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# Taxing Times for Tax-Exempt Organizations

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*With the enactment of tax reform legislation on December 22, 2017, frequently referred to as the Tax Cuts and Jobs Act of 2017 (the Tax Act), and its addition of Section 4960 to the Internal Revenue Code of 1986, as amended (the Code), many tax-exempt organizations may now face an excise tax on certain compensation payments that will increase the cost for the organizations to attract and retain top talent. This article first examines several requirements already faced by tax-exempt organizations with respect to structuring compensation packages, then discusses the new excise tax that will now be imposed on certain tax-exempt organizations as a result of the addition of Section 4960 to the Code. Finally, the article considers possible steps that organizations may wish to consider in light of these new rules. While many of the same considerations exist for compensatory arrangements for employees of many governmental employers as for other tax-exempt organizations, this article does not address the special rules applicable to governmental employers. This article reflects the*

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*text of the Tax Act and the information available as of May 31. There are many aspects of the Tax Act and its application to tax-exempt organizations that require additional guidance. On February 7, the United States Department of Treasury updated its 2017–2018 Priority Guidance Plan, which stated that Treasury hopes to issue guidance on the executive compensation provisions applicable to tax-exempt organizations under new Code Section 4960 by June 30.*[1]

## EXCESS BENEFIT TRANSACTIONS

Prior to the enactment of Code Section 4960, the Internal Revenue Service (IRS) could impose significant penalties for a tax-exempt organization paying excessive executive compensation. Under Code Section 4958, if the IRS determines that an applicable tax-exempt organization[2] provides a benefit to a disqualified person in excess of the value of the services being provided, Code Section 4958 imposes an initial tax of 25 percent of the excess benefit on the disqualified person who received the excess benefit.[3] Furthermore, an additional tax of 200 percent of the excess benefit will be owed by the disqualified person unless the excess benefit is promptly repaid.[4] Besides the tax on the recipient of the payment, Code Section 4958 imposes a tax of 10 percent of the excess benefit on managers in the organization if they knowingly participated in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause).[5] Since the term "disqualified person" includes a person with the ability to exercise substantial influence over the affairs of the organization, the excess benefit penalties under Code Section 4958 generally apply to the organization's executives and senior management.[6]

## THE PRE-TAX ACT CHALLENGES OF STRUCTURING COMPENSATION PACKAGES

Generally, when establishing employee benefit programs, tax-exempt organizations may select from a similar array of qualified retirement plan options that are available to employers in the for-profit sector, such as defined contribution and defined benefit plans.[7] In addition, many tax-exempt employers also have the option of establishing Code Section 403(b) plans. Although the executives of tax-exempt organizations may participate in such plans, their ability to accumulate benefits under such vehicles is limited by various restrictions (such as the limitations on contributions imposed by the Code and the requirements that nongovernmental qualified plans, including employer contributions to

Code Section 403(b) plans, not discriminate in favor of highly compensated employees). To provide additional benefits for their executives, employers in the for-profit sector often structure compensatory arrangements for their executives using compensatory equity grants, such as stock options, restricted stock, and restricted stock units, as well as nonqualified deferred compensation arrangements. Tax-exempt organizations often seek to provide their executives with compensatory arrangements in excess of that which is permissible under qualified retirement plans that, ideally, could be structured in ways that would defer taxation to achieve a result similar to what for-profit employers are able to accomplish. However, tax-exempt employers face additional obstacles in this effort because compensatory equity grants generally are not available to tax-exempt employers, and the treatment of nonqualified deferred compensation is very different from that of employers in the for-profit sector.

### *Code Section 457 Restricts Executive Deferred Compensation Options*

Many employers and executives, both in the tax-exempt world and the for-profit world, find the rules governing nonqualified deferred compensation plans restrictive since the passage of the American Jobs Creation Act of 2004 created Code Section 409A and the IRS began issuing guidance under Code Section 409A. The enactment of Code Section 409A did not prevent employers from implementing nonqualified deferred compensation arrangements for their employees, but Code Section 409A did create new statutory requirements that such arrangements must comply with both in form and operation to avoid adverse tax treatment. While tax-exempt employers and their employees generally are subject to the requirements of Code Section 409A, tax-exempt organizations face an additional hurdle when structuring nonqualified deferred compensation arrangements that generally do not apply to employers in the for-profit sector—Code Section 457.

