Insights

Tax-Exempt Organizations Should be Prepared to File and Pay the Section 4960 Excise Tax on Executive Compensation by July 15, 2020

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The Tax Cut and Jobs Act of 2017 ("**TCJA**") added Section 4960 to the Internal Revenue Code (the "**Code**"), which imposes a new 21% excise tax on compensation paid by certain tax-exempt organizations and related parties (the "**Excise Tax**"). In December of 2018, the Internal Revenue Service ("**IRS**") released interim guidance on the Excise Tax in the form of Notice 2019-09 (the "**Notice**") and, on June 11, 2020, released additional guidance in the form of Proposed Regulations (the "**Proposed Regulations**"), which largely followed the guidance provided in the Notice with some additional clarifications of the treatment of remuneration paid by related organizations, that are not themselves tax-exempt organizations, to covered employees.

This article summarizes the calculation of the Excise Tax and the related filing requirements, based on guidance provided in the Notice and the Proposed Regulations.

Excise Tax Summary

Section 4960 imposes an excise tax, at the corporate tax rate (currently 21%), on remuneration paid by an applicable tax-exempt organization to a covered employee that either exceeds $1 million or constitutes an excess parachute payment.

What is an "Applicable Tax-Exempt Organization"?

Section 4960 defines an applicable tax-exempt organization ("**ATEO**") as an organization that:

- is exempt from tax under Code section 501(a), which provides tax exemption for organizations described in Sections 501(c), (d), and 401(a);
- is a farmers' cooperative organization under Code section 521(b)(1);
- has income excluded from taxation under Code section 115(1); or
- is a political organization described in Code section 527(e)(1).

Note for Section 115 organizations, public hospitals and state colleges and universities:

> The exemption under Code section 115(1), as referenced in the definition of an ATEO, is relied upon by affiliates of governmental units (*e.g.*, public hospitals). The inclusion of these organizations in the definition of an ATEO, as well as certain clarifying comments made in the Proposed Regulations, highlight a distinction made in section 4960 between *true* governmental units (such as a state or political subdivision,

or an integral part of a state or political subdivision) and their affiliates. Governmental units, which are not taxed by the federal government under the doctrine of implied statutory immunity (as opposed to a statutory exemption) are not subject to the Excise Tax. However, affiliates of governmental units, such as those organizations whose income is exempt under Code section 115(1) or federal instrumentalities that are not states, political subdivisions, or integral parts thereof, generally will be subject to the Excise Tax. As a result, the threshold question related to the applicability of the Excise Tax will be the source of an organization’s tax exemption. It should be noted that the IRS and Treasury have specifically requested comments on how section 4960 applies to these organizations.

What Constitutes “Remuneration” Subject to the Excise Tax?

Code section 4960 defines "remuneration" as wages paid under the federal withholding rules of Code section 3401(a), with some modifications. Specifically, remuneration includes amounts required to be included in income under Code section 457(f) plans but does not include designated Roth contributions to tax-favored employer-sponsored retirement plans. Remuneration is treated as paid when it is no longer subject to a "substantial risk of forfeiture" (*i.e.,* vested) as defined for purposes of Code section 457(f)(3)(B). Earnings and losses on previously paid remuneration (*e.g.*, earnings accrued on an employee’s account under a deferred compensation plan) are included in remuneration, with losses being used to offset gains and any excess losses being carried forward to offset net earnings gains in future years.

The Proposed Regulations clarify that certain nontaxable benefits are not considered remuneration, such as expense allowances and reimbursements under an accountable plan and most insurance for liability arising from service with an ATEO, such as directors' and officers' liability insurance.

