New Tax Law Brings Penalties for Top Paid Non-Profit Executives

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The “intermediate sanctions” rules under Section 4958 of the Internal Revenue Code have long governed the payment of compensation to executives of public charities. While these rules are highly prescriptive, if followed, they offer taxpayers a significant advantage in the form of a rebuttable presumption of reasonableness. While there was concern among tax-exempts that the tax bill might reduce or even eliminate the presumption of reasonableness, that turned out not to be the case. But the final version of the legislation for the first time imposed a tax on certain excess compensation and excess parachute payments, which we discuss in more detail below.

How are public charities regulated under U.S. tax law?

U.S. tax law has long recognized and provided special, beneficial tax treatment of public charities in the form of an exemption from income tax under Code § 501(c). To qualify for this exemption, a public charity must, among other things, operate so that none of its income or assets inure to the benefit of any of its board members, trustees, officers, or key employees. These types of individuals are commonly referred to colloquially as “insiders” and technically under applicable law and regulations as “disqualified persons.” Thus, the prohibition precludes any of the income or assets of a charity from unfairly or unreasonably benefiting, either directly or indirectly, individuals who have close relationships with their organizations and the ability to exercise control over them.

What is the most common type of private inurement?

The most common type of private inurement is the payment of excessive compensation to insiders. Violation of these rules can result in the revocation of a charity’s tax-exempt status and/or in the imposition of intermediate sanctions as explained below.

What are the intermediate sanctions rules?

The “intermediate sanctions” rules under Code § 4958 prohibit the payment of excessive compensation or other benefits (called “excess benefits”) to certain individuals responsible for running tax-exempt organizations. Penalties under the intermediate sanctions rules can be significant.

What happens if the intermediate sanctions rules are violated?

If an excess benefit is paid or provided to a “disqualified person” (i.e., any person who is in a position to exercise substantial influence over the institution), he or she can be liable for an initial excise tax of 25% on the value of the excess benefit. This tax is imposed in addition to the individual’s other income taxes. A disqualified person is also liable for an additional excise tax of 200% if the excess benefit is not repaid to the organization, along with an amount equivalent to what the organization would have lost for the time value of money. In addition, any
manager of an organization (officers, board members, trustees, etc.) who knowingly participates in an excess benefit transaction may be subject to a 10% tax on the excess benefit, up to $20,000, unless the participation was not willful and was due to reasonable cause.

**What steps are required to comply with the intermediate sanctions rules?**

Final regulations issued under Code § 4958 provide a safe harbor in the form of a rebuttable presumption of reasonableness where the following procedural requirements are met:

- An “authorized body” (e.g., board or a board appointed committee) of the institution, none of whom have a “conflict of interest” with respect to the proposed transaction or transfer, must approve the compensation before it is paid.
- The board or committee must obtain and rely on “appropriate data” as to comparability of the compensation prior to making its determination.
- The board or committee must “adequately document” the basis for its determination “concurrently” with the making of that determination. (The final intermediate sanctions rules prescribe specific requirements as to what must be documented and by when).

The final intermediate sanctions regulations establish a procedure which, if followed, creates “a rebuttable presumption” that compensation payable to a disqualified person (i.e. the person whose compensation or other financial arrangement is under discussion) is reasonable under the circumstances.

Though not required, it behooves a public charity to follow this procedure so as to gain the benefit of this presumption. Establishing a rebuttable presumption of reasonableness shifts the burden of proof with respect to the reasonableness of compensation from the tax-exempt organization to the IRS in the event that the compensation is renewed. In addition, to the extent that a member of the authorized body relies upon a reasoned, written opinion of counsel, in-house counsel, accountants with relevant tax expertise, or independent valuation experts, he or she will not be subject to the separate tax imposed upon an organization manager. Proposed changes to the rules governing the rebuttable presumption of reasonableness were not included in the final legislation.

**What changes to executive compensation can public charities expect under the Tax Cuts and Jobs Act?**

Section 13602 of the Tax Cuts and Jobs Act imposes a 21% excise tax on compensation in excess of $1,000,000 paid to insiders, which include any current or former employee who would have been one of the charity’s five highest paid employees for the tax year or in a prior tax year beginning after 2016.

Under the provision, a tax-exempt organization is liable for the excise tax on:

- Any remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year (compensation is paid when the rights to the compensation are no longer subject to a substantial risk of forfeiture), and
- Any excess parachute payment paid by a tax-exempt organization to a covered employee.

Notably, the excise tax applies as a result of an excess parachute payment, even if the employee’s remuneration does not exceed $1 million.

An excess parachute payment is a payment that exceeds the portion of the “base amount” (i.e., the amount by which the current net present value of the payments exceed three times the average annual compensation of the employee for the five tax years before the employee’s separation from employment). The tax on excess parachute payments is imposed only on highly compensated employees. These rules are effective commencing in 2018.

**How does the Tax Cuts and Jobs Act affect tax reporting on non-profit executive compensation?**

Most tax-exempt organizations are required to annually file Form 990, an informational tax return that provides an overview of the organization’s activities, governance and financial information. Schedule J of Form 990 is used to report compensation information for disqualified persons – certain officers, directors, individual trustees, key employees and highly compensated employees – as well as provide information on the organization’s compensation practices.

Part II of Schedule J requires a comprehensive disclosure of the various components of executive compensation, including base compensation, incentive compensation, retirement and deferred compensation, nontaxable...
benefits, and other reportable compensation. Since the reporting rules for ineligible nonqualified deferred compensation (often referred to as “golden handcuff” plans to provide significant retention incentives for senior executives) require disclosure for both the year in which funds are deferred and the year in which the right to payment is substantially vested, there is in essence double reporting of this information.

Column F of Schedule J Part II addresses this in part by providing for separate disclosure of compensation that has already been reported in Column B of Schedule J Part II of prior 990s. However, as the excise tax penalty of the Tax Cuts and Jobs Act focuses solely on the year amounts are paid, irrespective of whether the amounts are the result of a series of prior year deferrals that were subject to a risk of forfeiture, it raises question whether the significant amounts of previously disclosed compensation in Column F is relevant for executive compensation tax reporting.

Organizations which may be liable for excise taxes under the Tax Cuts and Jobs Act will have to reconcile this standing with their responses to Line 25a-25b of Form 990, which requests disclosure of excess benefit transactions. To date, these responses in the Form 990 have been governed by compliance with the intermediate sanctions rules. Organizations which report such excess benefit transactions must provide further detailed information on the nature of the excess benefit transaction under Form 990 Schedule L.

**How does the Tax Cuts and Jobs Act impact unrelated business taxable income paid by tax-exempts?**

The new law increases unrelated business taxable income (“UBTI”) by the amount of certain fringe benefit expenses for which a deduction is disallowed, effective for amounts paid or incurred after 2017. Thus, for example, a tax-exempt organization’s UBTI will be increased in the amount the organization pays or incurs for any qualified transportation fringe benefit (even if paid through an employee’s pre-tax salary reduction), as well as any on-premises athletic facility.

**Considerations for Next Steps**

Going forward the Boards of tax-exempt institutions (or the committees endowed with authority for executive compensation decisions) will need to carefully evaluate conditions for both current and deferred compensation that would cause their senior leadership to exceed the new compensation threshold for excise taxes. In some instances, this may require significant restructuring and planning of governing compensation philosophies, performance incentive plans and non-qualified deferred compensation arrangements. There will also need to assess the effect of the new tax rules on availing the safe harbor threshold for intermediate sanctions and accurate reporting on Form 990. Counsel should advise on both the process and requirements for these decisions.

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