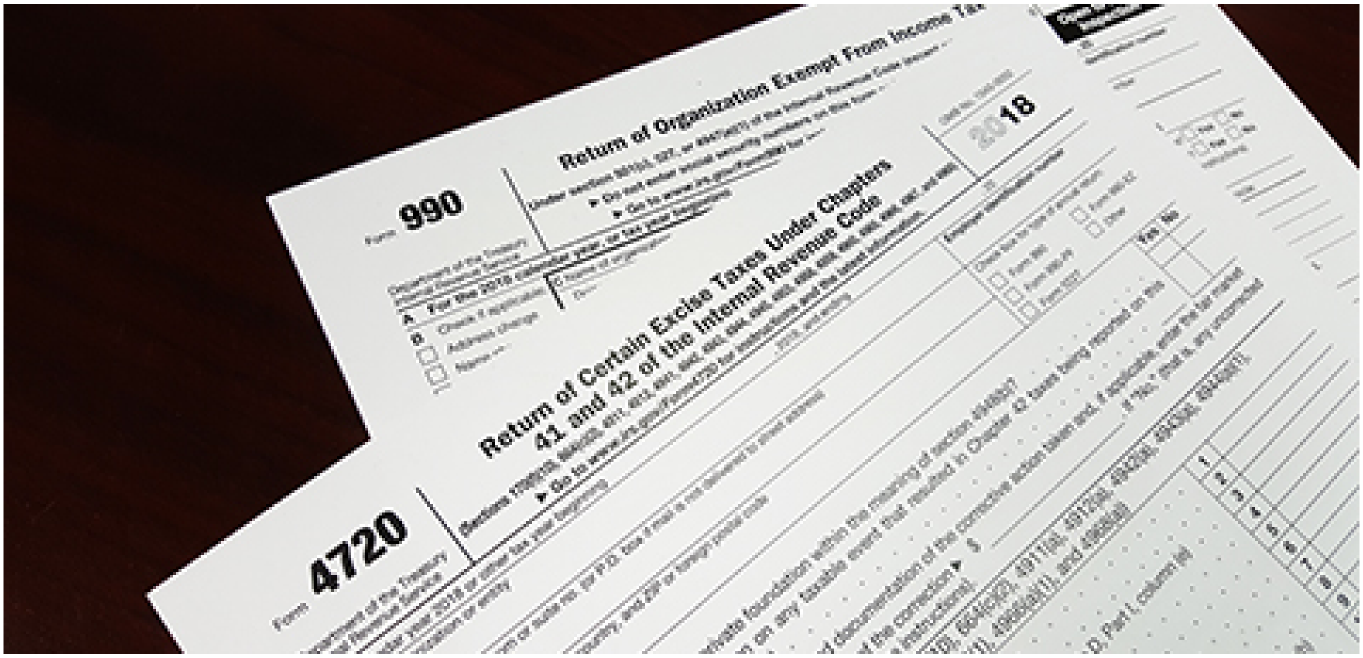

TCJA excise tax on excess executive compensation for nonprofits

January 31, 2019

Beginning with the 2018 tax year, nonprofit organizations that pay their top executives more than $1 million per year are subject to a new 21 percent excise tax.

The Tax Cuts and Job Act (TCJA) provides that publicly held corporations cannot deduct more than $1 million of compensation for the top four highly-paid executives and CEO or for excess parachute payments. These limits do not affect tax-exempt entities, and nonprofit boards must honor only the fiduciary obligations of paying executives a "reasonable and not excessive compensation."[1] To those obligations, the TCJA added a 21 percent excise tax on certain compensation above $1 million.[2]

Under Code Section 4960, an organization exempt under Section 501(a) will be subject to an excise tax equal to 21 percent of the total of (i) *remuneration* in excess of $1 million paid to a *covered employee* and (ii) separation pay excess parachute payments.[3]

Remuneration includes all wages except for designated Roth contributions and amounts included in gross compensation under Section 457(f).[4] Notably, remuneration paid to licensed medical professionals performing medical services is exempt. Health systems should consider tracking clinical compensation and unrelated compensation to physician, nurse and veterinarian executives.

Covered employees include the top five highest-paid employees during the tax year *and* any former employee who was a top-five covered employee during or after 2017 and is still being paid post-termination compensation subject to withholding that exceeds $1 million in the current year. Each tax year warrants a new calculation of covered employees, but the number may not be limited to five when including former employees.

Softening the impact

Regardless of current wages, entitlement and vesting dates of deferred compensation plans will swell the remuneration levels of many current and former executives.[5] There is some opportunity to defer compensation, as well as delay entitlement dates within the structure of the employer's plan and without triggering other 409A excise taxes on the employee. For example, a plan may allow an employee to change entitlement date elections regarding the time and form of payment if certain criteria are met. Organizations need to identify which employees are impacted by the new tax and possibly offer compensation strategies to soften it, such as if the executive is willing and permitted to delay an entitlement date to smooth or further delay taxation on the entity. These taxes may also warrant evaluation of an organization's policy goals in offering certain deferred compensation plans and the vesting schedule of benefits in them.

Line 15 on Form 990 has a new question regarding the applicability of Section 4960 excise taxation. If answered affirmatively, Form 4720 should accompany Form 990 to report and pay the excise taxes.

Interim guidance was released on December 31, 2018, to address how this tax will apply in common situations for tax-exempt employers. The Treasury and the IRS intend to issue proposed regulations that will incorporate the guidance provided in the notice. Employers should review the notice and continue to stay up to date on issued guidance in order to appropriately plan for, pay or possibly avoid the new taxation.

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[1] 26 U.S.C. 4958; 26 CFR 53.4958-1 through 8.

[2] 26 U.S.C. 4960.

[3] Remuneration is treated as paid when there is no substantial risk of forfeiture within the meaning of Section 457(f)(3)(B).

[4] Wages within the meaning of Section 3401(a) and certain deferred compensation amounts included in gross income the year of vesting.

[5] Amounts that accrued and vested prior to 2018 do not count toward the threshold. Notice 2019-09.

Authors