

Client Alert

January 2018

New “Excess” Compensation Excise Tax For Tax Exempt Organizations

The 2017 Tax Act (the “Act”) imposes a 21 percent excise tax on compensation in excess of \$1 million and “excess” severance paid by covered tax exempt organizations to certain employees starting in 2018. As reflected in the Act’s legislative history, the general intent behind this excise tax is to put tax exempt organizations (which are generally exempt from income taxation) in roughly the same position tax-wise as publicly held and other for-profit companies which cannot deduct excess compensation and “golden parachute” payments paid to their covered employees. However, unlike the changes made in the Act to the excess compensation rules for publicly traded companies, there is no transition relief for existing tax exempt organization compensation arrangements. This means that the new excise tax will apply to all compensation paid by a covered organization to a covered employee in tax years beginning after 2017.

Set out below is an overview of the scope and application of the new excise tax provision.

Covered Tax Exempt Organizations

In general, the new excise tax provision (Code section 4960) will apply to most tax exempt entities. Specifically, it will cover:

- Any entity which is exempt under Code section 501(a).
- Any state and local governmental entity with tax exempt income.
- An exempt political organization.
- An exempt farmers’ cooperative.

Interestingly, some of the early commentary on this provision suggests that it may not apply to public universities and colleges.

Covered Employees

The Act defines a “covered employee” as any employee of a covered organization who is one of the five highest paid employees in any year after 2016. Thus, the new excise tax can apply to any individual who is currently or was previously among the five highest paid employees of the organization after 2016 (even if the individual is no longer an employee).

Counted Compensation

In general, the Act provides that all compensation subject to federal income tax withholding is counted for purposes of the excise tax. It also includes any amounts that are subject to taxation under Code section 457(f) (which applies to certain deferred compensation arrangements of covered tax exempt entities). However, compensation does not include any Roth contributions made by the employee under

the employer's 401(k) or 403(b) plan. In addition, it also does not include compensation paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services. In short, only compensation for non-medical services is to be counted in applying the excise tax provision to this group.

It is also important to note that the Act provides that in determining the total amount paid to a covered employee for excise tax purposes, any compensation paid by a related organization to the employee for employment services is also counted.

Excise Tax for Excess Compensation

As pointed out above, the excise tax is imposed on any counted compensation in excess of \$1 million "paid" to a covered employee in any year. In this regard, the Act provides that compensation is to be treated as "paid" when the rights to such compensation are no longer subject to a substantial risk of forfeiture. Thus, it appears that the intent is to count a covered employee's compensation in the year the employee's rights to such pay become nonforfeitable (even if it is not paid or otherwise taxable under section 457(f) in that year).

Note also that it appears that all compensation paid to a covered employee, even after termination of employment, is to be counted in determining whether and to what extent the \$1 million limit has been exceeded in any year. However, to avoid double-counting, the Act provides that any post-termination compensation that is treated as excess severance pay for excise tax purposes (discussed in more detail below) is not counted in applying the \$1 million limit.

Excise Tax for Excess Severance Payments

As indicated above, the excess severance pay provisions are generally intended to mirror the "golden parachute" payment provisions under which for-profit entities cannot deduct excess parachute payments made to its employees. In general, the Act provides that any compensation paid to a covered employee which is "contingent" on the employee's termination of employment is counted. However, payments under a "tax qualified" retirement or savings plan (such as a 401(k) plan, 403(b) plan or 457(b) plan) are disregarded. In addition, it appears that severance paid to (i) a licensed medical professional for the performance of medical services or (ii) a non-highly compensated employee (within the meaning of the Code) also is not counted for this purpose.

In general, the excise tax only applies if the covered employee's total severance payments equal or exceed three times the employee's "base amount." However, if the employee's severance exceeds this threshold, any payments in excess of the covered employee's base amount will be subject to the excise tax. For this purpose, the "base amount" is the employee's average annual taxable compensation for the five years preceding his or her termination date (or, if shorter, the employee's period of employment during that timeframe). Thus, as pointed out in the Act's legislative history, the excess severance payment excise tax can apply even if the individual's compensation for the year is less than \$1 million.

Who is Liable for the Excise Tax

Under the Act, the covered tax exempt employer is liable for the 21 percent excise tax. However, where the covered employee's compensation includes amounts paid by an organization related to the covered employer, the Act provides that the related organization is liable for a pro rata portion of any associated excise tax.

If you have any questions or would like to discuss the Act's new excess compensation excise tax provisions for tax exempt entities, please contact one of the lawyers listed below.

Author

David Mustone
dmustone@hunton.com

Contacts

L. Scott Austin
saustin@hunton.com

J. G. Ritter, II
jritter@hunton.com

Leslie A. Okinaka
lokinaka@hunton.com

© 2018 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.