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How the Tax Act Upsets the Board/Executive Compensation Committee Dynamic

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Introduction

The new Tax Cuts and Jobs Act ("Act") contains a series of provisions that will have enormous consequences for tax-exempt hospitals and health systems, and for the manner in which they compensate their senior executive leaders. These include provisions that would apply an excise tax on compensation and benefits (including "parachute" payments and deferred compensation) payable to a certain class of hospital and health system executives.

From a corporate governance perspective, the significance of these new provisions carries the potential for recalibrating the relationship between the board and its executive compensation committee. The full board may have a heightened interest in reserving to itself fundamental authority over the compensation review and approval process. This is due not only to the new taxes being applied, but also due to the legislative process that led to the enactment of these new provisions, the fact that they are specifically targeted at executives of tax-exempt hospitals and health systems, and other areas of potential collateral regulatory and competitive implications.

Overview of the Executive Compensation Provisions

What Made it Into the Act The final language of the Act, in terms of provisions affecting tax-exempt organizations, largely followed the Senate version of the legislation. This means that the Act includes these key provisions:

- *An annual excise tax on compensation, to the extent it exceeds one million dollars, paid to a "covered employee"* (one of the five highest paid employees of that organization for that year or in any prior year after 2016). Note that it is the amount over one million dollars that is subject to the tax, and not the entire amount. The tax is charged to the exempt organization that pays the compensation, so multiple exempt organizations having separate payrolls could have separate groups of covered employees triggering the excise tax. Related employers are aggregated only for the purpose of determining the total amount of compensation provided to an employee (in other words, an organization cannot get the compensation below one million dollars, or get someone out of the covered employee group, simply be splitting the compensation between or among related organizations).

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- *An excise tax on any excess parachute payment to any covered employee* (using the same group of five highest paid employees). A parachute payment is any payment triggered by separation from employment and arising because of the termination. A parachute payment is subject to the excise tax to the extent that it exceeds three times the five year average of annual total compensation. This excise tax and the excise tax on compensation exceeding one million dollars are coordinated – both taxes will not apply to the same compensation dollars.

- *These provisions go into effect for taxable years beginning after December 31, 2017*. The Act does not indicate whose "taxable year" is used to determine the effective date, and for fiscal year exempt organizations this could have dramatic consequences. If an organization has a June 30 year end, for example, and is scheduled to pay a large amount of deferred compensation to one of its five highest paid executives in the first half of 2018, an effective date of July 1, 2018 (using the organization's taxable year) is far preferable to an effective date of January 1, 2018 (using the recipient employee's taxable year). Because the tax is imposed on the organization, and because other excise taxes placed on organizations often are structured with reference to the organization's taxable year, it would be reasonable to expect an effective date keyed to the organization's taxable year. Exempt organizations with a non-calendar fiscal year will eagerly await IRS guidance on this key issue.

- *Other key provisions*. Several affecting tax-exempt health-care organizations and board engagement, though beyond the scope of this discussions, include a requirement that unrelated business income tax be calculated separately for each separate unrelated business activity, so that losses from one activity cannot be used to offset income from a different activity, and a prohibition on the use of tax-exempt advance refunding bonds. A separate requirement that could affect academic medical centers imposes a 1.4% annual excise tax on the net investment income of certain private college and university endowments

The New Twists on Some of These Provisions While the final form of the Act preserved many of the previously "flagged" compensation provisions directly affecting tax-exempt hospitals and health systems*, it also included some surprising last minute twists*:

- The excise tax on compensation exceeding one million dollars, and on excess parachute payments, is 21%, not 20% (because the final corporate tax rate increased to 21%).

- Compensation, for purposes of the excise tax on pay over one million dollars, includes any form of deferred compensation when it becomes vested, whether or not it is paid. What is fundamental here is that any deferred compensation arrangement subject to the tax law rules of Section 457(f) of the Internal Revenue Code becomes taxable income when the deferred compensation becomes vested--which can lead to large amounts, earned in prior years, suddenly triggering the new excise tax.

- The group of "covered employees"--for purposes of both excise taxes--can include a former employee still being paid any form of compensation subject to tax withholding.

- The excise taxes do not apply to payments made to licensed physicians (or any other licensed medical professional), to the extent that those compensation payments relate directly to performance of medical services. In other words, only the payment for administrative and executive services will count for purposes of these excise taxes, and particularly for the tax on pay over one million dollars. Organizations that pay physicians in part for clinical services and in part for administrative or executive services will have to carefully consider how much is paid for each type of service, and assess whether such physicians are covered employees and trigger the new excise tax.

Implications for the Executive Compensation Committee

The well informed board will immediately recognize the new excise tax structure as a direct congressional challenge to the manner in which tax-exempt hospitals and health systems compensate their senior executives. Such a board will note that the excise taxes emerge from a legislative context that was especially punitive to charities in general and tax-exempt health-care systems in particular. And finally, the board will be aware that incurring the excise taxes may raise concerns with the state attorney general as to the extent to which such payment can be characterized as consistent with charitable, nonprofit purposes, and with the media and health-care consumers in the context of rising health-care costs and limited health insurance options.

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For these reasons, it is likely that the health system board will need to become more engaged in the executive compensation process, so as to assure compliance with these new statutory provisions, maintain a competitive executive recruitment and retention process, and address the broader issues described above that may be triggered by compensation structures that are subject to the new taxes.

In this regard, it is worth noting that prior Senate versions of the Act contained a proposal that would have removed the "rebuttable presumption of reasonableness" under the Intermediate Sanctions provisions of the Internal Revenue Code , and considered the rebuttable presumption approval process as a form of minimal due diligence (but without conferring the protection that the rebuttable presumption review and approval process now affords). The loss of this broadly-relied upon approval standard would have had an enormous impact on how executive compensation committees conduct their determinations. The fact that such a provision was under active consideration by the Senate also may serve to heighten the full board's interest in being more engaged with the compensation process.

Given the stakes involved, it thus is understandable for the board to seek greater direct involvement in, or greater awareness of, a series of decisions that might otherwise fall within the existing authority of the executive compensation committee. These include, but are not limited to: (i) the decision whether to pay the excise tax; (ii) the characterization of the payment action under state nonprofit laws; (iii) the scope of comparables relied upon by the committee in determining reasonable compensation; (iv) the final determination of compensation and benefits payable to senior executives; and (v) the extent of integration between executive compensation and talent development and retention activities of the board and its committees.

Notwithstanding this natural inclination, however, the board should exercise caution in efforts to significantly limit the extent of approval authority delegated to the executive compensation committee. Such limitations could imperil the availability of the rebuttable presumption of reasonableness for committee decisions; significantly lengthen the time frame in which compensation decisions are made; and diminish the willingness of board members with executive compensation experience to serve on the compensation committee (due to a lack of authority). Rather, while preserving the authority of the compensation committee to review and approve compensation in a manner that qualifies for the rebuttable presumption of reasonableness, the full board may wish to receive more detailed regular reports from the compensation committee on the work of the committee, and in particular on the manner in which the committee has taken into consideration the issues (described above) emanating from the new excise tax structure.

A governance decision to enter into executive compensation arrangements that would trigger excise tax liability should not be a foregone conclusion, whether it is made by the full board or the executive compensation committee. Especially for nonprofit corporate and charitable trust law purposes, the decision should be the byproduct of a good faith process that considers appropriate factors relative to asset stewardship, mission achievement, internal pay equity and organizational reputation concerns. The board, and its executive compensation committee, should consult closely with its general counsel on these and other important issues arising under the Act.

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