Pearl Meyer

ARTICLE | MAR 2018

The New Executive Compensation Excise Tax at Tax-Exempt Organizations

Margaret H. Black

MANAGING DIRECTOR

Ed Steinhoff

MANAGING DIRECTOR

On December 22, 2017, H. R. 1 was signed into law, imposing a new excise tax of 21% on two categories of executive compensation paid by certain tax-exempt organizations. The new tax found in Internal Revenue Code ("IRC") Section 4960 applies to compensation paid to "covered employees" in excess of $1 million per year and "excess parachute payments" paid to covered employees that are contingent upon their separation of employment.

Since the passage of the act in late December, we have been fielding a number of questions from our tax-exempt clients about this new excise tax. Below are some of the questions we've received.

What types of tax-exempt organizations are subject to the new excise tax?

Tax-exempt organizations subject to the excise tax generally include all tax-exempt organizations under IRC Section 501(a), exempt farmers' cooperative organizations, certain state or local governmental entities, and certain political organizations.

Why was IRC Section 4960 enacted and when are the rules effective?

IRC Section 4960 was enacted as an attempt to provide parity between the limitation on the deductibility of compensation by taxable publicly traded corporations and the treatment of executive compensation paid by tax-exempt organizations. Similar to the IRC Section 162(m) modifications, which eliminated deductions for any compensation which is performance-based in excess of $1M for covered employees, the new rules are effective for taxable years beginning after December 31, 2017.

Notably, the legislation did not incorporate the transition rule provided for in IRC Section 162(m), under which compensation paid pursuant to a written binding agreement in effect on November 2, 2017 is excluded from the new rules, so long as the agreement is not later modified.

Who is considered a "covered employee" under IRC Section 4960?

A covered employee includes:

- Anyone who is one of the top five (5) highest paid employees of the tax-exempt organization; and
- Anyone considered a covered employee of the organization in a preceding year

beginning after December 31, 2016.

What compensation is subject to the $1,000,000 limit?

The rules apply to all wages (excluding designated Roth contributions), and compensation that is required to be included in income under the deferred compensation rules under IRC Section 457(f) (i.e., when the compensation is no longer subject to a substantial risk of forfeiture).

Compensation paid to a licensed medical professional (e.g., a doctor, nurse, or veterinarian) for the performance of medical or veterinary services (but not administrative services) by that professional, is excluded from the excise tax. However, compensation paid to the medical professional in any other capacity is taken into account under the rules.

What is an "excess parachute payment"?

The rules and concepts for determining "excess parachute payments" are similar to the rules outlined in IRC Section 280G covering payments that are contingent upon a change-in-control ("CIC") of a corporation, except that the tax-exempt rules will generally apply to severance or severance-related compensation (i.e., a CIC is not required for the rule to apply).

An "excess parachute payment" is the amount by which any "parachute payment" exceeds a covered employee's "base amount."

- A "parachute payment" is generally any severance or severance-type compensation paid to (or for the benefit of) a covered employee for which the aggregate present value equals or exceeds three times the employee's "base amount."
- A covered employee's "base amount" is generally the average annualized compensation includible in the employee's gross income for the five taxable years ending before the date of the employee's separation from employment.

What types of compensation are not captured under the new rules?

Parachute payments do not include:

- Payments from various retirement plans and accounts:
    - Qualified retirement plans, simplified employee pension plans, simple retirement accounts, tax-deferred annuity contracts under IRC Section 403(b), and eligible deferred compensation plans under IRC Section 457(b) are excluded;
- Payments to a covered employee who is not a highly compensated employee (within the meaning of IRC Section 414(q)); and
- Payments to licensed medical professionals as described above.

Who is responsible for paying the excise tax?

Unlike IRC Sections 280G and 4999, where the excise tax is imposed upon the executive receiving the excess parachute payments, IRC Section 4960 excise tax applies to the employer and related organizations. If a covered employee's compensation is paid by more than one employer, then each employer is responsible for its pro-rata share of the excise tax.

As a result of the provision's broad definition of related organizations, it appears that it may be possible for a taxable entity to be subject to the excise tax.

What steps should tax-exempt organizations take now to begin preparing for the new excise tax rules?

While the law is still fresh and further guidance on a number of technical topics is necessary, organizations and their compensation committees or boards should begin now to better understand their exposures under IRC Section 4960. Some action steps include:

- Identify covered employees for 2018 and 2017; the covered employee status persists into subsequent years.
- Inventory existing compensation arrangements that may become subject to the excise tax.
  - All existing employment agreements, annual and long-term incentive plans, severance arrangements, deferred compensation plans, and any other compensation arrangements should be reviewed.
- Estimate the annual financial impact on the organization of excise tax payments for covered employees' compensation in excess of $1 million.
- Determine whether any adjustments should be made to annual compensation programs for covered employees to reduce or eliminate the payment of the excise tax—without jeopardizing executive retention and the competitiveness of executive pay because of compensation program changes.
- In anticipation of terminations and/or retirements, organizations should evaluate whether any excess parachute payments are likely to be triggered.
  - Until further guidance is provided, the IRC Section 280G golden parachute rules, which are similar in concept to IRC Section 4960, may be helpful to understanding how the rules practically should be applied.
- Consider how the new rules will apply when structuring new compensation arrangements.
  - For example, an employer may consider including protective language in any new executive compensation arrangement that would allow it to unilaterally modify or reduce compensation to the extent needed to avoid the excise tax (similar to clauses used by many taxable corporations for handling the golden parachute excise taxes under IRC Section 4999). Given the excise tax is applied on the employer, it will likely be much more difficult to negotiate reductions at the time of terminations when the excise tax applies.

About the Authors

Margaret Black is a managing director at Pearl Meyer and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.

Ed Steinhoff is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth

strategy and in the development of consultants at various stages in their careers. With more than 25 years' experience in executive compensation, Ed works with the boards of directors and senior management teams of public and private companies, ranging from small and middle-market firms to multibillion-dollar corporations, to design pay programs that drive business performance and value creation, secure high-performing executive talent, and meet both regulatory standards and stakeholder expectations.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.