PartnersFinancial® TAX PLANNING WHITE PAPER

WHAT'S NEW WITH THE EXCISE TAX?

EFFECTS OF THE TAX CUTS AND JOBS ACT ON EXECUTIVE COMPENSATION

Much has been written about how the 2017 *Tax Cuts and Jobs Act* changed the tax rate for C corporations and created a deduction for S corporations. But all this attention to corporations meant that other impactful provisions went into effect without much notice. One such unheralded provision is the "Tax on Excess Tax-Exempt Organization Executive Compensation" (the "excise tax").

WHAT IS THE EXCISE TAX?

An excise tax of 21 percent is imposed on the remuneration paid by all tax-exempt employers in the following two situations:

1. Amounts in excess of $1 million paid to a covered employee for a tax year
2. Any separation (parachute) payment paid to a highly compensated employee that is equal to or greater than three times the 5-year average annual earnings of that employee

The excise tax applies to all tax-exempt entities, including political organizations and farmers' cooperatives.

THE EXCISE TAX'S REACH

Just in case there was any confusion, the excise tax applies to all tax-exempt entities, including political organizations and farmers' cooperatives. Employees whose compensation will trigger the tax-exempt entity to have to pay the 21 percent excise tax, making them "covered employees" for the purposes of the excise tax, include

- The five most highly paid employees earning more than $1 million per year for the current year or any prior year, starting Dec. 31, 2016. The tax-exempt entity must determine the five most highly paid employees annually, which means that this could be an evolving roster of employees. But once an employee becomes a covered employee, they remain a covered employee.
- Any highly compensated employee (defined as receiving compensation equal to or greater than $120,000 in 2018) receiving a separation from service payment equal to or greater than three times the 5-year average final annual compensation.

Depending on the tax-exempt entity examining the excise tax, the tax-exempt employer might have a tendency to despair or to dismiss the excise tax as being not applicable. Before we do either of those things, let's look at the few exceptions and some of the opportunities arising from the excise tax.

EXCEPTIONS

The excise tax doesn't apply to

- Remuneration paid to licensed physicians, nurses or veterinarians, to the extent that the remuneration is for the performance of medical or veterinary services rendered by such professionals.
- Payments received from qualified retirement plans, such as 401(k), 403(b), simplified employer pension plans and 457(b) plans.
- Separation payments to highly-compensated employees if the payment is limited to 2.99 times their five-year average annual earnings.

NOT EXCEPTIONS

Many tax-exempt entities are likely to be quick to dismiss the excise tax as not applicable to their employees because of the $1 million threshold. Those employers need to be careful that they don't also ignore the fact that any single 457(f) payment that exceeds the threshold is subject to the tax made at the time of separation from service. Any amounts paid to a highly compensated employee under a SERP or 457(f) plan could be subject to the excise tax, not just the amounts paid to the top five employees. In addition, the excise tax applies to amounts paid to covered employees from related organizations, which is determined by common control. Avoiding the excise tax isn't as simple as creating a taxable entity to employ all covered employees.

THE GOOD NEWS

While it may seem that providing compensation to those employees who are crucial to the tax-exempt entity's continued success is impossible without paying a hefty excise tax, that's not necessarily the case. There are ways careful design of a compensation plan, coupled with the use of life insurance, can allow a tax-exempt entity to still provide meaningful remuneration to its employees without negative tax consequences to either the employer or the employee. The best place for a tax-exempt employer to start is by conducting a thorough review of the remuneration paid or promised to its highly compensated employees to determine the full applicability of the excise tax. Then the tax-exempt entity can start the process of revising its compensation structure to fit within the parameters of the excise tax.

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