

**Pearl Meyer**

**Morgan Lewis**

## Executive Compensation for Tax Exempts Just Got More Complicated

October 18, 2018

## Speakers



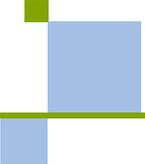
**Margaret Black** is a managing director in the Pearl Meyer Los Angeles office and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.



**Ed Steinhoff** is a managing director in Pearl Meyer's Chicago office and has more than 25 years of experience in executive compensation. He works with the boards of directors and senior management teams of public and private companies, ranging from small and middle-market firms to multi-billion dollar corporations, to design pay programs that drive business performance and value creation, secure high-performing executive talent, and withstand external scrutiny.



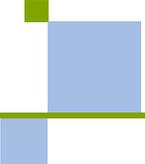
**Mims Maynard Zabriskie** is a Morgan, Lewis & Bockius LLP partner in the employee benefits and executive compensation practice and co-leader of the firm's executive compensation task force. Mims advises on complex executive compensation and employee benefit plan matters, including the design, negotiation, and implementation of executive compensation, equity compensation, and tax-qualified retirement plans and shareholder approval of equity plans. Her diverse clients include universities and non-profit organizations, as well as public and private companies ranging from emerging companies to Fortune 500 entities. Mims is consistently ranked in Chambers USA, Labor & Employment: Employee Benefits & Compensation, Pennsylvania, and recognized in The Best Lawyers in America, Employee Benefits (ERISA) Law, Philadelphia.



# Housekeeping

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- The slides are available for download at [www.pearlmeyer.com/executive-compensation-for-tax-exempts](http://www.pearlmeyer.com/executive-compensation-for-tax-exempts)
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# Agenda

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- An Overview of Section 4960 Excise Taxes
  - New Section 4960 Excise Taxes
  - Why was Section 4960 Implemented?
  - What Tax-Exempt Organizations are Subject to Section 4960?
  - Determining “Covered” Employees
  - The Excess Pay Excise Tax
  - Remuneration Measurement Period
  - Separation Pay Excise Tax – The Basics
  - Reporting and Paying the 4960 Excise Tax
- Coordination with Private Inurement and Intermediate Sanctions Rules
- Section 4960 Critical “To Do” List
- What We are Seeing Under Consideration...
- Questions?

# New Section 4960 Excise Taxes

## New Section 4960:

Imposes an excise tax equal to the corporate tax rate (currently 21%) on “applicable tax-exempt organizations” for compensation payable to “covered employees” that exceeds \$1M or is an “excess parachute payment”

### “Covered Employees”

- Includes anyone who is or was one of the top five highest paid employees (for tax years beginning after 12/31/2016)
- Status as a covered employee remains in perpetuity

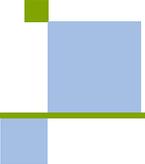
### Excess Pay Excise Tax 21%

- Applies to “remuneration” to covered employees in excess of \$1 million
- Pay includes:
  - Amounts treated as wages for federal income tax withholding
  - Any amounts vesting (when there is no longer substantial risk of forfeiture), even if payable later (i.e., deferred)

### Separation Pay Excise Tax 21%

- Payments contingent on separation are considered an “excess parachute payment”
  - Mimics Section 280G structure, but no change-in-control is required
  - Will apply if the separation payments equal or exceed the “Base Amount” (3x average compensation in five tax years prior to separation)
  - Excise tax is imposed on separation payments over 1x the Base Amount
  - Does not apply to certain non-highly paid employees (those earning less than \$120,000 (for 2018))

**Applicable for taxable years after 12/31/2017**



## Why Was Section 4960 Implemented?

**Congress justified the new rules as a way to move toward parity between tax-exempt organizations and taxable publicly held corporations**

### **Key tax provisions influencing the structure of Section 4960:**

- IRC Section 162(m)
- IRC Sections 280G/4999

- IRC Section 162(m) generally provides that a publicly traded company is limited to a \$1 million annual deduction for compensation paid to the CEO, CFO and three highest compensated officers
- IRC Section 280G generally denies a deduction to a corporation for certain payments (“excess parachute payments”) made to a disqualified individual that are in the nature of compensation and are contingent upon a change-in-control (“CIC”) of the company
  - In addition, under IRC Section 4999, the individual must pay a 20 percent excise tax on the excess parachute payments

