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## Final Tax-Exempt Organizations Executive Compensation Excise Tax Regulations Released

### IRS Largely Retains Rules Proposed in June 2020

On January 11, 2021, the Department of the Treasury and the Internal Revenue Service released [final regulations](#) (the “Final Regulations”) providing guidance on the excise tax under section 4960 of the Internal Revenue Code (the “Code”), which applies to certain executive compensation arrangements of tax-exempt organizations and their related organizations. The Final Regulations were published in the Federal Register on January 19, 2021.

Enacted as part of the Tax Cuts and Jobs Act in December 2017, section 4960 imposes an excise tax equal to the corporate tax rate (currently, 21%) on certain executive compensation arrangements of “applicable tax-exempt organizations” (“ATEOs”), including organizations exempt under section 501(a) of the Code, such as 501(c)(3), 501(c)(4) and 501(c)(6) organizations, and some governmental entities, as well as “related organizations” of ATEOs. The excise tax generally applies if 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 employees for the current year and any prior taxable year beginning after December 31, 2016 (“covered employees”).

The Final Regulations are largely unchanged from the proposed regulations issued in June 2020 (the “Proposed Regulations”), which were summarized in our previous [alert](#), providing only minor clarifications and some adjustments intended to ease compliance by taxpayers and falling short of wholesale interpretive changes that had been proposed by practitioners and tax-exempt organizations. Although a number of commenters requested a different approach, the Final Regulations retain the rules set forth in the Proposed Regulations that require consideration of all remuneration paid to an ATEO’s employees by both the ATEO *and* by any related organization of the ATEO when (1) determining the ATEO’s five highest-compensated employees for the year and (2) calculating the excise tax, regardless of whether the remuneration is paid for services provided to the ATEO or to the related organization.

### Summary of Changes from the Proposed Regulations

- *Exceptions to Covered Employee Status.* The Final Regulations retain the key exceptions to employee and covered employee status introduced by the Proposed Regulations without change, except for two modifications to the “nonexempt funds” exception (an important rule for addressing application of section 4960 to services received by an ATEO from related organizations, discussed in more detail below):
  - (1) The Final Regulations provide that the measuring period for the nonexempt funds exception will be a two-year period rather than a single year.
  - (2) Solely for purposes of the nonexempt funds exception, the Final Regulations also modify the attribution rules applicable in determining whether an organization is controlled by an ATEO, such that an interest in a corporation or nonstock entity is not attributed downward in determining control of the corporation or nonstock entity, thereby avoiding a taxable sister corporation being treated as controlled by the ATEO.
- *Remuneration in Excess of \$1 Million.* The Final Regulations follow the approach of the Proposed Regulations relating to calculating remuneration, with three modifications:

- (1) The Final Regulations confirm that remuneration excludes amounts that are not includable in gross income pursuant to the \$10,000 *de minimis* exception under section 7872(c)(3) for certain below-market loans.
- (2) The Final Regulations reserve for future guidance the coordination of section 4960 and section 162(m).
- (3) The Final Regulations provide that for *any* vested amount (rather than just amounts under a nonaccount balance plan) that is scheduled to be paid within 90 days, an employer may treat the entire amount to be paid on such future date as the present value on the date of vesting (without making a present value determination).
- *ATEO Status for Specific Types of Entities.* The Final Regulations adopt the definition of ATEO set forth in the Proposed Regulations, with two minor modifications:
  - (1) Consistent with earlier guidance, the Final Regulations exclude from the definition of an ATEO governmental entities, such as state colleges and universities, that have not been recognized as exempt under section 501(a) and do not exclude income under section 115(1), although such entities may still be subject to the excise tax as related organizations of an ATEO. Under the Final Regulations, Treasury and the IRS reserve whether section 4960 should apply to certain federal instrumentalities described under 501(c)(1)(A)(i) (for which enabling acts provide for exemption from all current and future federal taxes).
  - (2) The Final Regulations provide that a foreign organization that (i) receives substantially all of its support from sources outside the U.S., and (ii) is either exempt from tax under section 501(a) or is a taxable private foundation, is not liable for the excise tax as a related organization of an ATEO, although remuneration paid by such a foreign organization must still be taken into account in determining the ATEO's five highest-compensated employees and the ATEO's (and its other related organizations') excise tax liability under section 4960.

