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Tax-Exempt Organizations Face a New 21 Percent Excise Tax on Compensation Paid to Non-Profit Executives in Excess of $1 Million

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President Trump signed the Tax Cuts and Jobs Act of 2017 on Dec. 22, 2017. Effective as of Jan. 1, 2018, the Act adds Section 4960 to the Internal Revenue Code ("Code"), which imposes a new 21 percent excise tax on "Compensation" paid by an "Applicable Tax-Exempt Organization" with respect to employment of any Covered Employee. The employer is responsible to pay the excise tax, even if the amount paid is determined to be reasonable under the intermediate sanction rules. For purposes of Section 4960, the following terms are defined:

- "Compensation" means the sum of W-2 wages in excess of $1 million, plus any excess parachute payments. Compensation that is not vested (for example, deferred compensation under a 457(f) plan that is subject to substantial risk of forfeiture) is not counted until the risk lapses and it becomes vested.

- "Excess parachute payments" are payments, like severance, which are made contingent upon a covered employee's termination from employment in an aggregate amount greater than or equal to three times the employee's five-year average base compensation, and the tax applies to the excess parachute payment even if the W-2 wages are less than $1 million. There is an exception for parachute payments to individuals who are not highly compensated employees as defined by Code Section 414(q) (i.e., for 2018, this means employees who earned less than $120,000 in 2017).

- "Covered Employee" means any employee who is one of the five highest compensated employees of the organization for the current taxable year or any preceding taxable year beginning after 2016. Once an employee qualifies as a Covered Employee, the employee will always be treated as a Covered Employee in future years even if he or she is no longer one of the five highest compensated employees of the organization. As a result, organizations can have more than five covered employees.

- "Applicable Tax-Exempt Organization" includes 501(a) tax-exempt organizations and their related organizations. The provision defines related organizations broadly, and includes entities that are controlled by the organization, are controlled by the same person or people who control the organization, supported and supporting organizations, and if the organization is a voluntary employee benefit association ("VEBA"), organizations that make contributions to the VEBA. Employers likely to be affected by this law include large universities, cultural institutions and hospitals. An exception was made to carve out compensation paid to licensed doctors and veterinarians for the performance of medical or veterinary services by such professionals. State employees, including employees of state organizations, appear to be covered by this.

Under the Code, existing deferred compensation arrangements will be treated as paid when the amounts are no longer subject to a substantial risk of forfeiture or "vested." There is generally no ability to accelerate payment of certain deferred compensation to avoid the excise tax. One might be able to extend the vesting date by at least two years, if the deferred compensation is increased by at least 25 percent; this approach, however, would appear to exacerbate the problem rather than minimize it.

Tax-Exempt Organizations should review their existing employment contracts, 457(f) deferred compensation plans, severance and compensation arrangements to understand which employees are covered and whose compensation is potentially impacted by the new excise tax. Going forward, while the Tax-Exempt Organization will be responsible to pay for the tax, employers will need to budget this new excise tax into their compensation planning. When setting compensation or agreeing to provide severance payments, Tax-Exempt Organizations will need to analyze the impact of this excise tax and plan accordingly. For example, they may offer lower compensation in recognition of the tax, cap compensation to avoid the tax, or maintain the right to modify or reduce compensation to the extent needed to avoid the tax. In addition, when entering into agreements that provide for parachute payments, Tax-Exempt Organizations may require the departing employee to cover the excise tax amount out of his or her parachute payment.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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