

June 16, 2020

Tax-Exempt Organizations Executive Compensation Excise Tax Regulations Released

On June 5, 2020, the Department of the Treasury and the Internal Revenue Service released extensive proposed regulations ([REG-122345-18](#), the “Proposed 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.

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 tax-exempt organizations, including organizations exempt under section 501(a) of the Code, such as 501(c)(3), 501(c)(4) and 501(c)(6) organizations, some governmental entities (“applicable tax-exempt organizations” or “ATEOs”), 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 Proposed Regulations provide welcome relief in the form of a number of new exclusions and exceptions (including a volunteer exception) to the excise tax. They are otherwise generally consistent with guidance issued in December 2018 ([Notice 2019-09](#), the “Notice”) and described in our prior [Alert](#) while providing increased clarity on a number of key issues.

Covered Employees

Determining Who Are the Five Highest-Compensated Employees

The excise tax applies only with respect to an ATEO’s covered employees, and only common law employees (which include officers, except in limited circumstances) can be classified as covered employees.

- When determining the ATEO’s five highest-compensated employees for the year and when calculating the excise tax, all remuneration paid to an individual employed by both the ATEO and by any related organization of an ATEO is counted.
- Remuneration paid by a third party (e.g., related organization, an unrelated organization, or a payroll agent) for employment by an employer is deemed paid by the employer.
- Once an individual becomes a covered employee of an ATEO, they will be a covered employee of the ATEO for as long as they remain an employee, regardless of how much compensation they are paid in future years.

Exclusions and Exceptions to Employee and Covered Employee Status:

Treasury and the IRS specifically declined to adopt any minimum dollar threshold, any grandfathering rule, or any sunset rule for determining an ATEO’s covered employees. However, responding to concerns identified by the tax-exempt organization community, the Proposed Regulations include several distinct exceptions to the definitions of “employee” and “covered employee” that together are aimed at avoiding unintended application of the excise tax.

- *Independent contractor status:* An individual who is not an employee of an ATEO cannot be a covered employee of the ATEO. The Proposed Regulations note that whether an individual is an employee or an independent contractor (or an employee of an organization providing services as an independent contractor) is determined

based on facts and circumstances. If, however, an arrangement is structured to ensure an independent contractor relationship, section 4960 would be inapplicable. The Proposed Regulations reiterate that an individual serving as a director of an ATEO structured as a corporation is not an employee of the ATEO (in their capacity as a director).

- ***Practice Note: Consider application of section 4960 when facing a worker reclassification concern or preparing or reviewing a services agreement.***
- ***Minor services exception for unpaid officers:*** The Proposed Regulations provide that an unpaid officer who does not perform services (or performs only minor services) for a corporation is not considered an employee – and thus not a covered employee.
- ***Volunteer exception:*** The Proposed Regulations exclude from an ATEO’s five highest-compensated employees for the taxable year an individual who, for the applicable year, receives no remuneration or a grant of a legally binding right to nonvested remuneration from the ATEO or from any related organizations for services to the ATEO or any related organization.
 - ***Practice Note: The “volunteer exception” does not cover a situation where a paid employee of a related organization “volunteers” for the ATEO – but another exception may provide relief.***
- ***Limited-hours exception:*** An employee (1) whose total hours of service performed for the ATEO and all related ATEOs during an applicable year is 10% or less of their total hours of service performed for the ATEO and all related organizations, and (2) to whom neither the ATEO nor any related ATEO pays any remuneration or grants a legally binding right to nonvested remuneration, is not treated as one of the ATEO’s five highest-compensated employees for the taxable year. To be eligible for this exception, the ATEO may not reimburse a related organization that employs the employee who provides the services to the ATEO. The Proposed Regulations also provide a safe harbor rule, under which an employee who provides fewer than 100 hours of service to the ATEO and all related ATEOs during an applicable year will be treated as having worked 10% or less of the employee’s total hours for the ATEO and all related ATEOs.
- ***Nonexempt funds exception:*** An employee (1) whose total hours of service performed for the ATEO and all related ATEOs during an applicable year is less than 50% of their total hours of service performed for the ATEO and all related organizations, and (2) to whom neither the ATEO, nor any related ATEO, nor any taxable related organization controlled by the ATEO pays remuneration or grants a legally binding right to nonvested remuneration for services performed for the ATEO, is not treated as one of the ATEO’s five highest-compensated employees for the taxable year. As with the limited-hours exception, the ATEO may not reimburse 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.
 - ***Practice Note: This exception should address unintended application of the excise tax to a company whose employees devote a portion of their services to a controlled company foundation as long as the foundation does not reimburse the company for the employee’s time or for any other services. This exception does not cover the situation where an employee works for a taxable subsidiary of an ATEO.***
- ***Limited services exception:*** As under the Notice, an ATEO employee is not treated as one of the ATEO’s five highest-compensated employees for the taxable year unless the ATEO pays at least 10% 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% 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, meaning that this exception may be used only in the context of multiple ATEOs paying compensation to the same employee.

