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Interim IRS Guidance on New Executive Compensation Requirements for Tax-Exempt Entities Creates New Challenges

Under new Section 4960 (“Section 4960”) of the Internal Revenue Code of 1986, as amended (“IRC”) that was adopted as part of the Tax Cuts and Jobs Act of 2017 (Tax Act), an excise tax under IRC Section 11 (currently 21 percent) is imposed, effective for tax years beginning after December 31, 2017 (“Effective Date”), on remuneration in excess of \$1 million **and** any “excess parachute payment” paid by an applicable tax-exempt organization (“ATEO”) (or related organization) to a “covered employee.” Many of the concepts used in Section 4960 are borrowed from other key executive compensation provisions under the IRC, including IRC Section 162(m) for public companies, the golden parachute rules under IRC Section 280G, and the nonqualified deferred compensation rules in IRC Sections 457(f) and 409A.

On December 31, 2018, the Internal Revenue Service (IRS) published 92 pages of interim guidance on Section 4960 in [Notice 2019-09](#) (“Notice”). The Notice defines key terms, clarifies some of the unanswered questions in the Tax Act language and generally explains how to compute, report and pay the excise tax under Section 4960. This advisory highlights key aspects of the Notice.

Who Is Subject to Section 4960?

As further described below, Section 4960 applies to an “applicable tax-exempt organization” and any “related organization.” Whether any excise tax will be owed under Section 4960 will depend on the amount and type of remuneration paid to “covered employees” during the calendar year ending with or within the taxable year of the employer (each a “Measurement Period”).

What Is an ATEO?

An ATEO is any:

- organization exempt from tax under IRC Section 501(a);
- farmers’ cooperative described in IRC Section 521(b)(1);
- organization that has income excluded from tax under IRC Section 115(1); or
- political organization under IRC Section 527(e).

The Notice clarifies that any ATEO that is considered the common-law employer (as determined for federal tax purposes) of a “covered employee” will be liable for the excise tax. In other words, if an ATEO is a common-law employer, the ATEO cannot avoid the excise tax through the use of third-party payor (i.e., a payroll agent, common paymaster,

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statutory employer under IRC Section 3401(d)(1), a certified professional employer organization or an unrelated management company).

Finally, an ATEO generally will not be affected by Section 4960 if: (a) it (together with any related organization(s)) pays remuneration of less than \$1M to each of its employees for a Measurement Period; and (b) if the employer does not have any “highly compensated employees” (as defined under IRC Section 414(q)(1)(B) as adjusted for inflation, i.e., \$125,000 or more in 2019) for the applicable Measurement Period.

What Is a “Related Organization”?

A related organization is a person or governmental entity (including another ATEO) that:

- controls or is controlled by the ATEO (including for-profit entities);
- is controlled by one or more persons which control the ATEO (including for-profit entities);
- is a supported organization (as defined in IRC Section 509(f)(3)) with respect to the ATEO;
- is a supporting organization described in IRC Section 509(a)(3) with respect to the ATEO; or
- in the case of an ATEO, which is a VEBA described in IRC Section 501(c)(9), establishes, maintains or makes contributions to a VEBA.

The Notice provides that “control” is based on the definition of control under IRC Section 512(b)(13)(D) (aligning with the definition of related organizations for annual IRS Forms 990 and W-2 reporting purposes). In addition, the Notice stresses that there is no exception for public/for-profit or governmental entities.

Who Is a “Covered Employee” Under Section 4960?

An employee of the ATEO who is either: (a) one of the five highest-compensated employees of the organization (the “Top Five”) for the taxable year of the ATEO (there is no dollar threshold); or (b) was a covered employee of the ATEO (or any predecessor) for any of the ATEO’s preceding taxable years beginning after December 31, 2016 (once an employee becomes a covered employee, that designation continues regardless of whether the employee ceases to be a covered employee in a later year).

The Notice provides that the determination of whether an employee is in the Top Five is made based on remuneration paid by the ATEO and any related organization during the calendar year ending with or within the ATEO’s or related organizations tax year, excluding remuneration for medical or veterinary services (the Notice also clarifies what medical and veterinary services means).

The Top Five is determined separately for each ATEO and not collectively for the entire group of related organizations (thus, a group of related organizations could have more than five covered employees). There also is a *de minimis* exception that excludes certain ATEOs and related organizations where an ATEO paid less than 10 percent of the employee’s total remuneration as an employee of the ATEO and all the related organizations.

