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White paper

Executive benefit choices in tax-exempt organizations

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Key highlights

- Organizations subject to the 21% tax under Code section 4960
- Private inurement, private benefit and excess benefit transactions
- Remuneration for executives

The Tax Cuts and Jobs Act of 2017 (TCJA) has left some tax-exempt organization executives scratching their heads over how to recruit, retain and reward key employees. Section 13602 of TCJA added new Internal Revenue Code (Code) section 4960 which imposes a 21% tax on compensation in excess of $1 million paid to a covered employee in a taxable year. Tax-exempt organizations already are at a disadvantage in attracting top talent when competing with for-profit companies due to the excess benefit rules, state laws that may prevent making loans to officers, and the optics of remunerating employees commensurate with employees in the private sector.

This paper will analyze some of the choices organizations have with respect to providing basic and supplemental benefits to key employees.

Organizations subject to the 21% tax under Code section 4960

Tax-exempt organizations that are subject to paying tax on compensation in excess of $1 million paid to a covered employee include:

- Organizations exempt from tax under Code section 501(c) and 501(d), including credit unions, religious and charitable organizations, and labor, agricultural and horticultural organizations, among many others;
- Farmers' cooperatives described in Code section 521(b)(1);
- A political organization under Code section 527(e)(1). This includes a party, committee, or other organization operated primarily to accept contributions or make expenditures for the nomination, election or appointment of an individual to public office; and
- Organizations that have income excluded from tax under Code section 115(1), including organizations that receive income 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. Organizations that are considered "quasi-

governmental" fall under this Code section and are, therefore, subject to the 21% excise tax.

Private inurement, private benefit and excess benefit transactions

Certain organizations[1] can lose their tax-exempt status for violating the doctrine of private inurement; that is, the organization's net earnings inure to the benefit of any private shareholder or individual.[2] In general, private inurement may be found where an insider with financial control over an organization uses its assets for personal gain.[3] For example, inurement will result where an insider is overcompensated by a charity for services.[4] In determining whether an employee's compensation violates the prohibition on private inurement is a facts and circumstances analysis. The IRS considers (1) whether the compensation package is simply a way to distribute profits to insiders; (2) whether the compensation is the result of arm's length bargaining; and (3) whether the compensation is reasonable.[5] Furthermore, "all persons performing services for an organization have a personal and private interest and therefore possess the requisite relationship necessary to find private benefit or inurement."[6]

Likewise, the private benefit doctrine requires a charitable organization to establish that it is not "organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests."[7] In many cases, private inurement and private benefit are inextricably linked and discussed together.

In 1996, Congress created Code section 4958 to provide the IRS with sanctions that could be imposed on individuals who provide or accept private inurement — "excess benefits" as the statute says — without having to revoke the organization's tax-exempt status.[8] These sanctions apply to organizations that are described in Code sections 501(c)(3) and (4). If a "disqualified person" benefits from an excess benefit transaction, the disqualified person will be assessed a 25% tax on the excess benefit amount.[9] In addition, a 10% tax (up to a maximum of $20,000) would also be payable by the organization manager who participated in the excess benefit transaction.[10] The law provides a method for correcting the transaction, and failure to correct can lead to a tax equal to 200% of the excess benefit.[11]

An excess benefit transaction is one in which an economic benefit is provided to or for the use of a disqualified person if the value of the benefit exceeds the value of the consideration (including the performance of services) received for providing such benefit.[12] The payment of unreasonable compensation to a disqualified person is an excess benefit transaction.[13] Reasonable compensation is "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances."[14] The legislative history makes clear that employees of exempt organizations should not necessarily receive lower compensation than their peers in taxable organizations.[15]

Reasonable compensation is determined based on all the facts and circumstances and includes these common items (among others):

- Payments to welfare benefit plans (e.g., medical, dental, life insurance, severance pay and disability benefits);
- Expense allowances under a non-accountable plan; and
- Economic benefit of a below-market loan.[16] (More on this later)

A disqualified person is any person in a position (at any time during the five-year period ending on the date of the transaction) to exercise substantial influence over the affairs of the organization; a family member of a disqualified person; and a 35% controlled entity of a disqualified person or member of the family.[17] This includes (1) voting members of the governing body; (2) officers with ultimate responsibility for implementing the decisions of the governing body (e.g., CEO, president, COO); and (3) officers with ultimate responsibility for managing the finances of the organization (e.g., CFO and treasurer).[18]

Suffice it to say that the IRS has several tools with which to keep charitable organizations operating for the public good and without providing excess benefits to employees and other individuals who are affiliated with the organization. With this in mind, let's see what organizations can do to avoid losing their tax-exempt status or risk having an excise tax levied on an executive, while still providing sufficient remuneration to recruit, reward and retain those key executives.

