

What Tax Cut?

In an ironic twist to the just-enacted “Tax Cuts and Jobs Act,” many tax-exempt (not-for-profit) organizations - including credit unions - will be subject to a substantial new tax limiting their ability to recruit, compensate and retain leadership talent. While penalizing employers for providing certain levels of otherwise reasonable compensation is not a new concept for publicly-traded companies, it is unprecedented in not-for-profit organizations and will require some adjustment of strategy. Below, we review the public-company experience and then consider the Act’s impact on not-for-profit organizations.

Background

For many years, publicly-traded companies have been limited in their ability to deduct certain types of compensation for their chief executive officer and the four other most highly compensated executives.¹ Section 162(m) of the Internal Revenue Code (IRC) states:

In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.

By denying the tax deduction, the employer is penalized to the tune of the excess compensation multiplied by the corporation’s tax rate. The Act reduces corporate tax rates from 35% to 21%, making the 162(m) penalty 21% of compensation in excess of \$1 million.

Impact of the Act

While structured differently, the compensation practices of not-for-profit organizations have come under increasing scrutiny from the government as well as the public. There is a growing perception that executives of not-for-profit organizations are failing to embrace their organization’s stated purpose, are over-paid and should have their compensation and benefits limited beyond the current reasonable compensation tests and intermediate sanctions. Some in Congress have even raised the possibility of removing the tax exemption for some types of currently not-for-profit organizations based upon these perceptions – often fostered by their for-profit competitors. Numerous other methods have been suggested by legislation, including limiting executive compensation to that of the president of the United States or the applicable state governor.

The Act takes a different approach, imposing a 162(m)-type penalty on the not-for-profit employer. Since not-for-profit employers don’t use tax deductions, new IRC section 4960 imposes an excise tax on compensation in excess of \$1 million.² The excise tax rate is the corporate tax rate then in effect, which under the Act is 21%. The not-for-profit employer pays the tax.

There is hereby imposed a tax equal to the product of the [corporate tax rate] and . . . so much of the remuneration paid . . . by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of \$1,000,000 . . . The employer shall be liable for the tax imposed...

¹ The Act changed covered employees for public companies to the principal executive officer, principal financial officer and the three other most highly compensated executives.

² The Act also imposes the excise tax on parachute payments, which generally arise if the employer pays severance that is three times or more the individual’s 5-year average W-2 compensation. This parachute part of the excise tax only applies if the individual qualifies as a highly-compensated individual (\$120,000 in 2017 and 2018).

The 4960 excise tax applies to the not-for-profit organization's five highest compensated employees (or former employees) for the year, plus anyone who was in the five-highest group for any preceding year (2017 or later).³

Even though a covered employee's aggregate annual salary and incentive payments may be less than \$1 million, it is important to recognize that this change in the tax law essentially means that any deferred compensation arrangement increases the likelihood of incurring the 4960 tax. This is because "remuneration" includes deferred compensation, not as it accrues each year, but in a lump sum in the year it vests (i.e., is no longer subject to a "substantial risk of forfeiture"). Under many plans, deferred compensation accrues over 10 or more years so that the vesting amounts can represent many multiples of current salary and bonus. Nevertheless, the full amount of vesting deferred compensation is added to current compensation, significantly increasing the risks that the total for the year will exceed \$1 million, resulting in the 21% excise tax on the excess.

Conclusion

Most have not had the opportunity to study every aspect of the new tax law carefully. Typically, new tax law provisions have minimal, if any, impact on not-for-profit organizations. However, it is crucial that those in the not-for-profit sector recognize that the Act will affect thousands of organizations - especially in healthcare, higher education, trade and professional associations and credit unions. Failure to adapt to the new 4960 requirements will cause a not-for-profit organization to very likely find itself in a position where it has lost capital that would otherwise support its mission.

Not-for-profit employers should study the Act's potential impact on its presently structured deferred compensation plans, as well as those who are currently considering implementing such plans in the future. The competitive nature of recruiting, hiring and retaining the best and the brightest has always been a challenge for the not-for-profit sector when compared to its for-profit brethren. This new tax law will make that challenge even greater. The advice of qualified counsel is important regarding the options available for addressing the excise taxes in the new tax law.

Dennis Dollar

Principal Partner
Dollar Associates, LLC
(205) 991-1525
ddollar@dollarassociates.com
www.dollarassociates.com

H. David Wright, MHA, MBA

Senior Vice President
Triscend^{NP}, LLC
(972) 318-1110
dwright@triscendnp.com
www.triscendnp.com

³ The Act excludes compensation paid to physicians and nurses for rendering medical services. Payments to these professionals for administrative services are included, however.