

January 7, 2019

IRS Issues Guidance on Executive Compensation Excise Tax for Tax-Exempt Organizations

In [Notice 2019-09](#), issued December 31, 2018 (the “Notice”), Treasury and the IRS have provided interim guidance on the excise tax on certain executive compensation arrangements under section 4960 of the Internal Revenue Code. This new provision was enacted as part of the Tax Cuts and Jobs Act at the end of 2017. The Notice, which spans more than ninety pages, is primarily structured in a question and answer format and clarifies many ambiguities in section 4960. The Notice requests comments by April 2, 2019.

Treasury and the IRS intend to issue proposed regulations, but any future regulations will be prospective and will not apply to taxable years beginning before they are issued. Until further guidance is issued, employers may base their positions with respect to the excise tax on a good faith, reasonable interpretation of section 4960. Positions reflected in the Notice constitute a good faith, reasonable interpretation of section 4960.

Summary of Section 4960

Section 4960 imposes an excise tax equal to the corporate tax rate (currently, 21 percent) on certain tax-exempt organizations (“applicable tax-exempt organizations” or “ATEOs”) and related organizations that pay excess compensation to employees of the ATEO. The excise tax generally applies if, during the taxable year, the ATEO pays remuneration in excess of \$1 million or any “excess parachute payment” to any of the ATEO’s employees who are among the five highest paid for the current year and any prior taxable year beginning after December 31, 2016 (“covered employees”). Compensation paid by any related organization to an ATEO employee is taken into account in determining whether such employee is a covered employee and in determining total compensation subject to the excise tax.

General Clarifications

The Notice answers certain key questions regarding how to interpret section 4960, including the following:

- **Taxable year:** The statute was ambiguous as to whether the relevant taxable year for measuring remuneration and excess parachute payments, and for purposes of determining who are an ATEO’s covered employees, should be that of the covered employee or the ATEO. The Notice clarifies that the period for measuring remuneration paid and parachute payments is the calendar year that ends with or within the taxable year of the employer. This approach should be familiar to all ATEOs that already file the annual IRS Form 990, as this is generally the same method used for reporting compensation on that form.
- **Effective date:** Section 4960 is effective for an ATEO’s first taxable year beginning after December 31, 2017. The Notice clarifies that remuneration that (1) was paid or (2) is treated as having been paid because it vested, in each case prior to the effective date of section 4960, is not subject to section 4960.
- **Government entities:** The Notice indicates that certain government entities are not ATEOs. Specifically, government entities that are not recognized as tax exempt under section 501(a) and those that do not exclude income under section 115(1) are not ATEOs. This means that certain state colleges and universities may not be ATEOs subject to section 4960. This interpretation of the statutory language of section 4960 is inconsistent with the statute’s legislative history, which indicates that section 4960 was intended to cover highly paid employees at public universities. Even if it is not considered an ATEO, a government entity, including a state college or university, could be a related organization of an ATEO and, as a result, become subject to the tax (see below).
- **Related organizations – control:** The excise tax is triggered by compensation paid not only by the ATEO but also by any related organization, which is defined as a person or government entity that (1) controls or is controlled

by the ATEO, (2) is controlled by one or more persons that control the ATEO, (3) is a supported or supporting organization of the ATEO, or (4) in the case of a voluntary employees' beneficiary association (VEBA), that establishes, maintains or makes contributions to the VEBA. In establishing a definition of control for these purposes, the Notice applies the greater than 50 percent control threshold from the unrelated business income tax rules for payments from controlled entities, which also generally reflects the definition of related organization for IRS Form 990 reporting purposes.

