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What Do Your Executives Have In Common With Seven-Figure Income College Coaches?

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Tax-exempt organizations may be surprised to learn of the practical impact of a statute enacted as part of the Tax Cuts and Jobs Act in December 2017. Section 4960 of the Internal Revenue Code immediately put in place restrictions on what it labels “excess” executive compensation. Some organizations initially concluded that Section 4960 would have little or no impact on them, but many are now finding that the rules have more bite than anticipated.

Section 4960 focuses on compensation paid by a tax-exempt organization to any “covered employee.” A “covered employee” is any person who was one of the organization's five highest compensated employees for 2017 or any later taxable year. The surprising thing about this definition is that once a person is labeled a “covered employee” for any given year, they will remain in that category for the rest of their life.

The new law has two prongs. First, it puts a \$1M limit on all remuneration paid to a covered employee in any taxable year. Any amounts in excess of \$1M are subject to a 21% excise tax payable by the organization. In many ways, this puts tax-exempt organizations on par with public for-profit companies, which are denied a tax deduction for compensation they pay over \$1M.

Initially, many thought the \$1M limit would only impact high-profile college football coaches, highly paid university leaders and the heads of major non-profits. But in practice, even smaller organizations are finding the limit can be problematic. For example, many non-profits have generous 457(f) deferred compensation programs which are typically structured to pay in a lump sum. And many non-profits also have 457(b) plans for their executives, which also frequently have lump sum distribution provisions. If the 457(f) and 457(b) payouts hit in the same year that the executive has already earned a substantial salary, it is easy to see how the \$1M limit could be breached.

The second prong of Section 4960 imposes the same 21% excise tax on “excess parachute payments.” This provision looks at any and all compensatory payments to covered employees that are “contingent on such employee's separation from employment with the employer.” Whereas the first prong (the \$1M limit) looks at compensation in any given year, this second prong (on excess parachute payments) takes a snapshot calculation of payments and benefits at the time of separation from employment (present valued, as appropriate). That total amount is then

measured against the covered employee's average compensation for the five years prior to the separation (called the “base amount”), and if the total exceeds three times the base amount, the organization will owe the excise tax. The consequences of this are more costly than the organization might think – the excise tax is not just imposed on the amount in excess of the “three times” figure, but instead is imposed on all amounts *in excess of the base amount*.

The question whether a payment is “contingent on” an employee's separation from employment can be complicated. Clearly, amounts such as severance, residual bonuses, relocation benefits and continued medical coverage will count. And the statute does clearly state that payments from 401(k) or other qualified plans, 403(b) annuities, and 457(b) plans are not counted. Where a payment or benefit falls in a gray area, Section 4960 explicitly draws parallels to Internal Revenue Code Section 280G, which applies to parachute payments made by employers in the for-profit sector on account of change-in-control transactions. So until regulations or other guidance is issued, the regulations and other history of applying Section 280G will be useful.

Another notable fact about Section 4960 is its immediate effect. Both prongs apply to compensation paid by tax-exempt organizations in 2018. With so little time to consider the impact, strategies for minimizing the penalties are limited. There are a few things that tax-exempt organizations can do, however.

First, all organizations should identify their covered employees. This should be a list that is updated and monitored on an annual basis going forward.

Second, organizations should identify any circumstances where the \$1M annual limit might be exceeded. If there is risk of exceeding the \$1M annual limit, consider deferrals or other methods of stretching payments out. Keep in mind that any deferral arrangements must comply with Code Sections 409A and 457(f).

Third, organizations should be mindful of the Section 4960 when negotiating separation agreements, severance or other arrangements with executives that might trigger the excess parachute payment restrictions. Since this penalty can be especially painful, it might be worthwhile to include clauses in contracts to permit the organization to reduce parachute payments, if necessary. In addition, organizations need to be mindful of the substantial cost of the excise tax in valuing the overall cost of a severance package to a covered employee.

Section 4960's swift implementation is likely to have lasting and significant impact on how tax-exempt organizations compensate their executives. In the coming months, organizations should watch for regulations and other official guidance to be issued. And as affected parties share their experiences and concerns, the tax-exempt community of organizations and advisors will continue to develop strategies to adapt to the new restrictions.

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