CARLTON FIELDS

Excise Tax Problems? Retirement Compensation May Help

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Lowell J. Walters

All entities, including governmental entities,[1] are now potentially liable for overpaying higher-ranking employees. For-profit companies have been at risk for losing their tax deduction for excessive salaries, with publicly traded companies subject to a specific $1 million limit [2] and certain nonprofit organizations have been at risk for "intermediate sanctions."[3] Effective Jan. 1, 2018, the Tax Cuts and Jobs Act created an excise tax with newly enacted Internal Revenue Code Section 4960, to be imposed on tax-exempt organizations and governmental entities. At first glance, this section — titled "Tax on Excess Tax-Exempt Organization Executive Compensation" — appears to target the highest paid employees at universities, colleges and hospitals, but because of the amounts that count toward the threshold and the number of employees that can trigger the excise tax, many unsuspecting entities are at risk. Fortunately, there may be opportunities to avoid these excise taxes through planning with retirement plans.

Additional Penalties for Those That Ignore 4960?

While we expect the IRS to issue guidance clarifying the requirements of IRC Section 4960, it is important that entities intending to avoid the application of the excise tax take a proactive approach. The law is specifically effective right now and we expect the 2018 Forms 4720 — "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code" — and 990 — "Return of Organization Exempt From Income Tax" — and Schedule J — on which compensation information for certain employees must be provided — to be revised to account for this new law. If, as we suspect, entities will be required to self-report on this issue instead of being permitted to wait until the IRS notifies them and imposes the excise tax, a failure to comply and pay the excise tax voluntarily will probably trigger additional penalties and interest. This additional level of penalties is common with other aspects of the IRC that require self-reporting, including intermediate sanctions in which a 200 percent penalty applies on top of the initial 25 percent excise tax if the excess benefit transaction is not corrected timely,[4] and retirement plan "prohibited transaction" rules under which a 100 percent excise tax is imposed if the initial 15 percent excise tax is not paid timely.[5]

Amount and Employees at Risk

The excise tax is tied to the corporate income tax rate, currently set at 21 percent. It is not only assessable against tax-exempt and governmental employers if any of the five highest compensated employees of an organization exceed the $1 million threshold, but it can be triggered if any employee who has ever been one of the five highest compensated employees of that organization since 2017 exceeds the threshold. This subtlety increases the risk for organizations whose leadership tends to stay with the organization in different roles without a reduction in pay. In addition to the penalty applying to excessive ongoing compensation, it also applies to excess parachute payments,[6] which can be generally thought of as excessive severance pay.

Compensation Considered

Generally speaking, all compensation subject to income tax withholding is counted toward the threshold.[7] In general, retirement plan contributions and retirement plan distributions are not subject to the same withholding requirements.[8] However, amounts subject to IRC Section 457(f), commonly referred to as nonqualified plan amounts or ineligible deferred compensation, are included in compensation for the year in which the employee is vested with no substantial risk of forfeiture.[9] These arrangements commonly provide for vesting without a risk of forfeiture if the employee is still employed at a stated age and amounts can easily grow over time. This is probably the most likely area in which the excise tax might be triggered for an unsuspecting employer.

Fortunately, salary deferrals made to Roth accounts are not included in the threshold calculation, even though such amounts are subject to income tax withholding. Hospitals may get some relief since compensation paid to physicians for medical services are not included in the calculation.[10] If these organizations' highest paid administrators also provide medical services, they may exclude the compensation paid for providing those medical services from the calculation.[11]

Although clearer guidance would be welcome, since the excise tax focuses on compensation that is subject to income tax withholding, it appears that compensation exempt from income tax withholding is generally excluded, including amounts contributed toward medical insurance premiums.

In addition to ordinary compensation, excessive severance pay can also trigger the excise tax.[12] While the specifics are outside the scope of this article, organizations are at great risk if they provide severance arrangements with a value approaching three times an employee's standard annual compensation.[13]

How Retirement Plans Can Help

Since it appears that additions to and distributions from retirement plans intending to satisfy the requirements of IRC Sections 401(a), 403(b) and 457(b) — hereafter referred to as retirement plans — are not included in the calculation, "converting" taxable compensation into retirement plan contributions should alleviate the risk of triggering the excise tax or reduce the excise tax if it is triggered.

