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IRS Issues Guidance on New Excise Tax on Excess Compensation Paid by Not-for-Profit Entities

Volume 42

Issue 17

February 19, 2019

Authors
Joanne Jacobson, JD, LLM
Marjorie Martin, FSPA, EA, MAAA

First effective for compensation earned in 2018, tax reform imposes an excise tax on certain tax-exempt entities for excess compensation and excess parachute payments. Recently issued guidance by the IRS addresses how to calculate and apply the new tax.

Background

The Tax Cuts and Jobs Act of 2017 added Section 4960 to the Internal Revenue Code. This section currently imposes a 21% excise tax on certain tax-exempt entities for compensation in excess of $1 million and "excess parachute payments" made to certain highly compensated employees. This tax is intended to more closely align tax-exempts' compensation taxation with for-profit entities' taxation. The excise tax was first effective for compensation earned after December 31, 2017.

Interim IRS guidance released

IRS issued Notice 2019-09 to provide guidance on how to calculate and apply the new tax while waiting for proposed regulations. The guidance includes information on affected entities and employees, excess compensation and parachute payments, timing and payment instructions.

Which Entities are Impacted?

The new excise tax affects "applicable tax-exempt organizations", which include those that are exempt from tax under Code Section 501(a) [including 501(c)(3) organizations, 501(c)(5) labor organizations, and voluntary employees' beneficiary associations (VEBAs)], governmental entities that are exempt from federal tax under Code Section 115(1), and any "related organizations".

Public universities with an IRS determination letter recognizing their exemption under 501(c)(3) are impacted, but state colleges or universities that do not have such a letter or do not exclude income under 115(1) are not, unless the organization is related to an applicable tax-exempt organization. Some entities are exempt from federal taxation under the doctrine of implied statutory immunity; those entities are exempt from the excise tax unless taxed as a related entity.

> **Note:** The Joint Committee on Taxation's Explanation indicates that Congress intended to apply the excise tax to state colleges and universities (and thus highly paid athletic directors and coaches), but a technical correction may be necessary to reflect this intent. Notice 2019-09 does not make this assumption.

What is a Related Entity?

As noted previously, related organizations may be liable for a portion of the excise tax if they pay any part of excess compensation or an excess parachute payment. Related entities include organizations that: (1) control, or are controlled by, the non-profit entity, (2) are controlled by persons that control the non-profit, (3) are supported or supporting organizations, or (4) make contributions to a VEBA. "Control" means more than 50 % control — stock ownership for corporations, profits or capital interest for partnerships, beneficial interests for trusts, and director or trusteeship for non-stock entities. Thus, any type of organization — including for-profit entities — may be related and subject to excise tax.

> **Note:** The same rules that apply in determining a related entity for reporting on Form 990 apply here.

Which Employees are Impacted?

"Covered employees" subject to the excise tax include the five highest compensated common-law employees of an applicable tax-exempt organization for the calendar year or individuals who were covered employees in any prior year beginning on or after January 1, 2017.

> **Note:** There is no minimum dollar threshold for an employee to be a covered employee. Furthermore, once a covered employee, always a covered employee. This means that even if the tax-exempt entity has no liability under Section 4960 for one year, the entity must continue to track all covered employees because those employees may be paid excess remuneration or excess parachute payments in a future year.

Only tax-exempt entities have covered employees; however, compensation paid for services performed for a related entity is included in determining who is a covered employee. But an employee is not counted as a covered employee of a tax-exempt entity if the entity pays less than 10% of the total remuneration paid by all related entities during the calendar year. However, if an employee would not be treated as one of the five highest compensated employees of any entity because no tax-exempt entity paid at least 10% of the employee's compensation in the group, then the entity that paid the most to the employee will be considered the applicable tax-exempt entity subject to the excise tax, if applicable.

> **Note.** While remuneration from the related entities is aggregated, each tax-exempt entity in a control group has its own covered employees. Note, too, that it is unclear how the "once a covered employee, always a covered employee" rule applies in mergers and acquisitions.

What Remuneration is Counted and When?

"Remuneration" generally includes wages subject to income tax withholding (except for direct medical and veterinary services, which are defined narrowly) paid during the calendar year for services provided to the applicable tax-exempt entity or related organization. Payments from most retirement plans such as qualified plans and 403(b) annuities are not included, but payments from nongovernmental 457(b) plans are included.

Remuneration (which does not include elective deferrals because they are not subject to withholding) *does not* include designated Roth contributions (even though they are subject to withholding) but *does* include amounts required to be included in income under Section 457(f). Amounts are required to be included in income under Section 457(f) deferred compensation plans when no longer subject to a substantial risk of forfeiture (i.e., when it vests); thus, amounts may be included in remuneration for excise tax purposes and for purposes of determining covered employee status, before a distribution is made. The amount to be included is the present value of the vested remuneration using reasonable actuarial assumptions. Furthermore, any earnings on amounts previously taken into account are treated similarly – they are taken into account when accrued, not when paid (though losses may be carried over).

