IRS Answers Many Questions on New 21% Executive Compensation Tax

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This article originally appeared in BDO USA, LLP's "Nonprofit Standard" newsletter (Spring 2019). *Copyright © 2019 BDO USA, LLP. All rights reserved.* *www.bdo.com*

On Dec. 31, 2018, the IRS released Notice 2019-09 (the Notice), providing interim guidance regarding Section 4960 of the Internal Revenue Code (the Code) that was enacted on Dec. 22, 2017, by the Tax Cuts and Jobs Act (the Act). The Notice provides the first guidance on new excise taxes that tax-exempt and governmental entities (and their related for-profit entities) may need to pay on the amount of remuneration in excess of $1 million in compensation and any excess parachute payments paid to a covered employee as early as May 15, 2019 (for calendar year entities). Affected organizations must report and pay the tax on recently updated IRS Form 4720.

The 2017 Tax Reform and Jobs Act established new Code Section 4960, effective Jan. 1, 2018, which imposes an excise tax on "excess" executive compensation paid by tax-exempt and certain governmental entities. The excise tax rate is established in Section 11 of the Code and is currently 21 percent. For-profit employers related to such entities may also need to pay their pro rata share of the tax (such as for-profit entities within a tax-exempt hospital or university's controlled group).

Employers of all sizes must track "covered employees."

Employers Pay the Tax

The excise tax is the employer's responsibility — it is not withheld from employee compensation. The 21 percent excise tax applies to employers who pay, after taking into account payments by members of its controlled group:

- More than $1 million in annual "remuneration" — wages subject to withholding, including 457(f) income but excluding Roth contributions, certain retirement plan contributions and payments, and wages for certain medical services paid to any "covered employee" (five highest compensated employees for the current or any prior year starting with 2017)
- "Excess parachute payments" — amounts over three times the employee's five-year average wages that are contingent on an involuntary termination (including a "good reason" termination or non-renewal of an employment agreement), but only if the employee makes over the IRS' qualified retirement plan limit for "highly compensated employees" during the year (currently $125,000)

Even Smaller Employers are Affected

Notice 2019-09 clarifies that even if an employer never pays anyone more than $1 million per year, it could still owe the tax on excess parachute payments. But employers who do not pay anyone over $125,000 for a year may never have a 4960 tax liability. Nevertheless, employers of all sizes must track "covered employees."

Covered Employees

Since there is no minimum dollar test to be a "covered employee," tax-exempt employers who do not have a 4960 tax liability for a year would still need to make a list of covered employees each year. Per the Notice, once someone is a covered employee, he or she is a covered employee forever under 4960, even after termination of employment. Since the definition of "covered employee" is cumulative, the list will likely include more than five individuals over time.

Note that each applicable tax-exempt employer within a controlled group must make a cumulative list of its covered employees for 2017, 2018 and all subsequent years (there isn't one list for the whole controlled group). The Notice confirms that even though 4960 took effect Jan. 1, 2018, employers need to make a covered employees list starting in 2017, because remuneration paid to those individuals in 2018 or later could trigger the 4960 tax.

Remuneration is a New Concept

Section 4960 created its own concept of "remuneration" that is different from any other way that employers calculate annual compensation. To determine 4960 tax liability, employers need to look to when amounts are vested under 457(f)'s special timing rule (not when the amounts are paid). The Notice confirms that this analysis is required even if the amount is not technically subject to 457(f). For example, certain bona fide disability plans are exempt from 457(f)'s special timing rules because they are not treated as deferred compensation. But such amounts would be counted for 4960 tax liability purposes when they are vested (not when they are paid).

The Notice confirms that for 4960 purposes, amounts provided after an involuntary separation are excluded if all of the benefits vested before the separation (since the separation affected only the timing of the payments, not the employee's right to the payments). But any new increase in value (such as earnings) that accumulate after the vesting would be treated as remuneration subject to 4960 testing. Also, if the termination of employment accelerates vesting, then the value of the acceleration is treated as remuneration for 4960 purposes.

The Notice also clarifies that certain amounts are excluded from "remuneration" entirely, such as wages paid for medical services (which are discussed in detail in the Notice) and amounts paid to independent contractors (such as director's fees). The Notice also says that certain other amounts are included in "remuneration"— such as payments conditioned on a release of claims, damages for employment agreement breaches, payments under early retirement or other "window" programs, payments for noncompete and non-disclosure or similar agreements.

Who's the Employer

This Notice makes it clear that "common law" employers of the covered employee owe the 4960 tax. Employers with related entities will need to determine which entity is the common law employer under applicable IRS tests. Employers cannot avoid liability by using payroll agents, common paymasters, professional employer organizations (PEOs), etc.

