TRISCEND[NP]

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IMPLICATIONS OF THE TAX ACT FOR CREDIT UNIONS AND EXECUTIVES

Important Considerations

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The Power of a New Perspective

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Introduction

In the recently-enacted Pub. L. 115-97, also known as the "Tax Cuts and Jobs Act" (the Act), many tax-exempt (non-profit) organizations - including credit unions - are now subject to a substantial new tax placing limits on their ability to recruit, compensate and retain senior leadership talent. While penalizing employers for providing certain levels of otherwise reasonable compensation is not a new concept for publicly-traded companies, it is unprecedented in non-profit organizations and will require some adjustment to existing compensation and retention strategies.

Effective December 31, 2018, the IRS issued Interim Guidance for compliance with § 4960. Until proposed regulations are published, the further guidance upon which will be prospective only, the IRS provides that taxpayers "may base their positions upon a good faith, reasonable interpretation of the statute." Positions inconsistent with the interim guidance may be determined to be in good faith based on the facts, circumstances and consistency of the taxpayer's position; certain positions were also identified as being inconsistent with the statute. The interim guidance also provides the payment of an excise tax under § 4960 does not automatically result in unreasonable or excessive compensation triggering other excise taxes potentially applicable to non-profit organizations.

Below, we review the publicly held company history for context and then consider the Act's affect on non-profit organizations.

Public Company Background

For many years, publicly held companies have been limited in their ability to deduct compensation for their chief executive officer and the four other most highly compensated executives.[1] This limit is imposed by §162(m) of the Internal Revenue Code (IRC) which states:

> *In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000.*

By denying the tax deduction, the publicly held company is penalized to the extent of the excess compensation multiplied by the corporation's tax rate. Beginning in 2018, the Act dropped the corporate tax rate from 35% to 21%, reducing the §162(m) penalty to 21% of compensation more than $1 million.

Excise Tax[2]

While structured differently, the compensation practices of non-profit organizations have come under scrutiny from the government as well as the public. Executives of non-profit organizations have been increasingly perceived by some critics-particularly in the for-profit sector as failing to embrace their organization's stated purpose, too highly paid and should have their compensation and benefits limited as much as publicly traded companies in a manner that goes beyond the current reasonable compensation tests and intermediate sanctions.

Even though credit unions, non-profit hospitals and most universities have a very strong political support base, there have still been some in Congress that have raised concerns about the compensation of certain high-profile executives in the non-profit sector. Although there has been no significant legislation introduced to do so, there have even been a small number that have raised the

[1] The Act changed covered employees for public companies to the principal executive officer, principal financial officer and the three other most highly compensated executives.
[2] Triscend does not provide tax, legal or accounting advice. Consult with your independent adviser on these matters.

possibility of removing the tax exemption for some types of non-profit organizations based upon these perceptions. This type of legislative recommendation is often fostered by their for-profit competitors, but it is still a matter of concern. Numerous other methods have been suggested by those concerned with compensation at non-profit entities, including possibly limiting executive compensation to that of the president of the United States or the applicable state governor.

The Act recognizes that concern but takes a considerably different approach, imposing a §162(m)-type penalty on the non-profit employer. Since non-profit employers do not use deductions, the new IRC §4960 imposes an excise tax on compensation (as defined by §3401(a)) of more than $1 million for certain employees. The excise tax rate is the corporate tax rate then in effect, which under the Act is 21% for tax years beginning in 2018. The non-profit employer, not the employee, pays the tax.

> *There is hereby imposed a tax equal to the product of the [corporate tax rate] and . . . so much of the remuneration paid . . . by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000 . . . The employer shall be liable for the tax imposed...*

The §4960 excise tax applies to the non-profit organization's five highest compensated "covered" employees (or former employees) for the year, plus anyone who was a covered employee for any preceding year (2017 or later).[3] In addition to the excise tax on compensation over $1 million, the same excise tax would apply to parachute payments paid to covered employees that exceed three times annualized compensation for the five years prior to a change of control. See below for examples of how the calculations of tax would work.

1. **Excise tax on excess compensation.** For remuneration that exceeds $1 million paid to a covered employee, the employer is penalized in the form of a 21% excise tax.

	Sample Executive A
Amount of Remuneration[4]	$2,500,000
Remuneration over $1 million	$1,500,000
Excise Tax	*$315,000*

2. **Excise tax on excess parachute payments.** §4960 also provides for an excise tax on what are deemed to be "excess" parachute payments. According to the Act, these payments apply to "covered employees" meeting the definition of highly compensated.[5] Given the consolidation of credit unions, this excise tax could represent another unexpected cost directly affecting members. See below for a sample executives in two very similar scenarios with drastically different results.