Code Section 457 establishes the framework for nonqualified deferred compensation arrangements that can be offered by tax-exempt employers.[8] Generally, Code Section 457 permits tax-exempt organizations to offer two types of plans. First, Code Section 457 provides for "eligible" Code Section 457(b) plans that allow participants to defer taxes on amounts up to a specific annual limit until the amounts are paid or otherwise made available to the participant. The annual deferral limit under a Code Section 457(b) plan is generally $18,500 for 2018, subject to annual adjustment (which is inclusive of both employer and employee contributions), with additional catch-up contributions permitted in certain circumstances. Second, Code Section 457 provides for "ineligible" Code Section 457(f) plans, which are non-qualified deferred compensation arrangements that allow participants to defer taxes on compensation with no specific dollar limit under which taxation generally can be deferred until the compensation is no longer subject to a substantial risk of forfeiture (i.e., until it vests). Code Section 457(f) plans are subject to the rules governing non-qualified deferred compensation under Code Section 409A, but Code Section 457(b) plans are not.

### *Code Section 457(b) Plans: Limited Contributions but Taxes Deferred*

Apart from the annual contribution limits discussed above, there is a great deal of appeal for tax-exempt organizations to implement Code Section 457(b) plans. Code Section 457(b) plans can be structured to permit employer contributions or employee elective salary deferrals, or the plan could be structured so that contributions are based upon certain other metrics such as unused sick or vacation pay. Generally, a participant is not permitted to take a distribution from a Code Section 457(b) plan until the earliest of reaching age 70½, incurring a severance from employment with the organization, or facing an unforeseeable emergency.[9] A participant is not taxed on amounts deferred under a Code Section 457(b) plan until the amounts are actually paid or otherwise made available to the participant.[10] Code Section 457(b) plans are subject to the required minimum distribution rules under Code Section 401(a)(9), which generally require that a participant must begin taking minimum distributions by the April 1st following the year the participant reaches age 70½ or, if the plan allows, the April 1st following the year that the participant retires, if later.[11]

### *Code Section 457(f) Plans: Unlimited Contributions but Limited Ability to Defer Taxes*

In contrast to rules applicable to Code Section 457(b) plans, arrangements governed by Code Section 457(f) are permitted to allow unlimited contributions, but, in exchange, much of the ability to defer taxation of deferred amounts is removed. This is because amounts deferred under an arrangement subject to Code Section 457(f) remain tax deferred only so long as the amounts are subject to a substantial risk of forfeiture (i.e., the amounts are unvested). Under Code Section 457(f), when deferred amounts are no longer subject to a substantial risk of forfeiture, the amounts become taxable to the recipient, regardless of whether the deferred amounts will be paid at that time.[12] This means that in order to prevent the immediate inclusion of deferred amounts being taxable to the recipient, the recipient's right to receive the deferred amounts must be conditioned upon the future performance of substantial services, and there must be a substantial possibility that such benefits will be forfeited if the participant fails to complete such service. As with many IRS determinations, compliance comes down to a facts-and-circumstances test. This is very different from the tax treatment of nonqualified deferred compensation provided by employers in the for-profit sector. Employers in the for-profit sector generally can structure large deferred compensation payments to be compliant with Code Section 409A so that the deferred amounts may be fully vested in one year but will not be taxable until the amounts are paid (which could be in a later year).

