As we have previously discussed, the 2017 tax reform act created a new excise tax under section 4960 of the Internal Revenue Code that will affect many tax-exempt employers. The tax is 21% of certain compensation and can be triggered if an employee receives more than $1 million of compensation or an employee receives certain post-termination payments ("parachute" payments). The tax can apply even if the tax-exempt employer never pays $1 million in compensation. Two key dates are fast approaching for this new tax:

- **April 2nd** is the deadline to submit comments on Notice 2019-9, which provides interim guidance under section 4960. Employers affected by the tax or its administrative complexity should consider submitting comments (we can help); and

- **May 15th** is the deadline for calendar year organizations to file excise tax returns for 2018. As with Form 990, a 6-month extension is available if Form 8868 is filed by the May 15th

With that in mind, here are five tips for tax-exempt employers:

- **Tax**
- **Labor & Employment**
- **All Federal**
1. **Identify and Track Your Covered Employees.** The excise tax affects “covered employees,” which are generally defined as the employer’s top five highest-paid employees. Although payments to employees making under $120,000 (indexed) per year are exempt from the “parachute” payment tax, there is no compensation to be on the covered employee list. So every tax-exempt employer technically has covered employees; and they must be tracked until they have received all of their compensation from the tax-exempt entity and any related organizations.

2. **Beware of Related Organizations.** IRS Notice 2019-9 requires aggregation of compensation from a wide net of “related employers” (described below). Under the initial aggregation rules, the tax can be triggered even if no compensation is actually paid by a tax-exempt entity (and even if the employee is no longer working for the tax-exempt entity), and the tax obligation is generally allocated among the payers. Consequently, related for-profit companies could owe an allocation of the tax, and tax-exempt employers that pay only a small part of the employee’s total compensation can still owe a share of the tax. Also, payments by a third-party vendor (such as a professional employer organization) are generally treated as paid by the employer.

3. **Timing is Not Intuitive.** For excise tax calculations, compensation is taken into account when it is earned. Consequently, a bonus or deferred compensation can count toward the excise tax before it is included in the employee’s income or payment is actually made.

4. **Deferred Compensation Affects the Results.** Deferred compensation balances can trigger excise taxes even if the employee’s regular compensation is far less than $1 million. As explained below, this issue comes up in two ways: (i) large unpaid deferred compensation balances can push an employee over the $1 million threshold, and (ii) vesting of large balances when employment terminates can trigger a tax on “parachute” payments.

5. **Allocation Required for Doctors and Veterinarians.** Compensation to doctors and veterinarians must be allocated between (i) compensation for medical and veterinary services and (ii) compensation for teaching, research, and administrative services. Compensation in the first category is exempt from the excise tax, but compensation in the second category must be taken into account.

Each tip is discussed in more detail below. The excise tax and IRS guidance are discussed in more detail [here](#).
separation from service, including tax-exempt benefits. For example, parachute payments include accelerated vesting of deferred compensation, severance pay, and subsidized health benefits. The tax is triggered if an individual’s parachute payments equal or exceed 3 times his or her “base amount” (generally his or her average W-2 compensation over the last five years). If triggered, the tax applies on the entire excess over the base amount—not just the excess over 3 times the base amount.

- Second, the $1 million threshold is not indexed for inflation. With inflation, many employers that currently pay less than $1 million will eventually get to the $1 million threshold.

Because covered employees from any year since 2017 continue to be covered in perpetuity, it is important to keep track of who they are. For example, an employee who is among the five highest paid in 2017 or 2018 could trigger an excise tax years down the road due to severance or deferred compensation, even if the employee ceases to be among the highest paid.

For a more extreme example, suppose a for-profit company controls the board of a related tax-exempt foundation (see Related Employers, below). Suppose that an officer of the foundation is or later becomes an executive of the for-profit company. If compensation from the for-profit company exceeds the $1 million threshold, the tax can be triggered—even if the threshold is not reached until years later.