What Is “Excess Remuneration” Over \$1 Million That Would Be Subject to the Excise Tax Under Section 4960?

The Notice clarifies that remuneration is generally the same as “wages” under IRC Section 3401(a), excluding certain retirement benefits and directors’ fees, remuneration for medical or veterinary services, but **including** taxable amounts under IRC Section 457(f) (i.e., amounts that are vested, even if unpaid). The Notice includes significant detail on what constitutes remuneration and what is excluded for these purposes.

Remuneration also includes amounts paid by a related organization with respect to employee’s employment with the related organization and the Notice includes rules for allocating liability for the excise tax among the related organizations.

What Is an “Excess Parachute Payment” Under Section 4960?

An “excess parachute payment” means an amount equal to the excess (if any) of the total amount of any parachute payment over the portion of the base amount allocated to the payment. This is the excess over one times the base amount, and not the excess over three times the base amount (which is the standard under IRC Section 280G).

A “parachute payment” is a payment made to a covered employee: (a) that is contingent on ***separation from employment*** (consistent with IRC Section 409A but with certain exceptions) with the employer (the Notice clarifies that a payment is contingent on a separation from employment if the payment would not have been made or vested absent an ***involuntary*** separation of employment); and (b) the aggregate present value of the payments exceeds an amount equal to three times the base amount (if the aggregate present value is less than three times the individual’s base amount, then no portion of the payments are treated as parachute payments).

The base amount is computed by taking the average annual compensation earned by the covered employee with the ATEO and/or related organization over the five most recent tax years ending before the year in which the separation occurs.

There are specific exceptions for certain retirement plans, certain payments to licensed medical professionals and amounts paid to employees who are not highly compensated employees, as defined in IRC Section 414(q).

Is There Any Grandfathering Rule?

The Notice clarifies that, although there is no grandfathering provision for Section 4960, any remuneration that was vested before the Effective Date, including vested but unpaid earnings on deferred amounts, is treated as if it was paid before the Effective Date and is not subject to the excise tax under Section 4960 (although earnings after the effective date on those vested amounts would be treated as remuneration for purposes of Section 4960). Further, any vested amounts that would have been treated as remuneration paid before the year in which an employee first becomes a covered employee are not remuneration for the year in which the employee becomes a covered employee or any subsequent year.

What Are the Reporting Requirements?

The Notice clarifies that any excise tax is to be reported on the Form 4720, Return of Certain Excise Taxes under Chapters 41 and 42 of the IRC. Each ATEO or related organization is separately responsible for reporting and paying its share of the excise tax under Section 4960.

Request for Comments

The Treasury Department has requested comments by April 2, on all aspects of the Notice; including, specifically:

- for purposes of determining whether the employee is a “covered employee,” whether an employer can rely on an employee’s written representation that the employee did not perform services for any other employer during the applicable Measurement Period;
- how remuneration from a related organization should be calculated where the related organization experiences a change in status during the year;
- how remuneration based on fair market value (appreciation/depreciation) of the stock underlying equity incentives should be taken into account for purposes of Section 4960;
- how a related organization should treat remuneration on which it was subject to excise tax under Section 4960 in a prior taxable year and for which it is denied a deduction under IRC Section 162(m) in the current taxable year;
- how the term “predecessor” should be defined for purposes of defining “covered employees;” and
- how remuneration paid to medical service providers should be reasonably allocated between medical services and other services, including how reasonable allocations can be made taking into account comparable salaries, time spent performing medical services and other services, and any applicable employment agreements.

Reliance on the Notice

Although the Treasury Department and IRS anticipate issuance of additional guidance in the form of proposed treasury regulations (that will be applied prospectively), affected employers may rely on the Notice and any other good faith interpretation of Section 4960, effective from December 22, 2017 (the date of enactment of the Tax Act). The Notice includes several examples of interpretations that will not be considered to be in good faith, but it does not preclude or prohibit other reasonable interpretations.

Action Items

With respect to the 2018 Measurement Period, ATEOs should:

- determine all “related organizations” under the new Section 4960 regime and coordinate with a counterpart at each related organization to ensure accurate calculations;
- determine all “covered employees” and establish a record-keeping or tracking system to monitor remuneration paid (or deferred) in the future;
- carefully review existing documentation to note what compensation was vested as of the Effective Date, and is thus outside the scope of Section 4960; and
- carefully review all compensation arrangements to determine whether Section 4960 could be triggered in future Measurement Periods.

Katten will continue to monitor developments regarding Section 4960 and provide updates as they occur.

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