Proposed Regulations on the 4960 Excise Tax on Certain Compensation Paid by Tax-Exempt Employers

Related Attorneys

Jennifer Bibart Dunsizer

Anthony C. Ciriaco

Christine M. Poth

Jacquelyn Meng Abbott

Related Services

Corporate and Business Organizations

Employee Benefits and Executive Compensation

Labor and Employment

Related Industries

Tax-Exempt Organizations

CLIENT ALERT | 8.13.2020

The IRS released proposed regulations on June 11, 2020 regarding the excise taxes imposed under Code Section 4960.

Code Section 4960 imposes two different excise taxes, each at the highest corporate tax rate (currently 21%), on certain employers that either (a) pay their highest paid employees remuneration in excess of $1 million in any one year, or (b) pay those employees parachute payments (compensation contingent on separation of employment) equal to at least three times a covered employee's average pay.

Organizations subject to this rule are organizations that are tax exempt under IRC Section 501(a) and governmental employers who are tax exempt under IRC Section 115(1). Organizations subject to the new taxes are referred to as "applicable tax-exempt organizations" or "ATEOs."

In general, beginning in 2017, each ATEO must track a cumulative list of each year's top 5 highest compensated employees ("covered employees"). Compensation for this purpose, includes remuneration provided by both the ATEO and by "any related organization with respect to the ATEO." Once a person is a covered employee, compensation paid to that person in any future year could trigger the excise taxes.

Exceptions to Covered Employee Designation. The most helpful change reflected in the proposed regulations is defining who is a covered employee. The regulations provide three exceptions to when an employee of a related organization would not be treated as an employee of the ATEO for purposes of determining covered employees.

Limited hours exception. An individual is not considered one of the ATEO's five highest compensated employees for a taxable year if the individual does not receive any pay from the ATEO and either (a) the employee performs less than 10% of his service for the charity and works 90% for another entity (including a related non-charity) or (b) the individual works less than 100 hours per year for the charity no matter how few hours the individual works for the related employer. Prop.

Treas. Reg. §53.4960-1(d)(ii)

Nonexempt funds exception. Under this exception, an employee of a related organization may provide up to 50% of the employee's time to the ATEO as long (a) the employee works primarily for the related nonexempt organization and (b) The ATEO does not pay directly or indirectly for the services of such individual. There is, however, an additional requirement that the arrangement between the ATEO and the taxable related organization has to be a truly charitable relationship with no nonexempt funds flowing from the ATEO to the taxable related organization for any purpose. Prop. Treas. Reg. §53.4960-1(d)(iii).

Limited services exception. An individual is not considered a covered employee of an ATEO if the ATEO did not pay 10% or more of the employee's total remuneration for services performed as an employee of the ATEO and all related organizations, and the ATEO had at least one related tax-exempt organization and one of the following conditions apply: (1) a related tax-exempt organization paid at least 10% of the total remuneration paid by the ATEO and all related organizations; or (2) no related tax-exempt organization paid at least 10% of the total remuneration paid by the ATEO and all related organizations, and the ATEO paid less remuneration to the employee than at least one related tax-exempt organization. Prop. Treas. Reg. §53.4960-1(d)(iv). **VORYS COMMENT:** These helpful exceptions will preserve the foundations established by many employers. Even though the foundation and the related company will be aggregated, and foundation officers are normally deemed to be employees, these exceptions will enable remuneration paid to the vast majority of foundation officers and directors to be excluded from the excise tax. Contemporaneous records should be kept documenting hours worked on foundation business.

Determination of compensation subject to tax. The first tax under Code Section 4960 applies to compensation in excess of $1m in a year (similar to Code Section 162(m)). This calculation defines compensation differently than the company uses for either the employee's Form W-2 or the company's Form 990. While the calculation starts with wages for income tax withholding purposes, it subtracts out Roth retirement plan contributions and adds back 457(f) plan benefits. Another important clarification in the proposed regulations is that 457(f) plan contributions are not included in compensation at the time of contribution if the amount is not vested at that time. Contributions and earnings are included in the year that the benefit becomes vested. **VORYS COMMENT:** Given the cliff vesting in many 457(f) plans, this may push an employee's total pay in the vesting year above $1m. Careful modelling should be considered. Remember that Code Sections 409A and 457(f) limit the ability to amend these arrangements to change the tax result.

To the extent that the applicable employee provides medical services, the portion of the employee's pay attributable to those services are excluded from the employee's compensation for this excise tax calculation. **VORYS COMMENT:** Medical services is defined fairly broadly to include payments to doctors, nurses, vets, dentists, PRNs and other licensed medical professionals. This will enable many medical professionals to avoid triggering the tax. Employers will want to contemporaneously document an allocation method to split a medical professional's compensation between compensation for administration or teaching and compensation for delivering medical care.

The second tax under Code Section 4960 applies to excessive payments made upon separation from service (similar to Code Section 280G). If the present value of payments made upon an individual's separation from service equals or exceeds 3 times the employee's average box 1 W-2 wages for the 5 years preceding the employee's termination date, the amount of that present value in excess of one times the 5 year average is subject to the tax at the highest corporate tax rate (currently 21%). Although the statute counts all amounts payable in connection with a separation from service, the proposed regulations confirm that the tax only applies to amounts that are payable in connection with an involuntary separation. This means that, like Code Section 280G, the value of accelerated vesting and accelerated payment of amounts deferred under a 457(f) plan would count against the tax calculation, but the underlying deferred compensation payments themselves would not.

Some exempt organizations have entered into highly publicized split-dollar compensation arrangements as a way to reduce the Code Section 4960 excise tax. The regulations provide that imputed interest on a below-market split-dollar loan is treated as remuneration even though there is no federal withholding on the interest; however, split dollar withdrawals that are treated as loans are not included as remuneration. **VORYS COMMENT:** Split-dollar arrangements are being aggressively marketed as a way to provide significant amounts of deferred compensation in a tax effective manner. Given the number of listed transactions related to abuses of split-dollar arrangements and informal statements from regulators expressing skepticism about this tool, caution is warranted. Used cautiously, split-dollar insurance may be one of the few effective tools to mitigate the taxes otherwise triggered by future compensation.

Unlike Code Section 280G, amounts allocated to a non-compete covenant will not be excluded from the calculation.

ATEOs should work with their tax advisors to identify all of their covered employees and to confirm the treatment of their compensation arrangements so that they can properly calculate and report any taxes owed under Code Section 4960. Contact your Vorys attorneys for assistance.