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Private Foundations Bulletin

Understanding the New Tax on Excessive Compensation

By Mark A. Hertlein, CPA, Senior Tax Manager and Louis F. LiBrandi, EA, CEBS, ChFC, TGPC, Principal

The effects of the new tax law are wide-ranging and this newsletter will focus on compensation provided to certain employees by private foundations and tax-exempt organizations. This will further explain how so-called “excess” compensation may be affected by the new tax law.

Excise Tax on Compensation of Executives of Tax-Exempt Organizations

Prior to the enactment of the Tax Cuts and Jobs Act (TCJA), tax-exempt entities had to comply with “reasonableness” requirements and a prohibition against private inurement with respect to executive compensation. [A few States (notably, New York) impose additional requirements.] Pre-TCJA, there was no excise tax tied to the amount of compensation paid, as long as the amount was reasonable.

For tax years starting in 2018, the new law imposes a 21 percent excise tax on compensation over \$1 million as well as “excess” severance paid by covered tax-exempt organizations to certain employees.

The stated intent behind this excise tax is to put tax-exempt organizations in the same position as publicly held for-profit companies which cannot deduct excess compensation and “golden parachute” payments paid to their covered employees. However, unlike the changes made by the TCJA to the excess compensation rules for publicly traded companies, there is no transition relief for existing tax-exempt organization compensation arrangements. This means that the new excise tax will apply to all “excess” compensation paid by a covered organization to a covered employee in tax years beginning after 2017.

Covered Tax-Exempt Organizations

In general, the new excise tax provision (IRS Code Section 4960) will apply to most tax-exempt entities. Specifically, it will cover:

- Any entity which is exempt under Code Section 501(a) – including 501(c)(3) and 501(d).
- Any state and local governmental entity with tax-exempt income [Code Section 115(1)].
- An exempt political organization [Code Section 527].
- An exempt farmers’ cooperative [Code Section 521(b)(1)].

Covered Employees

The TCJA defines a “covered employee” as any employee of a covered organization who is one of the five highest paid employees in any year after 2016. The new excise tax can apply to any individual who is currently or was previously among the five highest paid employees of the organization after 2016 (even if the individual is no longer an employee). Interestingly, this determination does not require one of the five to be an executive or officer, but the “includable compensation” concept discussed below generally has the effect of limiting the excise tax to executives.

Includable Compensation

The TCJA utilizes the term “remuneration” which includes wages that are payable to a covered employee that are subject to federal income tax withholding. It also includes any amounts that are subject to taxation under Code Section 457(f), which applies to most forms of nonqualified deferred compensation arrangements of covered tax-exempt entities. However, compensation does not include any Roth contributions made by the employee under the employer’s 401(k) or 403(b) plan. In addition, it does not include compensation paid to a licensed medical professional (e.g., a doctor) for the performance of medical or veterinary services. In other words, only compensation for non-medical services is to be counted in applying the excise tax provision to this group.

It is also important to note that the TCJA provides that, in determining the total amount paid to a covered employee for excise tax purposes, any compensation paid by a related organization to the employee for employment services is also counted.

Excise Tax for Excess Compensation

As indicated above, the excise tax is imposed on any compensation in excess of \$1 million “paid” to a covered employee in any year. The TCJA provides that compensation is to be treated as “paid” when the rights to such compensation are no longer subject to a substantial risk of forfeiture. It appears that the intent is to count a covered employee’s compensation in the year the employee’s rights to such pay become non-forfeitable even if it is not paid or otherwise taxable under Code Section 457(f) in that year.

It appears that all compensation paid to a covered employee, even after termination of employment, is to be counted in determining whether and to what extent the \$1 million limit has been exceeded in any year. To avoid double-counting, the TCJA provides that any post-termination compensation that is treated as excess severance pay for excise tax purposes is not counted in applying the \$1 million limit. (See additional information below.)

Excise Tax for Excess Severance Payments

The excess severance pay provisions are generally intended to mirror the “golden parachute” payment provisions under which for-profit entities cannot deduct excess parachute payments made to their employees. The TCJA provides that any compensation paid to a covered employee, which is “contingent” on the employee’s termination of employment, is counted. However, parachute payments do not include payments under a “tax qualified “retirement or savings plan [such as a 401(k) plan, 403(b) plan, a 457(b) plan sponsored by a state or local government, and a simplified employee pension plan, and a simple retirement account]. In addition, remuneration paid to (i) a licensed medical professional for the performance of medical or (ii) a non-highly compensated employee, within the meaning of Code Section 414(q), is not considered for this purpose.

The excise tax only applies if the covered employee’s total severance payments equal or exceed three times the employee’s base amount. However, if the employee’s severance exceeds this threshold, any payments in excess of the covered employee’s base amount will be subject to the excise tax. For this purpose, the base amount is the employee’s average annual taxable compensation for the five years preceding his or her termination date (or, if shorter, the employee’s period of employment during that timeframe). The excess severance payment can apply even if the individual’s compensation for the year is less than \$1 million.

Therefore, the excise tax on compensation over \$1 million and the excise tax on excess parachute payments operate independently. One may apply, even when the other does not.

Who is Liable for the Excise Tax

Under the TCJA, the covered tax-exempt employer is liable for the 21 percent excise tax. However, where the covered employee's compensation includes amounts paid by an organization related to the covered employer, the TCJA provides that the related organization is liable for a pro rata portion of any associated excise tax.

Updating the Tax Code and Regulations

The law will now have to be incorporated into the Internal Revenue Code and Treasury Regulations. Through this process, additional information should be provided to clarify the language used as it relates to the new excise tax. As more guidance is provided, we will continue to keep you informed with future Thought Leadership communications.

Contact Us

If you have questions regarding how these rules will apply to your organization, contact any of the below or another member of your tax-exempt client service team or private foundation team at PKF O'Connor Davies.

Thomas F. Blaney, CPA, CFE
Partner, Co-Director of Foundation Services
tblaney@pkfod.com

Christopher D. Petermann, CPA
Partner, Co-Director of Foundation Services
cpetermann@pkfod.com

Garrett M. Higgins, CPA
Partner
ghiggins@pkfod.com

Louis F. LiBrandi, EA, CEBS, ChFC, TGPC
Principal
lilibrandi@pkfod.com

Mark A. Hertlein, CPA
Senior Tax Manager
mhertlein@pkfod.com

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