### **Pearl Meyer/Morgan Lewis Comment:**

Congress wanted tax-exempt organizations to be on an equal footing with publicly held corporations. However, note that privately held corporations are generally *not* subject to IRC Section 162(m) and face less stringent requirements for compliance with IRC Sections 280G/4999

# What Tax-Exempt Organizations are Subject to 4960?

## Applicable Tax Exempt Organizations

Section 4960 applies to “Applicable Tax Exempt Organizations” (“ATEOs”). The term is broadly defined and includes the following tax-exempt organizations:

### Section 501(a) Tax Exempts including:

- Hospitals, colleges and universities organized under Section 501(c)(3)
- Health maintenance organizations and other social welfare organizations under Section 501(c)(4)
- Labor organizations and professional football, baseball, and other types of sports leagues exempt under Section 501(c)(5)
- Business Leagues, Chambers of Commerce, Real Estate Boards, etc. under 501(c)(6)

### Section 115(1) Organizations:

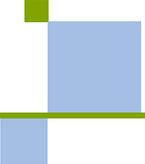
- Section 115(1) excludes income derived from the exercise of any essential government function that accrues to a state or political subdivision
- Applies to an entity regarded as separate from a state or political subdivision for federal income tax purposes
- By contrast, state and local governments themselves and “integral parts” of state or local governments are not subject to federal income tax under the doctrine of implied statutory immunity

### Section 527(e)(1) Political Organizations

### Section 521(b)(1) Farmer’s Cooperatives

### Pearl Meyer/Morgan Lewis Comment:

Although the entities subject to the rules seem straightforward, it’s unclear whether the reference to Section 115(1) includes organizations such as state universities and other state and local governmental entities that do not have a Section 501(c)(3) determination letter or that rely on Section 115 to exclude their income from federal income tax



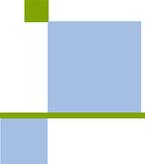
# Determining “Covered Employees”

## The statutory language does not provide definitions or guidelines for determining the five highest compensated employees

- The excess pay excise tax and the separation pay excise tax apply to “covered employees”
- Section 4960 defines a covered employee as any employee (including any former employee) of an ATEO if:
  - The employee is one of the five highest compensated employees of the organization for the taxable year, or
  - Was a covered employee for any preceding taxable year beginning after December 31, 2016
- With no statutory guidelines provided on how to determine these employees, employers will struggle with a number of basic concepts such as:
  - How is “employee” defined?
  - How is “compensation” defined?
  - How should compensation paid by related organizations be taken into account?
  - Should each ATEO determine its covered employees separately, regardless of whether it is related to other ATEOs?

### **Pearl Meyer/Morgan Lewis Comments:**

- Since an individual’s status as a covered employee remains in perpetuity, organizations will likely, at some point in time, have more than five employees to track
- Absent future guidance it appears organizations will need to determine covered employees on an entity by entity basis
- Some organizations with related ATEOs are considering moving employees to one ATEO



## Polling Question 1

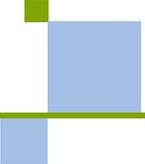
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Has your organization begun to identify who its covered employees might be?

# The Excess Pay Excise Tax

The 21% excess pay excise tax is applied to “remuneration” in excess of \$1 million

Remuneration		
Definition	Includes (+)	Excludes (-)
Section 4960 Remuneration	<ul style="list-style-type: none"> <li>Section 3401(a) wages (wages subject to federal income tax withholding)</li> <li>Amounts required to be included in gross income under Section 457(f)</li> </ul>	<ul style="list-style-type: none"> <li>Designated Roth contributions (under Section 402A(c))</li> <li>Remuneration paid to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services</li> </ul>
Section 3401(a) Wages	<ul style="list-style-type: none"> <li>Similar to amounts included in wages reported on Box 1 of Form W-2 with adjustments</li> <li>Generally includes all cash compensation and taxable compensation in any form other than cash including:                             <ul style="list-style-type: none"> <li>Base salary</li> <li>Overtime</li> <li>Bonuses</li> <li>Commissions</li> <li>Taxable fringe benefits</li> <li>Taxable reimbursements and allowance arrangements</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Payments to tax qualified pension or profit sharing plans including:                             <ul style="list-style-type: none"> <li>Deferrals to Section 401(k), 403(b), and 457(b) plans</li> </ul> </li> <li>Distributions from retirement plans reported on Form 1099-R</li> <li>Other amounts excludable from the definition of wages such as:                             <ul style="list-style-type: none"> <li>Non-taxable employer-provided meals and lodging (Sec. 119)</li> <li>Non-taxable fringe benefits (Sec. 132)</li> <li>Non-taxable expense reimbursements and allowance arrangements</li> </ul> </li> </ul>



