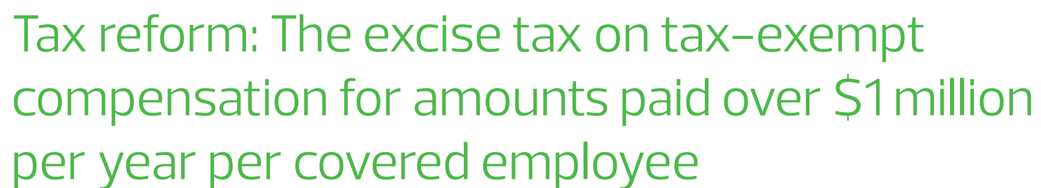

Tax reform: The excise tax on tax-exempt compensation for amounts paid over $1 million per year per covered employee

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Now that the Tax Cuts and Jobs Act (TCJA) has been signed into law by President Donald Trump, there is one provision that is of particular interest to all tax-exempt organizations. This provision is related to a punitive excise tax assessed against tax-exempt organizations for compensation arrangements of over $1 million paid to certain covered employees of their organizations.

The excise tax on excess tax-exempt organization executive compensation

Taxable employers and other service recipients are generally allowed a deduction for reasonable compensation expenses. This overarching position is set forth in the Internal Revenue Code section 162(a)(1). However, in some cases, compensation in excess of specific levels is not deductible in the taxable business world. In particular, section 162(m)(1) provides in the case of a publicly held corporation, subject to certain exceptions, the deduction for a taxable year for compensation

of the corporation's principal executive officer or for any of the corporation's three most highly compensated officers other than the principal executive officer is limited to $1 million ($1 million limit on deductible compensation). Also, under section 162(m)(6), limits apply to deductions for compensation of individuals performing services for certain health insurance providers.

In another punitive provision related to certain compensation payments, section 280G provides that a parachute payment (generally a payment of compensation that is contingent on a change in corporate ownership or control) made to an officer, shareholder or highly compensated individual is generally not deductible if the aggregate present value of all such payments to an individual equals or exceeds three times the individual's base amount. This is referred to as an excess parachute payment. An individual's base amount is the average annual compensation includible in the individual's gross income for the five taxable years ending before the date of the change in ownership or control occurs. Under this provision, certain amounts are not considered parachute payments including payments under a qualified retirement plan, a simplified employee pension plan, or a simple retirement account tax-exempt under sections 401(a), 403(a), 408(k), and 408(p), respectively.

Of course the focus of the government in the present law and cited in the previous paragraphs is intended to be punitive to taxable businesses by disallowing a favorable tax deduction for such amounts paid over statutorily set forth amounts of deemed reasonableness. The above deduction limit and penalty provision generally do not affect a tax-exempt organization under present law.

Historical analysis of the new law

In an attempt to level the playing field in some respects between the tax-exempt business sector and for-profit business sector, there have been congressional efforts in the past focused on penalizing tax-exempt organizations which had excessively high compensated employees. Thus, this particular law change as a part of the TCJA should not come as a complete surprise to tax-exempt industry members.

The Camp proposals, which were a part of the Tax Reform Act of 2014, yet never passed, provided almost verbatim what we see in the new law today. However, under that 2014 proposal, an employer was liable for an excise tax of 25 percent of the sum of the (1) remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and (2) any excess parachute payment paid by the applicable tax-exempt organization to a covered employee. Accordingly, the excise tax applied as a result of an excess parachute payment, even if the covered employee's total remuneration, which included that parachute payment, did not exceed the total $1 million threshold. The penalty applied by virtue of the parachute payment being deemed "too excessive."

Under that 2014 proposal, remuneration meant wages as defined for income tax withholding purposes under section 3401(a), but did not include any designated Roth contributions. Under section 402A(c), a designated Roth contribution is an elective deferral (that is, a contribution to a tax-favored employer-sponsored retirement plan made at the election of an employee) that the employee designates as not being excludable from income.

In addition, the 2014 proposal provided that remuneration that was to be taken into account of a covered employee included any remuneration paid with respect to employment of the covered employee by any person or governmental entity related to the applicable tax-exempt organization. It continued to provide that remuneration of a covered employee that was not deductible by reason of the $1 million limit on deductible compensation was not taken into account for purposes of the proposal. This presumably was in reference to the provision applicable to for-profit organizations under section 162(m).

