Published on *The National Law Review* https://natlawreview.com

Tax-Exempt Executive Compensation Excise Tax Regulations (Section 4960) Finalized

Article By:

Seth J Safra

Amanda H Nussbaum

James R Huffman

Katrine Magas

On January 19, 2021 the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") published in the *Federal Register* Final Regulations (the "Final Regulations") interpreting the excise tax under Section 4960 of the Internal Revenue Code on certain executive compensation paid by tax-exempt organizations. The Final Regulations maintain most of the concepts from the interim guidance (Notice 2019-09 (the "Notice"), discussed here and here, and Proposed Regulations (the "Proposed Regulations"), discussed here), with a few changes.

The Final Regulations became effective January 19, 2021, but they will apply only for tax years that start after December 31, 2021. Until then:

- Taxpayers may rely on the interim guidance under Notice 2019-09 or the Proposed Regulations, or the Final Regulations, but only if they apply the rules in their entirety; and
- The IRS will continue to allow a reasonable, good faith interpretation of the statute, if interpretation takes into account the legislative history. The Notice and the Proposed Regulations include a list of positions that the IRS considers to be an unreasonable (not good faith) interpretation of the statute.

The following is an update to our 10 key points under the Section 4960 regulations. (Throughout this post, "Sections" refer to sections of the Internal Revenue Code.)

1. No Grandfathering

The excise tax under Section 4960 applies for compensation that is paid or becomes vested during taxable years that start after December 31, 2017. The IRS has rejected requests to grandfather amounts paid under agreements that were in effect before Section 4960 was passed. The IRS reasoned that the statute does not provide authority for grandfathering: in contrast to Section 4960, Congress included a grandfathering provision for changes made at the same time to Section 162(m); the IRS has concluded that if Congress intended to also allow grandfathering for Section 4960, it would have said so.

2. "ATEO" (Applicable Tax-Exempt Organization) Includes Most Tax-Exempts

Consistent with earlier guidance, the Final Regulations provide that ATEOs include all organizations that: (i) are exempt from taxation under Section 501(a) (*i.e.*, organizations described in Section 501(c) or (d)), (ii) are farmers' cooperatives organizations described in Section 521(b)(1), (iii) have income that is excluded under Section 115(1), or (iv) are political organizations described in Section 527(e)(1). Under the Final Regulations, Section 4960 does not apply to a governmental entity that claims exemption from federal income tax based on sovereign immunity (such as many public universities), but only if the entity is not also tax-exempt under Section 501(a). A governmental entity that also has Section 501(a) tax-exempt status may relinquish its Section 501(a) status if it wishes to avoid designation as an ATEO.

Even if a governmental entity is not an ATEO, compensation paid by the governmental entity is still taken into account for purposes of identifying covered employees of related ATEOs; and the governmental entity can still be subject to the Section 4960 tax if it is related to an ATEO.

The Final Regulations also provide that a foreign organization described in Section 4948(b) (generally, an organization that was not created or organized in the U.S. or in any U.S. possession, or under the law of the United States, any state, D.C., or any U.S. possession and that has received substantially all of its support (other than gross investment income) from sources outside the United States) is not an ATEO. An organization's status as a Section 4948(b) organization is determined as of the end of its taxable year.

The Final Regulations leave open for future guidance the treatment of Federal instrumentalities.

3. Must Aggregate ATEOs With Related Organizations (the "Related Group"): 50% Test

Like the Proposed Regulations, the Final Regulations require that remuneration for each covered employee must include not only remuneration from the ATEO but also remuneration from all "related organizations." For this purpose, relatedness is similar to a controlled group test, except that the threshold for relatedness is 50% rather than 80%. As with a controlled group, organizations can be related on the basis of different factors, including voting rights or rights to value of a corporation, profits or capital interests in a partnership, beneficial interests in a trust, or control over the organization's board or similar governing body.

In finalizing the regulations, the Treasury and IRS rejected requests to count only remuneration paid by an ATEO for services provided to the ATEO. Treasury and the IRS concluded that loosening the aggregation rule could increase the potential for abuse.

Throughout this post, we refer to the ATEO and its related organizations as the "Related Group."

4. Covered Employees: Once Covered Always Covered – But With Some Relief

In general, covered employees are the top five highest paid employees of the ATEO. All "common law" employees of the ATEO must be taken into account, even if they are part-time. There is no compensation threshold in order to be covered: the top five highest-paid employees are covered even if no one in the organization has compensation approaching $1 million.

