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Impact of TCJA on compensation programs for tax-exempt organizations

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law. While the bulk of the new law affected individual and for-profit corporate taxation, several significant provisions were enacted that affected compensation programs for tax-exempt organizations. These changes are effective as of January 1, 2018.

Excise tax on "excess executive compensation"

The new law adds Code Section 4960 which imposes a new excise tax to be paid by tax-exempt organizations. The tax rate is 21% and it applies to "remuneration" in excess of $1 million paid in any year to a "covered employee". It appears the annual period refers to the fiscal year of the tax-exempt organization, however future IRS guidance is expected to address this question.

A covered employee is defined as being among the five highest paid employees of the organization in any particular year. And, once an employee is a covered employee, they will always be a covered employee (including any future payments to an employee's beneficiary). So, in practice, some organizations may have many more than five covered employees to the extent compensation varies year-to-year among highly compensated individuals. Also, employers will need to pay attention to a transition rule in the new law that any employees who would have been covered employees in 2017 will be covered employees going forward.

Remuneration is defined as compensation paid or no longer subject to substantial risk of forfeiture. It does not include amounts excludable from gross income (such as contributions to 403(b), 401(k) and 457(b) plans), but it does include amounts that vest in the current period in a 457(f) plan. Also excludable are payments made to "licensed medical professionals" for the performance of medical or veterinary services.

Once the tax-exempt organization determines the list of covered employees, the organization will owe the 21% excise tax on any remuneration above $1M for any of the covered employees in a given year.

Before entering into benefit agreements under 457(f) plans, organizations should consider the potential impact of the excise tax, especially when large lump-sum vesting schedules are used. In addition, tax-exempt organizations may want to review any existing 457(f) arrangements to see if they will cause the excise tax to be imposed. Under proposed regulations that may currently be relied upon, with proper planning, those arrangements may be modified to extend vesting periods and potentially reduce or avoid the tax.

Excise tax on “excess parachute payments”

The new law also imposes the same 21% excise tax on post separation payments meeting the definition of an “excess parachute payment”. This only applies to payments made to “covered” employees who are also highly compensated employees (HCEs) under section 414(q) – i.e., over $120,000 in 2018.

A payment is considered an excess parachute payment if the present value of aggregated payments made contingent to an employee’s separation exceeds three times a “base amount”. The base amount generally is the average compensation over the most recent five taxable years. The 21% tax applies to the excess amount over the base amount.

Payments made from qualified plans, 403(b) plans and 457(b) plans do not count as parachute payments. Since 457(f) benefits must generally vest while a participant is in-service, 457(f) benefits likely will not be counted as parachute payments in most cases. Although it’s not clear in the law, it appears 457(f) benefits that vest as a result of separation from service may be includible, for example, vesting upon termination for no cause. And, as with the excess compensation tax, payments made to medical professionals for medical services are also excluded.

Summary

Tax-exempt organizations with any employees making more than $1 million per year should carefully review Code Section 4960 and get processes in place to track both covered remuneration and covered employees.

Although the new tax law doesn’t seem to impact contributions to or distributions from 457(b) plans, tax-exempt organizations with 457(f) plans should carefully review existing arrangements and consider the provisions of Section 4960 before entering into new 457(f) agreements.

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