

What Tax Cut?

In an ironic twist to the just-enacted “Tax Cuts and Jobs Act,” many tax-exempt organizations will be subject to a substantial new tax limiting their ability to recruit, compensate and retain leadership talent. While penalizing employers for providing certain levels of otherwise reasonable compensation is not a new concept for publicly-traded companies, it is unprecedented in tax-exempt organizations. Below, we review the public-company experience and then consider the Act’s impact on tax-exempt organizations.

Background

For many years, publicly-traded companies have been limited in their ability to deduct certain types of compensation for their chief executive officer and the four other most highly compensated executives.¹ Section 162(m) of the Internal Revenue Code (IRC) states:

In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.

By denying the tax deduction, the employer is penalized to the tune of the excess compensation multiplied by the corporation’s tax rate. The Act reduces corporate tax rates from 35% to 21%, making the 162(m) penalty 21% of compensation in excess of \$1 million.

Impact of the Act

The compensation practices of tax-exempt organizations have come under increasing scrutiny from the government as well as the public. There is a growing perception that executives of tax-exempt organizations are failing to embrace their organization’s stated purpose, are over-paid and should have their compensation and benefits limited beyond the current reasonable compensation tests and intermediate sanctions. Numerous methods have been suggested, including limiting executive compensation to that of the president of the United States or the applicable state governor.

The Act takes a different approach, imposing a 162(m)-type penalty on the tax-exempt employer. Since tax-exempt employers don’t use tax deductions, new IRC section 4960 imposes an excise tax on compensation in excess of \$1 million.² The excise tax rate is the corporate tax rate then in effect, which under the Act is 21%. The tax-exempt employer pays the tax.

There is hereby imposed a tax equal to the product of the [corporate tax rate] and . . . so much of the remuneration paid . . . by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of \$1,000,000 . . . The employer shall be liable for the tax imposed...

¹ The Act changed covered employees for public companies to the principal executive officer, principal financial officer and the three other most highly compensated executives.

² The Act also imposes the excise tax on parachute payments, which generally arise if the employer pays severance that is three times or more the individual’s 5-year average W-2 compensation. This parachute part of the excise tax only applies if the individual qualifies as a highly-compensated individual (\$120,000 in 2017 and 2018).

The 4960 excise tax applies to the tax-exempt organization's five highest compensated employees (or former employees) for the year, plus anyone who was in the five-highest group for any preceding year (2017 or later).³

Even though a covered employee's aggregate annual salary and incentive payments may be less than \$1 million, any deferred compensation arrangement increases the likelihood of incurring the 4960 tax. This is because "remuneration" includes deferred compensation, not as it accrues each year, but in a lump sum in the year it vests (i.e., is no longer subject to a "substantial risk of forfeiture"). Under many plans, deferred compensation accrues over 10 or more years so the vesting amounts can represent many multiples of current salary and bonus. Nevertheless, the full amount of vesting deferred compensation is added to current compensation, significantly increasing the risks that the total for the year will exceed \$1 million, resulting in the 21% excise tax on the excess.

Conclusion

The Act will affect a large number of tax-exempt organizations- especially in healthcare, higher education, and trade and professional associations. Failure to adapt to the new 4960 requirements will cause a tax-exempt organization to lose capital that would otherwise support its mission.

Tax-exempt employers should contact the authors or seek the advice of qualified counsel regarding the options available for addressing the excise taxes.

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³ The Act excludes compensation paid to physicians and nurses for rendering medical services. Payments to these professionals for administrative services are included, however.