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## The Section 4960 Excise Tax: Application to Tax-Exempt and Affiliated Taxable Entities

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Federal tax law changes enacted with the Tax Cuts and Jobs Act of 2017 may require tax-exempt organizations to reevaluate their compensation practices, particularly with respect to employee severance. Section 4960 of the Internal Revenue Code imposes a 21% excise tax upon certain tax-exempt organizations and related organizations for remuneration in excess of \$1 million and for “excess parachute payments” (even if such payments total less than \$1 million) paid to the organizations’ “covered employees.” The Internal Revenue Service has issued interim guidance to assist taxpayers in applying Section 4960. The guidance, [Notice 2019-09](#) (the “Notice”), provides numerous Q&As that address issues surrounding the application of Section 4960, including how to identify covered employees, how to calculate remuneration and excess parachute payments, and how to allocate liability for any excise tax. The Notice also announced Treasury’s intent to issue proposed regulations. Before such regulations are issued, taxpayers may base their tax positions on a good-faith, reasonable interpretation of Section 4960 (including the associated legislative history). While adoption of the positions reflected in the Notice will constitute a good-faith, reasonable interpretation of Section 4960, a position that is inconsistent with the Notice will be evaluated based upon all of the relevant facts and circumstances, including whether the taxpayer has been consistent in its application of the position.

### *Which Organizations Are Affected?*

Section 4960 applies to organizations exempt from taxation under Section 501(a) (including Section 501(c)(3) organizations) and “related organizations.” Related organizations with respect to an applicable tax-exempt organization (“ATEO”) include entities that control or are controlled by the ATEO and entities under common control with the ATEO. For these purposes, “control” generally means ownership of more than 50% of the equity of a corporation or partnership. In the case of a nonprofit organization, control means that more than 50% of the directors of the organization are representatives of, or controlled by, the controlling entity. The definition of “related organization” encompasses both tax-exempt and for-profit entities.

### *Who Are Covered Employees and Who Is Taxed?*

An ATEO’s “covered employees” are its five highest-compensated employees for the taxable year

plus any employees who were covered employees for any of the ATEO's prior tax years beginning after December 31, 2016. The result of this rule is that "once a covered employee, always a covered employee." The highest-compensated ranking is made on the basis of the employee's remuneration for services performed for both the ATEO and related organizations. That is, if an employee of a related organization also provides services as an employee of an ATEO, the remuneration paid to the employee by both the related organization and the ATEO are taken into account when determining whether the employee is a covered employee of the ATEO. Despite a limited-services exception in the Notice, in certain situations an employee of an ATEO can be a covered employee even if the ATEO pays the employee no remuneration. Organizations subject to Section 4960 should take care to carefully track which employees are covered employees.

The Section 4960 excise tax is imposed upon the common-law employer of the covered employee. Generally, when a covered employee has more than one common-law employer, and each such employer is an ATEO or related organization, each employer is liable for the share of the Section 4960 excise tax allocable to the remuneration paid by such employer. Specifically, each employer will be liable for a portion of the excise tax based upon the ratio the remuneration paid by such employer bears to the aggregate remuneration paid to the employee by all employers.

#### *Payments Subject to Tax: Excess Remuneration and Excess Parachute Payments*

The 21% excise tax applies to 1) remuneration over \$1 million paid during the taxable year to a covered employee (other than excess parachute payments), and 2) any excess parachute payments paid to a covered employee. "Remuneration" includes wages paid to the employee as well as nonqualified deferred compensation required to be included in the employee's gross income under Section 457(f) (although amounts paid to a licensed medical professional for the performance of medical services are excluded). Remuneration is deemed paid when the employee's right to the remuneration is no longer subject to a substantial risk of forfeiture. Accordingly, tax-exempt organizations should pay particular attention to when employees' compensation becomes vested (including severance, deferred compensation and bonuses), even if such compensation will not be paid until a later taxable year.

Employers subject to Section 4960 should be wary of severance arrangements that can result in excess parachute payments. Parachute payments include payments in the nature of compensation if 1) the payment is contingent upon the employee's separation from employment, and 2) the aggregate present value of such payments equals or exceeds three times the employee's "base amount" (generally, the employee's average compensation paid by the employer over the previous five years). Payments are contingent upon the employee's separation from employment if they would not have been made but for the employee's involuntary separation from employment (including the employee's leaving for good reason). When such payments equal or exceed the three-time-base-amount threshold, all amounts over the employee's base amount are subject to the excise tax. These excess parachute payments are subject to excise tax even when they total less than \$1 million.

#### *Application to For-Profit Entities*

As noted above, liability for the Section 4960 excise tax can extend to for-profit entities that are related to an ATEO. When a for-profit entity is a related organization with respect to an ATEO and is a common-law employer of one of the ATEO's covered employees, the for-profit entity may be liable for a portion of the Section 4960 excise tax. In situations where a for-profit related organization pays the lion's share of the covered employee's remuneration, the for-profit entity could be responsible for a large portion of the excise tax. For example, if an ATEO and a for-profit related organization are both common-law employers of a covered employee whose remuneration consists of \$400,000 from the ATEO and \$1.6 million from the related organization, under the Notice the ATEO is responsible for only 20% of the applicable excise tax and the for-profit related organization is responsible for 80%. Related organizations that are publicly traded should note that any remuneration paid to a covered employee for which a deduction is not allowed by reason of Section 162(m) is not taken into account for purposes of Section 4960.

#### *But Wait, There's More: Additional Considerations*

Tax-exempt organizations and related organizations should be mindful of the \$1 million remuneration threshold and the excess parachute payment provisions when entering into or paying under compensation and separation arrangements. Any applicable Section 4960 excise tax must be paid and reported on Form 4720 by the 15th day of the fifth month following the end of the employer's taxable year (for calendar-year organizations, May 15).

These Section 4960 issues must be considered in addition to other compensation concerns that have historically applied to tax-exempt organizations. For example, deferred compensation is generally restricted because of the rules of Section 457(f). In addition, tax-exempt organizations must continue to ensure that compensation arrangements do not constitute excess benefit transactions under Section 4958 (the so-called intermediate sanctions rules) or, in the case of private foundations, self-dealing under Section 4941. As the Notice makes clear, the fact that remuneration paid to an employee is not subject to excise tax under Section 4960 provides no basis for concluding such compensation is reasonable for purposes of Section 4958 or not excessive or unreasonable for purposes of Section 4941.

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