## The Excess Pay Excise Tax (Cont'd)

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- Based on a literal read of the statute, “remuneration” should *not* include payments for performance of services other than as an employee, such as those reported on Form 1099-MISC
- This contrasts with how compensation is reported on Forms 990 and 990-PF which includes both wages on Form W-2, box 1 or 5 (whichever amount is greater) *and* Form 1099-MISC, box 7
- The statute directs Treasury and the IRS to produce regulations to prevent the avoidance of the excise tax through the performance of services as other than an employee

### **Pearl Meyer/Morgan Lewis Comments:**

- Further guidance on the treatment of services performed other than as an employee is needed in the near future
- Unlike Section 162(m), there is no grandfather or transition rule for existing arrangements, such as Section 457(f) retirement plans



## Exception for Remuneration Paid for Medical Services

**Section 4960 specifically excludes the portion of any remuneration paid to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services**

- This was a well received exception, but there are many questions on how the rule should be administered
- The scope of the exception is uncertain:
  - Clear that it encompasses the direct delivery of healthcare services to a patient
  - Less clear whether supervising the delivery of those services is excepted

### **Pearl Meyer/Morgan Lewis Comments:**

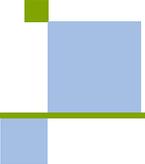
- Further guidance is needed on how to allocate pay between medical and “other” services



## Remuneration Measurement Period

**Fiscal year employers should determine remuneration subject to excise taxes based on pay during the employer's tax year, pending further guidance**

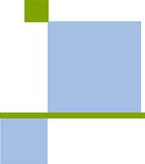
- The statutory language for Section 4960 refers to remuneration paid “for the taxable year”
- On Form 990 tax exempt employers report compensation based on amounts reported on Forms W-2 and 1099-MISCs filed for the calendar year ending with or within the organization's tax year
- Therefore, for filers not using a calendar fiscal year, the period over which the compensation is measured for Section 4960 purposes will be different from what is used to prepare the Form 990, pending further guidance



## Polling Question 2

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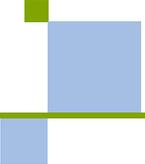
Has your organization modeled the potential financial impact of the excise tax on annual remuneration over \$1 million?



## Separation Pay Excise Tax – The Basics

The separation pay excise tax provisions are generally intended to mirror the “golden parachute” payment provisions under Sections 280G and 4999 which penalize companies and executives for paying/receiving excessive compensation in connection with a change-in-control

- Generally, under Section 4960 when payment contingent on a covered employee’s separation from employment (*parachute payments*) exceed his or her *safe harbor*, all payments in excess of his or her *base amount* are subject to a 21% excise tax
- These excess amounts are known as *excess parachute payments*
- Section 4960 defines a *parachute payment* as any payment in the nature of compensation to a covered employee that is contingent on the employee’s *separation from employment* with the employer
- Parachute payments are subject to the excise tax if they have an aggregate present value of at least *three times* the individual’s base amount



## Separation Pay Excise Tax – The Basics (Cont'd)

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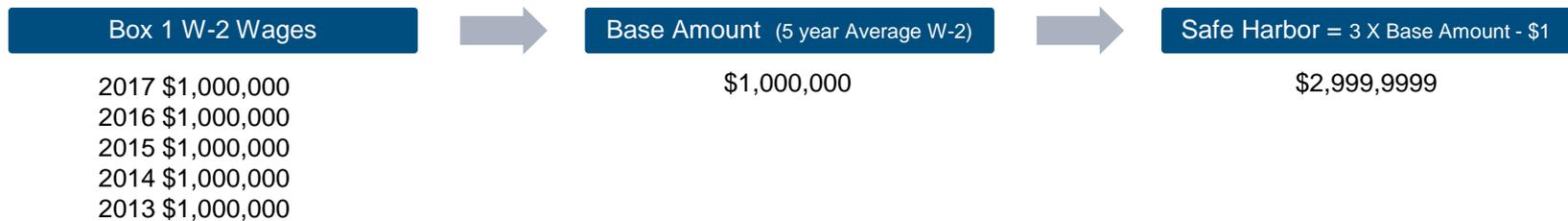
- Parachute payments *exclude* payments made:
  - Through qualified plans, Section 403(b) annuity contracts, and Section 457(b) plans
  - For medical services (as previously outlined)
  - To certain non-highly paid employees (those earning less than \$120,000 (for 2018))
- An employee's *base amount* is the average of his/her last five years' taxable income from the entity (typically Box 1 W-2s)
  - For individuals hired during the time frame, compensation is averaged over the number of years of service, with compensation in the year of hire annualized
- An employee's *safe harbor* is three times the base amount less \$1

