Impact of tax reform on tax-exempt organizations paying compensation in excess of US$1 million

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The tax reform bill approved by Congress enacts a new section of the Internal Revenue Code – Section 4960 – which will impose an excise tax on tax-exempt organizations that pay an employee compensation greater than US$1,000,000 per year. (We have written extensively on the many aspects of the tax reform bills. See here.)

You may think, "No one at my organization is paid anything near US$1,000,000 per year, so this aspect of the tax reform bill does not affect me." Before you mentally cross this off your list and move on, some of the details of Section 4960 deserve a closer look.

The basic contours

Section 4960 imposes an excise tax on tax-exempt employers. The tax is equal to 21% (the corporate tax rate imposed whether or not the tax-exempt organization is a corporation, trust, or another entity) of remuneration in excess of US$1,000,000 paid to a covered employee during the employer's tax year. Any organization exempt from taxation under IRC Section 501(a) – which includes charities exempt under Section 501(c)(3), social welfare organizations under 501(c)(4), trade associations described in Section 501(c)(6), and the many other subcategories of tax-exempt organizations – are subject to the tax. The provision also applies to farmers' cooperative organizations and certain political organizations.

Covered employees

A covered employee is any current or former employee of a tax-exempt organization who is one of the five most highly compensated employees for the taxable year or who was a covered employee for any preceding taxable year beginning after the end of 2016. Once an employee is on the "covered" list, he or she remains on the list forever.

"Remuneration"

Remuneration is a broad term. It includes not only the direct payment of any wages (as defined in the Code) but also certain deferred compensation and retirement benefits (discussed below in more detail) and amounts paid as employment compensation to the employee by any person or governmental entity that is "related" to the tax-exempt employer. Persons (individuals or entities) or governmental entities are related to a tax-exempt employer if they control or are controlled by, have common control with, or are a supported or supporting organization (as defined in Section 509), or maintain or contribute to a VEBA for the tax-exempt employer.

Section 4960 specifically excludes from the definition of remuneration designated Roth contributions or payments that are not deductible by the employer by virtue of Section 162(m) (denying business-expense deduction for certain payments by for-profit employers) and any compensation paid to a doctor, nurse, or veterinarian for the performance of medical or veterinary services. Section 4960 also authorizes the IRS to develop regulations to disallow strategies to avoid this tax by use of other entities or by misclassifying employees as independent contractors.

Nonqualified deferred compensation and retirement benefits

For purposes of Section 4960, the definition of remuneration specifically includes nonqualified deferred compensation, but only to the extent that the employee is required to include it as gross income under Section 457(f). When nonqualified deferred compensation is subject to a substantial risk of forfeiture (e.g., a provision saying that the employee will forfeit such compensation if he or she leaves the employ of the organization before the scheduled payment date), it is not treated as remuneration. However, when that risk of forfeiture lapses (which typically occurs when the deferred compensation becomes payable to the employee but can occur upon other occasions), the entire amount is treated as remuneration in that year.

Thus, a lump-sum payment to a key employee who has accrued nonqualified deferred compensation over many years may trigger this excess compensation excise tax. This is true even if the amount of any annual cash compensation paid plus the nonqualified deferred compensation earned each year totaled less than US$1,000,000 and even if total compensation was reasonable in amount and therefore did not trigger excise taxes on the employee under the excess benefit rules (Section 4958) or the self-dealing rules (Section 4941). This seems especially punitive given the strict rules that limit the ability of the employer or the employee to defer payment dates or spread out originally scheduled payments an impose already-existing excise taxes under Section 409A for breach of those rules.

Thankfully, it appears that the definition of remuneration does not include the payment of nonqualified deferred compensation subject to Section 457(b) (which in 2018 is limited to US$18,500 per year), because such deferred compensation is generally not subject to a risk of forfeiture.

Impact on severance pay and qualified retirement benefits

Section 4960 also triggers a 21% excise tax on "excess parachute payments" paid to a covered employee by a tax-exempt employer. A parachute payment is any payment in the nature of compensation that is contingent on the employee's separation from employment, and an excess parachute payment is one that exceeds three times the employee's annual compensation over a base period. Section 4960 specifies that payments under qualified plans (qualified pension or profit sharing plans, 401(k) plans, 403(b) plans, or 457(b) plans) are not parachute payments.

Liability for tax

The excise tax imposed by Section 4960 is payable by the tax-exempt employer (and by related persons or government entities), not by the employee. However, it seems likely that employers may reduce compensation to avoid the tax or recover the tax outlay, which would mean that employees would ultimately feel the impact.

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As you can see, the tax bill may have impact beyond what is assumed at first glance. To discuss Section 4960 or any other aspect of the reform bill, feel free to contact any member of the Withers Bergman LLP charities team.

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