

Alert | Tax-Exempt Organizations



June 2020

IRS Issues Proposed Regulations on Excess Nonprofit Executive Compensation

On June 5, 2020, the IRS issued [proposed Treasury Regulations under section 4960 of the Internal Revenue Code of 1986, as amended](#) (the Code).

Background

Section 4960 was added to the Code in 2017 as part of the Tax Cuts and Jobs Act. Section 4960 generally provides that if certain tax-exempt organizations (an “applicable tax-exempt organization” or “ATEO”) pay remuneration to certain employees (“covered employees”) in excess of \$1,000,000 or an excess parachute payment, the payments are subject to an excise tax on the excess remuneration and excess parachute payments at the corporate income tax rate, currently 21%.

An ATEO is defined in the Code as any organization which for the taxable year is exempt from taxation under section 501(a) of the Code (which includes a reference to section 501(c) organizations), is a farmers’ cooperative organization described in section 521(b)(1), has income excluded from taxation under section 115(1), or is a political organization described in section 527(e)(1). A “covered employee” is an employee (including any former employee) of an ATEO, if the employee is one of the five highest-compensated employees of the organization for the taxable year or was a “covered employee” of the organization (or predecessor) for any preceding taxable year beginning after Dec. 31, 2016.

“Remuneration” is defined as wages (as defined in Code section 3401(a)), except that such term does not include any designated Roth contribution and includes amounts required to be included in gross income under section 457(f) (deferred compensation). Remuneration is treated as paid when there is “no substantial risk of forfeiture” (generally, the risk of not receiving the payment for failure to provide future services) of the rights to such remuneration. The Code provides that remuneration does not include any remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.

Remuneration paid to a covered employee by an ATEO includes any remuneration paid with respect to employment of such employee by any related person or governmental entity. A person or governmental entity is treated as related to an ATEO if such person or governmental entity controls, or is controlled by, the ATEO; is controlled by one or more persons who control the ATEO; is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the ATEO; is a supporting organization described in Code section 509(a)(3) during the taxable year with respect to the ATEO; or, in the case of an ATEO which is a voluntary employees’ beneficiary association (VEBA), establishes, maintains, or makes contributions to the VEBA. Consequently, remuneration paid by a for-profit corporation that controls an ATEO to employees of that ATEO is included in computing excess remuneration for purposes of section 4960.

An “excess parachute payment” is defined as an amount equal to the excess of any parachute payment over the portion of the “base amount” allocated to such payment using rules similar to the rules of section 280G(b)(3) (which define excess parachute payments in the case of a for-profit corporation). Payments made to a licensed medical professional (including a veterinarian) to the extent the payment is for the performance of medical or veterinary services by the professional are not treated as parachute payments.

Notice 2019-09

On Dec. 31, 2018, the IRS issued [Notice 2019-09](#), setting forth initial guidance on the application of section 4960. The notice provides that taxpayers may rely on the notice until further guidance is issued. The notice also provides that certain interpretations of section 4960 are not consistent with a reasonable, good faith interpretation of the statutory language, and that the Treasury Department and the IRS intend to embody those positions as part of forthcoming proposed regulations.

Proposed Regulations

The proposed regulations define “employee” consistent with the definition of “employee” for purposes of federal income tax withholding in Code section 3401(c). Specifically, the proposed regulations’ cross-references include common-law employees, officers or elected or appointed officials of governments, or agencies or instrumentalities thereof, and certain officers of corporations. Therefore, “employee” does not include a member of a board of directors of a corporation who is not also an employee of the corporation. However, an officer is an employee of the entity for which the officer serves as an officer (unless the officer performs no services or only minor services and neither receives, nor is entitled to receive, any remuneration).

The proposed regulations provide that whether an employee is one of the five highest-compensated employees of an ATEO is determined separately for each ATEO and not for the entire group of related organizations. As a result, a group of related ATEOs can have more than five highest-compensated employees for a taxable year. Similarly, an employee may be a covered employee of more than one ATEO in a related group of organizations for a taxable year. Once an employee is a covered employee of an ATEO, the employee continues to be a covered employee for all subsequent taxable years of that ATEO.

An important point in applying section 4960 is that, for purposes of determining whether an employee is one of an ATEO's five highest-compensated employees for a taxable year, remuneration paid by the ATEO during the applicable year is aggregated with remuneration paid by any related organization during the ATEO's applicable year, including remuneration paid by a related for-profit organization or governmental entity, for services performed as an employee of such related organization. As a result, there was concern that the excise tax imposed by section 4960 would apply to employees of controlling for-profit corporations where no compensation was paid by the ATEO. The proposed regulations contain exceptions to address these issues.

An employee is disregarded for purposes of determining an ATEO's five highest-compensated employees for a taxable year if neither the ATEO, nor any related ATEO, nor any taxable related organization controlled by the ATEO pays the employee of the ATEO any remuneration for services performed for the ATEO or grants a legally binding right to uninvested remuneration to the employee.

Also excluded from an ATEO's five highest-compensated employees are employees of an ATEO who receive no remuneration from the ATEO and perform only limited services for the ATEO; this means that no more than 10% of total annual hours worked for the ATEO and related organizations are for services performed for the ATEO.

A third exception applies to employees from an ATEO's five highest-compensated who receive no compensation from an ATEO or an entity controlled by an ATEO, and less than 50% of the individual's services are performed for an ATEO.

Cash benefits such as expense reimbursements or director and officer liability insurance are not treated as remuneration for purposes of these exceptions.

Remuneration paid to an individual who is never an employee of the ATEO is not taken into account for purposes of section 4960. For example, an individual who performs services for the ATEO solely as a bona fide independent contractor is not an employee of the ATEO, and thus is not considered for purposes of determining the ATEO's five highest-compensated employees. Similarly, an individual who, under all the facts and circumstances, performs services solely as a bona fide employee of a related organization, including a related organization that provides services to the ATEO, is not an employee of the ATEO and thus is not considered for purposes of determining the ATEO's five highest-compensated employees.

Effective Date

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the *Federal Register*. The proposed regulations do not provide a grandfather rule. However, these proposed regulations provide rules that have the effect of grandfathering certain compensation. The proposed regulations provide that any nonqualified deferred compensation that vested prior to the first day of the first taxable year of the ATEO beginning after Dec. 31, 2017, is not considered remuneration for purposes of section 4960. Payments under contracts entered into before the date of enactment are not excluded from section 4960, other than deferred compensation earned prior to the date of enactment.

The guidance provided in the proposed regulations generally is consistent with the guidance provided in Notice 2019-09. However, in certain instances these proposed regulations modify the guidance provided in Notice 2019-09. Until the applicability date of the final regulations, taxpayers may rely on the guidance provided in Notice 2019-09 or, alternatively, on the guidance provided in these proposed regulations.

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