

MPLOYMENT & MMIGRATION LAW

Executive Compensation Issues For Tax-Exempt Employers

ATTORNEYS, CLIENTS SHOULD BE AWARE OF COMPLICATED RULES AND SANCTION THREATS

By **RACHEL ARNETT**

Compensation packages for executives of tax-exempt organizations can raise private inurement issues and are also subject to tax regulations governing benefits, including nonqualified deferred compensation, that do not apply to taxable employers. It's a thorny world out there. Tread carefully.

Private Inurement

Section 501(c)(3) of the Internal Revenue Code provides that a corporation, trust or association may qualify for exemption as a charitable or educational organization only if, among other things, no part of its net earnings inures to the benefit of any private individual. "Private inurement" can occur when an influential insider (e.g., an executive) gets a benefit or something of value from the organization and does not give fair value in return.

An egregious private inurement problem can result in revocation of an organization's tax exemption. More commonly, the Internal Revenue Service will seek to impose "intermediate sanctions," a set of

federal penalty taxes under IRC § 4958, on individuals who receive too great a benefit from a tax-exempt organization and on those who knowingly approve the excessive benefits. The key here is that intermediate sanctions penalize the insiders who benefit from control of the tax-exempt organization (and those who abet them) without penalizing the organization itself (by revoking its exempt status).

The tax on the organization's managers or directors who knowingly approve the excess benefit is 10 percent of the excess amount, capped at \$20,000 per excess benefit "transaction." The liability of the managers and directors who knowingly approve the excess transaction is joint and several—that is, each is liable for the full excise tax. The tax on the insider who gets too great a benefit is 25 percent of the excess amount, plus 200 percent of the excess amount if it is not corrected within a prescribed amount of time.

Compensation for purposes of intermediate sanctions is defined broadly and includes base salary, bonuses, health care and other welfare and fringe benefits, employer-provided housing, retirement benefits and severance, among other elements.

How can one avoid an intermediate sanctions problem? The intermediate sanction regulations provide for a rebuttable presumption that a compensation



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arrangement is reasonable if the organization meets three requirements: (1) approval in advance of payment of the compensation by an authorized body—the board or a committee of the board composed entirely of directors without a conflict of interest; (2) reliance on external market comparability data in setting the compensation, taking into account similarly situated organizations for functionally comparable positions; and (3) documentation:

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the authorized body must adequately document the members of the authorized body who participated in the decision, the comparability data and how it was obtained, and the basis for its determination of reasonableness concurrently with making the determination.

Moreover, all benefits provided to the executive must be documented; failure to document a benefit converts it to an excess benefit, even if the total compensation provided is reasonable.

Retirement And Deferred Compensation

An executive can participate in the organization's existing retirement plans on the same terms and conditions the organization provides to its rank-and-file employees. However, trouble can arise if an executive gets a "better" deal, especially in the form of nonqualified retirement benefits.

Because of IRS limits imposed on qualified retirement plans, executives often want to participate in a "non-qualified" deferred compensation plan (or plans) in addition to the organization's qualified plan, so that they can defer taxation on a greater portion of their compensation. There are two main types of nonqualified deferred compensation plans available to tax-exempt organizations: IRC §§ 457(b) and 457(f) plans.

Section 457(b) Plans: These plans are only for a select group of management or highly compensated employees of tax-exempt employers. The amount that can be deferred each year is capped; the current maximum is \$17,500. All amounts contributed to a tax-exempt organization's § 457(b) plan, whether by the executive or the employer, whether subject to a vesting schedule or not, are the general assets of the employer. In other words, plan participants are merely unsecured creditors of the employer.

Contributions to a properly drafted and administered—that is, an "eligible"—§ 457(b) plan become taxable income to the executive only when paid or made available, typically on termination of employment. If, however, the plan has a documentary or operational compliance failure, it becomes an "ineligible" § 457(f) plan, and amounts contributed become taxable income to the executive as soon as there is no substantial risk of forfeiture (SROF) with respect to the compensation. The plan also then would become subject to § 409A, which governs the form and timing of payment of nonqualified deferred compensation with respect to plans of both taxable and tax-exempt organizations.

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Section 457(f) Plans: These plans are only for a select group of management or highly compensated employees of tax-exempt employers. There is no cap on the amount that can be deferred each year. Only employer contributions are permitted to a § 457(f) plan. Like a § 457(b) plan, all amounts contributed to a § 457(f) plan are the general assets of the employer. Unlike § 457(b) plans, § 457(f) plans are subject to § 409A.

Amounts in a § 457(f) plan become taxable income to the executive as soon as the substantial risk of forfeiture, or SROF, lapses. SROF can be loosely equated with vesting. For example, if an executive's employment agreement pro-

vides for the organization to contribute \$15,000 per year for each year of a three-year agreement, and further provides that the executive does not vest in the employer contribution until he has completed all three years of the agreement, there would be a SROF until the last day of the three-year agreement period. The next day, the entire \$45,000 plus earnings becomes taxable income to the executive. For this reason (and for compliance with § 409A), in most cases the vesting event should also be the payment event.

An explanation of § 409A rules is far beyond the scope of this article. However, suffice it to say that the penalties for failure to comply with § 409A include (but are not limited to) a 20 percent excise tax payable by the executive, not the employer.

Conclusion

Sections 457 and 409A are complex and nonintuitive. What may seem like a simple term in an employment, retirement or severance agreement may have serious, unintended tax consequences to the executive. Moreover, the intermediate sanctions regime of § 4958 can result in excise taxes on both the executive and the directors who participated in the compensation decision.

Sometimes a client will approach you (typically for drafting duties) after working her way through the compensation or employment agreement process and may not be interested in rehashing the steps the directors have taken in determining the reasonableness of the deal. Or she may be loath to renegotiate a special retirement provision with the new CEO on the mere possibility of adverse tax consequences on audit. Protect your client by asking the right questions anyway. The possibility of adverse tax and reputational consequences is too great.