Comp and Benefits Brief

January 7, 2019

IRS Issues Guidance on Excise Tax on Executive Compensation of Tax-Exempt Entities

To start the New Year, the IRS issued 92 pages of interim guidance (Notice 2019-09) on Code Section 4960, the Tax Cuts and Jobs Act provision that imposes a 21% excise tax on remuneration in excess of $1 million and excess parachute payments by "applicable tax exempt organizations" (referred to as ATEOs). Some highlights are described below, including that tax-exempt entities that do not pay employees more than $125,000 must still be aware of and compliant with Code Section 4960.

The interim guidance is a precursor to proposed regulations that the IRS intends to issue. Until such future guidance, taxpayers must use a good faith, reasonable interpretation of the statute, which includes the interim guidance. In some instances, the interim guidance identifies positions that are <u>not</u> considered to be good faith, reasonable interpretations.

<u>Determination Year – Calendar Year</u>

Code Section 4960 was effective for the first year beginning after December 31, 2017. The interim guidance provides that the remuneration and payments are determined on a calendar year basis, using the calendar year that ends with or within the ATEO's taxable or fiscal year. This is viewed as a welcome simplification especially for entities with non-calendar year fiscal years. Remuneration paid before the first taxable year that begins after December 31, 2017 is not included. For example, if an employee is paid $1 million in calendar year 2018 by an organization with a July 1 taxable year, only $500,000 is included in the first year of compliance.

Tracking 5-Highest Paid by ALL Tax Exempts

While the interim guidance confirms that if an ATEO has no highly compensated employees, it may not have any excise tax exposure for a given year, the ATEO should still determine for each year the employees who are the 5 highest paid because once designated a "covered employee", the employee remains a covered employee and might be paid in future years amounts subject to the excise tax. Note that the excess parachute prong of Code Section 4960 does not require remuneration in excess of $1 million, only that separation payments exceed three times the "base" amount. A covered employee with annual remuneration consistently less than $1 million could still trigger the excise tax if that employee leaves with a very large severance/retirement package.

Control Uses 50% Test

In determining the total remuneration paid, payments by the ATEO and all related entities are considered. Related entities can include for-profit organizations and governmental organizations. Related entities share common control. The IRS guidance specifically rejects the control group test for qualified plans that uses 80% and adopts a 50% test – more than 50% ownership for

- stock corporations
- partnerships
- trusts, using beneficial interests and

more than 50% of directors or trustees who are representatives of nonstock entities.

Moreover, each ATEO and its related entity must determine its own covered employees, raising the possibility that there may be more than 5 covered employees within a related system.

Parallel Guidance under Sections 280G and 162(m) -- But Not Totally

The interim guidance acknowledges its reliance on the existing guidance under Code Section 280G [golden parachute rules] and Section 162(m) [$1 million compensation limitations]. However, there are a number of provisions which are not applied under the interim guidance. These are often technical, but will need careful review by taxpayers and their advisors. For example, the Section 280G rules apply when there is a change of control but the Section 4960 rules apply when there is payment contingent on separation from employment and are not applied in the same way. For Section 4960, a payment is made on account of involuntary separation but may not trigger liability if the payment was already vested in a prior year or would be paid in the same way upon any separation from employment.

Remuneration for Medical or Veterinary Services Exclusion Allows Allocation

Under Section 4960, remuneration paid to an employee for medical (or veterinary) services is excluded from remuneration used to determine any excise tax. The interim guidance narrowly identifies services for diagnosis, cure, mitigation, treatment or prevention of disease as medical services but excludes teaching or research services that do not relate directly to medical services. Where an individual provides both medical and other services, the employer must allocate remuneration on a "reasonable" basis. The interim guidance recognizes that an employment agreement may set forth a reasonable allocation which must be followed, thus allowing the individual to have some input on the allocation.

Tax Reporting Procedures

The interim guidance confirms that each ATEO and related entity share the excise tax, allocate the tax proportionately for commonly employed individuals, and must file a Form 4720. Payment of the excise tax is due the 15th day of the 5th month after the end of the employer's taxable year (subject to applicable extensions). Thus for calendar year tax exempt entities, the tax is due May 15 of the next calendar year. Quarterly estimated taxes are not required. Voluntary pre-payments are permitted.

2018 is the first year for Section 4960 excise taxes. While having more guidance is helpful, the guidance is very detailed and technical and its application to an employer's remuneration and plans can be complex. Tax exempt entities should start now to determine whether and to what extent they may be subject to Code Section 4960 and its detailed rules.

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