## Covered Employees

Under the Final Regulations, as under the Proposed Regulations, the excise tax applies only with respect to an ATEO's covered employees. Only common law employees (which include officers, except in limited circumstances) can be classified as covered employees. Once an individual becomes a covered employee of an ATEO, the individual will remain a covered employee of the ATEO indefinitely, regardless of whether the individual continues to be an employee of the ATEO in future years, creating potential tax exposure in future years if that individual later receives more than \$1 million from a related organization of the ATEO.

### Exclusions and Exceptions from Employee and Covered Employee Status

With some minor modifications to the "nonexempt funds" exception, the Final Regulations retain the exceptions to employee and covered employee status provided in the Proposed Regulations to address concerns with inadvertent application of section 4960 such as through donation of employee services to ATEOs by related companies (as may arise in the context of a corporate foundation) or family offices.

*Independent Contractor Exception.* An individual who is not an employee of an ATEO cannot be a covered employee of the ATEO. Where an arrangement is structured to ensure an independent contractor relationship, section 4960 is inapplicable. An individual serving as a member of the board of directors of an ATEO structured as a corporation is not an employee of the ATEO (in such individual's capacity as a director).

*Unpaid Officers Minor Services Exception.* An unpaid officer of an ATEO structured as a corporation who does not perform services or performs only minor services is not a covered employee. The Final Regulations clarify that, in order for this exception to apply, the officer may not receive payment from any source, whether from the ATEO or a related organization, for the minor services provided as an officer of the ATEO.

*Medical Services Exception.* Remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services is disregarded for purposes of determining an ATEO's five highest-compensated employees.

*Volunteer Exception.* An individual who, for the applicable year, receives neither remuneration nor a grant of a legally binding right to non-vested remuneration from an ATEO or any related organization is not a covered employee. This "volunteer" exception does not exclude from covered employee status paid employees of a related organization who volunteer for the ATEO (but another exception may apply).

*Limited-Hours Exception.* An employee is excluded from an ATEO's five highest-compensated employees for a taxable year if (1) neither the ATEO nor any related ATEO paid remuneration or granted a legally binding right to non-vested remuneration to the individual for services the individual performed as an employee during the applicable year, and (2) the individual's total hours of service performed for the ATEO and all related ATEOs during the applicable year were 10% or less of their total hours of service performed for the ATEO and all related organizations. This exception is not available if the ATEO reimburses a related organization that employs the employee who provides the services to the ATEO. Like the Proposed Regulations, the Final Regulations also provide a safe harbor rule, under which an employee is treated as satisfying the 10% threshold if the employee provides no more than 100 hours of service to the ATEO and all related ATEOs during an applicable year. This exception is intended to address unintended application of the excise tax to arrangements where a paid employee of a related organization provides relatively limited services to an ATEO without receiving any compensation from the ATEO for such services.

*Nonexempt Funds Exception.* An employee is excluded from an ATEO's five highest-compensated employees for a taxable year if (1) neither the ATEO, nor any related ATEO, nor any taxable related organization controlled by the ATEO paid remuneration or granted a legally binding right to non-vested remuneration to the individual for services the individual performed as an employee during the applicable year and the preceding applicable year, and (2) the individual's total hours of service performed for the ATEO and all related ATEOs during the applicable year and the preceding applicable year were not more than 50% of their total hours of service performed for the ATEO and all related organizations. Departing from the Proposed Regulations, the Final Regulations provide that the measuring period for the nonexempt funds exception will be a two-year period rather than a single year. As with the limited-hours exception, this exception is not available if the ATEO reimburses a related organization for remuneration paid to the employee. Additionally, any related organization that provides remuneration to the individual may not provide services for a fee to the ATEO, to any related ATEO, or to any taxable related organization controlled by the ATEO. This exception is intended to address application of the excise tax to arrangements where a paid employee of a related organization provides services to an ATEO without receiving any compensation from the ATEO for such services, but where the amount of services provided exceeds the 10% threshold of the limited-hours exception. The nonexempt funds exception does not, however, exclude from covered employee status an employee who works for a taxable subsidiary of the ATEO.

*Limited Services Exception.* An employee is excluded from the ATEO's five highest-compensated employees for a taxable year if the ATEO paid less than 10% of the employee's total remuneration paid by the ATEO and all related organizations during the applicable year. However, if no ATEO paid at least 10% of an employee's total

remuneration during the applicable year, this exception does not apply to the ATEO that paid the most remuneration to the employee during the applicable year.

