This article identifies the pertinent issues in section 4960 and summarizes the extent to which the Notice addresses them, while also providing specific actions that employers should take to address the immediate implications of the excise tax.

In December 2017, Congress, as part of broader tax legislation, enacted a new excise tax on annual compensation paid by all tax-exempt organizations in excess of $1 million and on excess parachute payments. On December 31, 2018, the Internal Revenue Service issued Notice 2019-09 (the “Notice”), to provide interim guidance to assist in applying section 4960, which contains the excise tax provisions.

Background

Section 4960 imposes an excise tax on tax-exempt organization executive compensation equal to 21% of: (1) remuneration (other than any excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a tax year, plus (2) any excess parachute payment paid by an applicable tax-exempt organization to a covered employee other than an employee who is not highly compensated. This provision imposes the 21% excise tax on an excess parachute payment, even if the covered employee’s total remuneration does not exceed $1 million threshold amount. The $1 million threshold is not adjusted for inflation.

Who is a covered employee?

The Notice did not expand or change the key elements regarding covered employees, despite receiving numerous requests to do so. Consequently,

- A “covered employee” means an employee (including any former employee) of an applicable tax-exempt organization if (a) the employee 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.
- Determining who is a covered employee is made each year.
- Once a person is a covered employee, they are always a covered employee – this is the case even if the employee’s remuneration does not exceed $1M in a particular year.
- Determining who is a covered employee is done organization-by-organization, even if a group of organizations considers themselves part of a larger enterprise; e.g., individual hospitals, each of which is a separate section 501(c)(3) corporation, and a parent corporation, which controls all of the hospital corporations and which also is a section 501(c)(3) corporation, must determine their covered employees separately, even if they are part of a single healthcare system.

1. All “section” references are to a section of the Internal Revenue Code of 1986, as amended.
2. 21% is the current rate for the corporate income tax. If that rate is increased in the future, the rate imposed by section 4960 would increase as well.
What is remuneration?

The Notice reinforced and expanded on what is included and not included in “remuneration.” An organization needs to identify the following when determining an employee’s remuneration:

- Remuneration includes all cash and compensation in any medium other than cash (this is the starting point for determining remuneration: the definition of “wages” as defined in section 3401(a)).
- Remuneration also includes amounts that are vested (i.e., the employee does not have to provide any future services to receive the amount), even if the vested amount is not paid until a later date.
- Remuneration also includes earnings on previously paid remuneration (i.e., amounts that were treated as remuneration in a previous year but have not been actually paid to the employee).
- Remuneration does not include payments to or from a tax-qualified pension or profit-sharing plan.
- Remuneration does not include amounts paid for medical services provided by the employee who is a licensed medical professional:
  - Services for diagnosing, curing, mitigating, treating or preventing disease, or services for the purpose of affecting any structures or function of the body (section 213(d)(1) (A)).
  - In general, teaching and research, peer review, and medical director services are not considered medical services.
  - Employee must be a licensed medical professional – physician, nurse or veterinarian are specified in the Notice.

Also, remuneration may come from more than one employer or organization, even if only one organization is treated as the common-law employer for federal tax purposes.

All remuneration paid by related organizations to a covered employee for the services rendered by that employee must be treated as remuneration. In addition, all remuneration paid to a covered employee for services rendered to an applicable tax-exempt organization (i.e., an organization subject to the excise tax provisions), must be treated as remuneration, even if one of the paying organizations is not related to the employer of the covered employee.

When is remuneration determined for purposes of identifying covered employees?

The Notice clarified the timing for determining remuneration in order to identify the covered employees: remuneration for an employee is to be the remuneration paid for the calendar year ending with or within the employer’s tax year. For example, if the employer’s tax year is June 30, then remuneration paid to employees for the calendar year that ends the previous December 31 is the remuneration that should be used to determine the covered employee group for that year (and do not forget that any employee who had been determined to be a covered employee in a prior year continues to be one for this year, regardless of their remuneration for the year being reviewed).

Which organizations are subject to the tax?

To start, the statute applies to virtually all tax-exempt organizations: the term “applicable tax-exempt organization” is broadly defined, with a few exceptions.