# Separation Pay Excise Tax – A Simple Example

▪ Facts:

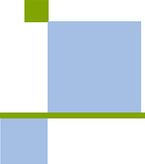
- A separation from employment occurs by an Executive who is a Covered Employee in 2018
- Executive is paid \$3,000,000 of lump sum severance at termination
- Executive’s Box 1 W-2 wages were \$1,000,000 in each of the 5 calendar years prior to separation

▪ Step 1: Calculation of Safe Harbor



▪ Step 2: Determination of Excess Parachute Payment and 4960 Excise Tax

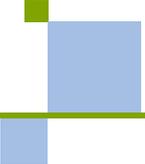
<b>A</b>	<b>B</b> Base Amount X 3 - \$1	<b>C = A - B</b>	<b>D = A - Base Amount</b> Base Amount = \$1M	<b>E = D X 21%</b>
Separation Payments	Safe Harbor	Separation Payments less Safe Harbor	Excess Parachute Payments	Excise Tax
\$3,000,000	\$2,999,999	\$1	\$2,000,000	\$420,000
\$2,999,999	\$2,999,999	<0	None	None



## Polling Question 3

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Has your organization modeled the potential financial impact of the excise tax on excess parachute payments?



## Reporting and Paying 4960 Excise Taxes

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- Section 4960 excise taxes apply to the employer and related organizations, not the employee
  - If a covered employee's compensation is paid by more than one employer, then each employer is responsible for its pro-rata share of the excise tax
- In July 2018, the IRS released drafts of the 2018 Form 990 and Form 990PF
  - Each return added a question regarding whether the organization is subject to the excise tax on compensation paid over \$1 million or on excess parachute payments under Section 4960
- Section 4960 excise taxes are reported and paid on Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code
  - The draft Form 4720 (issued in August of 2018) includes a new Schedule N for organizations to calculate and report the taxes
  - The Form 4720 is due on the 15th day of the fifth month following the organization's year end. The filing date can be extended for six months. However, to avoid interest and penalties, organizations should pay their excise tax liability by the original due date
  - The instructions to the Form 4720 make it clear that organizations are *not* required to make estimated tax payments for the excise tax

# Coordination with Private Inurement and Intermediate Sanctions Rules

## Section 4960 does *not* replace existing rules covering unreasonable compensation for certain tax exempts and does *not* insulate an organization from “intermediate sanctions”

- Tax-exempt entities have historically not been subject to compensation limitations, but have been limited under the private inurement doctrine and the excise tax provisions of Section 4941 and Section 4958 if compensation was excessive
- The most common type of private inurement is the payment of excessive compensation to insiders. Violation of these rules can result in the revocation of a charity’s tax-exempt status and/or the imposition of “intermediate sanctions”
- Penalties under intermediate sanctions can be significant. If an excess benefit is paid or provided to a disqualified person, the person and those approving the arrangement can be liable for:
  - An initial excise tax of 25% on the value of the excess benefit
  - If the excess benefit is not repaid to the organization, an additional excise tax of 200% along with an amount equivalent to what the organization would have lost for the time value of money. In addition, any manager of an organization (officers, board members, trustees, etc.) who knowingly participates in an excess benefit transaction may be subject to a 10% tax on the excess benefit, up to \$20,000, unless the participation was not willful and was due to reasonable cause
- Establishing a rebuttable presumption of reasonableness is one of the easiest, most effective ways an organization can protect itself from IRS claims that it has paid its executives too much. If properly established, the presumption shifts the burden of proof to the IRS and ordinarily shields the organization, its executives, and its directors from liability