	Sample Executive A	Sample Executive B
Base Amount	$250,000	$250,000
Parachute Payment	$750,000	$749,999
"Excess" Parachute Payment	$500,000	$0
Excise Tax	*$105,000*	*$0*

[3] The Act excludes compensation paid to physicians and nurses for rendering medical services. Payments to these professionals for administrative services are included, however.
[4] In a given year from all sources including deferred compensation payments.
[5] The Act also imposes the excise tax on parachute payments, which generally arise if the employer pays severance greater than three times the individual's 5-year annualized compensation for the period immediately prior to the change in control. This part of the excise tax only applies if the individual qualifies as a highly-compensated individual ($120,000 in 2017 and 2018).

This example illustrates the importance of the credit union maintaining a clear understanding of its agreement to provide severance benefits and the resulting impact. As the above example shows, the cost of exceeding the three times threshold can have a dramatically adverse effect on the economics of the parachute payment for the non-profit employer.

Even though a covered employee's aggregate annual salary and incentive payments may be less than $1 million, it is essential to recognize this change in the tax law means the existence of any deferred compensation (or similar) arrangement increases the probability of incurring the excise tax. This is the case because "remuneration" includes deferred compensation and similar arrangements, not as it accrues each year, but in a lump sum in the year it vests (i.e., is no longer subject to a "substantial risk of forfeiture"). Under many plans, deferred compensation accrues over 10 or more years so the vested amounts can represent many multiples of current salary and incentive compensation. Nevertheless, the full amount of the vested deferred payment is added to current compensation, significantly increasing the likelihood the total for a given year will exceed $1 million, resulting in the 21% excise tax on the excess.

Timing of Remuneration

The "taxable year" of the payment of remuneration will be determined in accordance with the calendar year ending with or within the organization's taxable year, not the fiscal year of the organization or related organization itself. This guidance aligns the calculation of remuneration with the reporting of compensation on the W-2 and Form 990. Further clarification on the timing of remuneration was provided as follows:

- Generally, any amounts vested in one taxable year will be deemed as "paid" in that taxable year even if the payments are not constructively made during the year.
- Further, all amounts vested before the effective date of § 4960 will be treated as "paid" before the effective date and therefore not included as remuneration under § 4960. However, any earnings accruing after the effective date on previously vested amounts will be subject to § 4960.

Payments that are subject to a substantial risk of forfeiture (as defined under the proposed 457(f) regulations) are excludable from remuneration.

Reporting

In addition, to the extent an arrangement results in compensation over $1,000,000 in any given year, the excise tax is to be reported (and calculated) on Form 4720 and is due in concert with chapter 42 taxes, the 15th day of the 5th month after the end of the taxpayer's year. While excise taxes may be prepaid in the year of the separation of employment, or any tax year prior to the payment, taxpayers are not subject to quarterly payments of estimated taxes under Section 6655.

Form 4720 provides for a new schedule, Schedule N, whereby the taxpayer will record the name of the covered employee, as well as the amount of excess remuneration (remuneration over $1 million) and the excise tax amount. Form 4720 is available online at irs.gov.

Notable Exemptions

Certain governmental entities (such as state colleges and universities) that are not recognized as exempt under §501(a) and that do not exclude any income from gross income under §115(1) are not considered "applicable" tax-exempt organizations for the purposes of §4960.[6]

Implications for Individual Executives

The impact of the new §4960 is clear and straightforward as to the non-profit employer. However, even though the impact on employers is spelled out clearly through the excise tax, the effect on individual executives could be quite significant as well.

In addition to the excise tax on non-profit employers, the Act added (6) to §164(b) placing limits on the ability of individuals to deduct state and local taxes (SALT), including income, sales, and property taxes. While the limitation is offset somewhat by an escalation in the standard deduction, this increase will be of little comfort to senior executives with high incomes. Even with this offset, experts predict a net increase in tax revenue of over $400 billion by limiting these deductions.

Cumulatively, the results of the Act could affect senior executives on several levels.

1. The increase in employer's tax expense (§4960) to provide the same benefit could create downward pressure on compensation and benefits in general.

   We are already starting to see discussion around employers either reducing or changing the compensation structures of highly compensated executives as a way to avoid or minimize the increased cost of the excise tax. These changes will be of particular concern for executives without significant negotiating leverage.

   Alternatively, non-profit employers can modify incentive and retention plans to pay out more frequently and keep total compensation under the threshold. While this can benefit the employer due to the potential avoidance of the excise tax, this type of change would eliminate much, if not all, of the retention value associated with deferred plans. Also, executives could come out on the short end by losing the benefit of tax deferral.