The most common way to convert taxable income to retirement plan contributions is through salary deferrals. This method is most likely to be agreeable to higher paid employees who tend to defer salary at higher rates. This is important because salary deferrals are required to be optional at the election of the employee.[14] To the extent employees at risk for triggering the excise tax are willing to defer more compensation, but applicable limits prevent this, organizations can address this problem multiple ways. A lesser known option that will help organizations with only a 401(k) plan or 403(b) plan is the establishment of a 457(b) plan to allow an additional set of salary deferrals for employees at risk for triggering the excise tax.[15] Additional deferrals may also be made to a nonqualified deferred compensation plan, discussed separately in the next section. More well known options, like offering incentives to nonhighly compensated employees, focus on alleviating deferral limits triggered by average contribution test requirements.

A less common, but equally effective way to convert taxable income into retirement plan contributions is to convert bonus or even ordinary compensation into mandatory employer contributions.[16] For example, if an employee might be entitled to a bonus, the arrangement could provide that the bonus amount will be made as a contribution into the applicable retirement plan. Similarly, the organization and the employee might negotiate for the employee to receive a "pay cut" of $10,000 in exchange for a $10,000 retirement plan contribution. If an organization is in a position to make additional retirement plan contributions to certain employees, but finds itself restricted due to the contribution limits of IRC Section 415, a solution might be to establish a second plan under a different IRC section.[17] For example, an organization with a profit sharing plan under IRC Section 401(a) can usually maximize its contributions under that arrangement and then contribute additional amounts to a 403(b) plan.[18]

The option to convert compensation to retirement plan contributions may be more available to governmental entities than nonprofit organizations since governmental entities are exempt from most nondiscrimination requirements that may trigger obligations toward rank-and-file employees if additional contributions are made to highly compensated employees. If nondiscrimination requirements restrict the ability to make employer contributions to the group of employees at risk for triggering the excise tax, the organization could consider a more drastic restructuring of its benefit and compensation arrangements so employer contributions are made to all employees without increasing total costs.

Since amounts paid toward medical benefits also appear to be excluded from the calculation, that might be another area where converting compensation to benefits may be helpful. However, both governmental entities and tax-exempt organizations are generally subject to nondiscrimination rules that would limit the effectiveness of this type of planning.

Similarly, "converting" severance pay to retirement plan contributions may avoid the excise tax on excess parachute payments. Retirement plans are technically restricted from receiving severance pay,[19] which severely restricts the ability of employees to make salary deferrals from severance pay. However, carefully structured severance and employment agreements may provide for retirement plan contributions that coincide with a termination of employment. Entities sponsoring 403(b) plans may have an amazing solution in their retirement plan, as 403(b) plans can accept employer contributions for up to five years following a termination of employment — although the nondiscrimination rules applicable to nongovernmental entities will make this less useful.

How Nonqualified Plans Can Help.

Nonqualified plans generally refer to retirement benefits that are subject to IRC Sections 457(f) or 409A. Nonqualified plan benefits normally delay taxation of ordinary compensation until paid or no longer subject to a substantial risk of forfeiture. As previously noted, this is the same time at which amounts are considered for excise tax purposes. An employer and employee must agree in advance on the amounts to be paid into a nonqualified plan; the key is to direct compensation into these arrangements before it is made available to the employee, but there is a lot of flexibility in their design. For example, it can be agreed that a set amount of future compensation will accrue in the nonqualified plan for the benefit of the employee or it can be agreed that if the $1 million limit is hit during the year, all future compensation will be redirected into the nonqualified plan to be paid out later. Either of these options should work to avoid the excise tax for that year.

Of course, placing amounts in a nonqualified plan means that the employee is at risk for never receiving those funds. These plans can provide certain assurances, such as guaranteeing payment if the employee becomes disabled or dies before satisfying the applicable requirements, however, most employers view this risk as an additional incentive for the employee’s continued employment. As a result, unless this option is negotiated in advance, it would not be unfair for an employee to want to receive additional amounts to offset the risk. For example, if an employer wants to place $20,000 into a nonqualified plan, the employee might argue that it is more fair to offset $20,000 of guaranteed compensation with $30,000 of at-risk nonqualified contributions. Obviously, many considerations could factor into this negotiation, including how much employers will save by avoiding the excise tax and whether deferrals will help employees reduce their taxes.

Risks of Forfeiture

Nonqualified plans only help delay or avoid excise taxes to the extent amounts are subject to a significant risk of forfeiture.[20] The most common risks of forfeiture provide for an employee to forfeit amounts if they are not employed on a particular date — which is often tied to the end of an employment contract or the date the employee reaches a certain age. Another risk of forfeiture that has been approved is the loss of benefits upon a voluntary termination of employment.[21] Formerly, it was common to use a noncompete agreement to provide for a risk of forfeiture beyond termination of employment,[22] but this is currently out of favor due to guidance indicating that risks of forfeiture should require future services, as opposed to the abstention from providing future services.[23] To the extent it is expected that executives will help successors ease into their roles, providing for executives to forfeit benefits if they fail to provide consulting services after employment ends in their current position has been used to create a substantial risk of forfeiture.[24]

Organizations may be creative with their risks of forfeiture. As long as the risk is “substantial” and relates to the purpose of the benefit,[25] it is likely to be honored as long as it does not run afoul of existing guidance. If an entity can find a creative structure that would create a risk of forfeiture until years in which annual compensation falls below $1 million, that would likely be an excellent solution to avoiding the excise tax under IRC Section 4960.