Individuals who are not common law employees, such as non-employee directors and independent contractors, are disregarded. But officers are presumed to be common law employees, and therefore generally must be taken into account unless one of the exceptions below applies.

Identifying the covered employees and tracking them is critically important for two reasons:

- First, even if an individual does not receive $1 million, separation payments to the individual could trigger the "parachute payment" tax described under #6, below.
- Second, the statute has a "once covered, always covered" rule, which means that "covered employee" status stays with an individual indefinitely—even after the individual's service with the ATEO has ended.

For example, suppose a former employee of a tax-exempt foundation is later hired into the corporate office of a related for-profit. If that individual was a covered employee of the foundation for any taxable year beginning after December 31, 2017, future compensation for service to the for-profit would be subject to the $1 million cap—leaving the possibility that the excise tax could be triggered long after the individual's service to the foundation, even if the individual never again provides services to the foundation.

Like the Proposed Regulations, the Final Regulations include two exceptions for ATEOs that are affiliated with for-profits: (1) a "nonexempt funds" exception and (2) a "limited hours" exception. To qualify for either exception, the ATEO must not pay or promise any remuneration to the individual. In addition to not paying compensation directly, the ATEO must not promise deferred compensation, even if it is subject to vesting conditions, and the ATEO must not reimburse another entity for any part of the individual's remuneration (whether through a direct reimbursement or a fee). In addition, the following conditions must be satisfied:

- ***For the nonexempt funds exception,***the employee's time spent providing services to the ATEO (and any related ATEOs) over the applicable year and the preceding year must not exceed 50% of his or her total time for the Related Group during that period. (Under the Proposed Regulations, the 50% test was measured only over the applicable year.) For purposes of this test, service time can be measured by hours or days (where any day in which the individual works for at least an hour on behalf of an ATEO counts as a full day worked for the ATEO). For this exception, the prohibition against paying or promising remuneration to the employee applies not only to the ATEO but also to any for-profit organization that is controlled by the ATEO. Solely for purposes of the nonexempt funds exception, the Final Regulations allow the ATEO's level of control over another organization to be determined without regard to certain downward attribution rules.

- ***For the limited hours exception,*** the employee's time spent providing services to the ATEO (and any related ATEOs) over the applicable year must be less than 10% of his or her total time for the Related Group during that year. Again, service time can be measured by hours or days (where any day in which the individual works for at least an hour on behalf of an ATEO counts as a full day worked for the ATEO). Like the Proposed Regulations, the Final Regulations include a safe harbor, under which an individual who does not work more than 100 hours for the ATEO (and any related ATEOs) in a year will automatically be treated as below the 10% threshold. Unlike the nonexempt funds exception, this exception does not prohibit compensation paid or promised by a taxable organization that is controlled by the ATEO.

The exceptions should help to avoid excise taxes as a result of compensation paid by for-profits to employees who provide limited services to ATEOs. But it is important to keep the "once covered, always covered" rule in mind. If an individual ever becomes a covered employee, he or she will retain covered status even if service and compensation levels later drop below the level for an exception.

Under the Final Regulations, every ATEO must have its own list of covered employees. Where two or more ATEOs are related to one another, each ATEO must have its own list. Consequently, if an individual is employed by more than one related ATEO, he or she could be a covered employee of more than one ATEO.

However, the Final Regulations include a "limited service" exception (carried forward from the Notice and the Proposed Regulations) for cases where an individual provides service to more than one related ATEO. Under the limited service exception, an ATEO can disregard an individual for a tax year if, for that year, the ATEO paid less than 10% of the individual's total remuneration from the Related Group, ***and*** at least 10% of the individual's total remuneration from the Related Group is paid by another related ATEO. If no other related ATEO paid at least 10% of the individual's total remuneration, the individual must be included in the covered employee analysis for the ATEO that paid the highest percentage of the individual's total remuneration.

Again, the exception does not erase covered employee status for someone who was a covered employee in a prior year. As described below, failure to apply the "once covered, always covered" rule is on the list of positions that the IRS considers to be an unreasonable interpretation of the statute.