### Summary of Requirements for Covered Employee Exceptions

	Volunteer	Limited-Hours	Nonexempt Funds	Limited Services
<b>Hours Restriction</b>	No limitation.	Hours worked for ATEO and related ATEOs cannot be more than 10% of total hours worked for ATEO and all ROs; 100 hours or less/year safe harbor.	Hours worked for ATEO and related ATEOs cannot be more than 50% of total hours worked for ATEO and all ROs.*	No limitation.
<b>Compensation from ATEO for services to ATEO</b>	None allowed.	None allowed.	None allowed.	Must be less than 10% of total remuneration from ATEO and all ROs.
<b>Compensation from Related Organization (“RO”) for Services to ATEO</b>	None allowed.	None allowed if RO is another ATEO. Permitted if from a non-ATEO RO to individual as an employee of the RO.	None allowed if RO is an ATEO or is taxable and controlled by the ATEO.  Permitted if from a non-controlled taxable RO to individual as an employee of the RO.	At least one related ATEO paid at least 10% of total remuneration paid by ATEO and all ROs;U  At least one other related ATEO paid more remuneration than ATEO and no related ATEO paid at least 10% of the total remuneration.
<b>Reimbursement of/Fee for Service to Related Organization</b>	No specific restriction.	No reimbursement by the ATEO to RO.	No reimbursement by the ATEO to the non-controlled taxable RO.  No services for a fee provided by that RO to the ATEO, any related ATEOs or any taxable controlled ROs.	No specific restriction.

\*Computed over current and preceding applicable year measuring period. This is a change from the Proposed Regulations.

### Related Organizations

Section 4960 treats remuneration paid by a related organization of an ATEO to an employee of the ATEO as paid by the ATEO. A related organization of an ATEO includes, among other categories, a person (which includes organizations) or a governmental entity that “controls or is controlled by” the ATEO or is “controlled by one or more persons that control” the ATEO. The Final Regulations generally retain the control standard from the unrelated business income tax rules for payments from controlled entities, which uses a greater than 50% threshold, as well as attribution rules for determining

direct or indirect control. The Final Regulations leave unchanged the rules established in the Proposed Regulations for determining control for stock corporations, partnerships, trusts and nonstock corporations.

## Remuneration in Excess of \$1 Million

<p><b>What payments count as remuneration?</b></p>	<p>For purposes of section 4960, “remuneration” means wages as defined for purposes of the rules related to federal income tax withholding, with certain modifications and clarifications.</p> <p>Remuneration <i>includes</i>:</p> <ul style="list-style-type: none"> <li>• Amounts required to be included in gross income under section 457(f) as vested deferred compensation – but see <i>Timing</i> note below regarding short-term deferrals and the lapse of a substantial risk of forfeiture.</li> <li>• Compensation includible under section 7872 related to below-market compensation-related loans (e.g., arising as a result of certain split-dollar life insurance arrangements). Amounts that are not includable in gross income pursuant to the \$10,000 <i>de minimis</i> exception under section 7872(c)(3) are <i>excluded</i>.</li> <li>• Taxable fringe benefits (e.g., employer-provided parking in excess of the value excluded under section 132).</li> </ul> <p>Remuneration <i>excludes</i>:</p> <ul style="list-style-type: none"> <li>• Designated Roth contributions (along with other retirement contributions and distributions to a qualified employer plan or a section 403(b) plan).</li> <li>• Deferrals under a governmental section 457(b) plan.</li> <li>• Amounts paid by a related organization for which a deduction is otherwise disallowed under section 162(m) (generally, this means compensation paid by public companies in excess of \$1 million and certain health insurance providers in excess of \$500,000 to certain highly compensated executives). Unlike the Proposed Regulations, the Final Regulations reserve for future guidance the coordination of section 4960 and section 162(m). Until such future guidance is provided, where it is unknown whether a deduction for remuneration will be disallowed under section 162(m) by the due date of the return reporting the excise tax, taxpayers may use a reasonable, good faith approach with respect to the coordination of section 4960 and section 162(m).</li> <li>• Excess parachute payments. However, a parachute payment that is not an excess parachute payment is <i>included</i> in remuneration.</li> <li>• Remuneration paid to an employee who is a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services is disregarded for purposes of determining whether excess remuneration or excess parachute payments have been paid.</li> </ul>
<p><b>When is remuneration treated as paid?</b></p>	<ul style="list-style-type: none"> <li>• Remuneration that is considered “regular wages” (generally remuneration paid at a regular hourly, daily or similar periodic rate) is treated as paid when it is actually or constructively paid.</li> <li>• All other remuneration is treated as paid when it is no longer subject to a substantial risk of forfeiture (i.e., when it vests). As under the Proposed Regulations, the determination of whether an amount has vested is based on the definition in the</li> </ul>

