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Practical Recommendations for Compliance with Section 4960

This Feature Article is brought to you by AHLA's Tax and Finance Practice Group.

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As many tax-exempt organizations approach the May 15 excise tax return deadline under Section 4960 of the Internal Revenue Code (the Code), we have considered and developed several practical recommendations for compliance with the Final Regulations effective for tax years commencing after 2021.[1] While tax-exempt organizations are not subject to the limitations under Code Sections 162(m) and 280G, Code Section 4960 applies similar concepts from these Code sections to certain tax-exempt organizations. However, instead of a deduction limitation, Code Section 4960 generally imposes a 21% excise tax on payments made to covered employees of: (1) remuneration in excess of $1 million for a taxable year, or (2) any excess parachute payments that are contingent on such employee's involuntary separation from employment. This excise tax has applied to applicable tax-exempt organizations (ATEOs) for tax years commencing after 2017.

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In recent years, there appears to have been increased focus from the IRS (and potentially Congress) on tax-exempt organization employees' pay packages, which given its complexity, may foreshadow Code Section 4960-related compliance issues. Thus, now is a good time for tax-exempt organizations to remind themselves of their obligations under the Final Regulations. With this in mind, this article provides (1) a summary of many key concepts under Code Section 4960, and (2) several practical recommendations for compliance with these legal requirements.

Key Concepts under Code Section 4960

As a general matter, when issued, the Final Regulations largely tracked the proposed regulations published in June 2020 (Proposed Regulations), with relatively minor modifications.[2] While there may have been some limited additional flexibility prior to 2022, compliance with the Final Regulations is no longer a new requirement, and we provide below a summary of many key concepts under Code Section 4960.

Applicable Tax-Exempt Organizations

The excise tax under Code Section 4960 generally applies to compensation paid to a covered employee either by an ATEO or a related organization. Code Section 4960 identifies four categories of ATEOs: (1) tax-exempt organizations under Code Section 501(a), (2) farmers' cooperatives under Code Section 521(b)(1), (3) entities with excludable income under Code Section 115(1), and (4) political organizations under Code Section 527(e)(1). Furthermore, a person or governmental entity is treated as "related" to an ATEO if it: (1) controls, or is controlled by, the ATEO, (2) is controlled by one or more persons that control the ATEO, (3) is a supported or supporting organization (as defined in Code Sections 509(f)(3) and (a)(3), respectively) of the ATEO during the taxable year, or (4) establishes, maintains, or contributes to an ATEO that is a voluntary employees' beneficiary association (VEBA). For these purposes, an organization "controls" another organization when it possesses 50% or greater ownership of stock (for a corporation, by vote or value), profits or capital interests (for a partnership), or beneficial interests (for a trust). If the organization does not have owners or persons with beneficial interests, "control" by another person or entity means that more than 50% of the directors or trustees of the organization are either representatives of, or directly or indirectly controlled by, the other person or entity. These rules generally align with the definition of control used in the Form 990 instructions, so this is hopefully a familiar concept to tax-exempt organizations.

Under the Final Regulations, governmental entities (such as public universities) with an IRS determination letter recognizing their tax-exempt status under Code Section 501(a), are ATEOs. Additionally, a governmental entity that excludes all or part of its income from taxation under Code Section 115(1) is an ATEO regardless of whether it has an IRS letter to that effect. Furthermore, even if a governmental entity does not meet the ATEO definition above, it may still be liable for the excise tax under Code Section 4960 if the governmental

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entity is a related organization with respect to an ATEO. However, there remains an issue of whether federal instrumentalities should be treated as ATEOs subject to Code Section 4960. Technically, until clarified by Congress, a federal instrumentality for which an enabling act provides for exemption from all current and future federal taxes is not subject to Code Section 4960 (as an ATEO or related organization).

Covered Employees

Under Code Section 4960, a "covered employee" is any individual who is one of the five highest-compensated employees (including former employees) of the ATEO for a taxable year, or any individual who was a covered employee in any preceding taxable year beginning after December 31, 2016. Because there is not a minimum dollar threshold for an employee to be treated as a covered employee, an employee of an ATEO may be designated as a covered employee even if he or she does not receive excess remuneration or an excess parachute payment. Importantly, each and every ATEO has its own set of covered employees, and once an employee is a "covered employee" of a particular organization, he or she will always remain a covered employee of that organization.

