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Executive Compensation for Tax-Exempt Organizations: New 4960 Rules and IRS Notice 2019-09 Guidance

21% Excise Tax for Certain Organizations, Aggregation Rules, Excess Remuneration and Parachute Payments, Reporting Requirements

TUESDAY, AUGUST 20, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Agenda

Legal Framework

Legal Framework

The Internal Revenue Code uses a series of deduction limits and excise taxes to prevent taxable entities from providing excess compensation to executive.

- Qualified Plan Deferral Limits
- Limit on deductions for compensation in excess of $1M (§162(m))
- Excise tax on excess parachute payments on a change-in-control (§280G)

Tax Deductions and Restrictions historically didn't apply to tax-exempt entities.

Internal Revenue Code Restricted Excess Compensation through Other Means

Tax-Exempt Status (Code §501(3)(c))

Prohibition Against Private Inurement

- No part of the net earnings of a charitable organization can inure to the benefit of any private shareholder or individual
- Internal Revenue Service can revoke tax-exempt status if any inurement were to occur.
- Are Employees expected to work for free?

IRS Guidance and Court Decisions Refined Rule

- Permitted to pay for reasonable and necessary expenses (i.e., reasonable employee compensation)

Tax-Exempt Status (Code §501(3)(c))

Excessive Compensation

- Was compensation negotiated at arm's-length and approved by an independent board or compensation committee?
- What was the insider's influence over the organization?
- How much time will the insider devote to his or her position?
- What is the history of the insider's salaries and salary increases?
- What is the availability of comparable services from a third-party?
- How does the insider's compensation compare to others in the same line of business and/or with the same or similar job responsibilities?

Excessive Compensation can lead to loss of tax-exempt status

Intermediate Sanctions/Excess Benefit Transaction (Code §4958)

Disqualified Individuals Subject to Excise Tax on Excess Compensation

- President
- CEO
- COO
- CFO
- Treasurer
- Others with "Significant Influence"
- Family Members

Intermediate Sanctions/Excess Benefit Transaction (Code §4958)

Recipient subject to 25% excise tax on excess amount and must return excess amount

Recipient subject to 200% excise tax if excess amount is not returned

Decision makers responsible for excess amount subject to an additional 10% excise tax on the excess amount

Intermediate Sanctions/Excess Benefit Transaction (Code §4958)

Safe Harbor Presumption of Reasonable Compensation

- Approved in advance by an authorized body (e.g., compensation committee)
- Based on Data Comparing Compensation to Peers
- Document the basis on which the compensation is reasonable

Compensation publicly disclosed on Form 990

Typical Arrangements

Typical Arrangements

The elements of compensation that tax-exempts offer executives is comprised of:

- Salary
- Bonuses
- Medical, Dental, Vision, Disability and Life Insurance
- Qualified Retirement Plan(s)
- Non-Qualified Retirement Plan(s) - 457(b) and 457(f)
- Annual and Long-term Incentive Plans
- Severance

Focus on Executive-Specific Arrangements

Typical Arrangements

457(b) Plans

- Necessary because of significant limits on qualified plans
  - Code §402(g)
  - Code §401(a)(17)
  - Code §415
- Combination of Employer and Employee Contributions
- Unlike taxable entity non-qualified plans, substantially limited contributions, currently $19,000 (historically combined with Code §402(g))
- Distributions generally on separation and taxable when distributed (i.e., not when vested)
- Special 457(b) catch-up contributions, if permitted by the plan, allow a participant for 3 years prior to the normal retirement age (as specified in the plan) to contribute the lesser of:
  - Twice the annual limit $38,000 in 2019 and $37,000 in 2018, or
  - The basic annual limit plus the amount of the basic limit not used in prior years (only useful if there are unused amounts)

Typical Arrangements

457(b) Plans – Pros and Cons

- Pro – Allows executives to exceed qualified plan limits
- Pro – Flexible, can have different plan terms for different employees
- Pro – No fiduciary/ERISA requirements
- Con – Must be a top-hat – so eligibility must be limited
- Con – Subject to employer’s creditors – “unfunded”
- Con – Limited in amounts