2. **Related Employers.** Section 4960 requires aggregation of compensation from related employers. Under Notice 2019-9, “related” is generally determined based on owning more than 50% of the organization’s stock (measured by voting rights or value) or capital or profits interests (or, if the organization is a trust, beneficial interests in the trust), or controlling more than 50% of the organization’s board. Once related employers are identified, compensation from all of the related employers must be aggregated to determine whether the tax applies (and, if so, the amount), and each related employer that is tax-exempt will have to create its own list of covered employees.

For example, suppose a for-profit company controls more than 50% of the board of a tax-exempt foundation, and the company’s treasurer also serves as an officer of the foundation. If the foundation is treated as a common law employer of the treasurer (even if the for-profit company is also a common law employer), the treasurer could be a covered employee of the foundation. To make this determination, compensation paid by the for-profit company would have to be taken into account. Depending on the circumstances, the for-profit company could have to pay an excise tax even though it is not tax-exempt; and if the foundation pays (or is deemed to pay) part of the treasurer’s compensation, the foundation would have to share part of the burden. As noted above, this could occur even if the treasurer is no longer working for the foundation when he or she gets over the $1 million threshold.

A special rule for tax-exempt entities that pay less than 10% of an individual’s compensation does not appear to change the result here. The 10% rule allows a tax-exempt entity to omit from its covered employee list anyone to whom it pays less than 10% of total compensation, if another tax-exempt entity pays at least 10% of the total compensation. This rule is relevant only for constructing the tax-exempt
entity’s list of covered employees. It is not a complete shield from the excise tax: all compensation still counts for determining whether the excise tax applies, and an entity that pays less than 10% can still owe an allocation of the tax.

3. **Timing.** For purposes of the section 4960 rules, compensation is generally treated as paid when it becomes vested—even if the compensation is not paid or included in the employee’s income at that time. For example, bonuses earned in 2018 but paid in early 2019 would count toward compensation paid for 2018, even though the bonus typically would not be included in income until 2019. This result can be avoided by conditioning the bonus on remaining employed until the payment date.

4. **Deferred Compensation.** There are two ways deferred compensation accounts can trigger the excise tax, even if the employee’s ordinary compensation is far less than $1 million:

   - First, an accumulated deferred compensation balance counts toward the $1 million threshold in the year of vesting, even if payments to the employee do not reach the $1 million threshold. For example, suppose an employee who is paid $300,000 per year accumulates a deferred compensation balance of $800,000 that is conditioned on remaining employed by the organization until age 55. When the employee turns 55, the $800,000 balance would be added to the employee’s other $300,000 of compensation for the year. Consequently, the employee’s total compensation for the year would be $1.1 million, triggering an excise tax of $21,000 (21% of the $100,000 excess over the $1 million threshold).

   - Second, any part of the balance that becomes vested upon an involuntary termination can count as a parachute payment. For example, suppose an employee’s average compensation is $200,000. Suppose that, on an involuntary termination of employment, the employee becomes entitled to $100,000 of severance and a $500,000 deferred compensation account becomes vested. In this case, the $600,000 (severance plus deferred compensation) could trigger the excise tax—even though the employee’s total compensation is less than $1 million. Fortunately, Notice 2019-9 includes a special rule for valuing deferred compensation when the only vesting condition is the requirement to continue working for a specified period. Depending on the amount of time left until the vesting date, this rule can help to mitigate or avoid the excise tax from accelerated vesting. (A similar rule applies for purposes of valuing acceleration of vesting under the section 280G golden parachute rules.) But even with the special rule, vesting of deferred compensation can cause unexpected results.

5. **Doctors and Veterinarians.** Section 4960 has an exclusion for compensation paid to medical and veterinary professionals, but only to the extent the compensation is “for the performance of medical or veterinary services.” In contrast, compensation for teaching, research, and administration counts toward the $1 million cap. Hospitals and other tax-exempt entities that employ medical and veterinary professionals will need to allocate the employees’ compensation between compensation for medical/veterinary services and other compensation. Notice 2019-9 gives employers flexibility to establish a
reasonable allocation methodology.

The allocation is important for purposes of establishing the covered employee list, determining whether an excise tax is due on compensation in excess of $1 million, and determining whether any post-termination pay will trigger the excise tax on excess parachute payments.

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