In limited circumstances, tax-exempt organizations may put in place arrangements that are exempt from Code Section 457(f) and which would allow accrued amounts under such arrangements to not be included in taxable income until actually paid. Arrangements exempt from Code Section 457(f) include: (1) short-term deferrals of compensation that a recipient actually or constructively receives on or before the last day of the period ending on the later of the 15th day of the third month following the end of the calendar year in which the right to the payment is no longer subject to a substantial risk of forfeiture, or the 15th day of the third month following the end of the employer's taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture;[13] (2) bona fide severance pay arrangements that provide benefits upon a participant's involuntary severance from employment, pursuant to a window program that is offered for a limited amount of time or a voluntary early retirement incentive arrangement where the amount payable under such a plan must not exceed two times the participant's annual compensation and the severance must be paid no later than the end of the second calendar year following the calendar year in which the severance from employment occurs;[14] (3) disability plans;[15] (4) bona fide sick or vacation plans;[16] and (5) death benefit plans.[17]

Employers must take extreme care to ensure that their nonqualified deferred compensation arrangements are drafted and administered in such a way as either to be exempt from Code Section 457(f) or to maintain a bona fide substantial risk of forfeiture until the benefits are intended to be included in the recipient's taxable income. Thus, apart from the limited amounts that can be accumulated using a 457(b) plan or a tax-qualified retirement plan, including a Code Section 403(b) plan, tax-exempt organizations generally are deprived by Code Section 457(f) from providing the benefits of substantial deferred compensation to employees beyond the time that such deferred amounts become vested.

## CONGRESS TAKES INSPIRATION FROM EXECUTIVE COMPENSATION RESTRICTIONS IMPOSED ON FOR-PROFIT EMPLOYERS

Before the enactment of Code Section 4960, there already were adverse tax consequences in place intended to dissuade for-profit entities from providing excessive compensation to executives. Congress clearly was inspired by Code Section 162(m) and Code Section 280G when drafting Code Section 4960:

- Code Section 162(m) generally provides that a publically traded company is limited to a $1 million annual deduction paid to the CEO, CFO, and three highest compensated officers; and

- Code Section 280G generally denies a deduction to a corporation for certain parachute payments made to a disqualified individual that are in the nature of compensation and are contingent upon a change of control if the payments exceed a specific amount. In addition, under Code Section 4999, the individuals must pay a 20 percent excise tax on these parachute payments that are not deductible by the corporation.

While the application differs, Code Section 4960 extends the general concepts applicable to certain employers in the for-profit sector with respect to using the Code to penalize both annual compensations provided to certain executives over $1 million and certain parachute payments. Although perhaps intended as a means to impose similar restrictions on employers that are tax-exempt organizations and employers in the for-profit sector, the actual effect of Code Section 4960 may further decrease the flexibility of a tax-exempt organization when structuring its executive compensation arrangements—flexibility which was already significantly less than that of employers in the for-profit sector. Code Section 162(m) generally only applies to publicly traded companies (including companies with publicly traded equity or debt, as well as foreign private issuers). Private companies in the for-profit sector do not face adverse tax consequences for paying annual compensation packages over $1 million. The penalties imposed by Code Sections 162(m) and 280G on the employer are targeted primarily at eliminating tax deductions that an employer can take with respect to certain executive compensation payments (and an additional tax placed on the executive for parachute payments under Code Section 280G through Code Section 4999). Depending on an employer's specific circumstances, the significance of the denial of a tax deduction will have a different punitive effect on various employers. However, since tax-exempt organizations generally are exempt from taxes, denying a tax deduction to such organizations obviously would fail to provide a meaningful deterrent to tax-exempt organizations. Thus, though inspired by Code Sections 162(m) and 280G, Code Section 4960 addresses the issue differently by imposing a new tax on tax-exempt organizations with respect to certain compensatory payments rather than denying any tax deductions.

### *The New Excise Tax Imposed by Code Section 4960*

Code Section 4960 begins by imposing a tax on tax-exempt organizations, simply stated as 21 percent of the sum of the following amounts:[18]

- Any remuneration (other than an excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1 million; plus

- Any excess parachute payment paid by the applicable tax-exempt organization to any covered employee.

The new excise taxes imposed by Code Section 4960 are placed on the tax-exempt organization and not on the individuals receiving the payments.