Typical Arrangements

457(f) Plans

- Necessary because of 457(b) limitations
- Unlike 457(b) plans, become subject to taxes when vested
- Distributions generally tied to vesting so short-term deferral under Code §409A and proposed rules under Code §457(f)
- Vesting/Substantial Risk of Forfeiture: Have to perform meaningful future services
- 2016 proposed regulations permit vesting date to incorporate meaningful non-competition provisions
- “Rolling risk of forfeiture” permitted in limited circumstances
  - Present value of amount to be paid on extension must be more than 125% of amount prior to extended vesting date and pushed at least two years out
  - Agreement must be reduced to writing in advance (before beginning of the year or at least 90 days in advance, depending on the circumstances)

Typical Arrangements

457(f) Plans - Pros and Cons

- Pro – Allows employers to provide additional deferred compensation in excess of qualified plan and 457(b) limits with no set limit.
- Pro – Flexible, can have different plan terms for different employees.
- Pro – No fiduciary/ERISA requirements

- Con – Must be a top-hat – so eligibility must be limited.
- Con – Subject to employer's creditors – "unfunded".
- Con – Taxation upon lapse of substantial risk of forfeiture (vesting) even if not yet distributable

Typical Arrangements

Severance

- Benefits are payable only upon “involuntary severance from employment”
- ERISA welfare benefit (not subject to comprehensive retirement plan rules if:
  - The amount payable does not exceed two times the participant's annualized compensation
  - The entire severance benefit must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs

If the above criteria are not met, severance is considered deferred compensation subject to 457 rules provided previously

Typical Arrangements

Incentive Plans

- Annual (short-term)
- Long-term (e.g., 3 years performance period)
  - run concurrently or consecutively
  - distributable immediately following performance period or in tranches over time (e.g., 3 years)

- Considerations
  - 409A/457(f) short- term deferral exceptions and substantial risk of forfeiture
  - 990 reporting

Code Section 4960 Excise Taxes

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Effective January 1, 2018, IRS has new tool to limit excess executive compensation

- $1 million limit on annual compensation
- Cap on “parachute payments”

Annual Compensation

- Levies a 21% excise tax on annual compensation in excess $1M, regardless of whether "reasonable" under an excess benefit analysis
- Applies to compensation paid to any "covered employee"
  - Covered employees are any employee that was ever one of the 5 highest paid employees in any tax year starting after December 31, 2016
  - The number of individuals subject to the excise tax will continue to grow
  - Includes payments to former employees who were at one time a top-five paid employee

Code Section 4960 Excise Taxes

Remuneration includes all amounts on which the organization is required to withhold income taxes.

- Remuneration will not include an individual's pre-tax elective deferral contributions to an employer-sponsored retirement plan (e.g., a 401(k), 403(b) or 457(b) plan)
- No grandfathering; so previously promised retirement distributions and severance commitments could trigger excise tax

Remuneration from all "related" organizations, including "supporting" and "supported" organizations, is to be aggregated for these purposes.

- Related tax-exempt organizations include entities that: (i) control or are controlled by another tax-exempt organization; (ii) are controlled by one or more persons which control another tax-exempt organization; and (iii) "supported" and "supporting" organizations (as such terms are defined under Code Sections 509(f)(3) and 509(a)(3))

Code Section 4960 Excise Taxes

Related Organizations

- IRS issued Notice 2019-09 to provide detailed rules on which organizations are related organization
- In cases where the aggregate remuneration of a covered employee exceeds the $1 million limitation, each organization is liable for a ratable portion of the excise tax based on the amount of remuneration it pays in relation to the remuneration paid by all aggregated organizations. An organization could be partially liable for this new excise tax even if it pays remuneration to the executive below the $1 million annual threshold
- Amounts paid to a licensed medical professional—including doctors, nurses, and veterinarians—attributable to the performance of medical or veterinary services are not counted as remuneration.
- Highly paid department chairs or other highly paid executives will not be eligible for this exclusion, assuming they also do not provide “medical services”

Parachute Payments

- Additional 21% excise tax on “parachute payments” to covered employees
- The same definition of covered employee applies
- Parachute payments are payments contingent on separation from employment
- The tax applies if these parachute payments exceed 3x the “base amount”
  - The “base amount” is the annualized compensation over the previous five years
  - All payments are subject to the 21% excise tax (not just amounts above 3x the base amount)
- Parachute payments exclude payments under a qualified retirement plan

Parachute Payments

- Tax-exempt organizations must perform considerably more diligence when structuring compensation packages for employees
- Employees who are not currently covered employees may be covered employees by the time compensation is taken into account
- Consider structuring the timing of retirement plan distributions to avoid excise taxes
- Consider timing of severance payments to avoid excise taxes

Questions?