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## Tax reform imposes new 'excise tax on excess tax-exempt organization executive compensation'

### In Brief

The 2017 tax reform reconciliation act (the Act) significantly affects tax-exempt organizations in numerous ways, including a new 'excise tax on excess tax-exempt organization executive compensation' effective for tax years beginning after December 31, 2017. Exempt organizations should consider the impact of the tax and begin planning how they identify and track covered employees and their compensation.

### In Detail

#### Background

The Act creates Section 4960 of the Internal Revenue Code, which imposes a 21-percent excise tax on (i) annual remuneration in excess of \$1 million paid by an applicable tax-exempt organization to a covered employee, and (ii) certain separation payments deemed excessive in relation to historic compensation (excess parachute payments) to a covered employee. Employers, not the covered employees, are liable for the excise tax.

An 'applicable tax-exempt organization' includes any organization exempt from tax under Section 501(a) as well as certain other types of tax-exempt entities.

A 'covered employee' is one of the top five most highly compensated employees of an applicable tax-exempt organization for the taxable year, plus any person who was a covered employee in any preceding taxable year beginning after December 31, 2016.

**Observation:** The excise tax on compensation over \$1 million and the excise tax on excess parachute payments operate independently. One may apply even if the other does not. However, no more than one 21 percent excise tax may apply to a particular payment.

### **Excise tax on remuneration over \$1 million**

The Act creates a 21-percent excise tax on 'remuneration' over \$1 million paid by an applicable tax-exempt organization to a 'covered employee' during a taxable year (other than an excess parachute payment).

'Remuneration' includes amounts treated as wages for Federal income tax withholding purposes, but does not include designated Roth contributions. Any amounts vested (and taxable under Section 457(f)), even if not yet received, are included as part of remuneration. Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration. The definition of 'substantial risk of forfeiture' is based on Section 457(f)(3)(B).

'Remuneration' also includes any remuneration paid with respect to the employment of a covered employee by any related organization of the applicable tax-exempt organization. If a covered employee's remuneration from more than one employer is taken into account, the excise tax is prorated among the various employers in proportion to the remuneration paid by each.

### **Excise tax on excess parachute payments**

Separately, a 21-percent excise tax is imposed on any 'excess parachute payment' to a covered employee. A payment is a 'parachute payment' if it is contingent on the separation from service of the covered employee. The payment does not need to be in excess of \$1 million to be subject to the excise tax. Such a payment does not include a payment under a qualified and similar plan (but may include a payment from a nonqualified SERP). A parachute payment also does not include a payment to licensed medical professionals as described above. Finally, a parachute payment to a covered employee who is not a "highly compensated employee" for purposes of Section 414(q) is not considered a parachute payment for this purpose.

A payment may be an excess parachute payment if the total present value of all parachute payments exceeds three times the covered employee's 'base amount.' The base amount is the covered employee's average W-2 compensation over the preceding five years. If the 'three times' threshold is exceeded, then the excess parachute payment subject to the excise tax equals the amount of the parachute payment less the applicable base amount.

### **The takeaway**

Tax-exempt organizations should review their compensation arrangements to consider the impact of this new excise tax for taxable years beginning after December 31, 2017. Organizations also should begin planning how they identify and track covered employees and their compensation. At this time, it is unclear how the IRS will require organizations to report and pay the excise tax. Tax-exempt organizations should monitor for any future guidance on reporting and paying the excise tax.