

Tax Cuts and Jobs Act – New Compensation Tax for Non-Profit Organizations on Excess Compensation and Excess Parachute Payments

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The [Tax Cuts and Jobs Act](#) passed late last year and became effective as of January 1, 2018. The Act includes a new provision that subjects certain “excess compensation” paid by exempt organizations (organizations exempt from income tax under section 501(a) of the Internal Revenue Code (the Code)) to the corporate income tax.

Corporate Income Tax Imposed on Compensation paid to Employee Compensation in Excess of \$1 Million

Section 4960 imposes the corporate income tax on any compensation paid to certain “covered employees” in excess of \$1,000,000 annually. The provision also applies to “excess parachute payments.” In both cases, the amounts paid by the tax-exempt organization are subject to the (new lower) 21% corporate income tax. This provision is designed to parallel rules that limit income tax deductions for excess compensation and parachute payments paid by public companies.

The Section 4960 tax applies to employees who are currently among the tax-exempt organization’s five highest paid employees as well as any employee who was one of the organization’s five highest paid employees for any taxable year beginning after December 31, 2016 (even if the person is no longer employed by the organization).

The amount of compensation subject to tax is generally the employee’s amount of reportable W-2 income (“wages” under the payroll tax provisions, which includes many non-cash benefits such as club dues paid for private uses, housing allowances, and many moving allowances), less any contributions to certain retirement plans. It specifically includes amounts that the employee has not yet received, but has a vested right to receive under section 457(f).

Exception for Compensation Paid to Medical Professionals

Importantly for hospitals and health care organizations, compensation 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.” Because of this exception, the tax will not apply to compensation paid to highly-paid doctors and professionals, but only if the compensation is for providing medical services. Compensation to doctors or other professionals performing management services, however, will be subject to the tax. It is not clear how the tax would apply to those medical professionals, like medical directors, who not only provide direct patient care but have an administrative role as well. Depending on the facts and circumstances, it may be possible to take the position that medical director type services, because they require professional licensure and medical judgments, are not subject to the tax.

Tax Also Imposed on Excess Parachute Payments

Section 4960 also applies to so-called “excess parachute payments.” The tax is triggered if the employee receives compensation contingent on the employee’s separation from service with the employer (e.g., severance payments) more than three times (3x) the employee’s base amount. Any future payments to be received are discounted to present value. Generally, the employee’s “base amount” is equal to the employee’s average taxable compensation (usually the amount shown on Form W-2, Box 1) received from the employer for the five calendar years preceding the year in which the employee is terminated.

If the tax is triggered, then the amount of the parachute payment in excess of the employee’s base amount will be subject to the 21% tax rate. The rule contains exceptions for payments from qualified plans and for employees who are not highly compensated.

Statute Contains Anti-Avoidance Rule

In addition, Section 4960 includes an anti-avoidance rule that considers all remuneration from related organizations (such as the hospital foundation or parent entity) as paid by a single employer.

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