While there are many unanswered questions with respect to Code Section 4960, an initial issue is the lack of the definition of the term "taxable year." The manner in which such term is used throughout the statute raises the question of whether it refers to the taxable year of the employee or the taxable year of the tax-exempt organization. This will, of course, not affect those organizations with fiscal years that match the calendar year (since the organization's tax year corresponds to their employees' calendar year taxable year); however, organizations with a different fiscal year will need guidance regarding which taxable year to use to make the determinations mandated by the statute.

As discussed earlier, tax-exempt organizations already were tasked with meeting the "reasonable compensation" standard for its executive employees. However, this new excise tax under Code Section 4960 now creates an absolute maximum threshold for their executives' compensation before tax penalties are automatically imposed, regardless of whether the employer can establish that such pay levels are reasonable. For example, assume that a tax-exempt organization can justify that annual compensation of $1.2 million is reasonable for its CEO because of the CEO's talent, experience, responsibilities, and distinguished performance. To evidence the reasonableness of the compensation package, the organization retained a compensation consultant who provided a detailed report demonstrating that not only is the CEO's compensation reasonable under the facts and circumstances but the compensation is also actually significantly less than what likely would be paid by a similar tax-exempt organization. While the organization in this scenario avoids any intermediate sanctions penalty under Code Section 4958, it still faces an excise tax under Code Section 4960 because the executive's annual remuneration exceeds $1 million. In this example, the tax-exempt organization would be subject to an excise tax of $42,000 for the applicable year, which is 21 percent of the amount that the CEO's annual remuneration exceeded $1 million.

If a tax-exempt organization pays annual compensation over $1 million that is determined to be an excess benefit, not only will the penalties under Code Section 4958 apply (discussed earlier) but also the new 21 percent excise tax under Code Section 4960 (though guidance is necessary to understand how the penalties interact, particularly with respect to any compensation that is repaid to the tax-exempt organization by the employee).

### *To Which Employers Does Code Section 4960 Apply?*

The excise tax in Code Section 4960 applies to applicable tax-exempt organizations. The term "applicable tax-exempt organizations" is defined as an organization which for the taxable year:[19]

- Is exempt from taxation under Section 501(a);
- Is a farmers' cooperative organization described in Section 521(b)(1);
- Has income excluded from taxation under Section 115(1); or
- Is a political organization described in Section 527(e)(1).

While this definition generally includes most tax-exempt organizations, it remains unclear how Code Section 4960 will apply to public institutions, such as state colleges and universities. The definition of applicable tax-exempt organizations includes organizations exempt from tax under Code Section 115(1). Code Section 115(1) states that gross income "does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia…." The intent behind Code Section 4960 may have been to capture public institutions within the definition of "applicable tax-exempt organizations." However, many public institutions do not rely upon Code Section 115(1) as the basis for their tax exemption, but rather rely on the doctrine of implied statutory immunity.[20] Given the size of the compensation packages currently in place for certain individuals employed by some public institutions (for example, high-profile coaches and athletic directors at some public universities), exempting these organizations from the new excise tax would result in a significant loss of tax revenue for the federal government. It also would result in very different treatment for public and private universities with respect to their compensation packages for highly compensated individuals, thereby creating a significant financial advantage for the former in their ability to recruit and retain high-level employees.

### *To Which Employees Does Code Section 4960 Apply?*

The excise tax under Code Section 4960 applies to certain remuneration and excess parachute payments paid to a covered employee. A "covered employee" means any employee (including a former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the current tax year or any prior tax year that began after December 31, 2016.[21] Notably, once an employee becomes a covered employee, the individual will remain a covered employee who is subject to these rules indefinitely. Thus, a tax-exempt organization may, and likely will, at some point, have more than five covered employees. In order to comply with Code Section 4960, a tax-exempt employer should maintain a cumulative list of covered employees, regardless of whether any of its employees currently earn annual compensation in excess of $1 million.