Summary of Exceptions from Covered Employee Status

	Volunteer	Limited Hours	Nonexempt Funds	Limited Services
Hours Restriction	None.	Hours worked for ATEO and related ATEOs cannot be more than 10% of total hours worked for ATEO and all ROs; fewer than 100 hours/year safe harbor.	Hours worked for ATEO and related ATEOs must be less than 50% of total hours worked for ATEO and all ROs.	None.
Compensation from ATEO for services to ATEO	None allowed.	None allowed.	None allowed.	Must be less than 10% of total remuneration from ATEO and all ROs.
Compensation from Related Organization (“RO”) for Services to ATEO	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; or At least one other related ATEO paid more remuneration than ATEO and no related ATEO paid at least 10% of the total remuneration.
Reimbursement of/Fee for Service to Related Organization	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.

Related Organizations

Relevant for determining total remuneration: Section 4960 treats remuneration paid by a related organization of an ATEO as paid by the ATEO. A related organization includes, among other categories, a person (which includes organizations) or a governmental entity (hereinafter, a “person”) that “controls or is controlled by” the ATEO or is

“controlled by one or more persons that control” the ATEO. The Proposed 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.

Nonstock organizations: The Proposed Regulations provide additional guidance regarding control of a nonstock organization, defined as a nonprofit or other organization without owners, including a governmental entity. The Proposed Regulations generally retain the two-prong definition from the Notice, providing that a person controls a nonstock organization if more than 50% of the directors or trustees of the nonstock organization are either representatives of or are directly or indirectly controlled by the person. To alleviate concerns over “accidental control,” however, the Proposed Regulations provide that a representative does *not* include a director or trustee of a nonstock corporation who is also a lower-level employee of a person, so long as the employee does not act as the person’s representative in their service to the nonstock corporation.

The Proposed Regulations also clarify application of attribution principles in the context of a nonstock organization, including indirect control. A person that controls a nonstock organization is attributed a percentage of the stock owned by the nonstock organization based on the percentage of directors or trustees of the nonstock organization who are representatives of, or controlled by, the person. The reverse is also true—the stock held by a nonstock organization’s controlling person is attributed to the nonstock organization in accordance with these same calculations.

Applicable Year

As under the Notice, 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. The Proposed Regulations provide further guidance for determining the applicable year for taxable years in which an employer’s status as an ATEO begins or terminates.

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 whether excess remuneration or excess parachute payments have been paid. The Proposed Regulations, like the Notice, clarify that such remuneration is also excluded when determining which ATEO employees are its five highest-compensated and therefore covered employees. Additionally, consistent with the Notice, the Proposed Regulations provide 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.

Remuneration in Excess of \$1 Million

Remuneration for purposes of section 4960 means wages as defined for purposes of the rules related to federal income tax withholding with some modifications and clarifications:

- amounts required to be included in gross income under section 457(f) as vested deferred compensation are *included* as remuneration – but see *Timing* note below regarding short-term deferrals and the lapse of a substantial risk of forfeiture.
- any 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) is *included* as remuneration.
- along with other retirement contributions and distributions to a qualified employer plan or a section 403(b) plan, designated Roth contributions are *excluded* from remuneration.

- deferrals under a governmental section 457(b) plan are *excluded* from remuneration.
- amounts paid by a related organization for which a deduction is otherwise disallowed under section 162(m) are *excluded* from remuneration. Section 162(m) generally disallows a deduction for 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. Coordination of section 4960 and section 162(m) is further elaborated upon in the Proposed Regulations through several helpful examples.
- an excess parachute payment is *excluded* from remuneration but a parachute payment that is not an excess parachute payment is *included* in remuneration.

Timing: 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.

