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IRS Notice 2019-9 Provides Interim Guidance for Tax-Exempt Organizations Paying Excess Executive Compensation

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January 24, 2019

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The IRS has released a technical interim guidance on Section 4960, which was added to the Internal Revenue Code of 1986, as amended, as part of the Tax Cuts and Jobs Act. Very generally, Section 4960 imposes an excise tax in an amount equal to the corporate tax rate (currently, 21 percent) on that portion of a covered employee's pay that exceeds $1 million or is treated as an excess parachute payment (as explained below). The tax is imposed upon the applicable tax-exempt organization and its related organizations and became effective for tax years beginning after December 31, 2017. For a high-level summary of the law change, please see our earlier blog post.

Although these concepts may seem simple, the interim guidance issued by the IRS on December 31, 2018, in the form of IRS Notice 2019-9 creates a vast web of defined terms and potential pitfalls. The guidance necessitates that every entity that is, or is associated with, a tax-exempt organization and every practitioner or advisor who touches executive compensation matters involving tax-exempt organizations and their related entities gain a comprehensive understanding of these rules.

The guidance not only will drive the design and implementation of executive employment agreements and deferred compensation plans, but it also will influence the structuring of severance payments and settlement agreements. It also may necessitate changes to management service agreements, payroll systems, and internal controls to better manage and account for executive compensation.

Our initial overview of the interim guidance is designed to help organizations gain a basic understanding of the rules. Subsequent updates will drill down into some of the nuances and unanticipated consequences of Code Section 4960, as well as provide planning points to minimize the impact of this tax law change.

Who is subject to the excise tax?

The excise tax applies only to an applicable tax-exempt organization ("ATEO" in the Notice) or a related organization paying excess remuneration or excess parachute payments to a covered employee, all as defined below.

An **applicable tax-exempt organization** includes all organizations exempt from taxation under Code Section 501(a) *(e.g.,* public charities, including many private colleges and universities, private and public foundations, social welfare organizations, chambers of commerce, trade associations, electric cooperatives, and social clubs), governmental entities that are separately organized from a state or political subdivision of a state and that have their income excluded under Code Section 115(1) and certain other entities described in the Notice. Importantly, hospitals that have dual tax-exempt and governmental status will be subject to the excise tax, as are tax-exempt foundations that support public universities.

Thus, for example, a public university that has not also received a determination letter that it is exempt from taxation under Section 501(c)(3) is not an ATEO.

However, importantly, if governmental units are related to other ATEOs, they may be subject to their allocable portion of the excise tax, even though they do not constitute applicable tax-exempt organizations.

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Related organizations subject to the Code Section 4960 excise tax include taxable, tax-exempt, and governmental entities meeting certain control and support tests set forth in the Notice.

For example, a related organization would include a governmental unit, such as a county, that has the power and authority to choose the directors of a non-profit Convention and Visitor's Bureau or a public hospital that has a Section 501(c)(3) determination letter. A related organization might also include a taxable corporation that established a tax-exempt foundation to pay scholarships or make community grants and that has a board of directors comprised of representatives of the taxable corporation.

Employer Takeaway: The important point here is that tax-exempt organizations are not the only entities potentially subject to the excise tax. Taxable businesses and governmental entities also may be subject to this tax pursuant to the interim guidance.

Who is a covered employee?

Unlike most employee benefit rules that focus only on highly compensated employees, an employee can be a covered employee even if the nominal amount paid to the employee is not very high. Rather, an employee will be treated as a **covered employee** if he or she is one of an ATEO's five highest-compensated employees, including pay from related organizations. Once an employee meets the definition of a covered employee, the employee is always a covered employee (even if the employee ceases to be one of the top five highest-compensated employees or terminates employment). Certain exceptions apply to pay received in exchange for medical services or if the ATEO pays less than 10 percent of employee's total pay.

Employer Takeaway: As covered employee status is never shed, employers will need to be diligent about keeping an ongoing list of covered employees. ATEOs should immediately appoint an employee to keep this list and should confirm that the list is being accurately maintained to avoid inadvertent tax and reporting failures.

What is excess remuneration?

Very simply, **excess remuneration**, which is subject to this excise tax, means that portion of the covered employee's remuneration from the ATEO when combined with remuneration the covered employee receives from related organizations that exceeds $1 million in a calendar year.

Remuneration means wages that are subject to income tax withholding purposes under Code Section 3401(a), excluding designated Roth contributions. Here, the devil is in the details.

