

The Code Section 4960 Excise Tax on Excess Executive Compensation – Part I: Tax on Excess Compensation and Potential Tax Mitigation Strategies

The Tax Cuts and Jobs Act (signed into law in late 2017) added Section 4960 to the Internal Revenue Code (“Code”). Code Section 4960 imposes an excise tax (currently 21 percent) on certain excess executive compensation paid by an applicable tax-exempt organization to certain covered employees. The exempt organization, and not the employee, is responsible for paying the tax. The excise tax generally applies to excess compensation paid (or deemed paid) in tax years that begin after 2017.

This memorandum is Part I in a two-part series on the Code Section 4960 excise tax. Part I provides a general overview of the tax on excess compensation, interim guidance recently issued by the Internal Revenue Service (“IRS”), and potential strategies that applicable tax-exempt organizations may wish to consider to mitigate the potential impact of the tax. Part II will provide an overview of the Code Section 4960 excise tax on so-called “excess parachute payments” paid by an applicable tax-exempt organization.

Questions that will be addressed in Part I include the following:

- What entities will be considered applicable tax-exempt organizations?
- Which employees will be considered covered employees?
- What types of compensation are taken into account?
- When is compensation considered paid for excise tax purposes?
- Who pays the tax, and how can the tax be apportioned?
- How can applicable tax-exempt organizations mitigate exposure to the tax?

I. Statutory Terms

Internal Revenue Code Section 4960 generally imposes a tax, currently 21 percent, on so much of the remuneration paid (or deemed paid) to a covered employee by an applicable tax-exempt organization during the taxable year in excess of \$1,000,000.

An applicable tax-exempt organization (“Applicable Organization”) is defined as any organization which for the taxable year – (A) is exempt from taxation under Section 501(a) of the Code, (B) is a farmers’ cooperative organization described in Section 521(b)(1) of the Code, (C) is a state or political subdivision that has income excluded from taxation under Section 115(l) of the Code, or (D) is a political organization described in Section 527(e)(1) of the Code.

A covered employee is any employee (including any former employee) of an Applicable Organization if the employee – (A) is one of the five highest compensated employees of the organization for the taxable year, or (B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

The term remuneration is defined generally to include wages, as well amounts required to be included in gross income under Section 457(f) of the Code. Remuneration of a covered employee includes any remuneration paid by any related person or governmental entity. A related person or governmental entity is defined as a person or governmental entity:

- that controls or is controlled by an Applicable Organization;
- is controlled by one or more persons which control an Applicable Organization;

- is a supported organization as defined in Section 509(f)(3) of the Code during the taxable year with respect to an Applicable Organization;
- is a supporting organization described in Section 509(a)(3) of the Code during the taxable year with respect to an Applicable Organization; or
- in the case of an organization which is a voluntary employees' beneficiary association described in Section 501(c)(9) of the Code, establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.

There are several exceptions from the definition of remuneration, including designated Roth contributions, and any remuneration paid to a licensed medical professional, including a veterinarian, for the performance of medical or veterinary services by such a professional.

II. IRS Interim Guidance – Notice 2019-09

The IRS has yet to issue regulations regarding the Code Section 4960 tax. Until regulations are issued, an exempt organization generally will be considered in compliance with Code Section 4960, if the exempt organization applies a good faith, reasonable interpretation of the statute, including consideration of the legislative history, if appropriate. An exempt organization's adherence to the positions reflected in IRS Notice 2019-09 will constitute a good faith, reasonable interpretation of the statute. Notice 2019-09 includes answers to the following:

A. What entities are considered Applicable Organizations?

As noted above, an Applicable Organization is defined by the statute to include entities that:

- are exempt from taxation under Section 501(a) of the Code;
- are a farmers' cooperative described in Section 521(b)(1) of the Code;
- are a state or political subdivision that has income excluded from taxation under Section 115(1) of the Code; or
- are political organizations described in Section 527(e)(1) of the Code.

One question commentators posed to the IRS that was not fully addressed by the statutory definition of Applicable Organization is whether governmental organizations are subject to Code Section 4960. Notice 2019-09 provides that a governmental unit (such as a state college or university) that is not recognized as tax-exempt under Section 501(a) of the Code, and does not exclude income under Section 115(1) of the Code, is not an Applicable Organization.

Commentators also sought guidance from the IRS regarding the definition of related organization and what it means for an entity to control or be controlled by an Applicable Organization. Notice 2019-09 provides that control means (i) ownership of more than 50 percent of the interest in a stock corporation, partnership or trust, or (ii) control of more than 50 percent of the board of directors or trustees of a nonstock corporation. For most Applicable Organizations, the board control test in (ii) will be used to determine if two entities are related for purposes of the Code Section 4960 tax.

