

IRS ISSUES FINAL REGULATIONS ON THE EXCISE TAX IMPOSED ON EXECUTIVE COMPENSATION ARRANGEMENTS OF TAX-EXEMPT ORGANIZATIONS

Hodgson Russ Employee Benefits Newsletter
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On January 19, 2021, the Treasury Department and Internal Revenue Service issued final regulations under Code Section 4960 (“Final Regulations”), which impose a 21% excise tax on applicable tax-exempt organizations (“ATEO”) that pay remuneration to covered employees in excess of \$1 million or provide excess parachute payments.

The Final Regulations do not depart significantly from the proposed regulations issued in June, 2020, or the interim guidance published in Notice 2019-9 (see our article [here](#)).

Rejection of Grandfathering Existing Agreements

The Section 4960 excise tax applies to compensation that is paid or vests during tax years commencing after December 31, 2017. Unlike Section 162(m), Congress did not provide an express grandfathering provision. Therefore, the Treasury and IRS concluded that it would not be appropriate to include a grandfather rule to protect executive agreements that were in effect before the Tax Cuts and Jobs Act became law.

Applicable Tax-Exempt Organizations

The Final Regulations leave in place the definition of ATEO as including any organization that:

- is exempt from taxation under Section 501(a),
- is a farmers’ cooperative organization as described in Section 521(b)(1),
- has income that is excluded under Section 115(1), or
- is a political organization 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, unless it happens to also be tax-exempt under Section 501(a). However, governmental entities may be related organizations to ATEOs, and thereby be subject to the excise tax.

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In addition, the Final Regulations clarify that remuneration paid to a covered employee of an ATEO by a related foreign organization as described in Section 4948(b) may be taken into account under Section 4960, but the foreign organization itself is not liable for payment of the excise tax.

The Final Regulations indicate that future guidance will be forthcoming regarding the treatment of federal instrumentalities.

Related Organizations – 50% Test

The Final Regulations confirm that related organizations will be determined under the 50% standard relevant to Form 990 filings, rather than the 80% control rules of Code Section 414. Depending on the type of entity, control may mean 50% ownership of stock, a profits interest, or a beneficial interest. In the case of an entity without such interests, control exists if 50% of the trustees or directors are representatives of the entity, or the entity has the power to remove 50% of the directors or trustees. Finally, a related organization includes an entity that is supported or a supporting organization of the ATEO (as defined in Code Section 509(f)(3) and (a)(3)), or that establishes, maintains, or contributes to an ATEO that is a voluntary employees' beneficiary association.

Covered Employees – Once In Always In

Section 4960 defines “covered employees” as the top five highest paid employees of the ATEO for any tax year beginning after December 31, 2016. All “common law” employees of the ATEO are taken into account, but non-employees such as directors and independent contractors are not included. There is no compensation threshold in order to be covered - the top five highest-paid employees are covered even if none has compensation of \$1 million.

The Final Regulations maintain the rule that once an employee is a covered employee the person will remain a covered employee of the organization for all subsequent taxable years. Each ATEO and each related organization must maintain its own list of covered employees.

Exceptions to Covered Employee Status

Commenters expressed concern that employees performing limited, temporary or volunteer services to an ATEO might trigger the excise tax. In response, the Final Regulations clarify and expand on three exceptions:

Non-exempt Funds Exception – An employee is disregarded for purposes of determining an ATEO's five highest paid employees for a taxable year if s/he was not paid or granted a legally binding right to non-vested remuneration by the ATEO or any related organization, and if his/her time performing service for the ATEO and any related organization over the applicable year and the preceding year do not exceed 50% of his/her total time performing services for the related group. The Final Regulations have expanded this measurement period to two years, and have allowed the determination of the ATEO's level of control over another organization to be determined without regard to the “downward attribution” rules.

Limited Hours Exception - An employee is disregarded for purposes of determining an ATEO's five highest paid employees for a taxable year if s/he was not paid or granted a legally binding right to non-vested remuneration by the ATEO or any related organization, and if his/her time (measured in hours or days) spent performing services for the ATEO during an applicable

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year is less than 10% of the time spent performing services for the entire related group. A safe harbor also exists, whereby an individual is disregarded if s/he does not work more than 100 hours for the ATEO and any related organization during an applicable year, thereby automatically satisfying the less than 10% of hours rule.

Limited Service Exception – The Final Regulations also address situations where the individual provides services to more than one related ATEO. In such cases, an employee is disregarded if the ATEO paid less than 10% of the employee’s total remuneration from the related group, and a related ATEO paid at least 10% of the employee’s total remuneration from the related group.

Remuneration

Remuneration to covered employees includes wages under Section 3401(a) and any amounts required to be included in gross income under Section 457(f). Under Section 457(f), remuneration is included in the calculation of the \$1 million excess compensation when such amounts are no longer subject to a substantial risk of forfeiture. The Final Regulations point out that 457(f) requires amounts to be taking into account unless such compensation is conditioned upon the performance of substantial future services. Presently, the Proposed Regulations under 457(f) can be relied upon in making the determination of whether amounts are subject to a substantial risk of forfeiture.

Remuneration does not include the portion of any remuneration paid to a licensed medical professional for the performance of medical services. The Final Regulations are consistent with prior guidance in allowing ATEOs to make a reasonable, good faith allocation of remuneration for medical services and non-medical services provided by an employee. Such an allocation may be based on the terms of a written employment agreement, an analysis of patient, billing or time records, or an estimate of comparable services provided by similarly situated employees.

Applicable Year and Tax Reporting

The Final Regulations leave in place the rule that the “applicable year” is the calendar year ending with or within the ATEO’s tax year. For example, if an ATEO uses the calendar year as its taxable year, the ATEO’s applicable year for 2021 is the period from January 1, 2021 through December 31, 2021. However, for an ATEO using a fiscal year that runs from July 1, 2020 through June 30, 2021, the applicable year will be the 2020 calendar year.

The reporting on Form 4720 and payment of any excise taxes are due on the 15th day of the 5th month after the end of the ATEO’s tax year (May 15 for a calendar year employer), subject to applicable extensions.

Excess Parachute Payments

Payments to a covered employee triggered by an involuntary separation from service can also trigger the Section 4960 excise tax. If the covered employee’s parachute payments equals or exceeds three times the base amount, then the payments result in an “excess parachute payment” – the amount of the payment in excess of the employee’s base amount – that is subject to the tax. The base amount is the average of the employee’s annual compensation over the five most recent taxable years or the portion of the five-year period during which the employee was an employee of the ATEO or a related organization.

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For purposes of excess parachute payments, remuneration is not limited to severance payments, but includes obligations to pay fringe benefits, continued health insurance, life insurance and the present value of any deferred compensation triggered by accelerated vesting. The Final Regulations contain an anti-abuse rule that may result in a payment being treated as contingent upon involuntary separation if, for example, the ATEO increases salary or accelerates the vesting of a bonus, or deferred compensation around the time of a separation.

The Final Regulations become effective December 31, 2021.

Department of Treasury, Internal Revenue Service, 26 CFR Parts 1 and 53 [TD 9938], Tax on Excess Tax-Exempt Organization Executive Compensation, Final Regulations, 86 Fed. Reg. 6196 (January 19, 2021).