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Topic: Interim Guidance on Executive Compensation Paid by Tax-Exempt Organizations after the Tax Cuts and Jobs Act

Market Trend: The Tax Cuts and Jobs Act of 2017 added Section 4960 to the Internal Revenue Code, which affects the way tax-exempt organizations pay their most highly compensated employees. Section 4960 brings executive compensation for tax-exempt organizations more in line with their for-profit counterparts and borrows heavily from Code Sections 162(m) and 280G, with key differences.

Synopsis: Section 4960 imposes an excise tax (currently 21%) on the amount of remuneration in excess of $1 million and any excess parachute payments paid by applicable tax-exempt organizations to a covered employee for tax years beginning after December 31, 2017. Notice 2019-09 provides interim guidance under Section 4960 in order to assist tax-exempt organizations in complying with Section 4960 before regulations are issued. Despite the guidance, compliance with Section 4960 will prove challenging, particularly for related entities with complex organizational structures.

Takeaways: All tax-exempt organizations, even ones who do not currently have liability under Section 4960, should become familiar with the most recent IRS guidance regarding the new rules applicable to executive compensation. Organizations that are currently subject to the rule should ensure compliance, and organizations that may become subject to the rule should implement adequate recordkeeping measures to ensure future compliance.

Background

Many for-profit corporations have long been subject to tax on payments that Congress deems as excessive compensation. This practice began in 1984 when Congress introduced Section 280G of the Internal Revenue Code of 1986, as amended (the “Code”). Following revelations that several former public corporation executives received what Congress perceived to be excessive amounts of compensation in connection with the sale of the corporation, Congress introduced Code Section 280G (“Section 280G”), which both denies the corporation a deduction for amounts paid in connection with a change in control above a certain limit and imposes an excise tax on amounts received by an executive in connection with a change in control that exceed the same limit. Congress then enacted Code Section 162(m) (“Section 162(m)”) in 1993. Rather than targeting only compensation paid upon a change in control or a sale of the corporation, Section 162(m) denies public corporations tax deductions for amounts paid to five top executives in excess of $1 million.

Although Sections 280G and 162(m) apply only to entities that are (i) corporations and (ii) operate for-profit, they set the backdrop for Code Section 4960 (“Section 4960”). Introduced as part of the Tax Cuts and Jobs Act (the “TCJA”) in December 2017, Section 4960 generally applies the same executive compensation provisions that Sections 280G and 162(m) impose on for-profit corporations to executive compensation paid by an applicable tax-exempt organization (“ATEO”).

Broadly, Section 4960 imposes a 21% excise tax on both:

- the amount of remuneration paid by an ATEO to a covered employee in excess of $1 million, and
- the amount of any excess parachute payment.

In determining the amount of compensation paid both for purposes of the $1 million limit and for calculating whether an excess parachute payment has been made, Section 4960 includes all compensation paid by related organizations. Additionally, the liability for Section 4960’s excise tax falls to the ATEO, not the covered employee.

While Section 4960 provides general guidance, it lacks many of the specifics that ATEOs and other applicable parties need to be able to comply with Section 4960. Recognizing this, the Internal Revenue Service (the “IRS”) issued Notice 2019-09 (the “Guidance”). Although the IRS intends to issue further guidance in the form of proposed regulations, such guidance is expected to be prospective and taxpayers and ATEOs may rely on the Guidance in the interim. Under the Guidance, until the IRS issues proposed regulations, ATEOs and other taxpayers may comply by taking positions that are good faith, reasonable interpretations of Section 4960. Determinations as to whether an interpretation is reasonable and made in good faith will be made based on all the facts and circumstances. The following outlines key takeaways from the Guidance.

Remuneration in Excess of $1 Million

Section 4960 provides that on or after the ***effective date***, an ***ATEO*** or a ***related organization*** that pays ***remuneration*** in excess of $1 million to a ***covered employee*** is subject to a 21% excise tax on that excess amount. Although the rule seems straightforward on its face, a few definitions in the Guidance make compliance with the rule more complex, as further described below. In addition, although this rule is similar in substance to Code Section 162(m), there are key distinctions that should be noted.

