JONES DAY

COMMENTARY

NOVEMBER 2017

Pending Tax Legislation Would Affect Executive Compensation for Tax-Exempt Organizations

IN SHORT

The Situation: Tax legislation moving through Congress would put a new excise tax on tax-exempt organizations that pay more than $1 million in annual compensation to their most highly compensated employees.

The Result: Both the House and Senate tax bills include the same new excise tax for exempt organizations, increasing the likelihood that it will become law.

Looking Ahead: Tax-exempt organizations will want to follow the legislation and anticipate the potential financial impact of the new tax. Also, although profound changes to the taxation scheme for nonqualified deferred compensation arrangements of tax-exempt employers (as well as for-profit employers) have been removed by House and Senate tax-writing committees in the course of the legislative process, careful monitoring is warranted as the proposal could reappear in the pending bill during conference or in future tax legislation.

On November 9, 2017, the House Ways and Means Committee passed its version of the Tax Cuts and Jobs Act ("TCJA"). The House will vote on the bill this week. The Senate Finance Committee is considering its Chairman's version of the TCJA this week and is expected to pass the bill and send it to the full Senate for consideration in the week after Thanksgiving. Although there are differences between the bills and further changes that may occur in the legislative process, tax-exempt organizations should be aware that the pending tax legislation has the potential to change the taxation of the compensation they pay to their executives.

Excise Tax on Compensation Over $1 Million

The House and Senate versions of the TCJA both impose an excise tax of 20 percent on any remuneration (meaning salaries, bonuses, taxable fringe benefits, taxable nonqualified deferred compensation, and anything else that is reported as wages) paid to a covered employee that exceeds $1 million. Covered employees include the five highest paid employees for the current year or for any prior year from 2017 forward. This 20 percent excise tax applies independent of whether a board approved the employee compensation as reasonable and within market comparable ranges for purposes of the "rebuttable presumption" procedures that protect against an intermediate sanctions penalty. The House and the Senate bills also apply a 20 percent excise tax to any severance given by a tax-exempt organization to a departing covered employee in excess of three times the employee's base amount (the employee's average annualized compensation from the employer over the five calendar years preceding her separation from service).

The excise tax on tax-exempt employers is intended to parallel an existing part of the law that prohibits publicly held companies from deducting compensation over $1 million paid to the CEO or certain other covered employees. Under both bills, the definition of "covered employee" for tax-exempt employers includes the five highest paid employees. Once an employee qualifies as a covered person, she will remain so as long as she (or her beneficiaries) receive remuneration—even if she is no longer employed by the organization. Tax-exempt organizations will need to take heed: This definition of "covered employee" could create excise tax liability if a former "covered employee" stays on in a limited capacity and is later given a severance package.

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Proposals to Change Taxation of Nonqualified Deferred Compensation Have Been Dropped—For Now

The House and Senate bills both initially included a proposal to drastically alter the taxation of nonqualified deferred compensation ("NQDC"). However, the House Ways and Means Committee removed the provision during mark-up, and the Chairman of the Senate Finance Committee also removed the NQDC provision when he issued an updated version of his bill before mark-up. Although the NQDC provision is now less likely to be enacted as part of the pending tax legislation, tax-exempt organizations will still want to understand the provision so they can appreciate its significance in the event that it comes back for discussion as part of the current or a future tax bill.

Under current law, there generally are two varieties of NQDC arrangements for tax-exempt employers: eligible deferred compensation arrangements ("457(b) plans") and ineligible deferred compensation arrangements ("457(f) plans"). Amounts deferred under a 457(b) plan are not taxed until paid or made available, but an executive may defer only up to a statutory limit ($18,000 for 2017, as adjusted for inflation in future years). There is no limit on the amount that may be contributed to a 457(f) plan on an executive's behalf, but amounts deferred to a 457(f) plan are taxable in the first year such amounts are no longer subject to a substantial risk of forfeiture. Under 457(f), compensation generally is treated as subject to a substantial risk of forfeiture if entitlement is conditioned on future performance of substantial services or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. Earnings accrued on deferred compensation after that deferred compensation vests under 457(f) are taxable when paid or made available and also may be subject to the complex tax rules governing the NQDC arrangements of for-profit employers. Bona fide severance is exempt from treatment as NQDC.

Under the proposal that originally was included in both the House and Senate versions of the bill, starting in 2018, *all* types of NQDC arrangements for tax-exempt employers—including compensation that previously would have been deferred under eligible 457(b) plans—would be taxed at vesting once any substantial risk of forfeiture has lapsed. Also, the proposal would limit what may be treated as a "substantial risk of forfeiture." The risk of forfeiture would have to be service-based; other conditions related to the "purpose of the compensation" would no longer delay vesting and taxation. Additionally, earnings on amounts deferred also would be taxed when vested (rather than when paid). Finally, contrary to present law, it appears that severance plans would be treated as NQDC under the original proposal.

Existing NQDC arrangements for services performed through 2017 generally would have been grandfathered until the end of 2026 or, if later, when the compensation vested under the amended definition of "substantial risk of forfeiture." This proposal to change profoundly the tax treatment of NQDC first appeared in the proposed tax reform legislation introduced by former Representative Dave Camp in 2014. Its inclusion in the initial versions of the House and Senate tax bills suggests that it is continuing to get serious consideration in Congress. Tax-exempt organizations will want to remain vigilant for the possibility that it is reinserted in the pending tax legislation or appears in future tax legislation.

Concluding Thoughts

Tax-exempt employers will want to follow the progress of tax legislation in both the House and Senate so they can prepare for potential changes in the taxation of executive compensation. The excise tax on compensation over $1 million is proposed to be effective for taxable years beginning after December 31, 2017.

TWO KEY TAKEAWAYS

1. Tax-exempt organizations may be facing an excise tax on employee compensation over $1 million.
2. Tax-exempt organizations may also be facing an excise tax on severance payments that exceed certain levels.

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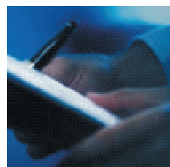

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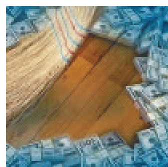

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