5. Special Timing Rule for Remuneration

For purposes of the $1 million cap, "remuneration" generally has the same definition as wages under Section 3401 (the income tax withholding rules), but there is an important timing difference for amounts that are earned in one year and paid in a later year. Rather than wait until remuneration is paid, deferred compensation must be included in remuneration for the year in which it becomes vested under Section 457(f)—*i.e.*, when the remuneration is no longer subject to a substantial risk of forfeiture.

Unlike Section 457(f), the Final Regulations do not have a short-term deferral rule for purposes of applying Section 4960. Treasury and the IRS rejected requests to take deferred compensation into account for purposes of Section 4960 when the applicable amounts are included in income.

The absence of a short-term deferral rule means, for example, that a bonus payable in January or February for service during the prior year could count toward the $1 million cap for the prior year. The analysis turns on whether the bonus is conditioned on continuing to provide services during the year of payment. If the bonus is conditioned on continuing to provide services during the year of payment, it would count for the year of payment; but if the bonus is not conditioned on providing services during the year of payment, it would count for the prior year. Similarly, the focus on vesting rather than income inclusion suggests that Section 83(b) elections should be disregarded for purposes of the $1 million cap—although the Final Regulations do not directly address Section 83(b) elections for purposes of the $1 million cap.

In light of this rule, the vesting schedule for retention bonuses and other deferred compensation can have a dramatic impact on the excise tax. For example, suppose an executive's five-year employment agreement provides for $150,000 per year of deferred compensation, to be paid only if the individual serves out the term. If the deferred compensation vests at the end of the term, the full $750,000 ($150,000 per year times 5 years) would count for Section 4960 purposes in the last year of the term. If the individual has more than $250,000 of salary or other remuneration for that last year, the organization would have to pay an excise tax—even though the accruals never reach $1 million per year. In contrast, if the deferred compensation were to vest ratably (for example, $150,000 at the end of each year), the excise tax might not be triggered.

If deferred compensation becomes vested before the year of payment, the remuneration for the year of vesting would be the present value as of the end of that year. (The Final Regulations provide that discounting for present value is not required if payment will be made within 90 days.) Earnings (or growth in value) for the period after vesting would count for Section 4960 purposes each year as they accrue. In contrast, income tax on earnings would generally be deferred until the year of payment.

6. Beware of "Parachutes": They're Easier to Trigger Than You Might Expect

As noted above, separation pay to covered employees can trigger the "parachute payment" tax even if the individual's compensation never reaches $1 million. For this purpose, separation pay includes any amount that becomes payable as a result of a covered employee's involuntary separation from employment with an employer—*i.e.*, amounts that would not become payable if not for the involuntary separation. Similar to Section 409A, "involuntary" separation includes resignation for "good reason" if certain conditions are satisfied.

In general, the parachute tax is triggered if separation pay equals or exceeds 3 times a covered employee's "base amount." For the following reasons, the tax can be triggered even if an individual's severance never gets close to 3 times salary:

- First, the "3 times" test is not based on current compensation, but rather is based on the individual's "base amount." The base amount is the individual's average taxable wages (as reported in Box 1 of Form W-2) over the preceding five years (or, if less, the individual's period of employment with the ATEO). If an individual's compensation has increased over the years, the base amount can be significantly smaller than the individual's salary at the time of separation.

- Second, for purposes of parachute payments, remuneration is not limited to taxable compensation. With limited exceptions (such as payments under a tax-qualified or Section 403(b) plans), all amounts in the nature of compensation must be taken into account. For example, the value of continued health insurance, which is often more than $30,000 per year, and life insurance must be taken into account for purposes of the parachute analysis.

- Third, separation pay includes not only severance, but also vesting of bonuses, equity (even if a Section 83(b) election was previously made) and deferred compensation. For example, if an individual has a deferred compensation balance that is conditioned on continued service but becomes vested upon involuntary termination without cause, at least part of the balance would count for purposes of the parachute payment calculation.

It is important to analyze separation payments carefully, because the consequences of hitting the 3 times threshold can be dramatic. Although the threshold for triggering the excise tax is 3 times the base amount, the tax applies to separation pay in excess of 1 times the base amount. For example, suppose an individual's base amount is $100,000. The excise tax would be triggered if the individual's separation pay (taking into account the value of deferred compensation that becomes vested and fringe benefits) is $300,000 or more. If the individual's separation pay is $299,999.99, the excise tax would not be triggered. But if the individual's separation pay is $300,000.00, the excise tax would be $42,000 (21% of the excess of $300,000 over $100,000). The penny makes a big difference.

