

NONPROFIT GOVERNANCE & TAX-EXEMPT ORGANIZATIONS LAW ALERT

IRS Issues Interim Guidance Regarding New Excise Tax Imposed on Tax-Exempt Organizations for Excess Remuneration Paid to Covered Employees

On December 31, 2018, the Internal Revenue Service (IRS) issued [Notice 2019-09](#) which provides interim guidance regarding a new excise tax that will be imposed on tax-exempt organizations that pay remuneration in excess of \$1 million to certain covered employees. The new tax is found in Section 4960 of the Internal Revenue Code (IRC), which was enacted as part of the Tax Cuts and Jobs Act of 2017.

Section 4960 imposes an excise tax equal to the corporate tax rate (currently 21%) on an applicable tax-exempt organization (an “ATEO”), or a related organization, that pays (1) remuneration in excess of \$1 million, or (2) any excess parachute payment, to a covered employee during a taxable year.

The new excise tax is effective for taxable years commencing after December 31, 2017. The tax does not apply to any remuneration that was paid prior to 2018, nor to remuneration that was paid in 2018 (or later) but was vested prior to 2018.

The tax is imposed on “applicable tax-exempt organizations” (ATEO’s), as well as “related organizations.” There are four categories of tax exempt organizations included in the ATEO definition: (1) organizations exempt from taxation under IRC Section 501(a), including IRC Section 501(c)(3) charitable or educational organizations; (2) farmers’ cooperative organizations described in IRC Section 521(b)(1); (3) organizations with income excluded from taxation under IRC Section 115(1), such as States or political subdivisions thereof; and (4) political organizations described in IRC Section 527(e)(1). The Notice addresses questions that were raised about governmental and quasi-governmental entities and provides clarification regarding the types of government entities that are included in the ATEO definition.

“Related organizations” include entities that control or are controlled by the ATEO, supported and supporting organizations, and if the ATEO is a voluntary employees’ beneficiary association, organizations established, maintained, or that make contributions to the association. The determination of “control” is made using a 50% control threshold, which generally aligns with the definition of related organization for purposes of the annual IRS Form 990 reporting requirements.

A “covered employee” of the ATEO is any employee who is one of the ATEO’s five highest compensated employees for the current taxable year, as well as any employee who was a covered employee of the ATEO for any preceding taxable year (beginning after December 31, 2016). Once an employee becomes a covered employee, they continue to be a covered employee for all future years. The determination is based upon remuneration paid within the calendar year ending with or within the employer’s taxable year.

“Remuneration” includes wages subject to tax withholding, as well as amounts required to be included in gross income under IRC Section 457(f), whether or not those amounts are distributed to the plan participant. Section 4960 provides that remuneration does not include designated Roth contributions under IRC Section 402A(c). The Notice makes it clear that remuneration does not include other qualified retirement benefits (such as benefits from a 403(b), 401(k) or qualified pension plan) because these payments are excluded from the definition of wages in IRC Section 3401(a). Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to remuneration.

Compensation that is paid for the performance of medical or veterinary services by a licensed medical professional is excluded from the definition of “remuneration.” The exclusion is strictly limited to remuneration for the direct performance of medical or veterinary services. Activities related to medical services, such as administrative, teaching, and research services are not included unless the medical or veterinary professional performs direct medical or veterinary care while performing those activities.

“Excess remuneration” for purposes of Section 4960 includes remuneration that exceeds \$1 million in annual remuneration. If the \$1 million annual remuneration cap is exceeded, only the compensation that exceeds \$1 million is subject to the 21% excise tax.

In addition to excess remuneration, the excise tax is also imposed on “excess parachute payments.” A parachute payment includes any compensation payment to (or for the benefit of) a covered employee if (1) the payment is contingent upon the employee’s involuntary separation from employment and (2) the aggregate present value of the contingent payment equals or exceeds three times the base amount. Section 4960 includes exceptions for certain retirement plans, certain payments to licensed medical professionals, and payments to individuals who are not highly compensated employees as defined in IRC Section 414(g).

The Treasury Department and the IRS intend to issue proposed regulations on Section 4960 that will incorporate the guidance provided in Notice 2019-09. The IRS makes clear that any future regulations or guidance will be prospective and will not apply to taxable years beginning before the date of issuance. In the meantime, the IRS is permitting taxpayers to rely on a good faith, reasonable interpretation of the statute, and the IRS affirms that the positions contained in Notice 2019-09 constitute a good faith, reasonable interpretation. The IRS will accept comments on the guidance through April 2, 2019.

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