- **Related organizations – for-profit and government entities:** The Notice makes clear that for-profit and government entities can be considered related organizations, meaning that compensation paid by these entities to an ATEO employee must be considered in determining whether such employee is a covered employee and whether such employee receives excess remuneration or an excess parachute payment. The Notice further clarifies that for-profit and government entities (as well as any other related organizations) are liable for their proportionate share of any resulting excise tax based on the portion of the employee's total compensation paid by each related organization.
- **Covered employee:** Only an ATEO has covered employees, and the Notice clarifies that only common law employees (including officers) can be covered employees. An employee need not be paid excess remuneration or an excess parachute payment during a taxable year to be treated as a covered employee. The Notice makes clear that once an ATEO employee is a covered employee, he or she will *always* be a covered employee of such ATEO, with no expiration date. This means that ATEOs will need to keep track of their covered employees at all times, regardless of whether those covered employees are paid excess remuneration or excess parachute payments in a given year, as the excise tax could be triggered if the covered employee receives excess remuneration or an excess parachute payment in any future year. Over time, this may become increasingly likely, as the \$1 million threshold for excess remuneration is not indexed for inflation.
- **Limited services exception:** The Notice provides an exception that excludes from the group of covered employees certain employees of an ATEO and related organizations, if the ATEO pays only a small portion of the total remuneration paid to the employee. Under this exception, an ATEO employee is not treated as one of the ATEO's five highest-compensated employees unless the ATEO pays at least 10 percent of the total remuneration paid by the ATEO and all related organizations to the employee during the year. However, if no ATEO pays at least 10 percent of an employee's total remuneration during the year, this exception does not apply to the ATEO that paid the most remuneration to the employee during the year.
- **Medical services exception:** Remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services by such professional is disregarded for purposes of determining whether excess remuneration or excess parachute payments have been paid. The Notice clarifies that such remuneration is also excluded when determining which ATEO employees are its five highest-compensated and therefore covered employees. The Notice indicates that administrative, teaching, and research services generally are not considered medical services for purposes of the exception and provides rules for allocating time spent by medical professionals between medical and non-medical services. The employer must make a reasonable, good faith allocation of such services, and if any remuneration allocation is set forth in an employment agreement or similar written arrangement, such allocation must be used to the extent the amount allocated to medical services is not unreasonable.

Remuneration in Excess of \$1 Million

- **Scope:** The Notice provides guidance on what constitutes remuneration for purposes of section 4960 and makes clear that remuneration is not limited to amounts reported on IRS Form W-2 in boxes 1 or 5.
- **Timing:** Remuneration is treated as paid when it is no longer subject to a substantial risk of forfeiture (i.e., when it vests), using the definition in proposed Treasury Regulations under section 457(f) for this purpose, regardless of whether the arrangement under which the amount is or will be paid is subject to section 457(f) or section 409A. Under this definition, compensation is subject to a substantial risk of forfeiture only if it is conditioned on the performance of substantial future services or if it is conditioned upon the occurrence of a condition related to a purpose of the compensation and the possibility of forfeiture is substantial.
- **Amount:** The amount of remuneration treated as paid when such remuneration ceases to be subject to substantial risk of forfeiture is the present value of such remuneration, determined using reasonable actuarial assumptions. Subsequent earnings on such amounts are treated as paid at the end of the calendar year in which they accrue.

Excess Parachute Payments

- The excise tax is imposed on excess parachute payments, which is defined as any payment in the nature of compensation made by an ATEO or a related organization to a covered employee if (1) the payment is contingent on the employee's separation from employment with the employer and (2) the aggregate present value of the parachute payments equals or exceeds an amount equal to three times the "base amount" (generally, an employee's average annual compensation over the most recent five-year period). The Notice emphasizes that an excess parachute payment equals the excess of the parachute payment over the base amount (i.e., not only on the portion of the payment in excess of three times the base amount).
- The Notice provides guidance on what constitutes a payment in the nature of compensation, when the payment is considered to be made, when it is contingent upon an employee's separation from employment, and what constitutes a separation from employment, as well as rules on how to calculate the base amount and excess parachute payments that are modeled on, but differ in some respects from, the rules under section 280G. In particular, the Notice indicates that a payment is contingent on separation from employment under section 4960 only if the separation is involuntary. The Notice also clarifies that parachute payments include unvested deferred compensation that is accelerated as a result of the involuntary separation.
- The preamble to the Notice provides helpful step-by-step instructions for how to determine whether any excise tax is due as a result of making a payment contingent on separation from employment.

Payment and Reporting

- The Notice provides that employers must report their excise tax liability on IRS Form 4720 and makes clear that each employer liable for tax is responsible for separately reporting and paying its share of the tax. The Notice further clarifies that no quarterly estimated payments are required with respect to the tax.

If you have any questions about the Notice, please contact a member of the [tax-exempt organizations](#) practice.