The Final Regulations include anti-abuse rules to prohibit avoidance by shifting the time of payment proximate to an involuntary separation. For example, if an employer accelerates the vesting of a bonus or deferred compensation so that it is paid shortly before employment is terminated, the amount accelerated could be treated as contingent on the separation of employment that soon followed.

7. Medical Services Exception: Reasonable, Good Faith Allocation

By statute, the excise tax under Section 4960 does not apply for amounts paid for medical and veterinary services; and amounts paid for medical and veterinary services must be disregarded for purposes of determining the ATEO's five highest paid employees. For example, compensation that hospitals pay to doctors and nurses must be disregarded to the extent that the compensation is for medical services (as distinct from compensation for administrative services, whether paid directly by the ATEO or by a related organization such as a management services organization).

Where an individual performs both medical/veterinary and administrative services (for example, a Chief Surgeon), the Final Regulations carry forward the "reasonable allocation" rule from the Notice and the Proposed Regulations. Consistent with the prior guidance, the Final Regulations provide that the employer can follow an allocation specified in an employment agreement (or other written arrangement), if the allocation is reasonable and made in good faith. Another possible approach would be to allocate based on time records or to allocate based on compensation for individuals with comparable duties (*e.g.*, determine the medical portion based on compensation paid to other doctors in the same field who do not have administrative responsibility, or determine the administrative portion based on compensation paid to administrators who do not also have medical responsibility). The Final Regulations clarify that the reasonable, good faith allocation rule applies both for current remuneration and for deferred compensation.

8. Applicable Year for Organizations With Non-Calendar Fiscal Years

Like the prior guidance, the Final Regulations provide that the applicable tax year is the calendar year ending with or within the ATEO's tax year. For example, if an ATEO's fiscal year ends on June 30, the applicable year for the tax year ending June 30, 2021, is calendar year 2020. If the excise tax applies for compensation paid during 2020, it would have to be reported on Form 4720, and paid, by the Form 990 filing deadline for the ATEO's tax year ending June 30, 2021—*i.e.*, by November 15, 2021. For amounts paid in calendar year 2021, the excise tax would have to be reported and paid by the Form 990 filing deadline for the ATEO's tax year ending June 30, 2022—*i.e.*, by November 15, 2022, subject to extension. An extension for filing Form 990 automatically extends the deadline for filing Form 4720, but an estimated tentative tax must be paid by the due date without extension.

The applicable year for purposes of Section 4960 is the same as for purposes of Form 990. But the compensation calculations for Section 4960 are not the same as for Form 990. For example, the requirement to count compensation in the year of vesting (described in #5, above) does not apply in the same way for Form 990 purposes. Consequently, the amount treated as current compensation for Section 4960 will not necessarily be the same as the amount reported as current compensation on Form 990.

9. Allocation and Payment of Excise Tax

If a covered employee receives compensation from more than one affiliated organization (taxable or non-taxable) and the excise tax is triggered, the tax must be allocated among the organizations, including for-profit organizations. In general, each organization's allocation is determined by a ratio. The numerator is the amount of remuneration that is paid or payable by the organization for the year, and the denominator is the covered employee's total remuneration for the year from the Related Group. Like the prior guidance, the Final Regulations include rules to prevent double-counting.

10. Per Se Unreasonable and Non-Good Faith Interpretations

The IRS will continue to allow a reasonable, good faith interpretation of the statute for periods before the Final Regulations apply. For this purpose, the Final Regulations incorporate by reference the warning from the Notice and the Proposed Regulations that the following positions are per se not reasonable, good faith interpretations:

- Failing to apply the "once covered, always covered" rule—for example, treating an individual as no longer covered after a certain period of time has passed.

- Failure of a related organization—which may be a for-profit or a governmental entity that is not an ATEO—to pay its share of the excise tax under Section 4960.

- Counting remuneration for medical or veterinary services for purposes of identifying the ATEO's five highest-compensated employees.

- Having a single group of five covered employees for a group of related ATEOs. Each ATEO must have its own list of covered employees.

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The excise tax under Section 4960 will reach many tax-exempt organizations and their affiliates—even if annual compensation does not reach $1 million.

National Law Review, Volume XI, Number 32