Effective Date

Section 4960 is applicable to tax exempt organizations on the first day of the first taxable year beginning after December 31, 2017. Amounts paid before the beginning of that taxable year are not subject to the excise tax.

For ATEOs with calendar year taxable years, Section 4960 first applies beginning on January 1, 2018. For ATEOs non-calendar taxable years, the effective date is the first day of the first taxable year beginning in 2018. For example, a university with a July 1-June 30 taxable year must begin to comply with Section 4960 beginning on July 1, 2018 and amounts paid earlier in 2018 are not subject to the excise tax.

Unlike Code Section 162(m), there is no "grandfather" rule for payments promised but not vested prior to the effective date. The Guidance provides, however, that Section 4960 does not apply to compensation that was vested prior to the effective date, including vested but unpaid earnings on deferred amounts that were accrued before the effective date. Earnings on those amounts that accrue after the effective date are subject to the rule. This is because remuneration is treated as paid under Section 4960 when the remuneration is no longer subject to a substantial risk of forfeiture rather than when the amounts are actually paid.

ATEOs and Related Organizations

Section 4960 applies to ATEOs and related organizations. An ATEO includes (1) organizations exempt from tax under Code Section 501(a) (which will include most 501(c)(3) organizations), famers' cooperatives described in Code Section 521(b)(1), organizations that have income excluded from tax under Code Section 115(1) and political organizations under Code Section 527(e)(1).

The Guidance clarifies that a governmental entity (including a state college or university) that is not tax-exempt under Section 501(a) and does not exclude income under Section 115(1) is not an ATEO for purposes of Section 4960. Therefore, although most universities will be subject to the limitations of Section 4960, some public universities may be able to continue offering covered employees compensation in excess of $1 million without paying the 21% excise tax, unless they are a related entity of an ATEO and have common employees (see below). A governmental entity that is currently a Section 501(c)(3) organization, and therefore subject to Section 4960, may relinquish its Section 501(c)(3) status under the procedures described in Rev. Proc. 2018-5 and therefore become exempt from the Section 4960.

A “related organization” for purposes of Section 4960 is a person or governmental entity that is related to an ATEO if the person or governmental entity:

- controls or is controlled by the ATEO:
- is controlled by one or more persons which control the ATEO;
- is a supported organization (as defined in section 509(f)(3)) with respect to the ATEO;
- is a supporting organization (described in section 509(a)(3)) with respect to the ATEO; or
- in the case of a voluntary employees’ beneficiary association (“VEBA”), establishes, maintains or makes contributions to such VEBA.

“Control” for purposes of Section 4960 is described in detail in the Guidance. Being a related organization is critical, because the common law employer, not necessarily the ATEO, is liable for any excise tax under Section 4960. Therefore, although a non-ATEO related organization cannot have its own covered employees, it may provide remuneration to a covered employee of a related ATEO and will be liable for a portion of any excise tax owed with respect to excess remuneration paid to that covered employee.

Remuneration

For purposes of determining remuneration paid to a covered employee, a covered employee’s remuneration includes amounts paid by the ATEO and amounts paid for services performed as an employee of a related organization. Although only an ATEO can have covered employees, the covered employee may also be an employee of a related organization, and all of that remuneration must be aggregated for purposes of determining the employee’s remuneration.

As a general rule, compensation is treated as paid for purposes of Section 4960 on the first date that the right to the remuneration is not subject to a substantial risk of forfeiture (i.e., when it vests), and not when it is paid. Once amounts vest, net earnings on those previously vested amounts are treated as paid at the close of the calendar year in which they accrue. Net losses on amounts may offset later net earnings, but not other types of compensation that are earned. The examples in the Guidance prove that this rule can be complicated, and employers should pay close attention to when amounts vest and when earnings accrue under a plan or program. The rules on tracking net earnings and losses for purposes of determining when amounts are paid under these rules may prove especially challenging for 457(f) and similar plans for ATEOs.