Remuneration for key executives

Besides salary, bonus and payments for welfare benefit plans discussed above, what other perks or benefits can employers offer to recruit, retain and reward its most valuable employees?

Qualified plans

Some qualified plans provide employees with the ability to defer compensation on a pre-tax basis, and earnings accrue free of tax. Amounts, both employee deferrals and contributions made by the organization, are taxed only when distributed. The following list is not exhaustive. Tax-exempt employers can also sponsor IRA-based plans (e.g., SEP and SIMPLE).[19]

Some qualified plan options for tax-exempt employers

	401(a)[20]	401(k)[21]	403(b)	457(b)[22]
State/local government and agencies	✓			✓
Public education employers	✓		✓	✓
Churches	✓	✓	✓	
Qualified church-controlled organization (QCCO)[23]	✓	✓	✓	
For the following organizations, the 457(b) option is "nonqualified;" i.e., unfunded and only available to a select group of management and highly-compensated employees (the "top-hat" group).				
501(c)(3) organizations (not including churches and QCCOs)	✓	✓	✓	(top hat)
Any other non-governmental tax-exempt organization (e.g., credit unions)	✓	✓		(top hat)

If an employer sponsors both a 401(k) and a 403(b) that permit elective employee deferrals, the limit on employee deferrals ($18,500 in 2018) is applied in the aggregate. If an organization has a 457(b) eligible deferred compensation plan that permits elective employee deferrals ($18,500 in 2018), those deferrals are not aggregated with a 401(k) or 403(b) plan so that an employee could potentially defer up to $37,000 in 2018 (not including any catch-up contributions that the employee may be eligible to defer).

A non-governmental tax-exempt organization can offer a 457(b) plan only to a select group of management or highly compensated employees — the top-hat group. Because the contribution limit to a 457(b) plan is not aggregated with any other plan, offering this to key employees as a tool to recruit, reward and retain them is a good first step. The total contribution that can be made to a 457(b) plan in 2018 is $18,500. Those contributions can come from the employee, the employer or a combination of the two. This is in addition to any amount deferred by the employee or contributed by the employer to any other qualified plan listed in the chart above.

Case study

A non-profit, tax-exempt hospital has a 401(k) plan and a 457(b) top-hat plan. Sam Onella is the Chief Operating Officer and earns $275,000 per year. He would like to retire in 10 years. He contributes the maximum to the 401(k) plan and to the 457(b) plan, and the hospital contributes a match of 50% of the first 6% of compensation deferred to the 401(k) plan. Assume that the contribution to each plan increases by 3% per year.[24] Both plans earn 6% per year.

Year	401(k) with match annual contribution	401(k) with match balance		457(b) plan annual contribution	457(b) plan balance	Total balance (1-10) and payout (11-20)
1	$18,995	$20,135		$18,500	$19,610	$39,745
5	$21,379	$120,104		$20,822	$116,975	$237,079
10	$24,784	$299,961		$24,138	$292,144	$592,105
Annual distribution years 11-20						
	($40,755)			($39,693)		($80,448)
20 year total	($815,100)			($793,860)		($1,608,960)

What else can Sam's employer do to help keep Sam and to better prepare him for retirement? Let's look at the other options from which tax-exempt employers may choose.

Nonqualified plans

All nonqualified pension and welfare benefit plans can be offered only to a select group of management or highly-compensated employees (the "top-hat" group). To avoid current taxation of benefits, pension benefit plans must also be unfunded to avoid having the participation, vesting, funding, reporting and disclosure and fiduciary duties of Title I of ERISA apply to the plan.[25] In this context, "unfunded" means that the employees cannot have any interest in assets of the employer, nor can they have a security interest in their benefits other than the employer's promise to pay. If the employer becomes insolvent or bankrupt, employees who participate in these plans will be general, unsecured creditors with respect to the benefits from nonqualified pension plans.

These plans can be used as a supplement to all the qualified plans discussed above without having to coordinate contribution or benefit limits.

Nonqualified plan options for key employees of tax exempt employers

	Life insurance-based plans				
	Executive (162) bonus arrangement	**Economic benefit (endorsement) split dollar**	**Loan regime split dollar life insurance**	**457(f) ineligible deferred compensation**	**457(b) eligible deferred compensation (top-hat)**
State/local governments and agencies	✓	✓	✓	✓	
Public education employers	✓	✓	✓	✓	
Churches	✓	✓	✓		
QCCOs	✓	✓	✓		
501(c)(3) organizations (not including churches and QCCOs)	✓	✓	✓	✓	✓
Any other non-governmental tax-exempt organization	✓	✓	✓	✓	✓

Decision chart

How does an organization decide which type of benefit will be appropriate and appreciated? First, the organization must determine if there are any statutes, regulations or self-imposed restrictions (e.g., in its bylaws) that would prevent it from offering a particular type of benefit. Then, review the primary advantages and disadvantages of each design.

