Tax-Exempts Subject to Excise Tax on Executive Compensation

Considerations for non-profits regarding new excise tax.

By Kelly Davis and Lee Nunn

Pursuant to the Tax Cuts and Jobs Act enacted on December 22, 2017, Internal Revenue Code (IRC) Section 4960(a) imposes an excise tax (currently 21 percent) on the amount of compensation in excess of $1 million, and on any excess parachute payment, paid by an applicable tax-exempt organization, or a related organization, to a covered employee, effective for tax years beginning after December 31, 2017.

On December 31, 2018, the Department of the Treasury and the Internal Revenue Service (IRS) released Notice 2019-09 to provide taxpayers with interim guidance on the application of IRC Section 4960 and the associated annual tax filing on Form 4720, Return of Certain Excise Taxes.

IRS Notice 2019-09

Section 4960 applies for the first taxable year of an employer that begins after December 31, 2017. Any wages paid or vested before the beginning of the first taxable year is not subject to the excise tax. Under IRC Section 4960, the excise tax is determined on wages that are considered paid, or on any excess parachute payment, during any calendar year that ends with or within the taxable year of an applicable tax-exempt organization, or related organization.

ATEO

An applicable tax-exempt organization (ATEO) is defined as any organization exempt from tax under IRC Section 501(a), which includes all IRC 501(c) organizations. Related organizations subject to the IRC Section 4960 excise tax may include taxable, tax-exempt, or governmental entities. A related organization is one that controls, or is controlled by, an ATEO, is controlled by one or more persons which control an ATEO, or is a supported organization.

Covered Employees

A covered employee is any employee, or former employee, who is, or was, one of the five highest-compensated employees of the ATEO, or a related organization, for any tax year, starting with tax years that began after December 31, 2016. To be considered a covered employee, that employee does not need to be a highly-compensated employee (annual salary of 120,000 or more), be paid in excess, or receive an excess parachute payment. The determination of a covered employee is made annually and once an employee becomes a covered employee, he or she will continue be a covered employee for all subsequent taxable years, even after separation from employment. The determination of the five highest-compensated employees is separate for each ATEO and not for an entire group of related organizations. To that end, a group of related organizations could have more than five covered employees. To identify the five highest compensated employees, an ATEO should consider compensation paid for the taxable year by any related organization, including a related for-profit organization or governmental entity, for services performed as an employee of such organization.

Included Compensation

Compensation for covered employees includes wages subject to income tax withholding, including amounts required to be included in gross income and excluding designated Roth contributions. Although the nature of amounts subject to the excise tax is defined, the timing is not. Instead, these amounts are treated as paid when there is not a substantial risk of forfeiture.

Compensation deferred by a tax exempt or state and local government employer to participants under a deferred compensation plan (other than a 457(b) plan) is included as income for the first year in which it is not a substantial risk for forfeiture, otherwise at the time of vesting. A substantial risk of forfeiture is generally the criteria applied to determine when deferred

compensation vests and when its includable as income to the recipient.

For purposes of this new excise tax, compensation is treated as paid when there is no substantial risk of forfeiture of the rights to the compensation. Compensation vested in any tax year prior to December 31, 2017, is not subject to this excise tax. For example, an ATEO with a fiscal year beginning July 1 would not pay excise tax on a vested account balance in a 457(f) plan as of June 30, 2018 but earnings accrued on the vested amounts after June 30, 2018 would be subject to the excise tax.

Additional types of compensation may be excluded, such as:

- Certain retirement benefits under IRC Section 3401(a)(12),
- Certain directors' fees (see Rev. Rul. 57-246, 1957-1 C.B. 338), and
- Certain compensation for performing medical or veterinary services (however administrative services related to medical or veterinary services are included).

A parachute payment that is not an excess parachute payment is included. A parachute payment is any payment that is contingent on a covered employee's involuntary separation from employment. The parachute payment includes any amount that is probable to be paid, even if subject to a restriction such as adhering to a covenant not to compete. The excess amount, subject to the excise tax, is calculated as the aggregate present value of the parachute payments that exceeds three times the base amount.

In general, a covered employee's base amount is the average annual compensation for services performed as an employee of the ATEO (including compensation for services performed for a predecessor entity of the ATEO), or a related organization when there has been a separation from employment, if the compensation was includible in the gross income of the individual for taxable years in the base period, or would have been includible in the individual's gross income.

Compensation paid (or vested) to a covered employee between January 1, 2018 and June 30, 2018 is not included in compensation when measuring the $1M limit for a June 30, 2019 tax year. This is limited transition relief for calendar year 2018 compensation. Compensation paid (or vested) to a covered employee in calendar year 2019 will be used to determine whether the $1M limit is exceeded for the organization's June 30, 2020 tax year.

Example:

For a tax-exempt entity with a June 30th fiscal year-end, the new excise tax will first apply to the organization's tax year that ends June 30, 2019. Compensation paid (or that vests in a 457(f) plan) to a covered employee during calendar year 2018 will be used to determine whether the $1M limit is exceeded for the organization's June 30, 2019 tax year.

It should be noted that there is no particular relationship between liability for excise tax under IRC Section 4960 and excise taxes for unreasonable or excessive compensation (IRC section 4958), or compensation to disqualified persons for personal services (IRC Section 4941).

Form 4720 Excise Tax Filing

An ATEO, or related organization, is liable for the payment of their share of the excise tax and filing of Form 4720 with the IRS for any taxable year the tax applies. An employer is liable only for the greater of the excise tax it would owe as an ATEO or the excise tax it would owe as a related organization with respect to a particular covered employee.

The Form 4720 and excise tax payment is due by the 15th day of the fifth month following the end of the ATEO's, or related organizations, taxable year. To that end, the first filing due dates would be:

- December 31, 2018 tax year end — First filing and tax due May 15, 2019
- June 30, 2019 tax year end — First filing and tax due November 15, 2019

Considerations

Tax-exempts should determine the impact of IRC Section 4960 to prepare for the initial and subsequent excise tax liability and IRS filing of Form 4720. For example:

- Confirm ATEO status,
- Identify all related organizations,
- Determine list of covered employees and update annually,
- Determine compensation components for each covered employee including amounts vested, but not actually or constructively paid, prior to and after the effective date of IRC Section 4960,
- Identify amounts vested, but not actually or constructively paid, at the end of the calendar year preceding the tax year for new covered employees, and
- Identify arrangements that create parachute payments for covered employees and list covered employees who are highly-compensated to receive excess parachute payments and annually update base amounts.

Caution should be considered with modifying or terminating existing nonqualified or deferred compensation agreements, or the acceleration of deferred compensation benefits.

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