The US Department of the Treasury has released long-awaited proposed regulations regarding the section 4960 excise tax on certain remuneration or separation amounts paid to the five highest paid employees of a tax-exempt organization. The new proposed regulations continue the tough approach previously taken on section 4960 excise tax issues, while also providing some new exceptions and important clarifications. Set forth below is a discussion of the most significant

**Summary:** The US Department of the Treasury released long-awaited proposed regulations regarding the section 4960 excise tax (i.e., the 21% excise tax on vested remuneration over one million dollars paid to a covered employee, and on excess parachute payments triggered by an involuntary separation from service). Prior to these proposed regulations, the Internal Revenue Service (IRS) had issued a lengthy notice (Notice 2019-09, Dec. 31, 2018) that explained the IRS position on many section 4960 issues and nuances, but which otherwise was not mandatory or official. Overall, the proposed regulations continue the tough approach taken on section 4960 excise tax issues in Notice 2019-09, but provide some new exceptions and some important clarifications.
changes and clarifications in the proposed regulations.

**Background:** Section 4960 of the Internal Revenue Code, enacted as part of the Tax Cuts and Jobs Act in late 2017, imposes a 21% tax on compensation over $1 million and on excess parachute payments paid by tax-exempt employers with respect to “covered employees” for tax years beginning after December 31, 2017. The definition of “covered employee” is key to understanding the impact of the 21% excise tax. A covered employee for this purpose is defined as an employee who is one of the five highest-compensated employees of the applicable tax-exempt organization (ATEO) in any tax year beginning after December 31, 2016. The compensation, for purposes of determining the covered employees of an ATEO, include the remuneration provided by the ATEO and by any related organization with respect to the ATEO.

**Proposed Regulations:** The most helpful part of the proposed regulations is in defining who is, or is not, a covered employee. Many organizations had expressed concern about foundations and other exempt organizations established by public companies and other significant taxable corporations, where highly paid executive employees of those companies might spend a small part of their time assisting (usually on a volunteer basis) in the management (not just governance) of the exempt organization. If such executives were considered covered employees of the ATEO (e.g., the company foundation) for purposes of section 4960, the potential section 4960 excise tax could far exceed the portion of compensation allocable to those services provided to the exempt organization. To address this situation, the regulations provide three specific exclusions to the definition of covered employee under section 4960.

- **Limited Hours Exception:** An individual is not considered one of the ATEO’s five highest-compensated employees for a taxable year if (1) the ATEO and all other related tax-exempt organizations do not pay any compensation to the individual for services performed as an employee of the ATEO, and (2) the individual performs services as an employee of the ATEO for no more than 10% of the total hours the individual worked as an employee of the ATEO and all “related organizations” (which includes the taxable organization that primarily employs the individual and that set up the ATEO) or for no more than 100 hours annually. (Prop. Treas. Reg. §53.4960-1(d)(ii).)

- **Nonexempt Funds Exception:** This exception is similar to the limited hours exception, but the services provided by the employee to the ATEO can be more substantial. Under this exception, the employee may provide up to (but still less than) 50% of the employee’s time to the ATEO as long as (1) the employee works primarily for the related nonexempt organization, and (2) the ATEO does not pay directly or indirectly for the services of such individual. (Prop. Treas. Reg. §53.4960-1(d)(iii).) While this seems very similar to the limited hours exception, an additional requirement applies: the nonexempt funds exception requires that there be no other business between the related organization that pays the employee and the ATEO served in part by that employee (or to any related ATEO or to any taxable related organization controlled by the ATEO or a related ATEO). Stated otherwise, the arrangement between the ATEO and the taxable related organization has to be a truly charitable relationship with no
nonexempt funds flowing from the ATEO to the taxable related organization for any purpose. This additional “no other business” requirement does not apply to the limited hours exception.

- **Limited Services Exception**: An individual is not considered a covered employee of an ATEO if the ATEO did not pay 10% or more of the employee’s total remuneration for services performed as an employee of the ATEO and all related organizations, and the ATEO had at least one related tax-exempt organization and one of the following conditions apply: (1) a related tax-exempt organization paid at least 10% of the total remuneration paid by the ATEO and all related organizations; or (2) no related tax-exempt organization paid at least 10% of the total remuneration paid by the ATEO and all related organizations, and the ATEO paid less remuneration to the employee than at least one related tax-exempt organization. (Prop. Treas. Reg. §53.4960-1(d)(iv).)

In addition to the above exceptions, the proposed regulations clarify that neither directors nor officers-in-name-only (i.e., an individual having the title of an officer, but who provides only minor services and does not receive and is not entitled to receive any remuneration for such services) are treated as employees of the ATEO. (Prop. Treas. Reg. §§53.4960-1(e)(2) and 53.4960-1(e)(1), respectively.)