B. Which employees are considered covered employees?

The statute defines covered employee as (i) one of the five highest paid employees of the Applicable Organization for the taxable year, or (ii) anyone who was a covered employee of the Applicable Organization for any preceding taxable year beginning after December 31, 2016.

Commentators asked the IRS how an Applicable Organization should determine its five highest compensated employees. Notice 2019-09 provides that the determination of whether an employee is included in the high-five category is based on the employee's remuneration for services performed as an employee of the Applicable Organization or related organization. The remuneration used for purposes of determining the high-five employees is the remuneration paid to employees during the calendar year ending with or within the Applicable Organization's taxable year, excluding remuneration paid for medical or veterinary services.

Once an employee is considered a covered employee, he or she will always be considered a covered employee. This means that, regardless of the employee's remuneration in subsequent years (there is no dollar threshold to be a covered employee), and even if in subsequent years the employee is not a high-five employee of the Applicable Organization, that employee must continue to be considered a covered employee (even after employment ends). An issue not yet definitively determined is how high-five employees of a target entity will be treated by the acquiring entity in a merger and acquisition.

An exception applies, however, if an Applicable Organization pays less than 10 percent of an employee's total remuneration for services performed as an employee of the Applicable Organization and all related organizations. In that case, the employee will not be considered a high-five employee of that Applicable Organization.

C. What types of compensation are taken into account?

Commentators have posed various questions for the IRS regarding the types of payments that will constitute remuneration for excise tax purposes, and in what circumstances remuneration will be considered paid by an Applicable Organization for the taxable year.

Pursuant to the statute, remuneration generally includes current wages, as well as amounts that must be included in income pursuant to Section 457(f) of the Code. Notice 2019-09 clarifies that, in addition to wages and Code Section 457(f) income, remuneration also includes an amount that is a parachute payment if the parachute payment is not subject to tax as an excess parachute payment. (Parachute payments will be described in Part II.)

Remuneration must be treated as paid when there is no substantial risk that the remuneration will be forfeited. Notice 2019-09 provides that if entitlement to an amount of payment is conditioned on future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the remuneration, then there is a substantial risk of forfeiture. When the condition to perform substantial services lapses, or when the specified compensation-related condition occurs, the risk of forfeiture lapses (for Code purposes), and the compensation must be treated as paid and included in the employee's remuneration/income (even if payment is to occur in the future).

The amount of remuneration treated as paid when the risk of forfeiture lapses (i.e., upon vesting) is the present value on the vesting date of the future payments to which a covered employee has a "vested" right. Notice 2019-09 provides the methods that can be used to calculate present value, and how present value can be adjusted in certain scenarios.

One clarification provided by Notice 2019-09 is that any vested remuneration, including vested but unpaid earnings on deferred amounts, that is treated as paid before January 1, 2018, is not subject to the Code Section 4960 tax. However, any earnings on those amounts that accrue after 2017 will be treated as remuneration paid for purposes of the tax.

The statute provides that compensation paid to a covered employee shall not be counted as remuneration (or as a parachute payment) for purposes of the statute, if the compensation is for the performance of medical or veterinary services by a licensed medical professional. Furthermore, such compensation is excluded from the remuneration used to determine whether an employee is considered a covered employee. The caveat to this exception is that the compensation must be paid for actual medical or veterinarian services, and not for services of an administrative, teaching, or research nature. A licensed medical professional is not defined by the statute. However, Notice 2019-09 makes clear that the phrase "licensed medical professional" includes any individual licensed under state or local law to perform medical or veterinary services, which includes services for the diagnosis, cure, mitigation, treatment, or prevention of disease.

Roth contributions and compensation paid by an Applicable Organization to a member of its board (and not for services as an employee) also are not considered remuneration for purposes of the Code Section 4960 tax.

D. When is compensation considered paid for excise tax purposes?

The Code Section 4960 tax is imposed on remuneration in excess of \$1,000,000 paid by an Applicable Organization for the taxable year with respect to employment of any covered employee.

Notice 2019-09 clarifies that the excise tax is applied to excess remuneration that is paid (or deemed paid under the “vesting” rules summarized above) during the calendar year ending with or within the Applicable Organization’s taxable year. For example, in the case of an Applicable Organization with a July 1 to June 30 tax year, compensation paid (or deemed paid) to a covered employee during calendar year 2019 will be taken into account for the organization’s July 1, 2019 –June 30, 2020 tax year. If owed, the excise tax is reported to the Internal Revenue Service on Form 4720. The form and the tax are due on the 15th day of the 5th month after the end of the exempt organization’s taxable year, subject to an extension of time for filing the form (but not for paying the excise tax).