Other Alternatives

By focusing on solutions involving retirement plans and nonqualified plans, we do not mean to imply a lack of other options. For example, the use of pooled income funds, or PIFs,[26] might be an attractive option. Generally, a PIF is a fund maintained by a public charity that provides lifetime payments based on the income generated by the PIF, with the remainder going to the public charity after the income beneficiaries have passed.[27] Under this scenario, the tax-exempt employer donates the funds that would trigger the excise tax to the PIF, designating the employees — and perhaps their spouses and children — as the PIF income beneficiaries. The PIF distributes its income to the income beneficiaries until their death, at which time the principal reverts back to the public charity that sponsors the PIF — which if the tax-exempt entity is a public charity, could be the tax-exempt entity itself. Two IRS private letter rulings imply that an organization that is eligible to receive the principal, also known as the “remainder interest," of the PIF — which generally includes nonprofit hospitals, educational organizations and certain governmental entities[28] — can also be the donor.[29] Under this approach, the organization at risk for the 21 percent excise tax may be able to avoid the tax by negotiating a reduced compensation for an employee in exchange for an agreement to place an amount in a PIF sponsored by the employer that will generate an annual income stream for the beneficiary employee. Upon death, the principal returns to the employer for its unrestricted use. Since PIFs distribute nonwage income,[30] they should avoid inclusion in the excise tax calculation, but even if rules change to require the inclusion of these payments, they should be a much lower amount than what would ordinarily be paid to the employee since smaller amounts are paid to the employee over a longer period of time. Like the other options outlined in this article, additional analysis based on an employer's specific circumstances and the law at the time of the assessment would be needed.

Conclusion

Tax-exempt and governmental entities are subject to a 21 percent excise tax on excess compensation and excess severance paid to employees who are or were one of the top five highest paid individuals with the organization. Converting compensation to retirement plan contributions can help reduce or avoid these excise taxes, as might the use of other alternatives like pooled income funds. But it must be done carefully and with the understanding that future IRS guidance may change the landscape.

[1] See IRC § 4960(c)(1)(C), cross-referencing IRC § 115(1) to specifically include entities with "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia."

[2] See IRC § 162(m).

[3] See IRC § 4958.

[4] See Treas. Reg. § 53.4958-1(c)(2).

[5] See IRC § 49875(a), (b).

[6] See IRC § 4960(a)(2).

[7] See IRC § 4960(c)(3)(A) ("The term 'remuneration' means wages (as defined in section 3401(a))…")

[8] See IRC §§ 83(e)(2) (excluding retirement plan contributions to arrangements subject to IRC §§ 401(a) or 403(b) from withholding); 3401(a)(12)(A) (excluding retirement plan distributions from the definition of "wages" under IRC § 3401).

[9] See IRC § 4960(c)(3)(A).

[10] See IRC § 4960(c)(3)(B).

[11] See Ibid.

[12] See IRC §§ 4960(a)(2), (c)(5).

[13] See IRC § 4960(c)(5)(D), cross referencing IRC § 280G.

[14] See e.g. Treas. Reg § 1.401(k)-1 (e)(2)(i).

[15] See IRC § 457(c); Treas. Reg. § 1.457-4.

[16] This option has the added benefit of potentially excluding the contribution amount from employment taxes.

[17] See e.g. Treas. Reg. § 1.415(f)-1.

[18] See Ibid.

[19] See Treas. Reg. § 1.415(c)-2(e)(3).

[20] See IRC §457(f)(1)(A).

[21] See PLR 9815039.

[22] See Treas. Reg. § 1.83-3(c)(2), (4).

[23] See Treas. Reg. § 1.409A-1(d); IRS Not. 2007-62.

[24] See Treas. Reg. § 1.83-3(c)(2).

[25] See Treas. Reg. § 1.83-3(c)(1).

[26] See IRC § 642(c).

[27] See Ibid.

[28] See IRC § 642(c)(5)(A).

[29] See PLRs 8720065, 8650034.

[30] See Treas. Reg. § 1.642(c)-5(a)(2).