2. The elimination of the federal deduction for state and local taxes (§164 (b)(6)) will increase the taxes paid on any remuneration, including salary, incentive, and deferred compensation.

   Executives, like other employees, are accustomed to deducting state income tax from their income for federal income tax purposes. Consider this highly-simplified[7] example of an executive in a high-tax state like California, assuming the executive is in the highest marginal state income tax rate of 13.3% and the highest marginal federal income tax rate of 37%.

   a. Deduction allowed (pre-2018)

	Sample Executive A
Total Income	$1,000,000
State Tax Paid (13.3%)	$133,000
Adjusted Income (Federal)	$867,000
Federal Income Tax (37%)	$320,790
After-Tax Income	$546,210

[6] This exclusion may have been an oversight and subject to correction.
[7] This example is simplified, ignores deductions and for is illustration purposes only. The fact and circumstances of individual executives will determine the ultimate impact of the Act.

Effective Tax Rate	*45.38%*

b. Deduction eliminated (2018 onward)

	Sample Executive A
Total Income	$1,000,000
State Tax Paid (13.3%)	$133,000
Adjusted Income (Federal)	$1,000,000
Federal Income Tax (37%)	$370,000
After-Tax Income	$497,000
Effective Tax Rate	*50.30%*

Losing the ability to deduct SALT from the federal income tax calculation results in a roughly 37% increase in the effective "cost" of state income taxes and a 10.84% increase in overall effective tax rate.

Quantify the Impact

To summarize, certain dollars allocated to salary and compensatory benefits (including deferred compensation and excess parachute payments) could be 21% more expensive going forward. This increase in tax expense should be factored into the decision-making processe as alternatives for delivering executive benefits are considered. While there are multiple ways to deal with this potential expense, many options may result in a conscious trade-off between avoiding or paying the excise tax and the ability to retain key executives.

Alternatively, there are plan options which are not defined as remuneration in §3401(a) in the context of the new §4960. In addition to allowing tax-exempt entities to address the excise tax, certain options also provide for more favorable accounting treatment as well as capital preservation, growth, and recovery. All of these matters are of keen interest to non-profit organizations as they execute on their mission.

Potential Alternatives

Non-profit employers seeking an effective strategy to address the excise tax while achieving the sometimes conflicting goals of key executive retention and capital preservation and growth will have to become well versed in the available options. Each option has its advantages and disadvantages, and the ultimate decision on plan type should be based on the facts and circumstances of the employer and participating executive.

Restructure Existing Deferred Compensation Plans. Altering the vesting/payout timing for deferred compensation plans currently in place could keep the annual amount of total compensation to the executive under the $1 million threshold by breaking up what could have been a significant lump sum payment into smaller payments every two to three years. Changing the vesting schedule could require the non-profit employer to make a trade-off between excise tax savings and a reduced incentive for long-term retention of a key executive. Also, employers should consult their advisers to ensure these changes are consistent with regulations governing deferred compensation arrangements.

Executive Bonus Plans. Like deferred compensation, these plans are compensatory and frequently pay on an annual basis. In many cases, they involve the use of a life insurance policy as the financial instrument that accumulates value for the executive over time. Depending upon the circumstances, this could be an appropriate option, but the long-term retention benefit is almost entirely sacrificed in this scenario.

Split Dollar Plans. Many non-profit organizations are now considering the decades-old technique referred to as split-dollar because it is deemed to be non-compensatory for purposes of the excise tax. While roughly one in three credit unions with assets more than

$75 million already have a split-dollar plan in place, this concept will be new for most. On the surface, a split-dollar plan could be a useful solution, but non-profit employers should conduct detailed due diligence on plan designs before implementation to ensure it is prudently structured and does not create the potential for an adverse outcome in the future.

Assuming it is done correctly, split dollar arrangements can be an effective tool with myriad benefits beyond its ability to lessen the impact of the excise tax.

What's Next?

Historically, new tax law provisions have minimal, if any, impact on non-profit organizations. However, it is crucial for those in the non-profit sector to recognize the Act will affect thousands of non-profit organizations - especially in healthcare, higher education, trade and professional associations and credit unions. Failure to adapt to the new §4960 requirements will cause a non-profit organization to potentially find itself in a position where it has lost capital which would have otherwise supported its mission.

Non-profit employers should study, in detail, the Act's potential impact on their presently structured deferred compensation plans and other benefits, as well as the impact on the plans they are currently considering implementing in the future. The competitive nature of recruiting, hiring and retaining the best and the brightest has always been a challenge for the non-profit sector when compared to its for-profit brethren. The new tax law will make this problem even more significant. The advice of qualified counsel is vital regarding the options available for addressing the excise taxes in the new tax law.

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