

# IRS ISSUES INTERIM GUIDANCE ON THE EXCISE TAX IMPOSED ON EXECUTIVE COMPENSATION ARRANGEMENTS OF TAX-EXEMPT ORGANIZATIONS

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**Practices & Industries**

Employee Benefits

On December 31, 2018, the IRS issued Notice 2019-09 regarding the interpretation of Code Section 4960. Enacted as part of the Tax Cuts and Jobs Act, Code Section 4960 imposes a 21% excise tax on an applicable tax-exempt organization (“ATEO”) that pays remuneration in excess of \$1 million for a taxable year or any excess parachute payment to a covered employees of a tax-exempt organization.

Using a question and answer format, Notice 2019-09 provides interim guidance on a number of issues arising under Code Section 4960, including which taxable year is to be used for calculating the excise tax, the determination of an ATEO’s covered employees, the treatment of related organizations, the limited and medical service exceptions, and the timing and nature of remuneration, the allocation of excise tax liability among related organizations, and excess parachute payments subject to the excise tax.

## **Taxable Year**

As more generally set forth above, Code Section 4960(a)(1) provides that the 21% excise tax applies to remuneration paid by an ATEO to a covered employee in excess of \$1 million for a taxable year. Code Section 4960 did not specify whose taxable year is to be used, the ATEO’s or the covered employee’s. Notice 2019-09 clarifies that the relevant taxable year will be the calendar ending with or within the ATEO’s taxable year. This approach aligns more closely with how remuneration is reported on Form W-2 and Form 990.

## **Covered Employee Status**

A covered employee includes any individual who is among an ATEO’s five highest paid employees for the current taxable year or in any preceding taxable year beginning after December 31, 2016. Notice 2019-09 provides that covered employee status is determined based on remuneration for services performed as an employee of the ATEO or a related organization. The remuneration used for this purpose is the remuneration paid to an employee by the ATEO or any related organization during the taxable year (as defined above).

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The Notice provides limited relief where an ATEO pays less than 10% of an employee's total remuneration for services performed as an employee of the ATEO or any related organization. In that circumstance, the employee is generally disregarded in determining the ATEO's covered employees for the taxable year.

It is recommended that ATEOs develop a system for tracking covered employees.

### **Remuneration**

For purposes of the excise tax, "Remuneration" generally has the same meaning as Code Section 3401(a) wages for income tax withholding purposes, except that it excludes designated Roth contributions, and includes amounts required to be included in gross income under Code Section 457(f).

In determining covered employee status and whether there is Remuneration subject to the excise tax, "Remuneration" does not include remuneration paid to a licensed medical professional for the performance of medical (including nursing) or veterinary services. ATEOs with highly paid medical professionals that serve in dual capacities must make a reasonable, good faith allocation between remuneration for medical services and other services.

### **When is Remuneration Considered to be Paid?**

Remuneration is considered to be paid when it is no longer subject to a substantial risk of forfeiture within the meaning of Code Section 457(f) (but without regard to whether the remuneration is actually subject to Code Section 457(f)). Thus, in general, remuneration is considered paid if an employee's right to the remuneration is not conditioned on the future performance of substantial services or the occurrence of a condition that is related to a purpose of the remuneration – for example, the achievement of performance goals.

In a departure from the Code Section 457(f) rules, the Notice provides that earnings on remuneration previously considered to be paid are treated as paid at the close of the taxable year in which they accrue. Thus, in the case of an account-based deferred compensation arrangement, any earnings on previously vested amounts would be treated as paid during the year they accrue, even though not currently taxable under Code Section 457(f).

Since the rule views remuneration as being paid when it is vested, the present value of any remuneration that became vested, but was not actually received, before January 1, 2018 escapes the Code Section 4960 excise tax. Accordingly, even though there is no formal grandfathering rule under Code Section 4960, certain deferred amounts that remain to be paid nonetheless escape the excise tax. It is recommended that ATEOs inventory any deferred compensation arrangements they maintain and evaluate whether any amounts under those arrangements are "grandfathered."

### **What is the Amount of Remuneration Treated as Paid?**

If there is remuneration that is considered to be paid currently, but that is not actually paid currently, the amount of remuneration treated as paid currently is the present value of the future payments owed to the employee.

### **Related Organizations**

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If an individual performs services as an employee for an ATEO and organizations related to the ATEO, all remuneration paid to the individual is generally aggregated in determining covered employee status and whether more than \$1 million in remuneration was paid to the individual during the taxable year. In this regard, whether organizations are related to one another is determined using a 50% control threshold. Thus, organizations may be considered related even though they may not represent a controlled group for retirement plan purposes. That said, the methodology set forth in the Notice is generally consistent with Form 990 reporting.

### **Allocation of Excise Tax Liability**

If a covered employee is paid remuneration in excess of \$1 million for service performed for an ATEO and related organizations, the excise tax must be allocated between the ATEO and each related organization based on relative remuneration paid by each organization. The Notice provides guidance on (i) an ATEO determining whether excess compensation is paid to its covered employees and, if so, how to allocate the excess tax liability with respect to the excess compensation, and (ii) obtaining information from another ATEO as to whether the first ATEO is subject to excise taxes based on remuneration paid by the first ATEO as a related organization with respect to a covered employee of the other ATEO.

### **Excess Parachute Payments**

Generally, excess parachute payments subject to the excise tax are determined using rules similar to those applied under Section 280G. However, Section 4960 differs somewhat in imposing the excise tax only if the excess parachute payment is contingent upon an involuntary separation. The notice provides detailed information about how to calculate the base amount and makes clear that parachute payments may include accelerated vesting of deferred compensation as a result of an involuntary separation, even if such amounts remain unpaid.

### **Excise Tax Reporting**

If an organization owes excise taxes under Code Section 4960, the excise tax is to be reported using Form 4720.