However, there are a couple significant exceptions to the "covered employee" definition for certain individuals who provide limited services to an ATEO and a related taxable entity, including (1) the "limited hours" exception and (2) the "nonexempt funds" exception. Under the "limited hours" exception, an individual is disregarded for purposes of determining an ATEO's covered employees for a taxable year if: (1) the ATEO (or any related ATEO) does not pay remuneration or grant a legally binding right to non-vested remuneration to the individual for services the individual performed as an employee of the ATEO during the applicable year and (2) such individual performed services as an employee of an ATEO (and all related ATEOs) for no more than 10% of the total hours the individual worked as an employee of the ATEO (or total days with at least one hour worked for an ATEO) and all related organizations during the applicable year. This hours requirement can be fulfilled through a safe harbor if the individual performed no more than 100 hours of service as an employee of the ATEO (and all related ATEOs) during the applicable year.

Under the "nonexempt funds" exception, an individual is disregarded for purposes of determining an ATEO's covered employees for a taxable year if: (1) the ATEO, any related ATEO, or any controlled taxable related organization does not pay remuneration or grant a legally binding right to non-vested remuneration to the individual for services performed as an employee of the ATEO during the applicable year and the preceding applicable year, (2) such individual performed services as an employee of the ATEO (and all related ATEOs) for not more than 50% of the total hours worked as an employee of the ATEO (or total days with at least one hour worked for an ATEO) and any related organizations during the applicable year and the preceding applicable year, and (3) no related organization that paid any remuneration or granted a legally binding right to non-vested remuneration to such individual during the applicable year and the preceding applicable year provided services

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for a fee to the ATEO, any related ATEO, or any controlled taxable related organization during such period. However, for purposes of this exception, whether a taxable entity is treated as "controlled" is determined by disregarding the application of certain downward attribution rules under Code Section 318(a)(3).

Remuneration Exceeding $1 Million

An ATEO's five highest-compensated employees is determined by reference to the total remuneration paid from an ATEO and related organizations during the taxable year, for services performed as an employee of the ATEO or related organization. Code Section 4960 defines remuneration to include wages (as defined in Code Section 3401(a)), but excludes designated Roth contributions (as defined in Code Section 402A(c)). Contributions to, and distributions from, most tax-favored retirement plans are also excluded from the remuneration definition under Code Section 4960.

Further, remuneration does not include amounts that vested based on the standard in Code section 457(f), as described below, prior to the first day of an ATEO's taxable year beginning after 2017, which is often viewed as a type of grandfathering provision. However, earnings on those vested amounts, which continue to accrue and remain vested after the effective date, are treated as Code Section 4960 remuneration. Remuneration also does not include the portion of any compensation paid to a licensed medical or veterinary professional (Medical Professional) that is for the performance of medical or veterinary services (collectively, Medical Services), for which the employer may make a reasonable, good faith allocation between compensation for Medical Services and other administrative services. Under the Final Regulations, these same allocation principles may also be applied to contributions and earnings under a deferred compensation plan.

When remuneration exceeds $1 million for a taxable year, each ATEO and related organization is liable for the 21% excise tax on excess remuneration, in proportion to the amount of remuneration it paid to the covered employee (based on the ratio paid by the employer to the remuneration paid by all of the employers). Remuneration is considered paid, and will be included in the calculation of whether it exceeds $1 million, when the amount is no longer subject to a substantial risk of forfeiture under Code Section 457(f). In general, an amount remains subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the future performance of substantial services or the occurrence of a condition related to the purpose of the compensation where the possibility of forfeiture is substantial.

Code Section 4960 excludes from remuneration (for purposes of determining whether remuneration has been paid) those amounts for which a deduction is disallowed under Code Section 162(m), and the coordination of these Code Sections was still being considered at the time the Final Regulations were published. Until a resolution is reached, a taxpayer may use a reasonable, good faith approach with respect to such coordination.

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Excess Parachute Payments

Under Code Section 4960, an "excess parachute payment" is an amount equal to the excess of any "parachute payment" over the portion of the "base amount" allocated to such payment. A parachute payment is any payment in the nature of compensation made by an ATEO or related organization to a covered employee that is contingent on the employee's involuntary separation from employment with the employer. For example, severance amounts paid due to a covered employee's involuntary separation from employment would generally be included in the calculation of parachute payments, as would the value of an amount if the covered employee's separation from employment accelerates either its vesting or payment (but payments on a covered employee's death or disability, generally would not).

A covered employee's "base amount" is the average of the individual's annual compensation over the five most recent taxable years during which the individual was an employee of the ATEO or related organization, or if not employed for such period, the portion of the five-year period during which the employee was an employee of the ATEO or related organization. If the aggregate present value of a covered employee's parachute payments equals or exceeds three times his or her base amount, then those payments result in an "excess parachute payment" for which the ATEO will owe a 21% tax on the value of those payments that exceed one times the individual's base amount.