Also under the 2014 proposal, an excess parachute payment was the amount by which any parachute payment exceeded the portion of the base amount allocated to the payment. A parachute payment was a payment in the nature of compensation to (or for the benefit of a covered employee) if the payment was contingent on the employee's separation from employment and the aggregate present value of all such payments was three times or more of the base amount. The base amount was the average annual compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. It is interesting

to note that in the 2014 proposed legislative provision, parachute payments did not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local government employer.

Lastly, the 2014 proposed provision provided that the employer of a covered employee was liable for the excise tax.

The compensation excise tax law in the TCJA

During the legislative process, both the House and the Senate versions of the TCJA had the same provision related to the assessment of an excise tax for certain levels of compensation paid to employees of tax-exempt organizations. Both chambers of Congress accomplished this by establishing in the Internal Revenue Code a new code section 4960. In addition, it should be no surprise that the legislative language used in new code section 4960 was basically verbatim what the 2014 proposals provided, with a few minor differences.

Under the new law, an applicable tax-exempt employer is liable for an excise tax equal to 21 percent of the sum of the:

(1) Remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and

(2) Any excess parachute payment (under a new definition for this purpose that relates solely to separation pay) paid by the applicable tax-exempt organization to a covered employee. (The excise tax applies as a result of an excess parachute payment, even if the covered employee's remuneration does not exceed $1 million).

An applicable tax-exempt organization or applicable tax-exempt employer is an organization exempt from tax under section 501(a); an exempt farmers' cooperative (tax exempt under section 521(b)); a federal, state or local governmental entity with excludable income (tax exempt under section 115(1)); or a political organization (tax exempt under section 527(e)(1)).

For purposes of the law, a covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest-compensated employees of the organization for the taxable year or was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after Dec. 31, 2016. This particular provision merits further analysis. The statutory language in new code section 4960 seems unambiguous and provides:

> "...(2) COVERED EMPLOYEE.—For purposes of this section, the term 'covered employee' means any employee (including any former employee) of an applicable tax-exempt organization if the employee—
> (A) is one of the five highest-compensated employees of the organization for the taxable year, or
> (B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2016."

First, let's examine, for the purposes of this section, the term covered employee. The term covered employee means any employee (including any former employee) of an applicable tax-exempt organization. Employee for this purpose is anticipated to mean employee in its common law sense of the term. Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to

the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case.

As far as former employees are concerned, it is further anticipated that exit payments, or trailer payments under an employment agreement are to be taken into account. For example, upon separation from service to the tax-exempt employer, the employee is paid a certain amount of annual compensation pursuant to an agreement in place. These kinds of payments could possibly be payable for a term of years. It is these types of payout arrangements which appear to be the target of this statutory language (i.e., to include in the statute the "any former employee" language). This former employee reference is assumed to include those compensated persons reportable on Form 990, in Part VII of that form, and listed as a former employee in that context.

Next, it is important to point out what is meant by the language in the statute of "one of the five highest-compensated employees of the organization for the taxable year...or was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2016."

This language clears up the confusion to the question: Does the provision only apply to the top five highest-paid employees of the tax-exempt organization on an annual basis?

The answer to this question is "not really." Like most things in the tax law, in applying it to fact-specific situations, another valid comprehensive answer to this particular question is "it depends." It depends if, for example, we are talking about the first year of implementation of this new code section 4960, or future years' post-implementation year of new section 4960.

For example, let's examine the first year of application of new section 4960 for the calendar year 2018 (or fiscal year beginning after Dec. 31, 2017). In this first year, the tax-exempt organization will look at only its top five employees (or former employees) that were paid over this $1 million threshold of remuneration. These five persons are considered the covered employees. Therefore, in the 2018 tax year of analysis, the tax-exempt organization, at most, may have five persons in its covered employee population which may subject the tax-exempt organization to excise taxes. However, in years after the first year of implementation of new code section 4960, the population of the persons in the excise tax group may expand to include more than just this first year "group of five highest-compensated employees."

For future years after the implementation year of 2018 of new section 4960, the term covered employee is expanded to include not only the top five highest-compensated employees, but also those who may have been determined to be a covered employee in previous tax years after Dec. 31, 2016.