# Intermediate Sanctions: Creating a Rebuttable Presumption of Reasonableness

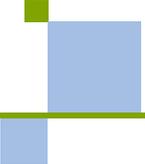
- Tax-exempt organizations can create a “rebuttable presumption of reasonableness” by meeting three criteria:
  1. Any transaction must be approved in advance by an authorized body (Board or Committee) made up entirely of independent people with no conflict of interest regarding the compensation of the disqualified person
  2. The Board or Committee must obtain and rely on appropriate comparability data on total compensation for like positions in like organizations and in like circumstances. The comparability data may include:
    - Compensation paid by comparable organizations, taxable as well as tax-exempt, for functionally comparable positions
    - Compensation patterns or norms in the organization’s immediate locale
    - Independent compensation surveys by nationally recognized independent firms
    - Written offers of employment from other firms
    - The comparability data must represent total compensation (salary, incentive compensation, benefits, and perquisites)
  3. Boards must adequately document the bases for their determinations

## **Pearl Meyer/Morgan Lewis Comment:**

Tax-exempt organizations will still need to take steps to establish the reasonableness of compensation and benefits as they have been doing for many years. This may even be more critical for compensation to which the excise tax under IRC Section 4960 applies

## Section 4960 Critical “To Do” List

Action:	Bear in Mind:
<ul style="list-style-type: none"> <li>✓ <b>Identify covered employees</b> for 2018 and 2017; the covered employee status continues into subsequent years</li> </ul>	
<ul style="list-style-type: none"> <li>✓ Once the covered employees have been identified, <b>inventory existing compensation arrangements</b> that may become subject to the excise tax</li> </ul>	<p><i>All existing employment agreements, annual and long-term incentive plans, severance arrangements, deferred compensation plans, and any other compensation arrangements should be reviewed</i></p>
<ul style="list-style-type: none"> <li>✓ <b>Estimate the annual financial impact</b> on the organization of excise tax payments for covered employees’ compensation in excess of \$1 million</li> </ul>	
<ul style="list-style-type: none"> <li>✓ <b>Determine whether any adjustments should be made</b> to annual compensation programs for covered employees to reduce or eliminate the payment of the excise tax – without jeopardizing executive retention and the competitiveness of executive pay because of compensation program changes</li> </ul>	
<ul style="list-style-type: none"> <li>✓ In anticipation of terminations and/or retirements, organizations should <b>evaluate whether any excess parachute payments are likely to be triggered</b></li> </ul>	<p><i>Until further guidance is provided, the IRC Section 280G golden parachute rules are helpful in understanding how the rules practically should be applied</i></p>
<ul style="list-style-type: none"> <li>✓ <b>Consider how the new rules will apply when structuring new compensation arrangements</b></li> </ul>	



## Polling Question 4

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Has your organization made any changes to its ongoing executive compensation programs or its programs which provide for payments upon separation of service because of the new excise taxes?

## What We See Under Consideration...

Action:	Commentary:
<p><b>Restructuring/implementing existing/new compensation arrangements</b> to avoid extreme fluctuations in pay</p>	<ul style="list-style-type: none"> <li>• For example, rather than an executive receiving a \$1 million lump sum after 10 years, organizations are considering structuring more frequent payouts in smaller amounts to avoid the \$1 million threshold</li> <li>• Compliance with the 409A and 457 deferred compensation rules and balancing periodic payouts with the need to retain executives long-term are critical to the analysis</li> </ul>
<p><b>Using collateral assignment split-dollar life insurance arrangements</b> as replacements for traditional non-qualified deferred compensation arrangements subject to section 457(f) or in addition to those arrangements</p>	<ul style="list-style-type: none"> <li>• In these types of arrangements the employer provides a benefit that it should ultimately recover upon the employee's death, unlike in Section 457(f) plans where the amount is often paid out in full to the employee upon vesting</li> <li>• As for the executive, the policy loan is generally not currently taxable to the employee and typically is non-recourse</li> </ul>
<p><b>Increasing qualified retirement benefits</b> in a manner that complies with the tax-qualification requirements; qualified retirement plan benefits are not included in compensation for purposes of the new Section 4960 excise tax</p>	
<p><b>Limiting payments</b> to be made upon a separation from employment</p>	<ul style="list-style-type: none"> <li>• Employers are considering including protective language in any new executive compensation arrangement that would allow the employer to unilaterally modify or reduce compensation to the extent needed to avoid the excise tax (similar to clauses used by many taxable corporations for handling the golden parachute excise taxes under IRC Section 4999)</li> </ul>



# Questions?