While Code Section 4960 provides that remuneration of covered employees is aggregated for purposes of the tax (discussed below), the statute does not contain a controlled-group rule for purposes of determining covered employees. Thus, it appears that, absent guidance to the contrary, organizations will be faced with determining covered employees and applying Code Section 4960 on an entity-by-entity basis. Such an interpretation would create administrative stress for multitiered tax-exempt organizations (e.g., if a health care system maintains separate entities for each organization in the system, each of those entities will maintain its own list of covered employees). If it is confirmed that the determination of covered employees is on an entity-by-entity basis, this may affect decisions with respect to which organization within a multiorganizational system should be treated as the employer of newly hired highly compensated employees in order to minimize the number of covered employees for whom the new excise tax may apply.

As noted earlier, the definition of covered employees under Code Section 4960 is made of up employees and former employees. Code Section 4960 is silent regarding independent contractors and consultants. However, the new statute states that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent the avoidance of such tax through the performance of services other than as an employee…." Thus, tax-exempt organizations should be cautious before attempting to use employment classification as a means to avoid the new excise tax.[22]

### *How Is Remuneration Calculated for Purposes of Code Section 4960?*

In order to determine the remuneration to which the 21 percent tax will be applied with respect to a covered employee, an applicable tax-exempt organization must consider not only the remuneration that it pays but also the remuneration paid to the covered employee by any related organizations.[23] Generally, remuneration for purposes of determining the excise tax under Code Section 4960 consists of Code Section 3401(a) wages less any designated Roth contribution (as defined in Code Section 402A(c)).[24] Code Section 3401(a) wages are similar to wages reported on Form W-2, and generally include compensation received from sources such as base salary, overtime, bonuses, commissions, fees for professional services, taxable fringe benefits, reimbursements, and expense allowances, but exclude items such as deferrals under Code Section 401(k) plans, Code Section 403(b) plans, and Code Section 457(b) plans, as well as distributions from retirement plans that are reported on Form 1099-R (i.e., qualified plans and governmental Code Section 457(b) plans).[25]

In contrast, distributions from nongovernmental Code Section 457(b) plans are treated as wages reportable on Form W-2 when paid (or otherwise made available) and, thus, would be included under the determination of remuneration with respect to the 21 percent excise tax on annual payments in excess of $1 million in such year. However, as noted later, such amounts are explicitly excluded from the tax on severance parachute payments.[26]

As explained below, remuneration for purposes of determining the excise tax under Code Section 4960 includes nonqualified deferred compensation that is required to be included in income under Code Section 457(f) and excludes certain remuneration paid for the performance of medical services.

### *Application to Nonqualified Deferred Compensation*

Remuneration includes any nonqualified deferred compensation that is required to be included in income under Code Section 457(f) (i.e., nonqualified deferred compensation that is required to be included in income because it is no longer subject to a substantial risk of forfeiture even if not yet paid).[27] The inclusion of these amounts in the determination of the applicability of the excise tax may increase the potential to extend the excise tax to organizations that otherwise pay compensation packages under the $1 million annual threshold. For example, assume an organization pays its executive director $500,000 in 2018; however, the organization also maintains a Code Section 457(f) nonqualified deferred compensation plan, under which $60,000 is deferred for the executive director each year for 10 years, and the entire deferred amount of $600,000 vests in 2018 but is not paid until a later year. Even though the $600,000 represents accruals over a decade of service with the organization, and even if the organization never actually pays remuneration in excess of $1 million in 2018, the organization will be subject to an excise tax of $21,000 (21 percent of $100,000) for the 2018 tax year because the $600,000 that was deferred under the Code Section 457(f) plan is taxable to the employee in 2018.

Likewise, since remuneration is treated as being paid when there is no substantial risk of forfeiture and not when it is actually paid, nonqualified deferred compensation that was vested and included in an employee's income prior to January 1, 2018, will not be subject to the 21 percent excise tax under Code Section 4960 even if it is paid after January 1, 2018.