> **Note:** This rule that requires earnings on amounts already taken into account to be included when accrued is unlike the treatment of earnings on amounts taken into account for FICA tax purposes; the general rule is that FICA inclusion will also exempt the future value of that amount from any additional FICA tax. Thus, the new rule adds an additional layer of administrative complexity.

The date when remuneration is no longer subject to a substantial risk of forfeiture — not the date of payment — requires particular attention by tax-exempt entities. The entities will have to track when deferred compensation and earnings accrue to determine whether or not the individual is a covered employee and has excess remuneration. And employers may be surprised to find that accumulations in these arrangements may be quite large and upon payment at termination will give rise to an excise tax (to the extent not previously taxed due to the lapse of forfeiture restrictions).

> **Note:** The Notice provides that "amounts includible in gross income under section 457(f)(1)(A) and any vested earnings that accrued before the effective date of section 4960 are not subject to the excise tax under section 4960." However, since 457(f) plans generally coordinate vesting and payment, the amounts deferred prior to 2018 likely would not have been taken into account.

Importantly, remuneration that is nondeductible under Section 162(m) is excluded from renumeration for this excise tax. This includes publicly held corporation compensation in excess of $1 million to covered employees and compensation in excess of $500,000 paid by a covered health insurance provider to an applicable individual, *but compensation up to $1M and $500,000, respectively, is included in remuneration for purposes of the excise tax.*

How is the tax on Excess Compensation determined?

The excise tax on excess remuneration is 21% of remuneration in excess of $1 million, exclusive of parachute payments.

What Are Parachute Payments?

Parachute payments are those payments to a covered employee by a tax-exempt entity and its related entities that are contingent on the employee's involuntary termination of employment and equal or exceed three times the employee's "base amount" — i.e., the employee's average annual taxable compensation over the five most recent years before termination. Because the base amount only includes taxable compensation but the parachute calculation includes all payments, certain fringe benefits are not included in the base amount but may be treated as parachute payments.

The Notice clarifies several items for parachute payments:

- Parachute payments only apply to "highly compensated employees" as defined in Code Section 414(q) and as used in qualified retirement plans (e.g., $125,000 in 2019, as indexed); employers should use the same definition used by their qualified plans or make an analogous determination if they do not have a qualified plan
- Payments to or from certain retirement plans, including qualified defined contribution and defined benefit plans, 403(b) and 457(b) plans are excluded
- Involuntary termination from employment includes a termination without cause, early termination of an employee's contract, and termination of employment for "good reason"
- Payments are contingent upon separation from employment if vesting or payment would not have occurred but for the involuntary separation and includes payments such as those made under noncompetition or "non-compete" agreements and window programs
- The definition of "separation from service" under Code Section 409A is generally applied here, but also includes changes from an employee to an independent contractor, even if the individual continues to provide services for the applicable tax-exempt organization, and only provides for a presumption of a separation from service upon an anticipated reduction of the level of service by 80%, with a reduction between 50 and 80% assessed based on facts and circumstances

    Note: This is unlike "golden parachutes" under Code Section 280G, where payments are contingent on a change of control.

How is the tax on Excess Parachute Payments determined?

The amount of the excess parachute payment subject to the excise tax is any parachute amount that exceeds the covered employee's base amount. This 21% excise tax is determined separately from the tax on excess compensation.

Example: A highly compensated employee is involuntarily terminated with a base amount of $200,000. At termination, the employee receives a $200,000 severance payment and $500,000 from her 457(f) plan that is payable upon involuntary termination. The parachute amount of $700,000 exceeds three times her base amount by $100,000. The excise tax applies to $500,000 ($700,000 parachute minus $200,000 base amount).

Who Pays and How are Excise Taxes Paid?

If there are no related organizations, the common law employer of the employee is liable for the excise tax. For groups of related organizations, responsibility for the tax is prorated in proportion to the remuneration paid by each employer for a particular employee for either excess compensation or an excess parachute payment. If the employee is counted in multiple organizations, the employer pays the greater of the excise tax owed as the tax-exempt organization or as a related organization to another tax-exempt organization.

Each employer must pay the tax directly, even if compensation is paid through third-party payors such as payroll agents or common paymasters. Each nonprofit and each related entity (including for profit organizations) must file its own separate IRS Form 4720 to report and pay its share of the excise tax by the entity's tax return filing due date, subject to any applicable extensions. For nonprofits, the Form 990 is due on the 15th day of the fifth month following the end of the organization's fiscal year (i.e., May 15 for calendar year entities), with a six-month extension available.

In Closing

There is much to be done by tax-exempt organizations with this new interim guidance in hand. Tax-exempt organizations should begin reviewing their compensation programs in light of Section 4960 and this guidance to determine if there are ways to limit the impact of these rules. In addition, tax-exempt organizations — especially those with related entities and employees that move between the entities — will need to determine : 1) who are covered employees, 2) the amount of remuneration paid by each entity, 3) which employees are subject to the excise tax, and 4) the liability to be shared by the entities. Furthermore, a system should be established to track covered employees in perpetuity.

Employers must take action soon to determine whether or not any excise tax is due for 2018 and to begin preparing for the filing and payment deadlines.

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