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Skadden

Executive Compensation and Benefits Alert

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Tax Cuts and Jobs Act: Impact on Tax-Exempt Organizations

On December 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (the Act), which imposes a new excise tax on certain tax-exempt organizations for compensation paid to their covered employees in excess of $1 million per year and on certain excess parachute payments paid to covered employees that are contingent upon their separation from employment. These new taxes are effective for taxable years beginning after December 31, 2017. The tax-exempt organization, not the employee, is responsible for paying the tax.

Tax-exempt organizations subject to the excise tax include all tax-exempt organizations under Section 501(a) of the Internal Revenue Code (the Code), exempt farmers' cooperative organizations, certain state or local governmental entities, and certain political organizations, as well as persons related to those entities. If a covered employee's compensation is paid by more than one employer, then each employer is responsible for its pro rata portion of the excise tax.

Compensation in Excess of $1 Million

The Act imposes an excise tax equal to 21 percent (*i.e.*, the rate of tax generally applicable to for-profit corporations under the Act) on any compensation paid by a tax-exempt organization to a covered employee in excess of $1 million for its taxable year. A "covered employee" means any current or former employee who is either one of the five highest compensated employees for the taxable year or was a covered employee of the organization (or any predecessor organization) for any preceding taxable year beginning after December 31, 2016.

Compensation subject to this limitation includes (i) all wages other than designated Roth contributions and (ii) amounts required to be included in income under the deferred compensation rules of Section 457(f) of the Internal Revenue Code, with such amounts being treated as paid when the rights to the payment are no longer subject to a substantial risk of forfeiture. For deferred compensation plans subject to Code Section 457(f), this can result in the excise tax applying to the value of compensation when it vests (*i.e.*, when it is no longer subject to a substantial risk of forfeiture) even if it is not yet paid.

Compensation paid to a licensed medical professional, which includes a doctor, nurse or veterinarian, for services performed is excluded from the excise tax. Under this exception, which was clarified by the conference agreement under the Act, the portion of compensation paid to a licensed medical professional that is directly related to the performance of services by that professional is excluded. However, compensation paid to the professional in any other capacity is taken into account.

Excess Parachute Payments

The Act also imposes an excise tax equal to 21 percent on any excess parachute payment paid by the tax-exempt organization to any covered employee. An "excess parachute payment" means the amount by which any parachute payment exceeds the covered employee's "base amount." A "parachute payment" refers to a payment in the nature of compensation to (or for the benefit of) a covered employee that is contingent upon the employee's separation from employment with the employer and for which the aggregate present value of all such payments equals or exceeds three times the employee's "base amount." An 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. Parachute payments do not include payments from qualified retirement plans, simplified employee pension plans, simple retirement accounts, tax-deferred annuity contracts under Code Section 403(b) and eligible deferred compensation plans under Code Section 457(b), as well as payments to a covered employee who is not a highly compensated employee (within the meaning of Code Section 414(q)). Payments made to licensed medical professionals as described above also are excluded. The rules for calculating excess parachute payments are similar to the golden parachute rules for corporations under Code Section 280G.

Amounts that are excess parachute payments are excluded from compensation for purposes of determining the extent to which the employee's compensation exceeds $1 million, so that the same amount should not be subject to the excise tax twice.

Planning for the Excise Tax on Excess Executive Compensation

Below are some planning considerations and action items for covered tax-exempt organizations to review as they prepare for the new excise tax on excess executive compensation.

- Organizations should prepare a list of their covered employees and take an inventory of their covered compensation arrangements to determine whether they may become subject to the excise tax for taxable years beginning after December 31, 2017. In this regard, tax-exempt organizations should be mindful that, as is the case under Code Section 162(m) as amended by the Act, once an individual becomes a covered employee for any taxable year beginning after December 31, 2016, that individual will remain a covered employee for all future years, including after termination of employment or even death. Unlike in the case of Code Section 162(m), there is no grandfathering rule for existing compensation arrangements. Organizations should review all existing employment agreements, annual and long-term incentive plans, severance arrangements, deferred compensation plans under Code Section 457(f) and other compensation arrangements that may apply to their covered employees.
- Organizations may consider implementing longer vesting schedules or extending the timing for cash payouts of awards or other compensation (such as severance or payments under a deferred compensation plan under Code Section 457(f)) by spreading the payments over multiple years in an attempt to come below the annual $1 million threshold. Organizations should be aware that doing so may have implications under the deferred compensation rules of Section 409A and Section 457(f).
- For covered employees who participate in deferred compensation plans subject to Code Section 457(f), organizations should determine when the rights to payment will cease to be subject to a substantial risk of forfeiture. As noted above, it is the lapse of the substantial risk of forfeiture, not the payment, that will determine when the amounts will be subject to the $1 million threshold (*i.e.*, if vesting occurs in a year before the year of payment).
- In anticipation of a covered employee's retirement or other termination of employment, organizations should conduct an analysis to determine whether any excess parachute payments will be triggered. We are hopeful that future guidance will be issued clarifying the application of the excess parachute payment rule to tax-exempt organizations. In the meantime, organizations may wish to review the golden parachute rules for corporations under Code Section 280G that are similar in concept.
- When designing executive compensation arrangements for covered employees, organizations will need to be keep in mind the implications of any potential excise tax on excess compensation paid to covered employees under the Act, in addition to the existing rules under Code Section 4958, which imposes a penalty excise tax directly on certain persons who receive excessive compensation from certain tax-exempt organizations.
- If organizations intend to rely on the exception for licensed medical professionals, they will need to keep track of the portion of compensation paid each year to those professionals directly for their medical or veterinary services performed and, if applicable, for services performed in any other capacity.

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The new excise tax on certain tax-exempt organizations for compensation paid to their covered employees in excess of $1 million per year and on certain excess parachute payments paid to covered employees will have a significant impact on the design and administration of executive compensation programs for taxable years beginning after December 31, 2017. Tax-exempt organizations should consult with their advisers to assess the impact of the excise tax on their executive compensation programs and develop a strategy that achieves their objectives for compensating executives.

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