There are two exceptions that help carve out remuneration. First, remuneration paid to a licensed medical professional for the direct performance of medical or veterinary services is not remuneration for purposes of making the determination of who is a covered employee, the $1 million threshold, and whether a payment is a parachute payment. This exception does not apply for teaching, administrative, and management services associated with the performance of medical or veterinary services. This exception is important for tax-exempt hospitals and medical universities that have many highly compensated doctors and staff. The exception will apply to the doctors but generally not to staff (unless they are licensed and perform direct medical care). If an employee performs both direct medical care and other services, the employer must make a reasonable, good faith allocation between remuneration for medical

services and other services. If an employment or similar agreement sets forth the remuneration to be paid for particular services, the employer must use that allocation unless it would be unreasonable based on the facts and circumstances. If there is no such agreement, an employer may use any reasonable allocation method (e.g., a representative sample of billing records, internal time reporting mechanisms, or comparable salaries for other employees who perform similar services).

Second, there is a “limited services” exception under which if an ATEO pays less than 10% of the total remuneration paid by the ATEO and all related organizations to an employee, that employee is not a covered employee of that ATEO. If no ATEO pays at least 10% of such an employee’s total remuneration, however, then the ATEO that pays the most remuneration to the employee during the calendar year must include the employee as a covered employee of that ATEO. For example, if an employee is employed by two ATEOs (A and B) during a calendar year taxable year, and 50% of the employee’s remuneration is paid by A and 50% is paid by B, the employee may be a covered employee of both A and B. However, if 95% of an employee’s remuneration is paid by A and only 5% is paid by B, then the employee may only be a covered employee of A because B did not pay at least 10% of the total remuneration paid the employee.

Covered Employee

A covered employee for purposes of Section 4960 is any employee of an ATEO if the employee (1) is one of the five highest-compensated employees of the organization for a particular taxable year of the ATEO, or (2) was a covered employee of the ATEO in a prior taxable year. Therefore, beginning in 2018, if an employee is ever one of the five highest-compensated employees of an ATEO, that employee remains a covered employee and subject to the Section 4960 limitations in perpetuity. Although seemingly straightforward, the determination of who is a covered employee is complex, particularly in controlled group situations.

If the ATEO is a member of a group of related organizations, determining who is a covered employee is more challenging, especially when employees work for multiple organizations within the related group. Importantly, unlike Section 162(m), ATEOs do not determine who is a covered employee on a controlled-group basis for purposes of Section 4960. Instead, each ATEO must make an independent determination of its five highest-compensated employees. This means that a complex tax-exempt system could have dozens of employees that may trigger the excise tax.

In addition, because covered employee-status is effective in perpetuity and there is no minimum dollar amount to qualify as a covered employee, an ATEO must track their covered employees, even if it has no liability under Section 4960 in the current year.

> Example: Assume an ATEO has no employees who receive compensation in excess of $1 million in 2018. However, Employee A is one of the five highest-compensated employees in 2018 making $400,000 per year. In 2025, the ATEO is much larger and has more highly compensated employees. Employee A is not one of the five highest-compensated employees in 2025, but makes $1.2 million

that year. Employee B also makes $1.2 million, but has never been one of the
five highest-compensated employees in the ATEO. In this case, even though neither
employee is one of the five highest-compensated employees in the ATEO, the
ATEO is subject to the 21% excise tax on $200,000 with respect to Employee A
because Employee A was one of the five highest-compensated employees in
2018 and is therefore a covered employee in 2025. However, the ATEO is not subject
to the excise tax for Employee B, even though Employee B made in excess of $1
million in 2025, because Employee B has never been a covered employee.

Excess Parachute Payments

Under Section 4960, “parachute payments” means payments that are contingent on a covered employee’s separation from employment and that exceed three times the employee “base amount.” This is a different definition than the traditional, Section 280G parachute payment definition, which generally defines parachute payments as payments that are contingent upon the change in control of a corporation. Also unlike Section 280G, Section 4960 includes carve-outs that exempt both (i) payments to licensed medical professionals and (ii) payments to non-highly compensated employees (employees making less than $125,000 in 2019) from being considered parachute payments. If a covered employee does not fall into one of these carve-outs and will receive payments that are contingent on his or her separation from employment, an ATEO should consider whether such payments may constitute parachute payments for purposes of Section 4960. If a covered employee receives parachute payments, the “excess parachute payments” (which are the parachute payments in excess of the covered employee’s base amount) will be subject to a 21% excise tax.