- ***Practice Note: “Regular wages” for a pay period spanning two calendar years are “counted” in the year paid, which is the same as the Form W-2 reporting rule.***

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 Notice, the determination of whether an amount has vested is based on the definition in the 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.

- ***Practice Note: Treasury and the IRS declined to adopt a “short-term deferral” rule for these purposes under which remuneration that vests in one year and is paid out quickly in a subsequent year would be treated as paid in the subsequent year. As a result, short-term deferrals under section 457(f) and 409A may be included in income for federal tax purposes in a different year and at a different time than their inclusion for purposes of calculating the section 4960 excise tax.***

Amount: As under the Notice, 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. Subsequent earnings on such amounts are treated as paid at the end of the calendar year in which they accrue. The Proposed Regulations provide detailed 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.

- ***Practice Note: Subsequent earnings on vested section 457(f) amounts are included in income for federal tax purposes at a different time than their inclusion for purposes of calculating the section 4960 excise tax.***

Excess Parachute Payments

The excise tax is also imposed on any excess parachute payment. A parachute payment 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 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 Proposed Regulations largely retain the guidance from the Notice 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 (which, in general, denies a deduction to publicly traded corporations paying excess parachute payments to certain disqualified individuals contingent upon a change of ownership or control).

- ***Practice Note: Generally, a payment is contingent on separation from employment when it is:***
 - *a traditional severance entitlement that is conditioned on the occurrence of an involuntary separation from employment; or*
 - *a deferred compensation entitlement that accelerates vesting or payment upon an involuntary separation from employment.*

The Proposed Regulations contain specific rules for determining how much of the above amounts are included in the parachute payment calculation.

The Proposed Regulations differ from the Notice by providing that only an excess parachute payment paid by an ATEO is subject to the excise tax on excess parachute payments (whereas the Notice suggested the excise tax would also be imposed on payments from related organizations). As in the Notice, payments from non-ATEO related organizations are still considered for purposes of determining the base amount and total payments in the nature of compensation that are contingent on separation from employment. The Proposed Regulations contain an anti-abuse provision allowing the Commissioner 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.

ATEO Definitional Guidance

Governmental entities: Consistent with the Notice, the Proposed Regulations provide that a governmental entity, such as a state college or university, that has not received an IRS determination letter recognizing its exempt status under section 501(a) and that does not exclude income under section 115(1) is not an ATEO, although such a governmental entity may still be subject to the excise tax as a related organization of an ATEO.

Foreign organizations: The Proposed Regulations clarify that a foreign organization can be considered an ATEO, unless it receives substantially all of its support from sources outside the U.S. Treasury and the IRS are still considering whether such a foreign organization should be liable for the excise tax as a related organization of an ATEO.

Predecessor ATEOs: A "covered employee" includes any employee who was a covered employee of a predecessor ATEO. The Proposed Regulations delineate the circumstances and timing giving rise to treatment of an organization as a predecessor ATEO, including with respect to asset acquisitions and corporate reorganizations, and address chains of predecessors.

Liability, Reporting, and Payment

The excise tax under section 4960 is imposed on the sum of the excess remuneration properly allocated to the employer (including a taxable related organization) with respect to the taxable year and, for ATEOs only, any excess parachute payment paid by the ATEO or a predecessor during the taxable year.

The Proposed Regulations also provide guidance and examples on calculating and allocating the excise tax in a variety of scenarios, including when multiple employers contribute to a covered employee's excess remuneration, when a taxpayer is liable for the excise tax as both an ATEO and a related organization, and when an ATEO has a short applicable year.

Similarly, the Proposed Regulations outline the process for calculating liability for, and computing the amount of, excess parachute payments.

Effective Dates

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

The Proposed Regulations are effective for taxable years beginning on or after the date on which final regulations are published in the Federal Register. For taxable years beginning before the regulations are finalized, taxpayers may rely on either the Notice or the Proposed Regulations, including for periods prior to the Proposed Regulations' date of publication in the Federal Register (June 11, 2020). Taxpayers may also rely on a reasonable, good faith interpretation of the statute that includes consideration of relevant legislative history when taking a position related to excess remuneration or excess parachute payments. Treasury and the IRS caution that several positions, outlined in the preamble to the Notice and reiterated in the Proposed Regulations, have been deemed inconsistent with a reasonable, good faith interpretation.

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