



WSC POLICY ALERT

Excise Tax on Executive Compensation in the Tax Cuts and Job Act

Overview

Under Section 4960 of the Tax Cuts and Jobs Act (Pub. L. No. 115-97), tax-exempt organizations will now be treated like publicly traded C corporations by imposing a similar limitation on the ability to compensate executives more than \$1 million annually.

For tax years beginning after December 31, 2017, a tax-exempt organization (not the employee) will be required to pay an annual 21% excise tax on compensation exceeding \$1 million paid to any of its five highest-paid employees for the tax year. This includes any employee who was one of the five highest paid employees in any previous year after 2016 (even if they weren't one of the "high five" in 2017 or later).

Current Law

Tax-exempt organizations generally are not subject to limitations on the compensation amounts paid to executives, but are limited by private inurement rules and potential sanctions if the executive's compensation is considered excessive relative to the value provided to the organization. However, no excise tax was imposed in connection to the amount of compensation paid.

Details of the Provision

- Unlike current law, which limits the definition of "covered employee" only to corporate officers, the new 21% excise tax provision under Section 4960 would apply to any employee, even if the employee were not an officer of the organization.
- The number of covered employees is not actually limited to five per year. The provision applies to the five highest-paid current or former employees for that year, as well as:
 - *Current* employees who were previously among the "high five" in any year after 2016 and are still being paid any form of compensation subject to withholding that exceeds \$1 million in the current year, and



- Former employees who were previously among the “high five” in any year after 2016 and are still being paid any form of post-termination compensation subject to withholding that exceeds \$1 million in the current year.
- In other words, once an employee is a “covered employee,” the employee will always be a covered employee and subject to the excise tax.
- The excise tax applies to:
 - I. Current compensation,
 - Wages as defined for income tax withholding purposes, other than designated contributions and elective deferrals to a 401(k) plan that an employee designates as not excludible from income.
 - II. All forms of deferred compensation – in many cases, when it becomes vested, whether or not paid – and “Excess parachute payments” to any high-five employee triggered by separation from employment, to the extent that the total “parachute payments” exceed three times the five-year average total compensation. The tax would apply to the amount that exceeds the portion of the base amount applicable to the parachute payment, so remuneration in this instance does not have to exceed \$1 million.
- For multi-corporate tax-exempt systems like large hospitals and universities, the excise tax applies on an entity-by-entity basis.
 - If two tax-exempt entities within a controlled system each have five persons earning in excess of \$1 million, all ten such employees will trigger the excise tax.
- If more than one employer is liable for the excise tax, because the employee is employed by multiple organizations, the entities are liable for the excise tax in the ratio that their compensation paid to the covered employee bears to the total compensation.
- Treasury has authority to prescribe regulations to prevent avoidance of tax, including through performing services other than as an employee or using pass-through or other entities.



Medical Staff Carve-out

The conference report of the House and Senate tax bills included a carve-out for medical professionals in response to concerns voiced by tax-exempt hospitals. As such, the excise tax does not apply to payments made to licensed medical professionals (physicians, nurses and veterinarians), *to the extent compensation payments relate directly to performance of medical services.*

- Compensation paid to physicians or other licensed medical professionals in a capacity other than for their professional services (e.g., hospital administration services), however, *would* be included in the definition of remuneration for purposes of determining whether the medical professional is a covered employee.
- In other words, only the portion of employee payment attributable to administrative and executive services will count for purposes of the excise tax.

We expect the Internal Revenue Service to issue guidance providing that:

1. The compensation paid to a licensed medical professional for professional services is not taken into consideration for purposes of determining whether the professional is a covered employee, and
2. The 21% excise tax does not apply to any compensation paid to that medical professional if the individual is not a covered employee.

What is not clear, however, is the extent to which the IRS will limit the definition of “professional services.” It is unclear how remuneration should be allocated in the case of a licensed medical professional performing multiple services for an organization (e.g., teaching, attending medical conferences, performing medical staff peer review in the credentialing and privileging of physicians, publishing research results).

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