		Life insurance solutions				
		Executive bonus	Economic benefit (endorsement) split dollar	Loan regime split dollar	Ineligible 457(f) plan	Eligible 457(b) plan
EMPLOYER CONSIDERATIONS						
May cause organization to owe 21% excise tax		Y	Y	Y	Y	Y
Must be accounted for as a liability on organization's balance sheet		N	N	N	Y	Y
Organization may recover cost of benefit		N	Y*	Y*	N	N
EMPLOYEE CONSIDERATIONS						
Retirement payments can be made in installments (taxable when paid)		Y	N**	Y	N	Y
Tax-free post-retirement income***		Y	N	Y	N	N
Benefits are subject to the claims of the employer's creditors		N	Y	N	Y	Y
Employee may have to be underwritten by insurance company		Y	Y	Y	N	N

*Provided the agreements are properly structured, the organization may recoup its costs either through a withdrawal or loan from cash values or the tax-free death benefit.
**If the policy is transferred to the insured employee, the employee will owe tax on the cash surrender value upon the transfer. Future withdrawals/loans can be taken in installments.
***Provided the life insurance contract is not a modified endowment contract (MEC)

Executive bonus arrangement
Often referred to as a "162 bonus" plan, in this type of arrangement, the employer pays the premiums on a life insurance policy that is owned by the executive and all the death benefit is payable to the executive's personal beneficiary. The executive pays tax on the bonus (the amount of the premium). The employer and executive may also have an agreement that the executive will repay some portion of the bonuses if the executive terminates employment prior to a specified date.

This arrangement is suitable for executives whose compensation will not exceed $1 million and for whom the organization would like to reward with a tax-deferred savings vehicle along with personal life insurance coverage.

Economic benefit (endorsement) split dollar life insurance
In an economic benefit split dollar arrangement, the employer owns a life insurance policy on a key employee's life and splits the death benefit between the employer and the employee's personal beneficiaries. The executive pays the "cost" of renting the annual death benefit payable to his or her personal beneficiary. Sometimes, the executive will be the legal owner the policy but the employer "owns" all the cash value and a portion of the death benefit. The executive will pay tax on the economic benefit (the death benefit to which the personal beneficiaries are entitled). If the employer assigns cash value to the executive, this will be a taxable event for the executive and may cause the arrangement to be considered deferred compensation under Code sections 409A and possibly 457(f).

This type of plan is best suited to an organization that would like to protect itself against the premature death of a key employee and agrees to provide a benefit to the employee for agreeing to be insured.

Loan regime split dollar life insurance arrangement
In a loan regime split dollar arrangement, the executive owns a life insurance policy on his or her life. The employer pays the premiums which are below-market loans to the executive. The executive pays tax on the foregone interest each year, based on the Applicable Federal Rate (AFR). Eventually, the loan needs to be repaid to the employer. When the executive retires, he or she can withdraw or borrow against the cash value of the policy which (under current law) are tax-free, if structured properly.

Provided an organization is permitted to make loans to key employees, this arrangement works well with executives whose annual remuneration makes them a covered employee and triggers the 21% tax. It also has the advantage of not creating a liability for the organization and when properly designed, provides the organization with repayment of the loan through cash values or death benefits.

Sometimes an employer will provide such a plan to a group of executives to supplement their group term life insurance while employed.

Ineligible deferred compensation arrangement under Code section 457(f)
There are both pros and cons to a 457(f) arrangement. It offers a great deal of flexibility to the employer. It can be a defined contribution or defined benefit design and there is no limit to what the employer can credit to an executive's account (provided the employer doesn't run afoul of the reasonable compensation rules). It also provides the employer with a golden handcuff; if the employee terminates employment prior to a specified date, he/she forfeits the benefit.

On the other hand, the plan is a liability on the organization's balance sheet until paid. The executive will have taxable income when an amount vests (whether distributed or not), which could trigger the 21% excise tax discussed above.

Eligible deferred compensation under Code section 457(b)
Unlike the 457(f) plan, an eligible deferred compensation plan restricts the amount that can be credited to a participant's account each year ($18,500 in 2018). Also, unlike a 457(f) plan, participants can elect to receive post-termination distributions in installment payments which are taxed when paid or made available to the participant.

