New Excise Tax On Excess Compensation Paid By Tax-Exempt Employers

July 26, 2018

The recently enacted Tax Cuts and Jobs Act (signed into law on December 22, 2017) adds a new provision rule imposing an excise tax on certain "excess" compensation paid by a tax-exempt employer (and certain governmental employers) to its highest paid employees (collectively, "tax-exempt organization"). The excise tax, payable by the covered tax-exempt organization, is equal to the product of 21% and the sum of (i) compensation paid to a "covered employee" for a taxable year in excess of $1 million, and (ii) any "excess parachute payment" paid by the tax-exempt employer to a covered employee. For the purpose of calculating the excise tax on compensation exceeding $1 million for a taxable year, compensation amounts that otherwise constitute an excess parachute payment are disregarded. While we anticipate the issuance of substantive guidance from the IRS concerning the implementation of this new excise tax on excess compensation, we have provided below our current understanding of the statutory language governing this new law.

$1 Million Compensation Cap

For purpose of this new $1 million compensation cap and the tax on excess parachute payments, a "covered employee" is a current or former employee of a tax-exempt employer if the employee is one of the five highest paid employees of the employer for the current taxable year or was a covered employee (based on being one of the five highest paid employees) of the tax-exempt employer (or any predecessor of such employer) for any preceding taxable year beginning after 2016. The impact of this definition is that once an employee is treated as a covered employee, this individual will continue to be treated as a covered employee for all future years, even for periods following termination of employment. Accordingly, it is possible for a tax-exempt employer to have more than five covered employees for any given taxable year.

In determining whether the $1 million compensation cap is exceeded, all wages and compensation subject to federal income tax withholding (other than any Roth contributions) are taken into account. In addition, nonqualified deferred compensation will be taken into account when includible in income (i.e., generally when such amounts vest in the covered employee). Moreover, compensation paid to a covered employee by an entity "related" to the tax-exempt organization shall be taken into account. An entity is treated as "related" to a tax-exempt organization if, (i) the entity controls, or is controlled by, the tax-exempt organization; (ii) the entity is controlled by one or more persons who control the tax-exempt organization; (iii) is a "supported organization" or a "supporting organization" with respect to the tax-exempt organization; or (iv) the tax-exempt organization is a voluntary employees' beneficiary association (as defined in Code section 501(c)(9)) (a "VEBA"), the entity establishes, maintains, or makes contributions to, such VEBA. Notwithstanding the foregoing, compensation paid to a licensed medical professional (e.g., doctor, nurse, or veterinarian) for the performance of medical services by such licensed medical professional shall be disregarded in applying the $1 million compensation cap.

Excess Parachute Payment

As noted, the new 21% excise tax also applies to an "excess parachute payment." The rules governing the calculation of an excess parachute payment with respect to a tax-exempt organization are generally similar to the "golden parachute" rules governing compensation paid in connection with a change in control involving a for-profit corporation.

An excess parachute payment is equal to the excess of a "parachute payment" over the covered employee's "base amount." A "parachute payment" exists if the aggregate present value of all compensatory payments made by the tax-exempt employer to or for the benefit of a covered employee on account of the employee's separation from employment equals or exceeds three times the covered employee's base amount. The base amount is the covered employee's average annual taxable compensation with respect to the tax-exempt organization in question for the five taxable years (or such shorter period of employment with the tax-exempt organization) ending before the year of the covered employee's termination of employment. In determining whether a parachute payment exists, payments made to a covered employee under a "qualified" plan (per Code section 401(a), 403(b) or 457(b)) are disregarded, as are compensatory payments made to a covered employee who is otherwise not treated as a "highly compensated employee," as defined in Code section 414(q) (i.e., for 2018, an employee whose compensation for 2017 does not exceed $120,000). In addition, the exclusion for compensation paid to a licensed medical professional, as described above for purposes of the $1 million compensation cap, also applies in determining whether an excess parachute payment has occurred.

If a parachute payment has been made, then the excise tax applies to the excess of such parachute payment over "one times" the covered employee's base amount. For example, assume Smith is a covered employee of a tax-exempt organization and is paid severance pay (i.e., compensation contingent on Smith's severance from employment with the tax-exempt organization) in a lump sum of $800,000 on termination of employment. Smith has a base amount of $250,000. Thus, Smith has received a parachute payment because the present value of his severance pay ($800,000) equals or exceeds three times his base amount (i.e., $750,000 ($250,000 x 3). Therefore, Smith will have an excess parachute payment of $550,000 ($800,000 parachute payment over $250,000 base amount), and the tax-exempt organization will owe an excise tax of $115,500 ($550,000 x 21%).

Conclusion

Fairly and properly compensating executives of a tax-exempt organization has been and will continue to be a necessary step in the operation of a successful organization as the demand for highly qualified leadership talent will inevitably rise. However, the new excise tax on excess compensation paid by a tax-exempt organization represents a significant sea change in the way in which tax-exempt organizations will likely proceed in providing annual compensation and post-termination severance pay to their executives. Accordingly, this will require all tax-exempt organizations to review and assess the manner in which they compensate their executives.