- **Practice Tip**: For most corporate foundations, reliance on the nonexempt funds exception may be the best option. To satisfy this option, the ATEO (the company foundation) should be prepared to demonstrate satisfaction of the primary employment requirement (with the related taxable organization) through contemporaneous documentation of the hours spent by the individual performing services to the ATEO. If more than a 0.5 FTE person is needed by the ATEO to achieve its charitable purposes, consideration should be given to having two executives from the related taxable organization share the duties needed by the ATEO, so that both individuals can satisfy the “primary employment” requirement and not be treated as covered employees of the ATEO.

- **Further Practice Tip**: If a corporate foundation relies on the nonexempt funds exception, the ATEO should review all business dealings to make sure it does not have, nor will enter into, a business arrangement with the related taxable organization (providing one or more highly paid employees to help manage the ATEO) or between that taxable organization and any other entity related to the ATEO. This should involve ongoing monitoring to avoid an inadvertent business deal that could negate the nonexempt funds exception and suddenly cause covered employee status.

**Definition of Related Organization**: The definition of a related organization is critical for many purposes, including the calculation of remuneration and allocation of excise tax liability. The regulations provide certain board control tests to determine when an ATEO is considered related to another entity, including other nonstock entities. For this purpose, control does not exist if a board member of the ATEO also happens to be a lower-level employee (not a trustee, director or officer) of the potentially related entity, and if the individual is not acting as a representative of the potentially related entity that employs the individual. In other words, the fact
that individuals serve on an ATEO’s board does not cause those board members’
employers to become related organizations of the ATEO by the mere fact of the board
service, if those individuals are not acting as representatives of their employers,
and if they do not also have a control relationship (as trustee, director or officer)
with their employers. Where this occurs, it will have to be disclosed and explained
on the Form 990.

**Split-Dollar Life Insurance Arrangements**: Some exempt organizations have
entered into split-dollar life insurance arrangements as a way to reduce their
section 4960 excise tax, because such an arrangement decreases the amount of
wages subject to federal income tax withholding. The regulations provide that
imputed interest on a below-market split-dollar loan (where the insurance
arrangement is structured using the loan approach) is treated as remuneration under
these rules, even though there is no federal tax withholding on the interest.

**Year of Vesting or Year of Payment**: If a tax-exempt organization provides
compensation to an employee, and that compensation is considered vested in one
year but paid after the end of that year and before March 15 of the following year,
the compensation payment avoids treatment as deferred compensation and is taxed
in the year of actual payment under what is known as the “short-term deferral
exception” (in IRS regulations having to do with deferred compensation
arrangements). The proposed regulations provide that this exception does not apply
for purposes of determining remuneration under section 4960—remuneration occurs
at the time of vesting, even if the vested amount is paid in the first two and a half
months of the following year. For example, if a bonus payment is vested at the end of
the service year, but is paid early in the next year (and taxed in that next year), it
still will be treated under section 4960 as vested remuneration in the service year,
and not in the year of taxation and payment. The IRS saw this as a way to spread out
remuneration and avoid or decrease the excise tax, so this change eliminates what
could have been a potential planning opportunity.

**Tax on Excess Parachute Payments**: For purposes of the parallel tax on excess
parachute payments (i.e., payments in the nature of compensation triggered by the
involuntary separation from employment of a covered employee), an ATEO cannot
avoid the tax by recharacterizing separation payments as damages payments, or
payment for a noncompetition covenant, or payment for services that the IRS would
consider not to be bona fide services involving payment of no more than reasonable
compensation. The proposed regulations include provisions intended to identify
these kinds of allocations and to treat them whenever possible as separation
payments that would not have been made but for the involuntary nature of the
separation. Exempt organizations will need to be careful with their separation
agreements on this issue, if there is any risk of total payments at the time of
separation exceeding three times annual total pay.

Also for purposes of the tax on excess parachute payments, related nonexempt
organizations are not liable for any portion of the tax. Separation payments made by
related organizations are counted in determining whether there are excess
parachute payments, but the portion paid by a related organization is not subject to
the section 4960 tax (and also is not paid by the applicable tax-exempt
organization).
Reliance on IRS Proposed Regulations and Earlier Guidance: Until final regulations are issued, an organization may rely on Notice 2019-09, or on these proposed regulations, or the organization may adopt its own reasonable, good faith interpretation of the statutory rules. In a notable and unusual coda to the proposed regulations, the IRS also provides four examples of positions that the IRS expressly considers not to be a reasonable, good faith interpretation of the statute (and that are very likely to be challenged by the IRS):

- That a separate, related for-profit entity does not owe its share of the excise tax on the portion of remuneration (over one million dollars) it has paid to a covered employee
- That covered employee treatment ends at some point
- That remuneration of a physician for medical services counts for determining covered employee status (but not in calculating the excise tax)
- That a group of related organizations has only one group of five covered employees for the entire group.

It is fair to say that these positions have been thoroughly dismissed by the IRS as inconsistent with the statute.

© 2020 McDermott Will & Emery

Source URL: https://www.natlawreview.com/article/treasuryirs-release-proposed-regulations-section-4960-excise-tax