Determining whether payments made to a terminating employee are parachute payments is a mechanical process, which generally requires a determination as to:

- whether a covered employee has experienced a separation from employment;
- whether the covered employee will receive any payments contingent on that separation from employment; and
- whether the aggregate value of those payments exceeds three times the covered employee’s “base amount.”

The following outlines the procedures involved in such a determination and highlights the additional information the Guidance provides.

Separation from Employment

To begin, ATEOs should determine whether or not a separation from employment has occurred. For purposes of Section 4960, the Guidance defines a separation from employment similarly to Section 409A’s regulation’s definition of “separation from service,” which includes an employee’s death, retirement, or other termination of employment from the employer and all related employers. Whether a separation from employment occurs will always depend on the

facts and circumstances, but the Guidance clarifies situations where there will be an ongoing relationship between the former employee and the employer. Under the Guidance, if the level of service an employee performs is anticipated to be reduced by 80% or more, a separation from employment will be deemed to have occurred. But, if the level of service an employee performs is anticipated to be reduced by less than 50%, the Guidance provides that a separation from employment will not be deemed to have occurred. In situations where the anticipated level of services post-termination will be between 50% and 79% of the level of pre-termination services, the employer must rely on the facts and circumstances to determine whether a separation from employment has occurred.

Importantly, the Guidance clarifies the importance of the employee/independent contractor distinction for purposes of whether a separation from employment has occurred under Section 4960. According to the Guidance, a bona fide change from an employee to an independent contractor would constitute a separation from employment for purposes of Section 4960. This distinction is not consistent with the Code Section 409A regulations.

Involuntary Separation from Employment

Once it has been determined that a separation from employment has occurred, the ATEO should determine whether the separation from employment was involuntary. The Guidance focuses on an involuntary separation from employment because a parachute payment includes only compensation that is contingent upon a separation from employment. If a payment could have been received upon a voluntary separation from employment, the Guidance would not deem such a payment contingent upon a separation from employment. Under the Guidance, an involuntary separation from employment is a termination of employment due to the employer's unilateral authority to terminate the employee's services. The Guidance makes clear that an involuntary separation from employment cannot be the result of the employee's implicit or explicit request. However, a termination of employment for good reason will qualify as an involuntary separation from employment.

Valuing Payments that are Contingent on a Separation from Service

Finally, the ATEO should determine the amount of payments it makes to an employee that incurs an involuntary separation from employment that are contingent upon the employee's separation from employment. Some amounts may be easier to determine, such as salary continuation or other cash severance payments, but some may be more difficult, such as an accelerated payment or accelerated vesting. The Guidance clarifies how an accelerated payment or accelerated vesting, in either case resulting from an involuntary separation from employment, should be treated for purposes of Section 4960, borrowing heavily from concepts in Section 280G.

For payments that are vested, if an involuntary separation from employment accelerates when the payment is made, the present value of the acceleration is considered a payment contingent upon separation from employment, and therefore potentially a parachute payment. If the ATEO cannot determine the present value of the payment absent the acceleration, but the acceleration

of the payment significantly increases its value, the future value (the full amount of the payment that would have been made on the original payment date) of the payment is treated as the value of the acceleration and is included in determining whether there has been a parachute payment. Notably, the acceleration of a payment by 90 days or less is not deemed to significantly increase the present value of the payment under the Guidance.

