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GMS Flash Alert

Global Compensation Edition

2018-097 | July 11, 2018

United States - Covered Employees and the New 21% Excise Tax

Tax-exempt organizations in the United States face an additional excise tax beginning in 2018. New U.S. Internal Revenue Code section 4960, imposes a 21-percent excise tax on remuneration paid in excess of $1 million to "covered employees." Covered employees include the five highest paid employees in any taxable year beginning after December 31, 2016. Any employee who is considered a "covered employee" in a taxable year beginning after December 31, 2016, is a covered employee for all future taxable years. Thus, a tax-exempt organization may expect to have more than five covered employees in later years.

WHY THIS MATTERS

As a result of this additional excise tax, tax-exempt organizations need to review their compensation arrangements with their executives to determine if they will be subject to the tax, and if necessary, assess possible mitigation strategies.

Similar Code provisions apply to for-profit entities, Code sections 162(m)(1) and 280(G).

Affected organizations may wish to consult with their tax professionals about:

- Reviewing employment contracts, severance agreements, deferred compensation agreements and any other type of executive compensation arrangement;
- Analyzing whether those agreements will give rise to an excise tax;
- Determining the tax and file any necessary excise tax returns; and
- Addressing the structure of future executive compensation so that it will reduce excise tax exposure.

Background

Public Law 115-97, otherwise known as *The Tax Cuts and Jobs Act of 2017* (the "Act") imposes a 21-percent excise tax on compensation in excess of $1 million paid by a tax-exempt organization, such as an educational or charitable entity, business league, VEBA, etc,. to any of its five highest paid employees.[1] The compensation subject to the excise tax includes amounts paid from related organizations, generally organizations controlling or controlled by the tax-exempt organization.

The Act also imposes a 21-percent excise tax on "excess parachute payments" a tax-exempt organization pays to any covered employee. A "parachute payment" is generally considered any payment contingent upon the employee's separation from employment if the aggregate present value of such payment equals or exceeds three times the employee's base amount, or annualized includible compensation over the five most recent taxable years.

Excise Tax on Amount over $1 Million

To compute the excise tax under this provision, all relevant remuneration must be aggregated. That remuneration includes all amounts paid to an employee that are subject to federal income tax withholding and amounts required to be included in income under Code section 457(f) because they are no longer subject to a substantial risk of forfeiture. Amounts paid to a licensed medical professional for the performance of medical or veterinary services are not includible.

Compensation paid to an executive by all "related organizations" must be aggregated to determine if the $1 million threshold is exceeded.

Tax-exempt organizations are related if one organization controls or is controlled by the other organization. In the case of a VEBA, other organizations may be "related" to that VEBA if they establish, maintain, or make contributions to that VEBA.

Additional Excise Tax on Certain Termination Payments

The 21-percent excise tax also applies to certain payments to covered employees of tax-exempt organizations upon termination of employment. As noted above, specifically, the excise tax applies to excess parachute payments. Amounts are considered excess parachute payments if the total present value of payments contingent upon an employee's separation from employment equals or exceeds three times the employee's average annual compensation from the organization over the five most recent taxable years. Parachute payments do not include any payments attributable to the performance of medical services, nor do they include any distributions from a tax-qualified plan such as a 403(b) plan or deferred compensation plan under Code section 457(b).

FOOTNOTE:

1 To see 26 U.S. Code § 4960 on the Web site of the Legal Information Institute of Cornell Law School, click here.

For further analysis see "Tax Reform: Issues for Exempt Organizations (Pub.L. 115-97)," a publication of the KPMG International member firm in the United States.

Contact us

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