### *Treatment of Remuneration Paid for Medical Services*

Code Section 4960 specifically excludes from the definition of remuneration "the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional."[28]

Although this exception is appreciated by the medical community, the "performance" limitation may prove troublesome and difficult to both interpret and administer. Tax-exempt organizations that provide medical and veterinary services may now be forced to track and categorize compensation for executives and senior management who perform multiple functions within the organization. For example, if an experienced surgeon who is on staff at a hospital is promoted to head of surgery, the hospital may be required to determine and document what portion of the individual's compensation is for performing medical services and what is not. In addition, the determination of what constitutes providing medical services may not always be clear. Although compensation paid for purely administrative duties will not be attributable to performing medical services, there may be the performance of other services that are not as clear. For example, what if the individual is not performing the actual medical service but is playing a significant role in the performance of medical services through direct supervision? What about various training activities that may involve patients? Hopefully, these are issues that the IRS will address.

While the statute is clear that the amounts paid to a medical professional for the performance of medical services are not used for purposes of determining remuneration (and also for determining excess parachute payments), there is no indication in Code Section 4960 itself whether such amounts should be excluded when determining the group of "covered employees." A joint House-Senate conference committee reconciled the differences between the House-passed and Senate-passed versions of the new tax legislation and issued a report that states: "For purposes of determining a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account. . . ."[29] This statement indicates that Congress intended that payments to a medical professional for the performance of medical services are not used when determining the group of covered employees. However, since similar language was not included in the statute, the question remains as to whether the omission was intentional.

### *Remuneration Paid by Related Organizations*

Code Section 4960 provides that the remuneration paid to a covered employee by an applicable tax-exempt organization includes any remuneration paid with respect to the employment of such employee by any related person or governmental entity.[30] For this purpose, a person or governmental entity will be treated as related to an applicable tax-exempt organization if such person or governmental entity (1) controls, or is controlled by, the organization; (2) is controlled by one or more persons who control the organization;

(3) is a supported organization (as defined in Code Section 509(f)(3)) during the taxable year with respect to the organization; (4) is a supporting organization described in Code Section 509(a)(3) during the taxable year with respect to the organization; or (5) in the case of an organization that is a voluntary employees' beneficiary association described in Code Section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.[31]

Code Section 4960 provides that if remuneration is paid by one or more employers that are related organizations, each employer will be liable for its proportional share of the excise tax.[32] While the statute describes a method for application of the excise tax among related exempt entities, guidance is needed with respect to exactly how the related-party rule will work in cases where an employee performs services for and receives compensation from both a tax-exempt organization and a related taxable entity.

In the meantime, employers that may otherwise consider restructuring their payroll practices in an effort to minimize or eliminate exposure to the excise tax should be aware that the statute warns that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent the avoidance of such tax … by providing compensation through a pass-through or other entity to avoid such tax."[33]

### *What Is an Excess Parachute Payment?*

As noted previously, Code Section 4960 imposed a 21 percent tax on tax-exempt organizations that pay excess parachute payments.[34] This applies to compensatory payments that are contingent on the covered employee's separation from employment. This excise tax is reminiscent of the concepts contained in Code Section 280G with respect to excess parachute payments paid in connection with a change of control.

Under Code Section 4960, if parachute payments equal or exceed three times the covered employee's base amount, then the 21 percent excise tax applies to the portion of the parachute payments that are in excess of the employee's base amount.[35] For these purposes, parachute payments include any payments in the nature of compensation to (or for the benefit of) a covered employee if (1) such payments are contingent on the employee's separation from employment with the tax-exempt organization, and (2) the aggregate present value of such payments equals or exceeds three times the covered employee's base amount.[36] The "base amount" is determined by applying the current rules of Section 280G, which generally will provide that a covered employee's base amount is the individual's average annual taxable income from the organization over the five-year period immediately preceding the year in which the separation from service occurs (or any shorter period of service with the organization if less than five years).[37]

Code Section 4960 provides that the following payments generally are excluded when determining the amount of a parachute payment:[38]

- Payments to or from qualified retirement plans (including defined contribution plans, defined benefit plans, Code Section 403(b) plans, and Code Section 457(b) plans);

- Payments to a licensed medical professional (including a veterinarian) to the extent that such payments are for the performance of medical or veterinary services by such professional; and

- Payments to an individual who is not a highly compensated employee (as defined in Code Section 414(q), the threshold for which in 2018 is $120,000, subject to annual adjustment).