Conclusion

With the passage of TCJA, it has become more expensive for tax-exempt organizations to compete with for-profit businesses for key employees. Hospitals and higher education will be particularly hard-hit. According to Gregory B. Lam, managing partner of Copilevits & Canter's Kansas City office, non-profit hospitals will respond to the 21% excise tax by either paying less to top executives and risk losing them to for-profit competitors, or they will continue to pay top dollar and incorporate the excise tax into their budgets....or will do a combination so as to create a balance between the two.[26] It almost goes without saying that any organization or business should first consider a qualified retirement plan before establishing a nonqualified plan for key executives. Once that is established, the organization has several options if the desire is to provide key executives with a supplemental retirement plan. Chief among those is the 457(b) plan that offers post-retirement installment payments, albeit the contribution limits are relatively low. The 457(f) plan has some inherent weaknesses in that amounts are taxed immediately upon becoming vested, but creative planning may help alleviate the impact of a huge tax bill for both the executive and the employer.

Finally, the executive bonus plan, endorsement split dollar and loan regime split dollar, are all life insurance based arrangements. If an executive's compensation is already near or over the $1 million mark, an executive bonus plan is probably not going to be a great choice. Endorsement split dollar arrangements can sometimes be "rolled-out" to an executive, but care must be taken not to run afoul of other deferred compensation rules. Loan regime split dollar arrangements are becoming popular; however, they will generally not work for older (and possibly less healthy) executives who are near retirement age.

There is no one "best" choice; but, with proper analysis and advice from competent counsel, there is a plan that will work for most tax-exempt employers and their key employees.

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[1] The organizations subject to the private inurement doctrine are those organized under Code secs. 501(c)(3), (c)(4), (c)(9), (c)(11), (c)(13) and (c)(19).

[2] Code Sec. 501(c)(3).

[3] Mark C. Westenberger, *A Path to "Inure" Peace: Consolidating the Perplexities of the Private Inurement and Private Benefit Doctrines*, 92 Wash. U.L. Rev. 227, 235 (2014), citing IRS Gen. Couns. Mem. 38459 (July 31, 1980).

[4] Id.

[5] IRS Gen. Couns. Mem. 39670 (October 14, 1987).

[6] Id.

[7] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[8] Westenberger, Supra at 237.

[9] Code sec. 4958.

[10] Code sec. 4958(a(2).

[11] Code sec. 4958(b).

[12] Code sec. 4958(c)(1)(A).

[13] H.R. Rep. No. 104-506 at 56.

[14] Treas. Reg. sec. 53-4958-4(b)(1)(ii)(A).

[15] H.R.Rep. No. 104-506 at 56 n.5.

[16] Treas. Reg. sec. 53.4958-4(b)(1)(ii)(b)(3).

[17] Code sec. 4958(f)(1) and see also IRS Instructions for Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.*

[18] Treas. Reg. sec. 53.4958-3(c).

[19] Simplified Employee Pension and Savings Incentive Match Plan for Employees. See IRS Pub. 4484 (Rev. 2-2015) for details on qualified retirement plans available to tax-exempt employers.

[20] Defined contribution (profit-sharing, money purchase), defined benefit pensions and cash balance plans.

[21] Code sec. 401(k) is shown separately from Code sec. 401(a) because government employers cannot offer elective employee deferrals under a 401(a) plan. Code section 401(k)(4)(B).

[22] Although not technically a "qualified plan," it has many of the same features as a plan under Code sec. 401(a) and 403(b) when it covers government employees (including schools).

[23] A QCCO is any church-controlled Code sec. 501(c)(3) organization, that (a) does not generally offer goods, services, or facilities for sale to the general public; and (b) receives less than 25% of its financial support from government grants or receipts from goods and services in related activities or business. Cobbt.org., retrieved 6/29/2018. Example: Seminaries, religious retreat centers, church pension boards, church youth groups or burial societies will usually be a QCCO. Usually, a church-controlled hospital will not be a QCCO. See IRS Form 8274.

[24] The employee deferral limit is increased in $500 increments for both the 401(k) and the overall limit in the 457(b) plan. The limit on the total contribution to the 401(k) plan is $55,000 and is increased in $1,000 increments.

[25] ERISA secs. 201(2), 301(a)(3) and 401(a)(1). The fiduciary duties apply to welfare benefit plans (e.g., endorsement split dollar, executive bonus), but they do not apply to pension benefit plans (e.g., deferred compensation plans) under ERISA.

[26] Steven Porter, *Tax Reform Redefines "Reasonable" Compensation for Nonprofit Execs,* HealthLeaders, December 20, 2017.

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