Chapman and Cutler LLP

Chapman Client Alert

December 6, 2017

Current Issues Relevant to Our Clients

Excise Tax on Compensation Paid by Exempts Under Pending Tax Bill

Both the House and Senate versions of the Tax Cuts and Jobs Act include a new provision that would impose an excise tax on the compensation paid by certain exempt organizations, including certain state and local governmental entities, if the compensation to a covered employee is over $1 million.

General Provisions

Under the new provision, a tax-exempt employer is liable for an excise tax equal to 20 percent of the sum of (i) any remuneration in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and (ii) any excess parachute payment paid by the applicable tax-exempt organization to a covered employee.

For purposes of the provision, a covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016. Tax-exempt organizations covered by the excise tax include organizations exempt from tax under section 501(a) (which includes churches, colleges, and hospitals, as well as unions, industry organizations and a variety of other exempt organizations), exempt farmers' cooperative organizations, state or local governmental entities with income excluded from taxation under Code Section 115(1) (which relates to income derived from public utilities or the exercise of other essential governmental functions), or political organizations described in Section 527(e)(1).

It should be noted that the proposed section distinguishes between (i) entities that are integral parts of a state or local government, (ii) entities that are instrumentalities of state or local governments and (iii) entities that are separate from state or local governments but which carryout essential governmental functions with the income accruing to state or local governments. The first two are not subject to the excise tax, but the third is.

"Remuneration" in the context of the proposed provision means wages as defined for income tax wage withholding purposes, but does not include any designated Roth IRA contribution. Remuneration of a covered employee includes any remuneration paid with respect to employment of the covered employee by any person, entity or governmental entity related to the applicable tax-exempt organization. A person, entity or governmental entity is treated as related to an applicable tax-exempt organization if the person, entity or governmental entity (i) controls, or is controlled by, the organization, (ii) is controlled by one or more persons that control the organization, (iii) is a supported organization during the taxable year with respect to the organization, (iv) is a supporting organization during the taxable year with respect to the organization, or (v) in the case of a voluntary employees' beneficiary association (''VEBA''), establishes, maintains, or makes contributions to the VEBA. However, remuneration of a covered employee that is not deductible by reason of the $1 million limit on deductible compensation in Section 162(m) is not taken into account for purposes of the new provision. In other words, remuneration paid by a taxable subsidiary of an exempt organization that meets the definition of a publicly held corporation under Section 162(m)(2) could exceed the $1 million limitation (although the deduction will be lost, such remuneration will not be subject to the excise tax).

The employer of a covered employee is liable for the excise tax.

If remuneration of a covered employee from more than one employer is taken into account in determining the excise tax, each employer is liable for the tax in an amount that bears the same ratio to the total tax as the remuneration paid by that employer bears to the remuneration paid by all employers to the covered employee.

Parachute Payments

The excise tax would apply as a result of an excess parachute payment, even if the covered employee's remuneration does not exceed $1 million.

Under the provision, an excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. A parachute payment is a payment in the nature of compensation to (or for the benefit of) a covered employee if the payment is contingent on the employee's separation from employment with the employer and the aggregate present value of all such payments equals or exceeds three times the base amount. The base amount is generally the average annualized compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment.

Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local government employer.

The proposed statutory language does not provide how the base amount will be allocated to parachute payments. However, regulations are authorized and the statutory language looks to Code Section 280G for its substantive rules.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Kelley M. Bender
Chicago
312.845.3439
bender@chapman.com

Paul D. Carman
Chicago
312.845.3443
carman@chapman.com

Van E. Holkeboer
Chicago
312.845.3401
holkeboer@chapman.com

Gary R. Polega
Chicago
312.845.2994
polega@chapman.com

Andrew Wool
Chicago
312.845.3730
wool@chapman.com

Christie R. Galinski
Chicago
312.845.3431
galinski@chapman.com

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

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