For payments that are not vested at the time of an employee's involuntary separation from service, the Guidance bifurcates their treatment for purposes of Section 4960 based on whether or not the payments have a service vesting condition. For payments that have a service vesting condition (i.e., the employee would have had to remain employed with the ATEO to vest in the payment absent the involuntary separation from employment), the amount considered as a payment contingent upon a separation from employment consists of (i) the value of the acceleration, which is determined in the same manner as for payments that are vested, plus (ii) the value of the lapse of the obligation to continue to perform services for the ATEO. The Guidance defines the value of the lapse of the obligation to continue to perform services as 1% of the amount of the accelerated payment multiplied by the number of months the payment is accelerated. These are similar concepts as found in the regulations implementing Section 280G. For payments that are not vested at the time of the employee's involuntary separation from service and that do not have a service vesting condition (i.e., performance-based vesting), the full amount of the accelerated payment is considered as a payment contingent upon a separation from employment.

Calculating Excess Parachute Payments

According to the Guidance, an excess parachute payment for purposes of Section 4960 is determined essentially in the same manner as an excess parachute payment for purposes of Section 280G. To determine whether a covered employee who incurs an involuntary separation from employment will receive an excess parachute payment, the ATEO should determine the covered employee's "base amount." Under the Guidance, a covered employee's base amount is his or her average annual taxable compensation for the previous five years from the ATEO. If the covered employee was not employed with the ATEO for the five years preceding his or her involuntary separation from employment, his or her base amount is the average annual taxable compensation he or she earned during the period he or she was employed with the ATEO. For the initial year of employment, certain elements of taxable compensation (like salary) may be annualized.

Once the ATEO determines the base amount for a covered employee who experiences an involuntary separation from employment, the ATEO should compare that amount against the total amount of payments contingent on the separation from employment that it will make to the covered employee. If the total amount of those payments equals or exceeds three times the employee's base amount, then the employee will be deemed to receive a parachute payment. The portion of the parachute payment that exceeds the base amount is referred to as the "excess" parachute payment.

Calculating the Excise Tax on Excess Parachute Payments

The excise tax due for excess parachute payments is calculated by multiplying the applicable excise tax rate (21%) by the total amount of excess parachute payments made to covered employees that incur an involuntary separation from employment in the ATEO's tax year.

Reporting and Paying the Excise Tax

For ATEOs that are subject to the Section 4960's excise tax, whether by reason of paying excess compensation or by reason of paying excess parachute payments, must report the amount of the excise tax due annually on Form 4720. Each employer subject to Section 4960's excise tax must file Form 4720, so related organizations cannot file a single return. Both Form 4720 and the amount of the excise tax owed are due on the 15th day of the fifth month following the close of the ATEO's taxable year, or May 15th for calendar year ATEOs. Form 4720 may be filed at a later date with a timely extension but no extensions are permitted for the excise tax. However, the Guidance makes clear that quarterly estimated payments are required for the excise tax.

What Actions ATEOs Should Take Now

- Determine which employees are covered employees for Section 4960. Organizations that are part of a related group will each have to make such a determination. Create a process for maintaining the list of covered employees and making annual additions as needed.

- Determine whether any covered employee will receive $1 million or more in remuneration in a taxable year. For remuneration that may be based on net earnings under certain benefit plans, the ATEO will need to coordinate with the plan administrators to track those net earnings annually, and to track and carry forward any net losses.

- Evaluate the services arrangements for employees that have reduced the level of services they provide to the ATEO to determine whether or not those that may have had their roles reduced involuntarily have incurred an involuntary separation from employment.

- Implement procedures to evaluate whether payments made to involuntarily terminating employees constitute excess parachute payments under Section 4960.

- Report and pay the excise tax due if an ATEO determines it has paid excessive remuneration or excess parachute payments in taxable years beginning after December 31, 2017.

ATEOs should consult with their legal advisors to ensure that they in compliance with Section 4960 and that any excise taxes owed are correctly determined, reported, and timely paid.

ATEOs should also continue to monitor future IRS proposed regulations further implementing these rules.

These rules likely also present opportunities for ATEOs to consider alternative methods to compensate covered employees that may reduce exposure to the Section 4960 excise tax. For example, collateral assignment split dollar arrangements taxed under the loan regime may provide valuable compensation to a covered employee with lower excise tax exposure.