

WHAT TAX-EXEMPT ENTITIES WITH NO MILLION DOLLAR PLUS EMPLOYEES SHOULD KNOW ABOUT SECTION 4960 EXCISE TAXES

Working Together

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The Tax Cuts and Jobs Act of 2017 added several new provisions to the Internal Revenue Code (the “Code”) which impose new excise taxes on tax-exempt entities. One of these new provisions is Code Section 4960, Tax on Excess Tax-Exempt Executive Compensation.

Code Section 4960 imposes excise taxes on certain compensatory payments to certain employees of certain tax-exempt entities. Specifically, Code Section 4960 imposes an excise tax on Remuneration[1] in excess of \$1,000,000, and on excess Parachute Payments[2] to Covered Employees[3] of Applicable Tax-Exempt Organizations (“ATEOs”)[4][5]. These excise taxes are applicable for the first tax year following December 31, 2017. The Code Section 4960 excise taxes are generally paid by the Employer of the Covered Employee. Recently, the Internal Revenue Service issued Notice 2019-9 as interim guidance to assist tax-exempt entities in determining whether any excise taxes are owed under Code Section 4960.

Many tax-exempt entities may have formed the opinion that there is no need to be concerned about the Code Section 4960 excise tax since no one on payroll comes close to earning \$1,000,000. Unfortunately, Notice 2019-9 makes clear that the excise tax on excess Parachute Payments can apply even when the executive at issue earns less than \$1,000,000. Consequently, every tax-exempt entity should determine whether Code Section 4960 is applicable to it.

The Questions and Answers below highlight the main issues a tax-exempt entity should consider when analyzing the applicability of Code Section 4960 to its operations for purposes of the excise tax on excess Parachute Payments. It should be noted that this article does not contain a complete description of all the issues to be considered in this analysis. Code Section 4960 and the interim guidance under Notice 2019-9 contain new “jargon” and “old jargon with new meanings” that require a careful, step-by-step approach in concert with the tax-exempt entity’s accountant and/or legal counsel.

What payments are considered Parachute Payments under Section 4960?

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Only Payments to Highly Compensated Employees who are Covered Employees

Only payments to a highly compensated employee who is a Covered Employee can trigger the excise tax on excess Parachute Payments. Covered Employees are the five highest compensated employees of the ATEO for the taxable year. Once an employee is determined to be a Covered Employee he or she will always be included in the Covered Employee group.

Payments Contingent on Involuntary Separation from Employment

Only payments in the nature of compensation that are contingent on an employee's involuntary separation from employment may be excess Parachute Payments. Generally an involuntary separation only occurs when an employer fires an employee or refuses to extend an employment contract beyond the end of the contract term. Notice 2019-9 provides, however, that a payment under a Window Program that is open for no more than twelve months will be treated as a Parachute Payment even though the employee voluntarily agrees to take advantage of the Window Program. A Window Program offers separation pay to employees eligible to participate in the Program who terminate employment during the period when the Program is open. (Window Programs are typically early retirement incentive programs.)

Other than a Window Program, the determination of whether there has been an involuntary separation from employment will depend on whether the facts and circumstances indicate that the employer would not be making the payment in the absence of the employer's unilateral decision to terminate the employment of the employee. Any damages paid to a former employee for breach of contract in connection with the termination of employment will be treated as a compensatory payment contingent on the employee's involuntary separation from employment.

Only Payments that satisfy the Three Times Base Amount Test

To determine whether payments in the nature of compensation paid in connection with an involuntary separation from employment are Parachute Payments, the payments must be compared to the employee's Base Amount. If the aggregate present value^[6] of the payments equals or exceeds three times the employee's Base Amount, the payments are Parachute Payments. Generally, the Base Amount is equal to the average annual compensation includible in gross income of the employee for the five most recent taxable years ending before the date on which the separation from employment occurs^[7]. It should be noted that Base Amount is limited to compensation includible in gross income whereas "payments in the nature of compensation" includes fringe benefits that are not includible in gross income (e.g. employer-provided health insurance).

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Accordingly, whenever an ATEO is considering terminating the employment of a highly compensated employee, negotiating an employment contract with a highly compensated employee, or not renewing an employment contract with a highly compensated employee, it should consider whether the terms of the contract under negotiation, the pending termination, or the pending non-renewal of an employment contract could trigger a Section 4960 excise tax.

Which Employees are considered Highly Compensated Employees?

Generally, if the tax-exempt entity sponsors or participates in a tax-qualified retirement plan (e.g. profit sharing plan, defined benefit plan, or a Section 403(b) Plan to which the Employer contributes), any employee treated as highly compensated under these Plans (e.g., the entity's executive director) will be highly compensated for purposes of the Section 4960 excise tax on excess Parachute Payments.

