment or election of, if such power includes a continuing power to appoint, elect, or approve or veto the appointment or election of, periodically or in the event of vacancies) 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.[12] Such power can be exercised directly by a (parent) organization through one or more of the (parent) organization's officers, directors, trustees, or agents, acting in their capacity as officers, directors, trustees, or agents of the (parent) organization.[13] 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.[14]

One or more persons (whether individuals or organizations) control a stock corporation if they own more than 50% of the stock (by voting power or value) of the corporation.[15]

One or more persons control a partnership if they own more than 50% 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).[16] A person also controls a partnership if the person is a managing partner or a managing member of a partnership or limited

[10] Treas. Reg. § 1.7872-15.

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

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

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

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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).[17] 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.

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

Excess Parachute Payments

An excess parachute payment is an amount paid to a covered employee upon such employee's separation from employment in an amount with a present value that equals or exceeds three times the employee's base amount.[18] Excluded from the definition of an excess parachute payment are payments under qualified plans, or any payment under or to an annuity contract described in section 403(b) or an eligible plan described in section 457(b).[19]

Coordination with the Excise Tax on Excess Benefit Transactions

There is no coordination between the excise tax on compensation in section 4960 with the excise tax on unreasonable compensation imposed by section 4958. That is, the payment of the 21% excise tax does not insulate an organization from "intermediate sanctions" - excise taxes on "excess benefit transactions." Likewise, we do not believe that there should or will be a presumption that the payment of compensation constitutes an "excess benefit transaction" merely because it triggers the section 4960 "tax on excess tax-exempt organization executive compensation."

Nonetheless, the importance of the establishment of the "rebuttable presumption of reasonableness" does appear to be amplified when the employer must pay a penalty in order to achieve such reasonable compensation. This simply means that tax-exempt organizations must still take steps to establish the reasonableness of all compensation and benefits as they have been doing for many years, with perhaps added vigilance when section 4960 excise taxes may become due.

Effective Date

The 21% "tax on excess tax-exempt organization executive compensation" 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.

If you have any question about this alert or would like further information, please contact Ofer Lion at *olion@seyfarth.com*, or Douglas Mancino at *dmancino@seyfarth.com*.

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[17] *Id.*

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

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

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