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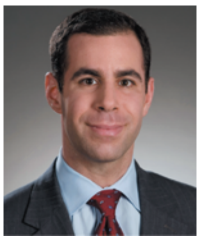
Tax-Exempt Organizations: Understanding the Proposed Tax Reform Act of 2014's Penalties on Excessive Executive Compensation



BY GREG M. DAUGHERTY AND EDWARD M. SEGELKEN

During the past several years, executive compensation and income inequality have attracted increased attention from Congress and the general public. After the collapse of Lehman Brothers Holdings Inc., this attention has been especially focused on large financial institutions. While most of the attention has focused on large, for-profit enterprises, tax-exempt nonprofit organizations haven't escaped scrutiny either.[1] Tax-exempt organizations came under fire again more recently when House Ways and Means Committee Chairman Dave Camp (R-Mich.) introduced the Tax Reform Act of 2014 (the ''proposed act'').

[1] Sen. Charles E. Grassley (R-Iowa) in particular has called for greater accountability of the executive compensation practices of tax-exempt organizations. See, e.g., http://www.grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=36004

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Although Congress is unlikely to pass the proposed act in its current form any time soon, it still provides some useful lessons to tax-exempt employers. If nothing else, it serves as a reminder of how complex the current executive compensation rules are. Tax-exempt organizations would be wise to review these rules to make sure they don't bring unwanted attention to themselves or their executives. Additionally, the proposed act signals what direction any executive compensation overhaul will take in the future. In particular, it appears that tax-exempt organizations could have their executive compensation practices governed under a regulatory structure that is similar to the one that publicly traded corporations face under tax code Section 162(m) and related guidance.

This article will provide a brief overview of how the tax code currently regulates executive compensation practices of tax-exempt organizations. That will provide context for understanding the potential impact of the proposed act. After explaining the new rules that the proposed act would impose, this article will conclude with thoughts about planning opportunities for the future.

Current Rules

Currently, organizations established under Sections 501(c)(3) (for religious, educational, or charitable purposes) or 501(c)(4) (organizations operated exclusively to promote social welfare or certain local associations of employees) generally are exempt from federal income tax. In order to maintain tax-exempt status, these organizations must not allow any part of their net earnings to inure to the benefit of any private shareholder or individual. The payment of reasonable compensation to service providers won't constitute private inurement, but the payment of excessive compensation might.

The following factors are used to determine the reasonableness of the compensation:

- whether the compensation arrangement was made at arm's length;
- if an independent committee determined the compensation arrangement;
- whether the compensation is comparable to compensation paid to other persons performing similar services to similar organizations;

- the compensation is justifiable based upon the benefit conferred on the organization;
- nature of the executive's duties and responsibilities;
- correlation between the services provided and compensation paid and
- if the organization has adequate maximum limits on the compensation.[2]

Because the loss of tax-exempt status is such a harsh penalty, Congress enacted Section 4958 to impose an intermediate sanction on Section 501(c)(3) and 501(c)(4) organizations that engage in an ''excess benefit transaction'' with a ''disqualified individual.'' A ''disqualified person'' includes a person in a position to ''substantially influence'' the applicable tax-exempt organization's affairs during the five-year period preceding the date of the transaction, a member of such person's family and an entity in which such persons own 35 percent or greater interest. Persons with ''substantial influence'' include (1) members of the applicable tax-exempt organization's governing board or who are entitled to vote on any matter in which the governing board has authority; (2) a person who, regardless of title, has ultimate responsibility for implementing decisions of the governing body or supervises the management, administration, or operation of the organization; and (3) a person who regardless of title has ultimate responsibility for managing the finances of the organization.[3]

An excess benefit transaction is a transaction where an applicable tax-exempt organization provides an economic benefit to a disqualified person, the value of which exceeds the value of the consideration received. This definition includes any unreasonable compensation. Compensation received by a disqualified person working as an employee or an independent contractor is considered unreasonable and thereby an excess benefit to the extent that it exceeds the value of the services provided. The value of the services provided is the amount that would normally be paid ''for like services by like enterprises (whether taxable or tax-exempt) under like circumstances.''[4]

If compensation is found to be unreasonable, Section 4958 imposes a tax equal to 25 percent of the amount of the excess benefit on each excess benefit transaction. The tax is payable by the disqualified person who receives the excess benefit, and not the exempt organization. If the disqualified person doesn't correct the transaction within the taxable period, the disqualified person is liable for an additional tax equal to 200 percent of the excess benefit. If more than one disqualified person receives an excess benefit, each person is jointly and severally liable for all such taxes. Whenever an initial tax is imposed on a disqualified person, an additional 10 percent tax, which may not exceed $20,000 per transaction, is imposed on the organization managers who knowingly participate in an excess benefit transaction without reasonable cause as a group. The term ''organization manager'' includes officers, directors, trustees, and person ''having powers or responsibilities similar to those of officers, directors, or trustees.''[5]

The regulations contain safe harbors and tests that an organization may satisfy to demonstrate either that certain individuals aren't disqualified individuals, or that the compensation they received is reasonable. These rules are beyond the scope of this article. The point is that the current regulatory regime that governs tax-exempt organizations contains extensive rules that attempt to limit the amount of compensation that Sections 501(c)(3) and 501(c)(4) organizations may pay to their executives. For the most part, however, these rules impose taxes only on the employees of the organization. Other than extreme cases where the organization also loses its exempt status, the organization itself doesn't pay any taxes.

Potential Taxes on All Tax-Exempt Organizations

The proposed act preserves these private inurement rules that impose taxes on certain individual employees who receive excessive compensation. The proposed act would add similar tax penalties to the organizations themselves, and it would impose these taxes on all organizations exempt from tax under Section 501(a), farmer's cooperative organizations and governmental employers (''applicable tax-exempt organizations''), rather than only on Section 501(c)(3) or 501(c)(4) organizations.