Practical Recommendations for Tax-Exempt Organizations

As shown above, Code Section 4960 and the Final Regulations are, in a word, complicated. However, given the potential consequences of non-compliance, ATEOs should familiarize themselves with these legal requirements. To assist ATEOs in navigating and complying with these rules, we provide below several practical recommendations.

Keep Track of Overlapping Board Memberships

While the definition of "control" for purposes of determining whether an organization is related to an ATEO generally tracks the definition used for Form 990 purposes, it is worth noting that where an organization does not have owners or persons with beneficial interests, "control" by another person or entity means that more than 50% of the directors or trustees of the organization are either representatives of, or directly or indirectly controlled by, the other person or entity. Therefore, it is important to track whether multiple board members could hold several, overlapping directorships, as inadvertent "related" relationships under Code Section 4960 could be created simply by a majority of board members for one organization also serving on the board of another, otherwise unrelated, organization.

Must Keep a List of Covered Employees from 2018 Forward

One thing that tax-exempt organizations should always keep in mind is that an individual who becomes a covered employee of an ATEO in any tax year remains a covered employee

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of that ATEO for all subsequent years, even after his or her employment has ended. It is therefore vitally important for employers to keep track of their covered employees and their related remuneration. For example, a covered employee of an ATEO who stops providing services to the ATEO, but continues providing services to a related organization, could continue to have compensation that is paid by the related organization subject to the Section 4960 excise taxes. Given this possibility, tax-exempt organizations may want to institute robust tracking procedures for all individuals who become covered employees, which should likely continue even after those covered employees terminate their employment.

Counting Remuneration Upon Vesting

As the Final Regulations consider an amount as remuneration when the amount is no longer subject to a substantial risk of forfeiture, it is important to keep in mind that the vesting date is crucial to keep track of even if the remuneration is generally designed to fulfill the short-term deferral exemption under Code Sections 409A and 457(f). Under Code Section 4960, there is no short-term deferral exemption for determining when an amount is treated as remuneration. For example, annual and long-term bonus and incentive programs, which are often designed to be short-term deferrals, may need to be counted as remuneration at the end of the period instead of in the year of payment.

Additionally, it is worth keeping in mind that if an amount is not paid until after vesting, the amount included in remuneration on the vesting date is generally the present value of a future payment (instead of the full amount of the payment). Subsequent earnings on this previously vested remuneration are included in the employee's remuneration for the calendar year in which the earnings accrue. However, in order to reduce the administrative burden on employers imposed by these rules, employers may treat the entire amount of remuneration to be paid in the future as the present value on the date the remuneration vests (without having to make a present value calculation), provided that such amount is scheduled to be paid within 90 days. As a result of these rules, there are some specific design opportunities to simplify remuneration counting for many short-term deferral incentive programs.

Implement Procedures to Capture New Definition of Remuneration

As identified above, there are several items that tax-exempt organizations will want to keep track of, or potentially adopt new internal procedures in order to handle. From a practical standpoint, the definition of "remuneration" used under Code Section 4960 and the Final Regulations differs in certain respects from the definition of compensation used for Form W-2 reporting. As a result, tax-exempt organizations will need to review and update their current compensation-tracking procedures in order to separately define and stay on top of their covered employees' Code Section 4960 remuneration amounts. Essentially, ATEOs must contend with three different definitions of compensation, including (1) compensation for Form W-2, (2) compensation for Form 990, and (3) remuneration for Code Section 4960 purposes.

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As noted above, Code Section 4960 excludes from remuneration those amounts for which a deduction is disallowed under Code Section 162(m), which creates a mismatch in timing between when an amount is treated as remuneration under Code Section 4960 (i.e., when vested) and when the availability of a deduction may be restricted by Code Section 162(m) (i.e., when paid). Therefore, the determination of whether an amount would be subject to the excise tax under Code Section 4960 is potentially far in advance of when the deduction is disallowed under Code Section 162(m).

Counting Compensation – Defining the Applicable Year

Code Section 4960(a)(1) refers to remuneration paid "for the taxable year" but does not specify whether the tax year of the ATEO, the related organization, or the covered employee controls in the event their respective tax years do not align. Under the Final Regulations, remuneration is paid for a taxable year if it is paid during the "applicable year," which is the calendar year ending with or within the relevant ATEO's taxable year. This is a particularly helpful clarification in situations where an ATEO uses a tax year that does not match the calendar year (as is the case for many colleges and universities). For example, if a college's fiscal year runs from July 1, 2024 to June 30, 2025, the "applicable year" will still be the 2024 calendar year. This helps alleviate problems for ATEOs that might otherwise have had to allocate remuneration paid during a single calendar year to multiple non-calendar taxable years. This applicable year concept should also be used for determining covered employees.

