

KROKIDAS & BLUESTEIN

ATTORNEYS

CLIENT ALERT

Tax on Excess Remuneration and Parachute Payments

The new § 4960 of the Internal Revenue Code, enacted on December 22, 2017 as part of the Tax Cuts and Jobs Act, imposes an excise tax on certain compensation arrangements entered into by tax-exempt employers. The new tax applies to amounts paid by certain tax-exempt employers and related organizations to covered employees that constitute:

1. Remuneration in excess of \$1 Million; or
2. An “excess parachute payment.”

The tax on excess remuneration is relatively straightforward. Tax-exempt organizations should pay close attention, however, to the tax on excess parachute payments. The threshold triggering the tax on excess parachute payments is deceptively easy to meet, and organizations must begin tracking covered employees immediately even if they do not anticipate owing a tax in the foreseeable future.

Overview

Section 4960 of the Code (“§ 4960”) imposes an excise tax equal to the corporate rate (currently 21 percent) on: (1) the amount of remuneration in excess of \$1 Million, except for remuneration paid for medical and veterinary services, paid by an Applicable Tax-Exempt Organization (“ATEO”) and/or a related organization, to a covered employee for the taxable year; and (2) any excess parachute payments paid by an ATEO and/or a related organization to a covered employee.

On December 31, 2018, the IRS issued Notice 2019-09 (the “Notice”), providing interim guidance relative to § 4960. The Notice is intended to assist taxpayers in applying § 4960 until the Treasury Department and IRS issue proposed regulations. Taxpayers may rely on the guidance set forth in the Notice as a good faith, reasonable interpretation of § 4960 until proposed regulations are issued.

ATEOs and Related Organizations

An ATEO is any organization that:

- is exempt from federal income tax under § 501(a) of the Code;
- is a farmer's cooperative under § 521(b)(1);
- has income excluded from taxation under § 115(1); or
- is a political organization described in § 527(e)(1).

This definition includes nonprofit organizations exempt from federal income tax under § 501(c) and certain government entities.

A person or governmental entity is related to an ATEO if the person or governmental entity:
Controls or is controlled by the ATEO;

- is controlled by one or more persons who control the ATEO;
- is a supported organization with respect to the ATEO;
- is a supporting organization with respect to the ATEO; or,
- in the case of a 501(c)(9) voluntary employees' beneficiary association, establishes, maintains or makes contributions to the association.

Liability for the Excise Tax

The common-law employer, as determined generally for federal tax purposes, is liable for the excise tax. Payment to an employee from a related organization for services rendered to the employer is considered a payment from the employer for purposes of calculating remuneration. Similarly, payment from a third party payor is considered a payment from the employer.

If a covered employee is an employee of both an ATEO and a related organization, each employer is liable for its proportionate share of the excise tax. The Notice provides rules for allocation of liability for the excise tax among multiple employers.

Covered Employees

Covered employees include any employee who is one of the ATEO's five highest-compensated employees during the taxable year, or who was a covered employee of the ATEO (or any predecessor) for any preceding taxable year beginning after December 31, 2016. Once an employee is a covered employee, the employee remains a covered employee regardless of his or her compensation in any succeeding year.

Compensation for certain medical and veterinary services is not taken into account for determining covered employee status, but compensation paid by a related entity is included.

Each ATEO has its own five highest compensated employees, even if the ATEO is part of a related group.

Excess Parachute Payments

Excess parachute payments are defined to mean the excess of any “parachute payment” over the “base amount allocated to such payment.” A payment will be considered a parachute payment if two conditions are met: (1) the payment is contingent upon the employee’s involuntary separation from employment or the employee’s separation for “good cause,” although technically voluntary; and (2) the aggregate present value of the payment (whether made as a single or multiple payments) equals or exceeds three times the employee’s base amount. The base amount is defined as the employee’s average compensation for the five most recent taxable years preceding separation.

Note that once a payment meets the definition of an excess parachute payment, the tax is imposed on the excess amount over the base, which is likely to be less than the employee’s compensation in the employee’s final year of employment.

Parachute payments include plans that are commonly made available by tax-exempt employers to management and “highly-compensated employees,” such as payments from Section 457(f) deferred compensation plans. Because 457(f) plans are not subject to a limit on annual deferrals, and because excess parachute payments are determined by reference to an employee’s “base,” payments from such plans may easily trigger the tax on excess parachute payments at an amount well below the \$1 Million threshold for excess remuneration. Parachute payments also include damages for breach of contract, health insurance and other benefits payable at separation from employment.

Excess parachute payments do not include qualified retirement plans, simple retirement accounts, tax-deferred annuity plans, payments to a licensed medical or veterinary professional for certain medical or veterinarian services, or payments to an individual who is not a “highly compensated employee” as defined in the Code.

Excess Remuneration

For each covered employee, excess remuneration is the remuneration paid by an ATEO and any related organizations over \$1 Million for the taxable year. Notice 2019-09 defines the applicable taxable year as the calendar year ending with or within the employer’s fiscal year. This approach aligns with the calendar year reporting of compensation on Forms W-2 and 990.

The Notice contains significant detail as to what compensation is included or excluded from remuneration. The term “remuneration” has the same meaning as “wages” for federal income tax withholding purposes, but includes contributions to deferred compensation plans required to be included in gross income and parachute payments, but not excess parachute payments which are taxed as described above. Remuneration does not include certain retirement benefits and director’s fees, remuneration for medical or veterinary services, or designated Roth contributions.

Notice 2019-09 is a 92-page document that provides highly technical guidance. If you have any questions about the application of the new tax or how it is calculated, please do not hesitate to contact Attorneys Elka Sachs (esachs@kb-law.com) or Eric Reustle (ereustle@kb-law.com).

* In 2019, any employee who earns \$125,000 or more is considered a “highly-compensated employee.”