To be a highly compensated employee in 2019 the employee must have earned at least \$120,000 in 2018. Similarly, to have been a highly compensated employee in 2018 the Employee must have earned at least \$120,000 in 2017. Any employee who earns at least \$125,000 in 2019 will be treated as a highly compensated employee in 2020. If the tax-exempt entity has no highly compensated employees, the Code Section 4960 excise tax related to excess Parachute Payments will not apply.

Is the tax-exempt entity an Applicable Tax-Exempt Organization?

Code Section 4960 excise taxes apply only to "Applicable Tax-Exempt Organizations" (referred to as "ATEOs" in Notice 2019-9)⁵. Accordingly, after determining whether it has any highly compensated employees, the next question for a tax-exempt entity is whether it is an ATEO. ATEOs are "limited" to entities which are exempt under:

1. Code Section 501(a) (includes entities exempt under Code Section 501(c)(3), like private universities, hospitals, and other charitable organizations);
2. Code Section 521(b)(1) (farmer's cooperative organizations);
3. Code Section 115(1) (generally a governmental entity that is separately organized from a state or political subdivision of a state, but which performs an essential government function);
4. Code Section 527(e)(1) (political organizations); and
5. Code Section 501(c)(9) Voluntary Employee Benefit Associations sponsored by, maintained by, or the recipient of contributions from the ATEO.

As an interesting side note, Congress intended Section 4960 to apply to public universities on the mistaken understanding that public universities are exempt from taxation under Code Section 115(1). Notice 2019-9 recognizes that public universities are exempt from taxation under the doctrine of implied statutory immunity,

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not under Code Section 115(1), and therefore, are not subject to Code Section 4960. Notice 2019-9 also provides that a governmental entity may relinquish its Section 501(c)(3) tax exempt status in order to avoid the Code Section 4960 excise tax.

How does the ATEO determine who is a Covered Employee for purposes of the excess Parachute Payment excise tax?

To determine which employees are Covered Employees the ATEO must determine Remuneration¹ for the calendar year ending with the taxable year (i.e. December 31) or within the taxable year of the ATEO (e.g. for 2018, December 31, 2018 for fiscal years that started between February 1, 2018 and December 1, 2018). Only highly compensated employees can be Covered Employees.

In determining who is a Covered Employee, Remuneration¹ paid for medical or veterinary services is not taken into account. Where a doctor, dentist, nurse or veterinarian provides non-medical or non-veterinary services (e.g. administrative services or classroom teaching) the ATEO needs to allocate the Remuneration paid between the medical/veterinary services and the other services provided. Notice 2019-9 clarifies that Remuneration for patient care provided during a clinical study is excluded when determining whether the employee is a Covered Employee.

What are payments in the Nature of Compensation?

Any payment that arises out of the employment relationship is a payment in the nature of compensation. Payments for covenants not to compete are included within this definition. The value of certain fringe benefits not taxable to the employee are also included in the definition. The following payments, however, are not included for purposes of determining whether a Parachute Payment has been made^[8]:

1. Contributions to and payments from any tax qualified plan, a 403(a) annuity plan, a simplified employee pension plan under Section 408(k), a Simple IRA Plan under Section 408(p), a Section 403(b) Annuity or a governmental Section 457(b) Plan; and
2. Any payments to licensed medical or veterinarian professionals to the extent the payment is for the performance of medical or veterinarian services.

What is an excess Parachute Payment?

An excess Parachute Payment is an amount equal to the excess of the Parachute Payment over three times the Base Amount. Where multiple related employers are contributing to the Parachute Payment, Notice 2019-9 provides guidance on how the excess Parachute Payment is allocated among the related employers.

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For questions about Code Section 4960 Excise Taxes contact Sharon Freilich.

[1] This term is a defined term in the statute and in Notice 2019-9. The definition is not addressed in the Q&As as it has limited impact on the determination of whether there is an excess Parachute Payment.

[2] This term is defined term in Code Section 4960 and in Notice 2019-9.

[3] This term is defined term in Code Section 4960 and in Notice 2019-9.

[4] Defined below.

[5] Code Section 4960 may also apply to any Related Organization, a defined term in Code Section 4960 and in Notice 2019-9. This article assumes that there are no Related Organizations involved in the determination of whether an excess Parachute Payment has been made.

[6] See Notice 2019-9 for guidance on how to compute the present value of payments.

[7] The computation of the Base Amount can be more complicated where partial years are involved.

[8] When the ATEO has a for-profit Related Organization that provides compensation to the employee, any payment by the Related Organization that is not deductible under Code Section 162(m) is also not considered when determining whether an excess Parachute Payment has been made.