Costs of Executive Pay Arrangements Could Increase

To the extent a tax-exempt organization owes excise taxes on amounts paid to their covered employees, it is important to keep in mind that this tax rate is tied to the corporate income tax rate. Currently, this excise tax rate is set at 21% (as described above), but this rate is subject to change if the corporate income tax rate is increased.

Exclusion of Certain Public Universities

Tax-exempt organizations should also be aware of exactly what category of tax-exemption their entities fall under, and how Code Section 4960 applies to them as a result. This may seem like a somewhat obvious point, but it is nonetheless worth stressing, because even different tax-exempt organizations (and their employees) who operate in the same industry may be treated differently under the Final Regulations based on seemingly technical differences. As described above, certain public universities that have an IRS determination letter recognizing their tax-exempt status under Code Section 501(a) will be treated by Code Section 4960 as ATEOs. For example, a public university with a determination letter that pays its basketball coach over $1 million in a given year would likely be subject to the excise tax for excess remuneration under Code Section 4960, but certain similar public universities that do not have such a letter (or, if applicable, surrenders its tax-exemption in order to escape ATEO status) are not subject to the same excise tax. This could have far-reaching consequences in the ability of a given university to recruit certain athletic coaches who command high compensation packages, as the same

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compensation package for the same coach could pose drastically different costs to two otherwise similar universities.

Nuances in Excess Parachute Payment Determinations

One common mitigation strategy under Code Section 280G is to exclude the value of an executive's non-compete (i.e., forbearance of services) from the calculation of parachute payments. However, it is very important to note that (unlike Code Section 280G), payments made pursuant to a non-competition arrangement are not excluded from the calculation of parachute payments under Code Section 4960. This means that the common parachute payment mitigation tool for public, for-profit corporations subject to Code Section 280G, is not available to tax-exempt organizations under Code Section 4960.

Additionally, while payments from related organizations are used to calculate the base amount and total payments in the nature of compensation that are contingent on a covered employee's involuntary separation from employment, only an excess parachute payment paid by an ATEO is subject to the excise tax on excess parachute payments. In practice, this means that any base amount and parachute payment calculations should include all remuneration from ATEOs and related organizations, but only an ATEO is liable for the excise tax on excess parachute payments made by the ATEO.

Further, given the remuneration counting rules above, there are specific design opportunities for nonqualified SERPs and other nonqualified deferred compensation plans to mitigate the amount of excise taxes owed under Code Section 4960. For example, tax-exempt organizations may want to avoid designing these plans with cliff vesting features upon a participant's involuntary termination, which has been a common design feature in years prior to Code Section 4960.

Severance Arrangements – Parachute Payment Protective Language

A tax-exempt organization may wish to examine its current (and any future) severance plans, programs, and agreements, to the extent that they could implicate excise taxes on excess parachute payments made to covered employees. While excess remuneration (for purposes of the $1 million threshold) does not include any parachute payments that constitute an "excess parachute payment," it still may be worthwhile to examine employees' employment agreements, offer letters, severance arrangements, and any other agreement which could result in large payments to an employee upon his or her involuntary separation from employment (collectively, Severance Arrangements). For example, it is common in the public, for-profit corporation realm to include special "cut-back" clauses into similar arrangements, which provide a hard cap on severance amounts and ensure these arrangements do not provide for excess parachute payments under Code Section 280G. Here, this mitigation technique could be proactively explored in future Severance Arrangements to avoid excess parachute payment liability under Code Section 4960.

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Employment Agreements – Compensation for Performance of Medical Services

Finally, as noted above, remuneration under Code Section 4960 does not include the portion of any compensation paid to a licensed Medical Professional that is for the performance of Medical Services, and for which the employer makes a reasonable, good faith allocation between compensation for Medical Services and other administrative services. Given this rule, a tax-exempt organization may wish to examine its current (and any future) employment agreements and similar arrangements for employees who receive compensation for both Medical Services and other administrative services, and consider spelling out in detail which portion of their total compensation is allocable to Medical Services. This is particularly helpful because in the absence of a reasonable allocation set forth in an agreement, Code Section 4960 requires the employer to use another reasonable allocation method. Many of the other allocation methods are time consuming and involve more cumbersome tracking processes. For example, compensation for Medical Services may be determined based on the portion of the total hours the employee worked while providing such services. This hour counting method is often less efficient and may need to use internal time reports or possibly even insurance and billing records, which likely would require significantly more resources than reasonably allocating compensation for Medical Services up front in an agreement with the Medical Professional.

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[1] 86 Fed. Reg. 6196 (Jan. 19, 2021).
[2] 85 Fed. Reg. 35746 (June 11, 2020).

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