Once any payment to be paid in connection with a covered employee's separation from service qualifies as a parachute payment, all amounts in excess of the base amount become subject to the excise tax. For example, assume that the average compensation of an executive over the last 5 years was $150,000 but, because of a promotion and pay increases during this time, the executive's current salary is $200,000. Assume that the executive director has a severance agreement to receive three times his compensation if he is terminated without cause. He is later terminated and receives $600,000 in severance (three times his current compensation of $200,000). In this example, there is a parachute payment because the payment that is contingent on the termination of employment ($600,000) equals or exceeds three times the base amount (three times $150,000, which is $450,000). Thus, the excise tax that is due under Code Section 4960 is 21 percent of the excess of the amount paid in connection with the termination of employment ($600,000) over the base amount ($150,000), which equals 21 percent of $450,000 or $94,500.

Although the exclusion of payments to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services from the calculation of parachute payments is welcomed by the medical community, as previously discussed, guidance is needed addressing how to apply this exception. The need for guidance on this issue seems particularly necessary for an organization trying to determine when payments that are contingent on a separation from employment should be considered to be paid for the performance of medical or veterinary services.

## INTERIM ACTION PLAN WHILE AWAITING FUTURE GUIDANCE

A number of items with respect to Code Section 4960 require additional guidance regarding the applicability and determination of the new excise tax. Accordingly, tax-exempt organizations should carefully review Code Section 4960 and also consult with their legal counsel regarding the applicability, and potential adverse effect, of the new law. Listed below are a number of initial steps that a tax-exempt organization should begin to consider:

- Review the organization's payroll for 2017 and 2018 in order to identify which employees are "covered employees" under Code Section 4960. This list should be maintained and updated annually.

- Once the covered employee group has been determined, review all compensation arrangements with the individuals in the covered group, including any employment agreements, bonus agreements, retention agreements, and severance agreements in order to determine whether the organization anticipates any current liability under the new excise tax or whether there are compensatory payments that may be made in the future that may cause potential liability.

- Those responsible for making high-level compensation decisions within the organization should consider how the new excise tax may affect new compensation plans and agreements in light of the organization's desire to attract and retain talented individuals, while also being sensitive to the potentially negative public perception that the organization may face as a result of the imposition of this tax.

- Develop a strategy for minimizing the potential impact of the new excise tax, both in terms of current and deferred compensation arrangements already in place as well as those that will be offered to future employees.

- Code Section 457(b) plans should be considered. If not already doing so, consider whether Code Section 457(b) plans should be implemented or whether existing plans could be better maximized for key executives. In addition, subject to further guidance on this issue, tax-exempt organizations should examine whether a distribution from a nongovernmental Code Section 457(b) plan could impose unexpected liability by causing a covered employee's annual remuneration to exceed $1 million for purposes of Code Section 4960. Accordingly, sponsors of nongovernmental Code Section 457(b) plans may wish to review participants' distribution options under these plans and whether it may be beneficial, or permissible, to modify the distribution options permitted under such plans.

- Consider the role of qualified retirement plans, including Code Section 403(b) plans, in the organization's compensation and benefits structure, and how such plans could be better utilized in light of the excise tax imposed by Code Section 4960.

- Determine when any nonqualified deferred compensation will vest and become taxable under Code Section 457(f), and, thus, potentially be subject to the excise tax under Code Section 4960. If large amounts will become taxable in specific years, review the applicable agreements and consider whether any amendments to such agreements would be permitted or beneficial (for example, in certain circumstances amending vesting schedules may be possible).

- Monitor any future guidance with respect to Code Section 4960. Code Section 4960 states that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section. . . ."[39] Tax-exempt organizations should be mindful of this provision when considering the structure of their compensation packages.

