Highlights of IRS Release of Interim Guidance on Excise Tax of Executive Compensation for Tax-Exempt Organizations

On December 31, 2018, the Internal Revenue Service (IRS) issued Notice 2019-09 (Notice), which provides interim guidance on the new excise tax applicable to certain compensation paid by tax-exempt organizations that was enacted as part of the Tax Cuts and Jobs Acts of 2017. As enacted, Internal Revenue Code (Code) Section 4960 imposes a 21% excise tax on tax-exempt organizations that pay excess amounts to certain applicable covered employees. The intent of this excise tax is to equalize the tax treatment with respect to the compensation of tax-exempt executives and for-profit executives.

The IRS guidance did address many of the statutory provisions. Certain of the larger, multiple-entity tax-exempt organizations will need to review these provisions to be certain to carefully classify employees, allocate compensation among entities, and be able to identify which employers throughout the system will be liable for the tax.

Tax-exempt organizations, including related tax-exempt and for-profit entities, have to address these new rules for the first time when filing their Form 990 for the first fiscal year that began after 2017. That could be as early as May 15, 2019.

The following is a summary of some of the key provisions of the law and the guidance:

- *Overview* — The excise tax can be imposed for taxable years beginning after December 31, 2017 on two types of compensation paid to selected employees of covered organizations:
  - Compensation paid in excess of $1 million, and
  - Parachute payments that are made contingent on an employee's separation from employment in excess of a calculated amount
  - The tax will not apply to remuneration that was paid prior to 2018, or even if was unpaid prior to 2018, was vested in 2018

- *Organizations subject to the excise tax* — In general, the excise tax applies to organizations exempt from federal income taxes, including charitable or educational organizations. Also covered are organizations that exclude income from taxation that are generally a state or political subdivision thereof, and certain political organizations. The treatment of a state university or college is specifically addressed in the Notice. Some state universities and colleges rely on the doctrine of *implied statutory immunity* to avoid federal income taxation, rather than seeking tax-exemption, these state universities and colleges are not subject to the Section 4960 excise tax. This distinction is very valuable for these organizations that have significant compensation packages in place.

- *Larger multiple-entity tax-exempt organizations* — Under the guidance, covered organizations include related organizations, including for-profit and governmental entities, generally determined using a 50% control threshold that is aligned with annual reporting requirements under Form 990.
- *Covered employee* – Under this excise tax, this person is any individual who is one of the organization's five highest-compensated common-law employees for the current taxable year, based on remuneration paid in the *calendar year* ending with or within the employer's fiscal year.
    - Each employer within a related group of tax-exempt organizations must make its own separate determination of who is a covered employee every year (even in years when the excise tax will not be triggered).

What is considered Pay (Remuneration)? — Defined as wages for purposes of federal income tax withholding, but *excluding* compensation designated as Roth contributions (*e.g.*, to a 401(k) or 403(b) plan). However, amounts required to be included in gross income under Code Section 457(f), *whether distributed to the plan participant*, are considered remuneration for purposes of the excise tax.

- Deferred remuneration is treated as having been paid for purposes of these excise tax rules when the right to the remuneration is no longer subject to a substantial risk of forfeiture (*i.e.*, when the remuneration is vested). For purposes of the excise tax, the amount of remuneration treated as paid at vesting is the present value of the vested remuneration, determined using reasonable actuarial assumptions.

What is a parachute payment under Code Section 4960? — A parachute payment is any payment *contingent* upon the employee's separation from employment. The Notice provides technical guidance for identifying parachute payments potentially subject to the excise tax. Specifically, the Notice states:

- Separation from employment refers to a covered employee's *involuntary* separation from employment, which may include termination of employment without cause, an employer's failure to renew the covered employee's contract upon its expiration, and voluntary separation of employment by the covered employee for good reason.
- Payments are contingent upon separation from employment if the separation from employment results in vesting the covered employee or accelerating the covered employee's right to payment, which includes payments that are conditioned upon restrictive covenants (such as a non-compete) or the execution of a release of claims.
- Uses the definition of separation from service under Code Section 409A and expands this definition to include certain changes in employment status, such as from an

employee to an independent contractor, even if the individual continues to provide services for the applicable tax-exempt organization.

This interim guidance is highly technical and recommendation is made to consult legal counsel when reviewing options and understanding requirements and obligations of employers.

Please share your thoughts!

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