Under Section 3803 of the proposed act, a tax-exempt employer would be liable for an excise tax of 25 percent of the sum of (1) any remuneration in excess of $1,000,000 paid to an employee by the organization or certain related organization for a taxable year, and (2) any excess parachute payment paid by the organization to a covered employee. In other words, the excised tax would apply whenever an excess parachute payment was made, even if the covered employee's remuneration didn't exceed $1,000,000.

For these purposes, a ''covered employee'' is an employee of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or ever was a covered employee of the organization in any preceding taxable year after Dec. 31, 2013. This definition could include employees who wouldn't be considered disqualified persons for purposes of the intermediate sanction rules. For example, a professor employed by a tax-exempt university could be one of the five highest compensated employees without being a disqualified person. Remuneration means wages defined for income tax withholding purposes, but doesn't include any designated Roth contributions.

Under the proposed act, an excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. A parachute payment is compensation paid to a covered employee that is contingent on the employee's separation from employment, and the aggregate present value of all such payments is three times or more of the base amount. The base amount is the average annual compensation includable in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. Parachute payments don't include payments

[2] Treas. Reg. § 53.4958-4(b).
[3] Treas. Reg. § 53.4958-3.
[4] Treas. Reg. § 53.4958-4(a).
[5] Treas. Reg. § 53.4958-1.

under a qualified retirement plan, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local government employer.

Essentially, Section 3803 of the proposed act imposes modified versions of tax code Sections 162(m) and 280G on tax-exempt organizations. Section 162(m) imposes a similar $1,000,000 deduction limit on publicly traded corporations, with an exception for ''performance-based compensation.''[6] Section 280G imposes an excise tax on certain individuals who receive excess parachute payments from for-profit corporations, and it disallows a deduction to the corporations for these excess parachute payments.

The Ways and Means Committee Majority Tax Staff Section-by-Section Summary explains that similar rules to Sections 162(m) and 280G will apply to tax-exempt organizations. It adds that the exemption from federal income tax constitutes a significant benefit conferred upon tax-exempt organizations. For this reason, the case for discouraging excess compensation paid out to such organizations' executives may even be stronger than it is for publicly traded companies. Further, the staff analysis questioned whether excessive executive compensation diverts resources from the stated purposes that allow an organization to achieve tax-exempt status in the first place.[7]

Deferred Compensation Opportunities

As stated previously, Roth deferrals will generally be exempt from these rules under the proposed act. Before discussing the impact of this exemption, it is important to provide a brief explanation of the types of deferred compensation opportunities available to tax-exempt organizations.

Traditionally, tax-exempt employers sponsored tax-sheltered annuities under Section 403(b). Tax-exempt employers also may sponsor 401(k) plans, the typical tax-deferral plans offered in the for-profit sector. Finally, tax-exempt employers may allow employees to participate in nonqualified deferred compensation plans governed under Section 457(b). These plans allow both the employees and employers to make contributions to the plan on a pretax basis. In other words, the amounts contributed aren't taxed when the contributions are made. Instead, they are taxed in the year of distribution. Earnings accumulate tax-free. Each type of plan, however, may allow employees to defer their compensation to a Roth account. When an employee makes a Roth election, the amount is taxed in the year of deferral to the plan. The distribution, however, isn't taxed.

[6] Section 3802 of the proposed act would eliminate this exception.

[7] See http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

Similar to pretax deferrals, the earnings on the amounts deferred aren't taxed.

If the proposed act becomes law, tax-exempt employers may want to consider adopting Roth deferral features to their 403(b) and 457(b) plans. One caveat is that employers may not have much of a choice and instead may have to require that certain executives make Roth deferrals. Under Section 1613, any deferrals in excess of half of the permitted deferral amount ($17,500 in 2014) would be required to be made to a Roth account. Employees could contribute the entire annual deferral to a Roth account if they wished. Further, plans generally would be required to offer Roth accounts. Employer contributions, in contrast would continue to be made to traditional tax-deferred accounts. This rule, however, wouldn't apply to employers that had 100 or fewer employees.

Section 1618 would take away additional deferral opportunities for tax-exempt and governmental organizations. For example, sponsors of 403(b) plans may make nonelective contributions for a period of up to five years after the employee has separated from service. Section 1618 would eliminate this break so that 403(b) plans would be consisted with 401(k) plans in this regard. Further, governmental employees may make additional catch-up contributions to 457(b) plans that aren't available to employees of tax-exempt organizations under either a 457(b) or a 403(b) plan or employees of for-profit entities that sponsor a 401(k) plan. This break also would be eliminated.

Conclusion

In short, executive compensation arrangements currently are governed by a complex set of rules that could result in either the tax-exempt organization losing its tax-exempt status or more commonly, result in the individual paying an excise tax on excessive compensation. Under the proposed act, the tax-exempt organizations themselves could be subject to an additional 25 percent excise tax. The proposed act allows some flexibility with deferred compensation, but it also limits the opportunities to take advantage of deferred compensation that otherwise might have been available. The good news from the employer prospective is that the proposed act isn't likely to become law anytime soon. Nevertheless, the proposed act does show that Congress has an eye on the executive compensation arrangements of tax-exempt organizations and that it is willing to consider either removing tax preferences or imposing additional taxes or both on these arrangements in order to raise revenue. Tax-exempt organizations, therefore, should review their current compensation arrangements to make sure that they are compliant with the current rules and don't attract any unnecessary attention from the government. This strategy will put the organization in a better position to handle any changes.