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August 22, 2018

LEGAL UPDATES AND NEWS

New Tax Law - What Every Credit Union Executive Needs to Know

The Tax Cuts and Jobs Act (the "Act"), which became law last December, ironically imposes a substantial new tax on many tax-exempt organizations, including federal and state-chartered credit unions, by adding a new Section 4960 to the Internal Revenue Code ("IRC"). IRC 4960 applies the principles of IRC 162(m) and 280G (which makes certain types of "excessive" compensation paid by a publicly-traded company to executive officers non-deductible for federal income tax purposes) to credit unions and other tax-exempt organizations, except that instead of a lost tax deduction (which doesn't apply to tax exempt organizations), a credit union (and not the employee) must pay a penalty tax equal to 21 percent multiplied by the sum of any: (1) compensation paid to a "covered employee" in excess of $1.0 million per year; and (2) "excess parachute payments" paid to a "covered employee" (collectively, referred to as "excessive compensation"). This new penalty tax is effective for taxable years of the credit union beginning after December 31, 2017.

This new penalty tax will likely have a significant impact on the design and administration of the executive compensation programs of many credit unions. Larger credit unions, in particular, will need to assess the impact of IRC 4960 on their executive compensation plans and arrangements.

Effective Date

IRC 4960 would apply to any excessive compensation paid by a credit union to a covered employee during any taxable year of the credit union beginning after December 31, 2017. IRC 4960 does not grandfather any existing compensation arrangements in effect prior to December 31, 2017, meaning any payments to covered employees by a credit union pursuant to compensation arrangements implemented prior to the Act appear to be subject to IRC 4960.

Covered Employees

A "covered employee" is any current employee of the credit union who is one of the five highest compensated employees for the taxable year. A "covered employee" also includes anyone who was one of the five highest paid employees of the credit union (or any predecessor) for any preceding taxable year beginning after December 31, 2016, even if he or she is no longer employed or one of the five highest paid employees in the current taxable year. In other words, a "covered employee" of any prior year after December 31, 2016 will continue to be a "covered employee" forever, even after termination of employment or death. For example, if a credit union's CEO is its highest paid employee in 2018, then retires in 2019 and vests in a deferred compensation benefit in 2023 due to CEO's continued service as a director, the CEO would be a "covered employee" and the deferred compensation benefit that vests in 2023 would be subject to IRC 4960.

Excessive Compensation

Compensation in Excess of $1.0 Million

IRC 4960 imposes a penalty tax equal to 21% of any compensation paid by a credit union to a covered employee in excess of $1.0 million for the taxable year.

Compensation of a covered employee subject to this limit includes: (1) wages, as defined for purposes of IRC 3401(a) for income tax withholding purposes other than designated Roth contributions; and (2)

amounts required to be included as taxable income under the deferred compensation rules of IRC 457(f), with such amounts being taxable to the covered employee when the rights to the payments are no longer subject to a substantial risk of forfeiture (i.e., becomes vested), even if not yet paid.

Although a covered employee's aggregate annual salary and bonus is likely less than $1.0 million, credit unions that offer SERPs and other non-qualified deferred compensation plans should be mindful that the deferred compensation payable thereunder (which may have accrued for 10 or more years and represent many multiples of the covered employee's salary and bonus) could cause the covered employee's total compensation to exceed the $1.0 million threshold during the taxable year in which the covered employee's deferred compensation becomes vested.

For example, CEO (who is a covered employee) is participating in SERP that provides for an accumulated benefit of $1,000,000 that vests upon attainment of age 65. In 2020, CEO received an annual base salary of $200,000 and a bonus of $50,000. CEO also became vested in the SERP benefit because CEO attained age 65 in 2020. For purposes of IRC 4960, the total compensation paid to CEO in 2020 is $1,250,000, resulting in a penalty tax of $52,500 (i.e., $250,000 excess amount above $1.0 million, multiplied by 21%) paid by the credit union and not the CEO.

Excess Parachute Payments

IRC 4960 also imposes a 21% penalty tax on any "excess parachute payment" paid by a credit union to any covered employee who is a highly compensated employee within the meaning of IRC 414(q) (i.e., an employee who earned more than $120,000 (as indexed) during the prior taxable year). An "excess parachute payment" means the amount by which any "parachute payment" exceeds the covered employee's "base amount." A payment would be a "parachute payment" if it is contingent on the separation from employment with the credit union and if the total present value of all such payments equals or exceeds three times the covered employee's "base amount" (i.e., the employee's average taxable compensation over the preceding five years).

Parachute payments would include severance payable under any employment, change in control or other severance arrangement and any benefit payable under a SERP or other non-qualified deferred compensation arrangement that becomes vested. Parachute payments do not include payments to covered employees from tax-qualified retirement plans and eligible deferred compensation plans under IRC 457(b).

Unlike excess parachute payments that are paid to employees of for-profit corporations on amounts paid that are contingent on a change in control, excess parachute payments paid by a credit union do not require a change in control -- only a separation from employment.

For example, upon termination of employment in 2018, CEO receives parachute payments that total $500,000, payable pursuant to CEO's employment agreement and SERP. CEO has the following taxable compensation for the years set forth below:

2013	$50,000
2014	$75,000
2015	$100,000
2016	$125,000
2017	$150,000
Base Amount	**$100,000**

Since CEO's parachute payment of $500,000 is equal to or greater than three times the CEO's base amount (3x $100,000 = $300,000), the CEO has received an excess parachute payment of $400,000 for purposes of IRC 4960. Accordingly, the credit union (and not the CEO) would pay penalty tax of $84,000, calculated as follows:

Parachute Payment	$500,000
Less: Base Amount	($100,000)
Excess Parachute Payment	$400,000
21% of Excess Parachute Payment	**$84,000**

Planning Considerations

Credit unions should identify their covered employees and review their existing compensation arrangements to determine whether the payments thereunder may be subject to a penalty tax under IRC 4960. For covered employees who participate in deferred compensation plans subject to IRC 457(f), credit unions should determine when the rights to payments under such plans will no longer be subject to a substantial risk of forfeiture (i.e., become vested). As noted above, it is the vesting of the benefits, and not the date of payment, that will determine when the amounts are subject to IRC 4960.

When designing an employment agreement, deferred compensation plan or other compensation arrangement, credit unions may consider implementing longer vesting schedules so that the benefits payable to covered employees vest over multiple taxable years (instead of in one taxable year) to increase the likelihood that the covered employee's annual compensation is below the annual $1.0 million threshold. Keep in mind that amending an existing deferred compensation plan to delay or extend the vesting of any benefits payable thereunder must comply with the deferred compensation rules of IRC 409A.

In anticipation of a covered employee's retirement or termination of employment, including in connection with a possible merger transaction, credit unions should prepare a "severance analysis" that quantifies the covered employee's severance payments, determines whether any excess parachute payment would be made and considers if there is a planning opportunity to restructure the covered employee's severance payments to avoid or mitigate the penalty taxes that may be triggered under IRC 4960.

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