	<p>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.</p>
<p><b>How much remuneration is treated as paid?</b></p>	<ul style="list-style-type: none"> <li>• 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. Separate guidance is expected to address how to calculate the present value of vested remuneration. However, the Final Regulations, expanding upon a rule of administrative convenience from the Proposed Regulations, provide that for <i>any</i> vested amount (rather than just amounts under a nonaccount balance plan) that is scheduled to be paid within 90 days, an employer may treat the entire amount to be paid on such future date (without making a present value determination) as the present value on the date of vesting.</li> <li>• Subsequent earnings on such amounts are treated as paid at the end of the calendar year in which they accrue. This means that subsequent earnings on vested section 457(f) amounts are included in income for federal tax purposes at a different time than they are included for purposes of calculating the section 4960 excise tax.</li> <li>• The Final Regulations retain the Proposed Regulations’ rules for treatment of net earnings on amounts that have vested and previously been treated as paid for section 4960 but that have not actually been received or constructively received by the employee.</li> </ul>
<p><b>What is the applicable year for measuring remuneration?</b></p>	<p>The applicable year for measuring remuneration and parachute payments is the calendar year that ends with or within the ATEO’s taxable year. This is generally the same method used for reporting compensation on IRS Form 990.</p>

## Excess Parachute Payments

The excise tax is also imposed on any excess parachute payment. A parachute payment is 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 all such 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). An excess parachute payment equals the excess of the parachute payment over the portion of the base amount allocated to such payment (*i.e.*, not only the portion of the payment in excess of three times the base amount).

The Final Regulations adopt without change the guidance from the Proposed Regulations concerning excess parachute payments. Although payments from non-ATEO related organizations are considered for purposes of determining the base amount and total payments in the nature of compensation that are contingent on separation from employment, only an excess parachute payment paid by an ATEO is subject to the excise tax on excess parachute payments. Like the Proposed Regulations, the Final Regulations contain an anti-abuse provision allowing the IRS to reallocate excess parachute payments to an ATEO if it is determined that such payments were made by a non-ATEO for the purpose of avoiding the section 4960 tax.

## Liability for Excise Tax

The section 4960 excise tax is imposed on the sum of (i) the excess remuneration allocated to the employer (including a taxable related organization) with respect to the taxable year, and (ii) for ATEOs only, any excess parachute payment paid by the ATEO or a predecessor of the ATEO during the taxable year. The Final Regulations emphasize that for each taxable year, each employer is liable for the tax on excess remuneration paid in the applicable year ending with or within the employer's taxable year. Like the Proposed Regulations, the Final Regulations provide guidance and examples for calculating the excise tax under a variety of scenarios.

## Effective Dates

Section 4960 is effective for an ATEO's first taxable year beginning after December 31, 2017. Consistent with the Proposed Regulations, the Final Regulations treat remuneration that either (1) was paid or (2) is treated as having been paid because it vested prior to the ATEO's first taxable year that began on or after January 1, 2018 as not subject to section 4960.

The Final Regulations are generally applicable with respect to taxable years beginning after December 31, 2021 (with the first applicable year generally being the 2022 calendar year). Taxpayers may choose to apply the Final Regulations to taxable years beginning after December 31, 2017 and on or before December 31, 2021, provided the taxpayer applies the Final Regulations in their entirety and in a consistent manner. Until the applicability date of the Final Regulations, taxpayers may instead continue to rely on Notice 2009-09 or alternatively the Proposed Regulations and, in each case, upon a reasonable, good faith interpretation of the statute.

For more information, please contact a member of the [Tax-Exempt Organizations](#) practice or a member of the [Benefits Consulting Group](#).