If a covered employee is also employed by another entity related to the tax-exempt entity, each employer, including taxable entities, is separately liable for its pro rata share of the 4960 tax, regardless of any arrangement between them to bear the cost of the tax liability. So the amount of 4960 tax owed could change if the related entities restructure their employment relationships.

Related Organizations

The Notice says that for 4960 purposes, an entity is "related" to an employer if it:

- controls (or is controlled by) the employer
- is controlled by one or more persons which control the employer
- is a "supported" or "supporting" organization with respect to the employer
- establishes, maintains or contributes to a voluntary employees' beneficiary association

The Notice defines what "control" means for stock corporations, partnerships, trusts and non-stock organizations. The Notice also explains how to determine the 4960 tax if the entity becomes or ceases to be related to the employer during the calendar year.

In addition, the Notice adopts (for 4960 purposes) the broad definition of "related organization" for annual Form 990 reporting. While using the Form 990 definition reduces burdens when determining 4960 liability, it is likely to cause more tax to be paid than if a more narrow definition was selected.

Governmental Employers

Despite much publicity about highly paid public university sports team coaches being subject to the tax on annual remuneration over $1 million, some schools may avoid paying the 4960 tax unless Congress enacts a technical correction. Per the Notice, governmental entities that rely on the doctrine of "implied sovereign immunity" for their tax-exempt status are not subject to 4960. The Notice also clarified that a governmental unit (including a state college or university) that received a favorable IRS determination letter confirming its 501(a) tax-exempt status may voluntarily relinquish that status (which may exempt it from 4960 tax).

How to Calculate the Excess Parachute Payment Tax

While calculating the 4960 tax on annual remuneration over $1 million may be fairly straightforward, calculating the tax on excess parachute payments is more complicated.

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The Notice sets out six steps for determining the excess parachute tax (which is separate from the $1 million tax). Remember that the tax applies to the excess over one times the base amount (not the excess over three times the base amount).

Generally, a covered employee's base amount is the average of the employee's Box 1, Form W-2 annual taxable compensation for services performed as an employee of an applicable tax-exempt organization (ATEO) (and any predecessor entity of the ATEO) or a related entity for the five years prior to the termination year.

Compensation for short taxable years generally must be annualized before determining the five-year average (but a special rule applies to covered employees who have a separation from employment during their initial year of employment). If the covered employee was not employed by the employer for the entire five-year period, use the portion of the five-year period during which the employee performed services for the employer, a predecessor entity or a related entity.

Calendar Year Tax Liability

The Notice clarifies that 4960 tax will be based on the calendar year ending with or within the employer's taxable year. For example, assume an employer's taxable year began on July 1, 2018, and ends on June 30, 2019. The employer may owe 4960 tax on remuneration paid between July 1 and Dec. 31, 2018 (remuneration paid from January 1, 2018 to June 30, 2018 would not be subject to 4960 tax, which gives an initial, first-year advantage to entities that use non-calendar year fiscal years).

To avoid penalties and interest, the employer should remit any tax owed by filing IRS Form 4720 on or before Dec. 15, 2019 (5 1/2 months after its fiscal year end). This approach aligns with employers' Form W-2 and Form 990 disclosures.

No Transition Rules

Despite what many had hoped, the IRS declined to provide any 4960 transition rules. The Notice confirms that the Act clearly mandates the Jan. 1, 2018 effective date. So employers should already be complying.

Nevertheless, the Notice may help employers review and revise existing employment, deferred compensation, severance and other agreements or design and implement new arrangements.

Employers may also want to consider whether changing existing management service arrangements among related entities may reduce 4960 liability exposure.

IRS intends to propose regulations under 4960, but until further guidance is issued, employers can apply a reasonable, good faith interpretation, which would include taking the Notice into account.

Accounting Considerations

Booking a contingent tax liability. Before reporting and paying the 4960 tax, employers may need to book a contingent tax liability if they are reasonably certain that they will incur a 4960 excise tax (for example, upon an employee's termination of employment based on existing employment agreements, deferred compensation agreements, etc.). Adjustments may need to be made ratably over the number of years between 2018 and when the tax is expected to be due. Many tax-exempt organizations may not be accustomed to booking contingent tax liabilities, so this may be uncharted territory for them.

Book/tax difference. The employer may also need to track a book/tax difference due to the timing of when the liability is accrued for financial statement purposes and when the amounts are subject to 4960 excise taxes (i.e., when the amounts are vested).

For further information, access the Notice. The Notice has a detailed frequently asked questions section and examples that clarify certain scenarios.

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