An example will clarify the application of this aspect of new section 4960:

For first year of implementation year 2018, the following employees with their related remuneration to be considered are is as follows:

1) Employee #1 – $1,600,000
2) Employee #2 – $1,250,000
3) Employee #3 – $1,200,000
4) Employee #4 – $1,190,000
5) Employee #5 – $1,050,000
6) Employee #6 – $1,045,000
7) Employee #7 – $1,045,000

In year one of the applications of the provisions of new section 4960, the tax-exempt organization would owe the excise tax on the top five highest-paid employees (as covered employees) plus no other employees as in this example. Employees #6 and #7 were not considered a covered employee for any other tax year beginning in 2017 (a 2017 tax year).

VARIATION: Moving to tax year 2019 for this same tax-exempt organization, let's assume that of these seven employees listed, all of their compensation packages remained the same for the 2019 tax year, except for employee #7. Employee #7 is now paid in 2019 remuneration to be taken into account for the purposes of this excise tax of $1,055,000. So now the top paid persons list appears as follows:

1) Employee #1 – $1,600,000
2) Employee #2 – $1,250,000
3) Employee #3 – $1,200,000
4) Employee #4 – $1,190,000
5) Employee #7 – $1,055,000
6) Employee #5 – $1,050,000
7) Employee #6 – $1,045,000

For the 2019 tax year, the tax-exempt organization would owe the excise tax on six persons who would be subject to the tax. This is determined by looking first to the top five highest-paid persons in the list of highly compensated employees. In performing this analysis we see that employees #1, #2, #3, #4 and #7 are in this top five highest-compensated employee population. However, in expanding the application of the statutory language to others under the "or was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2016" requirement, added to this list would also be employee #5, since although employee #5 in tax year 2019 was not in the top five highest-compensated persons, he/she was included in the covered employee population at some time post-Dec. 31, 2016 (he/she was a top five highest-paid employee in tax year 2018). As such, in year 2019, the tax-exempt organization would be subject to the excise tax for high compensation for employees for six employees: #1, #2, #3, #4, #7 and #5.

A few things can be concluded based on the example just provided:

1) Once you are in the top five employee highest-compensated population, you are considered a covered employee for all future years if you remain an employee and also continue to receive applicable remuneration of over $1 million.
2) An employee in the covered employee population may only be removed from that population, and thus not subject the tax-exempt organization to penalties in a future year, if such person ceases to be employed and compensated by that tax-exempt organization or his/her overall remuneration considered for the purposes of the excise tax falls below the $1 million threshold.

What is meant by remuneration?

The new section 4960 begins with the following statutory language related to its applicability:

> "(a) TAX IMPOSED.—There is hereby imposed a tax equal to 21 percent of the sum of—
> (1) so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus
> (2) any excess parachute payment paid by such an organization to any covered employee."

In order to adequately interpret the breadth of this tax, it is necessary to completely understand what is meant by the term remuneration. Remuneration means wages as defined for income tax withholding purposes as defined in section 3401(a), but does not include any designated Roth contribution (under section 402A(c)). A designated Roth contribution is an elective deferral (that is, a contribution to a tax-favored employer-sponsored retirement plan made at the election of an employee) that the employee designates as not being excludable from income for tax purposes, and as such, is included in Form W-2 and subject to income tax.

So, for the purposes of new section 4960 and the determination of the remuneration, or wages/compensation that must be considered in making the determination that an employee is paid over the $1 million threshold provided for in the statute, the term wages means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash;

and means all money paid to an employee for the purposes of the federal income tax withholding requirements. As such, certain amounts that provide for statutory exclusions from income are not considered remuneration under section 3041(a)'s definition. Also not included in remuneration for the purposes of the excise tax are specifically listed out exemptions of certain activities from the treatment of taxable wages and for the purposes of reporting on Form W-2.

Remuneration of a covered employee includes any remuneration paid with respect to employment of the covered employee by any person or governmental entity related to the applicable tax-exempt organization. A person or governmental entity is treated as related to an applicable tax-exempt organization if the person or governmental entity:

(1) Controls, or is controlled by, the organization,
(2) Is controlled by one or more persons that control the organization,
(3) Is a supported organization (in the context of supporting and supported organizations) during the taxable year with respect to the organization,
(4) Is a supporting organization (in the context of supporting and supported organizations) during the taxable year with respect to the organization, or
(5) In the case of a voluntary employees' beneficiary association (VEBA), establishes, maintains, or makes contributions to the VEBA.