There will be many variables for each tax-exempt organization to evaluate when considering the effect of the new excise tax imposed by Code Section 4960. Prior to the enactment of the Tax Act, executive compensation packages paid by tax-exempt organizations required careful planning and structuring. On top of the challenges faced by tax-exempt organizations prior to the enactment of the Tax Act, Code Section 4960 imposes a new set of challenges for tax-exempt organizations, on top of the challenges they faced prior to the enactment of the new law that will require even more careful analysis on the structuring of compensation practices and employee benefit plans and programs.

## NOTES

1. *https://www.irs.gov/pub/irs-utl/2017-2018_pgp_2nd_quarter_update.pdf*.

2. These sanctions apply to organizations described in Code §§ 501(c)(3), 501(c)(4), or 501(c)(29) and are exempt from tax under Code § 501(a), or an organization that fits such description during a 5-year lookback period. *See* Code § 4958(e) and Treasury Regulation § 53.4958-2.

3. Code § 4958(a)(1).

4. Code § 4958(b).

5. Code § 4958(a)(2) and Treasury Regulation § 54.4958-1(d).

6. Code § 4958(f)(1) and Treasury Regulation § 54.4958-3.

7. After May 6, 1986, state and local governments generally are not eligible to adopt Code § 401(k) plans except for rural cooperatives and Indian tribal entities. Under grandfather provisions, plans established prior to that date may continue to operate and add new participants. *See* Treasury Regulation § 1.401(k)-1(e)(4).

8. A Code § 457(b) plan is a special type of employer-sponsored retirement plan that many tax-exempt and governmental organizations can establish for their employees. However, there are different rules for Code § 457(b) plans maintained by nongovernmental tax-exempt organization compared with those established by governmental entities. Although the former must generally be structured as a "top-hat plan" available to only a select group of employees to avoid certain requirements under the Employee Retirement Security Act of 1974, as amended (ERISA), the latter do not need to be limited to the top-hat group because they are exempt from ERISA. This article will not focus on the special rules applicable to § Section 457(b) plans sponsored by governmental employers.

9. Code § 457(d).

10. Code § 457(a)(1). This refers to federal income and generally state income taxation. However, amounts deferred under a Code Section 457(b) plan is generally required to be taken into account for purposes of FICA and FUTA employment taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount. Thus, to the extent a Code Section 457(b) plan provides that annual deferrals are immediately vested, the annual deferrals are subject to FICA and FUTA employment taxes at the time of deferral. *See* Code §§ 3121(a)(5), 3121(v), 3306(b)(5) and 3306(r); Treasury Regulation §§ 31.3121(v)(2)-1(a) and 31.3306(r)(2)-1(a).

11. Code § 457(d)(2) and Treasury Regulation § 1.457-6(d).

12. Code § 457(f)(1).

13. Proposed Treasury Regulation § 1.457-12(d)(2).

14. Proposed Treasury Regulation §§ 1.457-11(c)(1) and 1.457-11(d).

15. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(e).

16. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(f).

17. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(e).

18. Code § 4960(a).

19. Code Section 4960(c)(1).

20. *See generally* Rev. Rul. 71-131, Rev. Rul. 71-132, *Estate of Shamberg*, 3 T.C. 131 (1944), and *State of Michican v. United States*, 40 F. 3d 817 (6th Cir. 1994).

21. Code § 4960(c)(2).

22. Code § 4960(d).

23. Code § 4960(c)(4).

24. Code § 4960(c)(3)(A).

25. Code § 3401(a).

26. Code § 4960(c)(5)(C)(ii).

27. Code § 4960(c)(3)(A).

28. Code § 4960(c)(B).

29. Joint Explanatory Statement of the Committee of Conference under the Tax Act, p. 349.

30. Code § 4960(c)(4)(A).

31. Code § 4960(c)(5)(B).

32. Code § 4960(c)((4)(C).

33. Code § 4960(d).

34. Code § 4960(a)(2).

35. Code § § 4960(a)(2) and 4960(c)(5)(A) and (B).

36. Code § 4960(c)(5)(A).

37. Code § 4960(c)(5)(D) and Treasury Regulation § 1.280G-1, Q/A-34.

38. Code § 4960(c)(5)(C).

39. Code § 4960(d).



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