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Tax-Exempt Organizations Face A New Excise Tax

By **James Malone** (February 7, 2018, 1:06 PM EST)


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On Dec. 22, 2016, the Tax Cuts and Jobs Act, P.L. 115-97, became law. For exempt organizations, the TCJA included a key change: There is now an excise tax applicable to exempt organizations on "excess" executive compensation. This new tax, which is imposed under section 4960 of the Internal Revenue Code, will apply to:

- "(1) so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000," and
- "(2) any excess parachute payment paid by such an organization to any covered employee."[1]

"Covered employees" are the five highest-paid employees for the taxable year, along with anyone who was previously a "covered employee" at the organization or a predecessor.[2] The tax is imposed on the exempt organization, not the employee. The applicable tax rate is the corporate rate, which is now 21 percent.[3]

This article will provide an overview of section 4960, and it will proceed as follows:

- First, it will discuss the manner in which compensation decisions at exempt organizations are treated under the code;
- Second, it will discuss the background to section 4960;
- Third, it will provide an explanation of the new tax.

Treatment of Compensation Decisions at Exempt Organizations

To qualify for tax-exempt status under section 501(c)(3) of the code, an entity must be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes ..."[4] As the Treasury Regulations explain, section 501(c)(3) requires that an organization satisfy two tests to qualify for an exemption, an organizational test, and an operational test: "If an organization fails to meet either the organizational test or the operational test, it is not exempt."[5]

Compensation decisions implicate the operational test, which focuses on whether an entity is "operated *exclusively*" for exempt purposes. Specifically, compensation decisions for senior management implicate the operational test for two reasons:

- One of the concerns addressed under the operational test is the anti-inurement principle: "An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."[6] Excessive compensation would violate this principle.
- A second is the private benefit doctrine: "[I]t is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[7] Excessive compensation would violate the private benefit doctrine as well.

Reasonable compensation, in contrast, is appropriate; an exempt organization needs competent people to advance its exempt purpose or purposes. The conundrum is that the line between reasonable and excessive compensation is often debatable.

Historically, that problem was compounded by the serious impact that an award of excess compensation could have, as the main enforcement mechanism available to the IRS was to revoke tax-exempt status. Subsequently, Congress created a new regime of "intermediate sanctions" that gave the IRS the ability to punish particular actions taken by an exempt organization without revoking its tax exemption.

Thus, since late 1995, compensation arrangements for senior managers of exempt organizations have been regulated under section 4958 of the Code, which imposes an excise tax on "excess benefit transactions." Under section 4958, an award of excess compensation will trigger the following tax consequences:

- A tax of 25 percent of the excess benefit on each "disqualified person" who receives an excess benefit;
- A tax equal to 10 percent of the excess benefit (up to $20,000 per person) on those involved in approving the excess benefit;
- A tax of 200 percent on the recipient if the excess benefit transaction is not unwound promptly.[8]

The code defines a "disqualified person" based upon criteria that include the ability to "exercise substantial influence over the affairs of the organization," making senior managers "disqualified persons."[9]

In an effort to avoid the adverse consequences of an excess benefit transaction, exempt organizations have been taking steps to assure that their compensation decisions for senior managers qualify for a presumption of reasonableness under the Treasury regulations by having an independent body approve compensation arrangements, by assuring that the independent body has solid information on comparable arrangements, and by documenting their decisions contemporaneously.[10]

Against that background, Congress elected to add section 4960 to the code.

Background to Section 4960

The initial House report expresses the view that excessive compensation is inappropriate for organizations that are exempt because they serve charitable or other public purposes: "[S]uch organizations are subject to the requirement that that they use their resources for specific purposes, and the Committee believes that excessive compensation (including excessive severance packages) paid to senior executives of such organizations diverts resources from those particular purposes."[11] Oddly, neither the initial House report nor the subsequent conference report made any mention of the existing excise tax regime under section 4958.

The new tax is modeled on section 162(m) of the Internal Revenue Code, which generally bars a public company from deducting compensation to its senior management over $1,000,000. The TCJA also made changes to section 162(m), removing a provision that made incentive compensation deductible without limit. The House report expresses the view that putting compensation of senior managers of exempt organizations and of public companies on the same footing would promote fairness: "The Committee further believes that alignment of the tax treatment of excessive executive compensation ... between for-profit and tax-exempt employers furthers the Committee's larger tax reform efforts of making the system fairer for all businesses."[12]

Understanding Section 4960

As with any tax statute, the defined terms are critical. The tax under section 4960 will be imposed on an "applicable tax-exempt organization," which is defined as "any organization which for the taxable year — (A) is exempt from taxation under section 501(a), (B) is a farmers' cooperative organization described in section 521(b)(1), (C) has income excluded from taxation under section 115(1), or (D) is a political organization described in section 527(e)(1)."[13] As noted above, the term "covered employee" is defined to reach the five highest-paid employees in the current tax year, plus those who previously were "covered employees."[14] As a consequence, the number of employees covered under section 4960 will likely grow, particularly if an organization's compensation model is variable due to incentive programs.