E. Who pays the tax and how can it be apportioned?

The Applicable Organization will be liable for any Code Section 4960 tax imposed. In the event that remuneration from more than one Applicable Organization is taken into account in determining the tax, each Applicable Organization shall be liable for such tax in an amount which bears the same ratio to the total tax determined with respect to such remuneration as the amount of remuneration paid by such Applicable Organization with respect to such employee, bears to the amount of remuneration paid by all such Applicable Organizations to such employee.

Notice 2019-09 includes the following example of this proration:

- F and G are each Applicable Organizations. G is a related organization with respect to F, and E is a covered employee of both F and G.
 - F pays E \$1.2 million of remuneration
 - G pays E \$800,000 of remuneration
 - E’s total remuneration is \$2 million (\$1 million of excess remuneration)
 - \$210,000 of excise tax will be owed (21 percent of the \$1 million excess remuneration)
- F paid 3/5 of E’s total remuneration (\$1.2 million/\$2 million); therefore, F is liable for 3/5 of the excise tax, which is \$126,000.
- G would be liable for 2/5 of the excise tax, which is \$84,000.

III. Potential Tax Mitigation Strategies on Excess Compensation

Since the addition of Section 4960 to the Code, various commentators have suggested strategies to mitigate exposure to the tax. The following are some of those strategies that Applicable Organizations may want to consider implementing in the event they are or may become subject to the tax. Of course, these mitigation strategies need to comply with the Code, and any other legal requirements that may be applicable. Therefore, before attempting to implement any mitigation strategy, an Applicable Organization should consult with its tax and benefits counsel, as well as all other appropriate/interested parties.

A. Analyze if the use of deferred compensation can reduce exposure to the tax.

The Code Section 4960 tax does not apply to payments made to or from certain tax-favored retirement plans on behalf of a covered employee. Therefore, maximizing contributions to and benefits from tax-favored retirement plans, as a component of executive compensation, may help to mitigate the tax owed. This strategy likely will require input from an actuary and the actuary’s application of advanced non-discrimination testing techniques. If the use of tax-favored retirement plans is not an effective or attractive mitigation strategy (e.g., due to contribution limits and/or non-discrimination testing constraints), an Applicable Organization may want to consider Code Section 457(f) arrangements for covered employees.

Code Section 457(f) arrangements are non-qualified deferred compensation arrangements that generally condition a covered employee’s right to future benefits on the performance of substantial future services. As noted above, when the deferred amounts are first vested under a Code Section 457(f) arrangement (e.g., when the required service condition has been satisfied), the deferred amounts must be taken into account as remuneration for Code Section 4960 purposes. Therefore, an Applicable

Organization may want to consider designing the Code Section 457(f) arrangement (or amending its current arrangement in accordance with Code Section 457(f)) such that the vesting schedule is graded or graduated. For example, providing for vesting to occur in 25 percent increments over four years, generally results in only 25 percent of the total benefit being taken into account as remuneration each year during the four-year vesting period in lieu of 100% recognition in year four. Staggering the vesting and remuneration in this manner could mitigate the Code Section 4960 tax.

B. Analyze the implementation of a split-dollar life insurance arrangement.

Under a split-dollar life insurance arrangement, the covered employee would obtain a whole life insurance policy, and the Applicable Organization would make annual loans to the covered employee in amounts needed by the employee to pay the premiums. Cash value accumulated under the policy could be a source of future retirement income to the covered employee (through withdrawals or policy loans). The death benefit payable under the policy can be used as a source of funds to repay the premium loans. Because loans are not wages, the amounts loaned to the covered employee by the Applicable Organization to pay the policy premiums would not be considered remuneration for Code Section 4960 purposes and would not be subject to the excise tax.

C. Analyze if new compensation committee policies should be adopted.

Generally, the compensation committee (or other body responsible for making compensation decisions) of Applicable Organizations should be made aware of the Code Section 4960 tax, and should monitor carefully the compensation paid to its covered employees to ensure the committee does not take any actions which may subject the Applicable Organization to the tax without appropriate preparation.

Compensation committees (or other bodies) may also want to review any fringe benefits (such as car allowances, club memberships, etc.) provided to covered employees to ensure that those benefits are being excluded from wages to the maximum extent permitted by the Code. In the event an Applicable Organization has failed to exclude an excludible fringe benefit from a covered employee's wages, it may want to consider doing so to reduce its exposure to the tax.

If you have any questions about this memorandum, please contact [Daniel J. Nugent](#), any of the [attorneys](#) in our [Employee Benefits or Executive Compensation Practice](#), or the Bond attorney with whom you are regularly in contact. Please look for Part II in a few weeks.



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