However, remuneration of a covered employee that is not deductible by reason of the $1 million limit on deductible compensation is not taken into account for purposes of the new law.

Lastly, remuneration taken into account to determine whether total remuneration is over the $1 million dollar threshold includes section 457(f) paid amounts which are included in Form W-2. Remuneration also includes vested 457(f) amounts, where the substantial risk of forfeiture has lapsed and which may not be included in the Form W-2.

Excise tax applicable to parachute payments

Under the provision, an excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. A parachute payment is a payment in the nature of compensation to (or for the benefit of a covered employee) if the payment is contingent on the employee's separation from employment and the aggregate present value of all such payments is three times or more the base amount. The base amount is the average annual compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local government employer. Therefore, in the classic situation where an employee retires and receives a large payment as he/she separates from service of the employer tax-exempt organization, these payments should not be adversely treated as any kind of excess parachute payment under the provision. In addition, it appears that these payments do not necessarily have to exceed the $1 million threshold in order for the penalty to apply to such payments.

It appears unclear whether payments under certain nonqualified deferred compensation arrangements, where the substantial risk of forfeiture lapses and payouts are made and reportable on Form W-2 as taxable compensation, and where there is no separation from service, will be subject to the general excise tax rules for covered employees under this parachute provision. It seems clear that such would be considered compensation for the purposes of determining the $1 million dollar threshold, however.

One exclusion that is provided in the law is that this parachute provision will not apply to employees who are not considered highest-compensated employees under such term's general definition, which for 2017 sets the level of compensation for a person to be considered highly compensated at $120,000.

The tax-exempt employer is the payor of the excise tax

The employer of a covered employee is liable for the excise tax. If remuneration of a covered employee from more than one employer is taken into account in determining the excise tax, each employer is liable for the tax in an amount that bears the same ratio to the total tax as the remuneration paid by that employer bears to the remuneration paid by all employers to the covered employee.

A special exclusion group from the overall application of the new law

The new law includes a special exclusion group from its application for certain health care industry employees. The new law exempts compensation attributable to medical services of certain qualified medical professionals from the definitions of remuneration and parachute payment for the purposes of section 4960. For purposes of determining a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account, whereas remuneration paid to such a professional in any other capacity is taken into account. A medical professional for this purpose includes a doctor, nurse or veterinarian. This special exclusion group was a welcome addition to the application of the excise tax under section 4960 and was not provided for in the code section 4960 2014 proposals as provided for by Representative Camp.

Although this exclusion for medically licensed employees paid for providing medical services was a welcome exclusion for the tax-exempt health care industry, it was a late change that seemingly has left some holes in the statutory construction of section 4960. In its haste to provide the exclusion, Congress failed to adjust the legislative text which provided for the definition of covered employee to exclude those licensed medical professionals paid for performing medical services which should include the top five highest-compensated employees of an organization. This is important since the top five highest-compensated employees make up the population of potential covered employees which may be subject to the excise tax provision. The statute lacks this clarity, so technically the top five highest-compensated employees of an organization may all be licensed medical professionals, and it is clear that if their compensation was all associated with the performance of medically recognized services, that although these persons make up the top five highest-compensated individuals in an organization, none of their compensation will be considered remuneration for the purposes of the excise tax and they will not be considered a covered employee.

You can see the dilemma that this statutory language omission has created. Tax-exempt health care organizations' five highest-compensated employees may all be the kind of employee who is not subject to the excise tax, thus the organization's entire C-level suite employees who are paid over $1 million per year may not make it to the population of employee who are the five highest-compensated employee of an organization subject to the excise tax and completely avoid section 4960 altogether. The Joint Commision on Tax explanation to this change states for purposes of determining a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account, whereas remuneration paid to such a professional in any other capacity is taken into account (it is silent related to excluding such a person in the five highest-compensated employee population). A medical professional for this purpose includes a doctor, nurse or veterinarian.

Seemingly, congressional intent was to exclude such medical professionals paid to provide medical services from the population of the top five highest-compensated employees of an organization for the purposes of the application of the excise tax if that person's compensation was paid and related to the provision of medical services, but it is obvious that the statutory construction of section 4960 misses this mark. This issue must be addressed in a technical corrections bill; if it isn't, no one in a tax-exempt health care organization may be subject to this excise tax.

Conclusion

With this new law, there is a need for formal clarifying guidance regarding its application. RSM will keep you posted as developments occur.

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