Special exception for payments for medical services

In addition to the modifications described above, section 4960 excludes from the definition of remuneration amounts paid to a licensed medical professional (including a veterinarian) that are directly related to the performance of medical or veterinary services by that professional. Both the Notice and the Proposed Regulations narrowly define amounts that can be excluded by limiting the exclusion to amounts paid for “medical care” services. That is, services for the diagnosis, cure, mitigation, treatment, or prevention of disease, including services affecting any bodily structure or function, and services that are integral to providing these medical services, such as creating patient records. Payments for teaching, research or management functions are not excluded, unless the services meet the “medical care” definition. In short, remuneration paid to a physician may be excluded, depending on the purpose for which the payments are made. However, remuneration is not excludable simply because it is paid to a medical professional.

Remuneration includes amounts paid by related organizations

Remuneration includes amounts paid by an ATEO and a “related organization.” A related organization is defined generally as a person or governmental entity if that person or entity: (1) controls, or is controlled by, the ATEO; (2) is controlled by one or more persons that control the ATEO; (3) is a supported organization of the ATEO (as defined in Code section 509(f)(3)); or (4) is a supporting organization with respect to the ATEO. Therefore, even though government organizations and taxable organizations are not ATEOs for Code section 4960 purposes, they are liable for reporting and paying the Excise Tax on their portion of any excess compensation paid to a covered employee of any related ATEOs.

Who are Covered Employees?

A covered employee is any individual who is one of the five highest-compensated employees of the ATEO for a tax year or was a covered employee of the ATEO (or any predecessor organization) for any preceding tax year beginning after December 31, 2016. Covered employees retain that status indefinitely, so an organization must track its covered employees in perpetuity. Under the Proposed Regulations, "employer" and "employee" are defined as under Code section 3401 for purposes of federal income tax withholding and include common-law employees and certain officers of corporations, whether or not those officers receive compensation.

What are Excess Parachute Payments?

For purposes of the Excise Tax, a parachute payment is the aggregate present value of all payments in the nature of compensation to a covered employee that are contingent on the employee's separation from service and exceed three times the individual's base amount (generally the individual's average annual compensation over the preceding five years). An "excess parachute payment" on which an ATEO would pay the Code section 4960 excise tax is the amount of the payment that exceeds the individual's base amount (i.e., not the amount that exceeds three times the base amount).

Consistent with the Notice, the Proposed Regulations limit parachute payments to amounts paid solely due to an involuntary termination of employment and generally adopt the standards under Treas. Reg. Section 1.409A-1(h)(1)(ii) to determine when a reduction in services results in separation from employment. In a change from the Notice, the Proposed Regulations do not impose the Excise Tax on excess parachute payments made by related organizations.

When and How is the Excise Tax Paid?

The Excise Tax is reported and paid to the IRS on Schedule N, Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*. In addition, for organizations that are required to file Form 990, *Return of Organization Exempt from Income Tax*, liability for the tax is disclosed on Line 15 of Part V of the Form 990. For this year (2020), the Form 4720 must be still be filed on paper with the IRS, pending conversion into electronic format. The IRS plans to have these returns ready for e-filing in 2021 (reporting on tax year 2020). Payment of the Excise Tax, and the related filing of Form 4720, was originally due on May 15, 2020 but, as a result of relief provided related to the ongoing COVID-19 pandemic (See Notice 2020-23, released April 8, 2020), the deadline was extended until July 15, 2020. While the filing must be done manually, the Excise Tax may be paid online or by phone using the IRS’s free Electronic Federal Tax Payment System at **https://www.eftps.gov/eftps/** and 1-800-555-4477, respectively. Finally, while the tax payment is due on July 15, 2020, taxpayers do have the option to extend the due date for the filing of the Form 4720 until January 1, 2021.

Current State of Law and Request for Comments

Until final regulations are issued, taxpayers may determine their liability for the Excise Tax, and calculate the amount due, using a reasonable, good-faith interpretation of the statute, the Notice, the Proposed Regulations or any combination of the three. The IRS and Treasury are accepting comments on the Proposed Regulations until August 10, 2020.

If you have any questions regarding the calculation of the Excise Tax, the filing of IRS Form 4720, or any other matter related to executive compensation issues of tax-exempt organizations you may contact **Sharon B. Hearn**, **Kendall A. Schnurpel** or your regular Krieg DeVault attorney.