EXEMPT ORGANIZATIONS: THE NEW EXCISE TAX ON EXCESS COMPENSATION

Posted on **January 8, 2018** by **James R. Malone, Jr.**

On December 22, 2016, the Tax Cuts and Jobs Act (the "Act") became law. While cutting certain tax rates, the Act also imposed a new tax: There is now an excise tax applicable to exempt organizations on "excess compensation." This new tax will apply to the following: "(1) so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus (2) any excess parachute payment paid by such an organization to any covered employee." Pub. L. No. 115-97, § 13602 (to be codified at I.R.C. § 4960). The tax is imposed on the exempt organization, not the employee. The applicable tax rate is the corporate rate, which is now 21%. Pub. L. No. 115-97, § 13001 (amending I.R.C. § 11).

As with any tax statute, the defined terms are critical. An "applicable tax-exempt organization" is defined "as any organization which for the taxable year — (A) is exempt from taxation under section 501(a), (B) is a farmers' cooperative organization described in section 521(b)(1), (C) has income excluded from taxation under section 115(1), or (D) is a political organization described in section 527(e)(1)." Pub. L. No. 115-97, § 13602. A "covered employee" is defined as

any employee (including any former employee) of an applicable tax-exempt organization if the employee–

(A) is one of the 5 highest compensated employees of the organization for the taxable year, or

(B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

Id.

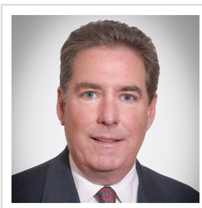
While these definitions seem straightforward, the definition of an "applicable tax-exempt organization" contains an anomaly: Although Congress thought that this excise tax would apply to highly-paid employees of public universities, such as football and basketball coaches, it probably does not, because public

universities are not exempt on the basis of any of the provisions listed in the definitions. Congress apparently assumed that state universities were covered by the reference to section 115(1) of the Code, but they are not.[1] As integral parts of a state, income of a public university is presumed exempt in the absence of an express statutory provision making its income taxable. Rev. Rul. 87-2, 1987-1 C.B. 18. Thus private universities, which are exempt under section 501(a) of the Code, will be subject to tax, but public universities apparently will not. Plainly this was a mistake, as here is no rational policy reason for treating the compensation paid to Villanova's basketball coach and Alabama's football coach differently.

Tax-exempt health care providers should pay close attention to the definition of "remuneration." While generally tied to wages, "remuneration" does not "include the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional." Pub. L. No. 115-97, § 13602. While helpful, this clause is not entirely clear: If a physician has supervisory duties with respect to a hospital as its chief executive, chief operating officer, or chief medical officer, is his entire compensation excluded from the scope of the excise tax? The conference report indicates that only compensation that is directly related to the performance of medical services by the individual is intended to be exempt, but even that language is subject to interpretation: If a doctor who is an officer of a hospital works on revising standards for patient care, is she performing medical services? One thing that is clear is that organizations that want to rely upon the exclusion of income for provision of medical services will need to have a defensible mechanism to identify what compensation is for provision of medical services and what compensation is not.

Another source of concern: By its terms, the excise tax will apply to apply to pre-existing commitments made by institutions before the Act became law. In contrast, the existing tax on excess compensation of public company officers carries an exclusion for pre-existing agreements. I.R.C. § 162(m)(4)(D). As part of the Act, Congress amended section 162(m) to expand its scope and again replicated the exclusion for pre-existing agreements. Pub. L. No. 115-97, § 13601. Given that context, the failure to include a similar provision for exempt organizations is troubling.

[1] Hat tip to the Tax Prof Blog for spotting this. http://taxprof.typepad.com/taxprof_blog/2017/12/aprill-congress-fumbles-the-ball-on-new-excise-tax-for-college-coaches-and-presidents.html.



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