Even though, for this purpose, distributions from tax-qualified retirement plans, 403(b) plans, and governmental 457(b) plans are excluded from the definition of wages, vested amounts under 457(b) plans appear to be included in remuneration (although there is some ambiguity as to this point). Further, amounts that are required to be included in income under Code Section 457(f) are included in wages for this purpose. This means that some severance arrangements with covered employees that are treated as deferred compensation plans are included in remuneration. This also means that all plans that are governed by Code Section 457(f), regardless of whether they are in the form of executive employment agreements, nonqualified deferred compensation plans, supplemental executive retirement plans, incentive compensation plans, etc. may provide remuneration to be taken into account for purposes of Code Section 4960.

Remuneration is treated as paid when it is not subject to a substantial risk of forfeiture *(i.e.,* when it is vested), as determined in accordance with the Notice, even if it is not paid at such time. The amount of remuneration that is treated as paid upon vesting is the present value of the future payments. The Notice includes detailed rules regarding how the present value is calculated.

The Notice also explains how remuneration is determined with respect to employees who become covered employees and with respect to pre-effective date remuneration.

Settlement payments made to covered employees or payments of damages to covered employees that are characterized as wages also fit within the definition of remuneration. This presents particular challenges under Code Section 4960 as these types of payments are often large vested payments.

Employer Takeaway: Employers need to understand what constitutes remuneration and when it is treated as paid in order to properly calculate their liability under Code Section 4960.

What is an excess parachute payment?

Similar to the calculation of an excess parachute payment under Code Section 280G, an excess parachute payment under Code Section 4960 means, generally, an amount equal to the excess (if any) of the total amount of any parachute payment over the base amount.

Generally, a **parachute payment** is a compensation payment (within the meaning of the Notice) to a covered employee where:

- The payment is contingent on the employee's termination (determined in accordance with the Notice), and
- The aggregate present value of such compensation equals or exceeds three times the base amount.

There are a number of exclusions from this definition, including (i) payments to or from a qualified plan or under or to a 403(b) or 457(b) plan (whether the employer is governmental or tax-exempt), (ii) payments to a licensed medical professional for the performance of medical services by such professional, and (iii) payments to individuals who are not highly compensated employees (as determined for purposes of 401(k), 403(b), etc.).

A covered employee's **base amount** is the average annual compensation for services performed as an employee of the ATEO or related organization, calculated based on includible compensation in the five most recent taxable years before the date of the employee's termination (subject to certain special rules).

Employer Takeaway: While employers in the private sector need only perform the similar 280G calculation in connection with an actual change in control (subject to any calculations run for reporting purposes), ATEOs will need to perform this calculation in connection terminations occurring at any time and for any reason. Thus, ATEOs will need to have a process in place to ensure this calculation can be performed regularly and efficiently. Further, ATEOs should be aware of these rules when designing severance or separation agreements involving their covered employees.

How is the Section 4960 excise tax calculated and allocated?

The excise tax on excess remuneration and excess parachute payments is calculated based on excess remuneration paid and excess parachute payments made during the calendar year ending with or within the employer's fiscal year. Say, for example, that an applicable tax-exempt organization uses the fiscal year ending June 30 as its tax year. For the fiscal year ending June 30, 2019, the excise tax is calculated on excess compensation and excess parachute payments made during the calendar year ending December 31, 2018. This rule is designed to better align the accounting with the Form W-2 timeframe.

Further, unlike Code Section 409A and unlike the Code Section 4999 golden parachute excise tax, which subjects the recipient of the pay to the tax, the Code Section 4960 excise tax is imposed upon the common law employer. Having the remuneration paid by a third party payor, such as a payroll agent or professional employer organization, or an unrelated management company does not avoid this result.

Employer Takeaway: Employers should have a structure in place to calculate the tax and to allocate the excise tax liability among the applicable tax-exempt organization and the related organizations.

How is the excise tax reported and paid?

Taxes imposed under Section 4960 are reported and paid on IRS Form 4720 Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code. Related organization with tax liability must file their own Form 4720. This filing is due the 15th day of the 5th month after the end of the employer's taxable year, which is May 15th for calendar year employers.

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The Treasury Department and the IRS have requested public comments on the topics in the Notice and any other issues under Section 4960. Comments must be submitted by April 2, 2019.

Please contact Jackson Lewis with any questions about the Notice or if you would like assistance in submitting comments.

*The National Operations Center serves as the firm's central administration hub and houses the firm's Facilities, Finance, Human Resources and Technology departments.