New Excise Taxes on Compensation Arrangements for Select Highly Paid Employees: Implications and Action Steps for the Board

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The Tax Cuts and Jobs Act of 2017 includes two organization-paid excise taxes that have implications for the executive compensation programs of tax-exempt hospitals and health systems. This article summarizes the act's provisions and identifies actions that healthcare organizations should take to understand the expected tax liability and its implications.

Overview of Excise Tax Provisions

The two excise taxes of 21 percent apply *only* to the following compensation arrangements for a limited group of the highest-paid employees ("covered employees"):

- Taxable compensation over $1 million
- "Excess parachute payments" (payments made contingent on a termination of employment; this applies only to certain arrangements, as defined below)

The excise taxes are paid by the tax-exempt organization, not the employee. The following definitions are important in understanding the scope of the taxes:

- **Effective date**: The excise taxes apply to organizations for tax years beginning after December 31, 2017.
- **Covered employees**: An employee (or former employee) who is one of the five highest compensated for the current tax year *or* any prior tax year beginning after December 31, 2016:
  - » Any employee may be considered a covered employee, not just executives (see below for an exception for certain compensation paid to licensed medical professionals).
  - » Once an individual is a covered employee, the designation remains—even as a former employee. Therefore, the number of covered employees may grow beyond five if there is year-to-year variability in the five highest-compensated individuals.
  - » Organizations with multiple tax-exempt entities may have multiple sets of covered employees.
  - » Identification of covered employees begins one year earlier than the effective date of the tax (i.e., tax years after December 31, 2016 vs. 2017).
- **Compensation**: Generally includes all taxable income subject to federal withholding (with limited exceptions):
  - » The portion of compensation paid to a licensed medical professional (including a physician) for the performance of medical services is excluded; however, amounts paid to such an individual acting in another capacity (such as administration, for example) are not excluded. The exclusion applies for purposes of determining the five highest-paid employees and the compensation subject to the tax.
  - » Compensation received by an individual from multiple entities under common control is aggregated, and the tax liability is similarly spread among those entities.
- **Excess parachute payments**: There are two steps for determining if the excess parachute payment excise tax applies:
  - » First, the excise tax is triggered when "parachute payments"—defined as the present value of amounts paid contingent on separation from service—are more than *three times* the individual's average taxable compensation over the past five years ("base amount").
  - » Second, if triggered, the tax is assessed on "excess parachute payments," which are amounts that exceed *one times* the base amount.
  - » Thus, there is a difference between what triggers the tax and how it is calculated—a substantial excise tax results even if parachute payments are only marginally above three times the base amount.

Outstanding Issues

There are several outstanding issues that are not clearly addressed in the legislation, which make it difficult to determine the precise excise tax pending further IRS guidance:

- **Definition of tax year for measuring compensation**: Since the law references the employer as being liable for the tax, the tax may be calculated based on the covered employee's compensation attributed to the employer's tax year. It is possible, however, that the IRS could define this as taxable compensation for the calendar year that ends within the organization's fiscal year (similar to the Form 990 disclosure rules).
- **Determining compensation for the performance of medical services**: For physicians with both clinical and non-clinical duties, the approach for allocating compensation among the various duties will need to be clarified.
- **Entities in a related group**: The tax is assessed on each tax-exempt organization. Clarity is required to determine the organization at which an individual is "employed" for those organizations with multiple entities.
- **Calculation of excess parachute payments**: The law contains references to the "golden parachute" rules of IRC section 280G for determining some, but not all, aspects of excess termination payments.

Key Board Takeaways

The 2017 tax reform legislation includes two organization-paid excise taxes that apply to all tax-exempt healthcare organizations on compensation arrangements for "covered employees": 1) a 21 percent tax on taxable compensation above $1 million, and 2) a 21 percent tax on "excess" termination payments. The taxes are effective for tax years after December 31, 2017. Covered employees are the five highest-paid employees during any tax year after December 31, 2016; compensation paid to physicians for the performance of medical services is excluded. Boards should:

- Determine the covered employees and estimated excise tax liability (short and long term).
- Assess the implications of compensation decisions on the excise tax.
- Evaluate potential compensation program strategies.

The excise taxes are likely to have a more significant impact on large health systems, those with multiple entities, and those that are affiliated with universities. Smaller health systems and hospitals may have only one individual with pay over $1 million, typically the CEO, so may face less significant liability and complexity.

Action Steps

Boards should work with legal, compensation, and finance professionals to understand the estimated tax liability and evaluate potential compensation program strategies:

- **Determine the tax-exempt entities that are subject to the excise taxes**:
  - » Assess if changing employment models is appropriate to minimize the number of covered employees.
- **Review the potential excise tax on compensation over $1 million**:
  - » Determine the current and projected covered employees for each entity based on expected taxable compensation, considering turnover and potential recruitment and succession initiatives.
  - » Estimate the projected tax liability as a baseline from which alternative approaches can be evaluated (e.g., a five-year projection). Consider the impact of future salary increases, vesting/payout of incentives and deferred compensation, performance, and other factors.
  - » For physicians, ensure compensation is adjusted for amounts related to the performance of medical services and that the allocations are consistent with fair market value requirements.
- **Review the potential excise tax on termination payments**:
  - » Review all plans, programs, and employment contracts to determine whether excess parachute payments may occur. Assess if any changes should be considered.
- **Review compensation program design**:
  - » Determine if there are any unintended excise tax consequences of expected compensation increases and deferred compensation/retention arrangements due to the lump sum nature of payouts. Assess if adjustments are appropriate.
- **Periodically revisit excise tax projections and compensation strategies**:
  - » Update projections annually and revisit compensation strategies.
  - » Understand the impact on the excise tax exposure prior to approving compensation changes.

Boards of tax-exempt healthcare organizations must carefully consider the implications of the excise taxes since they are a new cost of doing business. In that regard, it is critical to complete an ongoing, comprehensive review of these taxes and their impact on recruitment, retention, recognition, and cost. Since some details of the law's application are uncertain, organizations should monitor future guidance as they determine any possible liabilities and plan for potential strategic adjustments to their compensation programs.

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