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Client Alert

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Happy New Year for Tax-Exempt Employers!? IRS Issues Interim Guidance on the New Excise Tax on Executive Compensation

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In late December 2017, Congress enacted the Tax Cuts and Jobs Act, cutting corporate tax rates but adding several unwelcome new Internal Revenue Code ("Code") provisions for tax-exempt organizations, including a 21 percent excise tax on certain executive compensation paid by tax-exempt employers. The IRS rang in 2019 by issuing Notice 2019-09 (the "Notice") – its first piece of guidance on how to calculate and pay the new tax. The guidance comes just in time, as many tax-exempt employers will find they owe the tax for 2018.

Code Section 4960 imposes a 21 percent excise tax on "excess compensation" and "excess parachute payments" paid by an organization that is exempt from tax under Code Section 501(a) to certain "covered employees" during a taxable year. Given that Code Section 4960 took effect for a tax-exempt employer's first taxable year to begin after December 31, 2017, tax-exempt employers have been on the lookout for any official guidance on how to interpret and apply various aspects of the excise tax. This article provides highlights of the topics covered by the 90-plus-page Notice, with more detailed analysis to follow in subsequent Client Alerts.

If The Tax Applies, Who Pays It? The statute requires the tax to be paid by the employer.

Which Tax-Exempt Employers Are Affected? Generally, any organization that is exempt from tax under Code Section 501(a) is subject to Code Section 4960, and the excise tax rules are applied taking into account remuneration paid to a covered employee by the tax-exempt employer and any "related entities."[1]

- The Notice establishes rules for identifying which entities are "related entities" of a tax-exempt employer for purposes of determining a covered employee's remuneration for a tax year (notably, the Notice does not adopt wholesale the controlled group tests under Code Sections 414(b) and 414(c)).
- The Notice also provides guidance on how to apportion responsibility for the excise tax among related entities when more than one related entity provides compensation to the covered employee.
- The Notice clarifies the circumstances under which a governmental entity will be considered a tax-exempt employer subject to Code Section 4960.

Who Is a Covered Employee? A covered employee includes the tax-exempt employer's five highest-compensated employees in the current taxable year plus anyone who was a covered employee for any preceding taxable year beginning after December 31, 2016.

- The Notice provides guidance on how to identify these individuals and clarifies the IRS' position that <u>once an employee is deemed a covered employee, such individual will never cease to be a covered employee for purposes of Code Section 4960</u>. Tax-exempt employers will need to keep records going forward as to each employee or former employee who is deemed a covered employee in any year, even if no tax is actually required in that year.

What Types of Payments Trigger the Excise Tax? The excise tax equals 21 percent of the sum of (i) the compensation paid by the tax-exempt employer (and related organizations) to a covered employee in excess of $1 million (other than an "excess parachute payment" described in (ii)), plus (ii) the amount of any "excess parachute payment" paid by the tax-exempt employer (and related organizations) to the covered employee.

- For purposes of calculating the excise tax, "compensation" means a covered employee's wages for federal income tax purposes under Code Section 3401(a), including amounts required to be included in gross income under Code Section 457(f), but excluding designated Roth contributions and excluding remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.

  The Notice provides guidance on how to interpret the definition of compensation, when compensation is deemed to have been paid, how the concept of "substantial risk of forfeiture" applies under Code Section 4960, the scope of the exception for remuneration paid for the performance of medical services, and how to treat remuneration that was vested but not paid by the close of the taxable year preceding Code Section 4960's effective date.
- An "excess parachute payment" is an amount equal to the excess of any "parachute payment" over the covered employee's "base amount." Under Code Section 4960, an amount is a parachute payment if it is contingent on the covered employee's separation from

employment and the present value of the compensation equals or exceeds three times the covered employee's base amount.

The Notice provides guidance as to what constitutes a separation from employment for Code Section 4960 purposes, when a parachute payment is considered to be made, types of payments that may be considered parachute payments (*e.g.*, payments under a window program, accelerated payments and accelerated vesting of benefits), and how to calculate the present value of compensation in order to complete the "three times the employee's base amount" analysis.

What Is a "Taxable Year" for Purposes of the Tax? The tax-exempt employer's taxable year is used for purposes of reporting and paying the excise tax. However, to determine if a tax-exempt employer is required to pay the excise tax for a given taxable year--and to calculate the amount of the excise tax--excess compensation paid and excess parachute payments made to a covered employee in the calendar year ending with or within the taxable year of the employer are treated as paid for that taxable year.

How Do You Report and Pay the Excise Tax? Taxes imposed under Code Section 4960 must be reported on IRS Form 4720 by the 15th day of the fifth month after the end of the employer's taxable year (*e.g.*, May 15 for calendar year tax-exempt employers, the same as Form 990).

Is There Room for Interpretation as to How Code Section 4960 Applies? Until the IRS issues proposed regulations, the IRS will permit taxpayers to rely on a "good faith reasonable interpretation of the statute," including the guidance provided by the Notice. However, the Notice specifically notes certain interpretations that are contrary to the guidance in the Notice and that the IRS will not consider to be good faith interpretations of Code Section 4960.[1]

Tax-exempt employers who have questions about how Code Section 4960 applies to them, what steps should be taken now with respect to remuneration paid in 2018, and how to plan for 2019 and beyond should contact a member of our Employee Benefits and Executive Compensation Group or the Tax-Exempt Employers Team.

1 Also subject to the Section 4960 tax are (i) farmers' cooperative organizations described in Code Section 521(b)(1), (ii) organizations that have income excluded from taxation under Code Section 115(1) (*e.g.*, certain governmental entities), and (iii) political organizations described in Code Section 527(e)(1).

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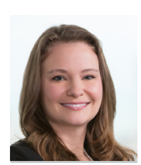

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