In light of the definition of the term "covered employee," exempt organizations should understand that the existing regimen of intermediate sanctions under section 4958 remains applicable to compensation decisions. The two tax regimes will operate independently:

- A compensation arrangement that qualifies for the presumption of reasonableness under the excess benefit regulations can still trigger the tax under section 4960.
- It is also possible for a compensation decision to trigger the excise tax on excess benefit transactions under section 4958 *and* the new tax under section 4960.

The overlapping excise tax regimes raise another complication: The section 4960 excise tax will apparently apply to pre-existing commitments made by institutions before the TCJA became law. In contrast, the existing tax on excess compensation of public company officers carries an exclusion for pre-existing agreements.[15] As part of the TCJA, Congress amended section 162(m) to remove an existing provision permitting public companies to deduct incentive compensation that exceeded $1 million, and it again replicated the exclusion for pre-existing agreements.[16] Given that context, the failure to include a similar provision for exempt organizations is troubling: An organization that did everything right in approving a multiyear compensation package by subjecting the package to scrutiny that triggered the presumption of reasonableness under the excess benefit regulations will now be taxed when it complies with its contractual obligations.

The tax reaches both normal remuneration and severance arrangements. Normal compensation is covered by section 4960(a)(1), which imposes a tax on "so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000."[17] That includes remuneration received from related organizations.[18]

Severance arrangements are subject to tax if they involve an "excess parachute payment."[19] These provisions are modeled upon section 280G of the code, which bars a deduction for excess parachute payments by public companies. A severance arrangement will potentially trigger the tax if it provides for payments with an aggregate present value that "equals or exceeds an amount equal to 3 times the base amount."[20] The "base amount" is to be applied based upon rules that are "similar to the rules of 280G(b)(3)."[21] The tax is then applied to the excess portion of the parachute payment, which is "an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment."[22]

Tax-exempt health care providers should pay close attention to the definition of "remuneration." While generally tied to wages, "remuneration" does not include "any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional."[23] While helpful, this clause is not entirely clear: If a physician has supervisory duties with respect to a hospital as its chief executive, chief operating officer, or chief medical officer, is his entire compensation excluded from the scope of the excise tax? The conference report indicates that only compensation that is directly related to performance of medical services by the individual is intended to be exempt.[24]

But even that language is subject to interpretation: If a doctor who is an officer of a hospital works on revising standards for patient care, is she performing medical services? Organizations that want to rely upon the exclusion of income for provision of medical services will need to have a defensible mechanism to identify what compensation is for provision of medical services and what compensation is not.

Another area of concern is the impact of the tax on an organization's continued qualification for tax-exempt status. In the context of excess benefit transactions, the regulations provide that an excess benefit transaction is not necessarily a reason to revoke an organization's tax-exempt status. Instead, the IRS applies a balancing test that considers the excess benefit transaction in light of other factors, including how the excess benefit transaction compares to the organization's overall activities that further its exempt purposes, the extent of the excess benefit transactions, the nature of any safeguards adopted to avoid future excess benefit transactions, and the extent to which excess benefit transactions have been corrected.[25] The language of the House report discussing the new excise tax could be read to suggest that a payment of compensation is a diversion of resources that should result in a loss of tax-exempt status, or the government could adopt a more nuanced approach.

Conclusion

The new tax under section 4960 creates additional complications for exempt organizations. Some of the concerns may be addressed either through a technical corrections bill or through regulatory guidance. In the interim, exempt organizations should proceed with great caution.

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[1] I.R.C. § 4960(a)

[2] I.R.C. § 4960(c)(2)

[3] I.R.C. § 11(b)

[4] I.R.C. § 501(c)(3)

[5] Treas. Reg. § 1.501(c)(3)-1(a)(1)

[6] Treas. Reg. § 1.501(c)(3)-1(c)(2)

[7] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii)

[8] See I.R.C. § 4958(a), (b)

[9] I.R.C. § 4958(f)(1)(A)

[10] See Treas. Reg. § 53.4958-6(a)

[11] H.R. Rep. 115-409, at 333 (2017)

[12] Id

[13] I.R.C. § 4960(c)(1)

[14] I.R.C. § 4960(c)(2)

[15] I.R.C. § 162(m)(4)(B)

[16] Pub. L. No. 115-97, § 13601(e)(2)

[17] I.R.C. § 4960(a)(1)

[18] I.R.C. § 4960(c)(4)

[19] I.R.C. § 4960(a)(2) (imposing tax upon “any excess parachute payment paid by such an organization to any covered employee”)

[20] I.R.C. § 4960(c)(5)(B)(ii) (defining “parachute payments”)

[21] I.R.C. § 4960(c)(5)(D)

[22] I.R.C. § 4960(c)(5)(A)

[23] I.R.C. § 4960(c)(3)(B)

[24] H.R. Rep. No 115-466, at 494 (2017) (“remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services is not taken into account” for purposes of the excise tax”)

[25] See Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii)