Baylor University

530. Highly Compensated Employees

Starting in 2018, tax-exempt organizations and related entities may owe a 21 percent excise tax on compensation paid to covered employees in excess of $1 million and on any excess parachute payments (amounts that exceed three times the employee's five-year average wages and are contingent on involuntary termination). The excise tax applies to what the IRS describes as "applicable tax-exempt organizations (ATEO)" and related entities. This includes all nonprofits and could also include for-profit entities controlled by a tax-exempt entity.

Compensation paid "for the taxable year" must be considered. According to IRS guidance, the tax is determined based on payments made in the calendar year ending within the employer's taxable year, aligning with amounts reported on Form W-2.

Who is included?

Covered employees include any current or former employee of the University who is either:

- One of the five highest compensated employees for a calendar year; or
- Was a covered employee for any preceding calendar year beginning after 2016.

Once an employee is on the covered employee list, he or she will remain on the list forever, even after termination of employment (including death). Even though this provision took effect January 1, 2018, the University must keep a covered employees list beginning with 2017. Since the definition of "covered employee" is cumulative, the list will likely include more than five individuals over time.

Each year, the University must rank-order the most highly compensated employees to identify the top five for that year, based on payments from the university and from any related entity for services as an employee during the calendar year. However, certain amounts are excluded in determining the top five:

- Payments for medical services (which are discussed in detail in the recent IRS guidance)
- Amounts paid to independent contractors (like board members
- Payments that total less than 10 percent of an employee's total remuneration

There is no minimum level of compensation to be included on the annual top five list, so the highest-paid employees should be included even if they were not paid over $1 million for that year and did not receive an excess parachute payment for that year.

What pay counts?

The excise tax applies to

(1) annual remuneration paid to covered employees in excess of $1 million and

(2) any excess parachute payments (amounts that exceed three times the employee's five-year average wages and are contingent on involuntary termination).

An excess parachute payment is the aggregate amount treated as paid to a covered employee that is contingent on the employee's involuntary separation from service, if the present value equals or exceeds three times the employee's five-year average compensation. Amounts paid due to a voluntary termination (such as a planned retirement) are not subject to the new tax. IRS guidance clarifies that even if an employer never pays an employee more than $1 million per year, it could still owe the tax on excess parachute payments.

Certain payments are included or excluded when calculating parachute payments, as follows:

Excluded:

- Contributions to and benefits from certain retirement plans and payments for certain medical services
- Deferred compensation payments and retiree medical benefits provided after an involuntary separation are excluded if the benefits vested before the separation, since the separation affected only the timing of the payments, not the employee's right to the payments.

Included:

- Payments conditioned on a release of claims
- Damages for employment agreement breaches
- Window program payments (i.e., special separation pay for certain employees who terminate employment during the window period, which must be less than 12 months)
- Payments for noncompete (or nondisclosure or other similar agreements)
- Value due to the acceleration of vesting upon separation from service