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# Don’t Forget About Section 4960 Compliance

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Section 4960 of the Internal Revenue Code of 1986 (IRC), as amended, imposes an excise tax on compensation of certain highly compensated employees of tax-exempt organizations. In an apparent attempt to level the playing field for tax-exempt and public corporations, Section 4960 imposes an excise tax of 21 percent on compensation paid to a covered employee in excess of $1 million and on any excess parachute payments paid to a covered employee. For purposes of Section 4960, any remuneration paid to a covered employee by a related entity is included in the calculation of the covered employee’s total remuneration for the year.

Under Section 4960, a “covered employee” is any employee (or former employee) who is one of the five highest-compensated employees of the organization for the taxable year or was a covered employee of the organization (or any predecessor) for any preceding taxable year. Organizations must determine their covered employees each year, beginning with the company’s first taxable year following December 31, 2016. Although the determination is made annually, it is important to note that once an employee becomes a covered employee, he or she will always be a covered employee (even after termination of employment).

Compensation, for purposes of Section 4960, is defined in IRC Section 3401(a). The IRC Section 3401(a) definition of compensation includes all compensation paid in cash, and in any medium other than cash, except for amounts that are excludable from the employee’s gross income. Although the definition is simple enough, there may be confusion for tax-exempt organizations with a fiscal year that differs from the calendar year (such as one with a June 30 year-end). Because Section 4960 specifically applies to compensation paid “for the taxable year,” and the excise tax is on the employer or organization, it appears that compensation paid in the organization’s (as opposed to the covered employee’s) taxable year should be used to determine the $1-million threshold. In addition, amounts in an IRC Section 457(f) plan will be included in income when such amounts become vested or otherwise are no longer subject to a substantial risk of forfeiture. Generally, the taxable year in which the substantial risk of forfeiture lapses will be the taxable year in which such amounts are included as wages to determine whether the organization will be subject to the excise tax.

Some organizations are simply including the excise tax in their operating budgets for the fiscal year. Others are looking for ways to avoid imposition of the excise tax, while waiting for additional guidance from the IRS, such as the following:

- There are those who believe that public universities and colleges could use their political subdivision status to be exempt from not only this tax, but also federal taxes in general.
- Some universities are looking into having portions of the covered employee's compensation paid by an organization that is not related to that university. Such an arrangement could allow the compensation paid by the university or college to stay under the $1-million threshold. "Not related" is the key term here. As stated above, for purposes of determining the compensation for the taxable year, monies paid from all related entities are included.
- Split-dollar life insurance policies may become popular again. Organizations have long used split dollar policies as part of the compensation packages for many of their highest-paid individuals. Although this is not a new idea, the addition of Section 4960 may bring split-dollar policies to the mainstream due to the perceived flexibility such policies provide. The theory is that an organization would buy a split-dollar policy and have the policy allow loans against the life insurance. The policy would loan monies to the covered employee, and the loan proceeds would not be included for purposes of determining the $1-million threshold under Section 4960. Although some split-dollar policies are legitimate, employers may want to carefully consider the ones that seem too good to be true, as the Internal Revenue Service (IRS) is likely to eventually tighten the rules on these policies.

Although employers certainly can strategize to avoid application of the Section 4960 excise tax, they may also want to keep in mind that Section 4960 grants the IRS the authority to issue regulations "as may be necessary to prevent avoidance of the tax under this section." However, oftentimes when new regulations are issued, they have prospective effect. Accordingly, until the IRS provides some guidance on Section 4960, organizations can approach compliance with Section 4960 with a reasonable reading of the statute.

Importantly, Section 4960 does not replace or modify any provisions that applied to compensation paid by tax-exempt organizations prior to its enactment, such as the prohibition against the private inurement of net earnings or the excise taxes imposed by IRC Section 4958.

Unfortunately, the drafting of Section 4960 leaves a lot to be desired, and there are several issues on which employers would appreciate clarification. We anticipate that the IRS will issue regulations to provide additional guidance regarding Section 4960 compliance soon, as Section 4960 is on the IRS's priority guidance list.



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