The Notice provides guidance that expanded on the law’s description of how organizations are related to each other for purposes of determining both remuneration to a covered employee and any shared excise tax liability:

- Makes clear governmental entities and for-profit organizations are not excluded from these determinations.
- Uses the concepts in section 512(b)(13)(D) to define how one organization “controls” another —this can be through stock ownership, partnership interests, trust interest, or board membership appointment, depending on the structure of the organization—and requires only more than 50% of ownership or board membership appointment to be considered controlled.
How is the excise tax liability addressed if more than one organization has paid remuneration to a covered employee?

The Notice provides detailed guidance on how to apportion excise tax liability among related organizations when:

- A covered employee’s remuneration is paid by two or more organizations for services provided to one organization.
- A covered employee’s remuneration is paid by two or more organizations for services provided to two or more organizations.

The Notice expands on the guidance contained in the statute, and without going into the detail of this guidance, is intended to avoid a duplication of excise tax liability when it is to be apportioned among organizations.

Excess parachute payments.

As noted above, the 21% excise tax also applies to any excess parachute payment paid to a covered employee. An excess parachute payment is an amount (1) paid to a covered employee, (2) contingent on the employee’s separation from employment, and (3) in an amount with a present value that equals or exceeds three times the employee’s “base amount.”

An employee’s base amount is in general the average of the employee’s “wages” from the employer for the five years prior to the year of separation from employment. Payments under qualified plans, or any payment under or to an annuity contact described in section 403(b) or an eligible plan described in section 457(b), are not included in the definition of excess parachute payment.

The Notice provides guidance in applying the details of how to calculate parachute payments, relying extensively on the structure (and in some cases, the wording and examples) of the regulations under sections 280G and 4999 (the “golden parachute” rules).

The Notice, however, points out that while the terminology (“parachute payments”) in section 4960 and in the Notice are similar to the golden parachute rules applicable to public companies, the definition of a parachute payment is much broader than in those rules: section 4960 and the Notice address payments that occur because of a separation from employment (and identify that the separation must be involuntary) and which do not have to be made in the context of a change in control of the organization.

In applying the detailed rules for determining whether an excess parachute payment exists, the Notice makes clear that even if payments upon a separation from employment do not result in an excess parachute payment, the amounts the covered employee receives upon a separation of employment must still be included in the calculation of whether remuneration exceeds $1 million in the year in which these payments are received.

If an excise tax is assessed, is the compensation subject to the excise tax considered unreasonable compensation?

The Notice makes clear that there is no coordination between the excise tax on compensation in section 4960 with the excise tax on unreasonable compensation imposed by section 4958 or 4941. This simply means that tax-exempt organizations must still take steps to determine the reasonableness of all cash and other compensation and benefits as they have been doing for many years: there is no presumption that simply because the section 4960 tax applies, that compensation in excess of $1 million is in any way excessive or unreasonable.

Effective date.

The provision is effective for a tax-exempt employer’s tax years beginning after December 31, 2017. Thus, for tax-exempt organizations with fiscal year-ends, the tax applies to compensation paid beginning with the first tax year beginning after December 31, 2017. For example, if an organization’s fiscal year ends September 30, these provisions are effective for the year that begins October 1, 2018, and remuneration for determining who is a covered employee would take into account remuneration for calendar year 2017 (for purposes of that “look-back” requirement) and calendar year 2018.
Steps a Board of Directors of a tax-exempt organization should take

Identify the employer/identify applicable tax-exempt organizations.

— Identify all of the separate organizations that are considered to be part of a larger enterprise (e.g., all organizations that are separate corporations or entities and considered to be part of the ABC Health Care System).

— Identify the common law employer of employees that provide services in the larger enterprise (NOTE that there may be more than one common law employer).

— Identify which of these organizations is an applicable tax-exempt organization under section 4960.

Confirm for each employee.

— Remuneration for the 2017 calendar year.

— Remuneration for the 2018 calendar year.

— Identify whether any of the employees is paid by more than their common law employer, and if so, by which organizations and the amount paid by each one.

Identify each organization’s five highest-compensated employees for 2018 and for 2017.

— Include all remuneration paid by related organizations to a covered employee for the services rendered by that employee.

— Include all remuneration paid for services rendered to an applicable tax-exempt organization (i.e., an organization subject to the excise tax provisions), even if one of the paying organizations is not related to the employer of the covered employee.

Calculate the excise tax liability.

— Apply the proportionality rules if a covered employee is paid remuneration for services from two or more related organizations.

Identify any severance amounts paid in 2017 or 2018.

— Apply the parachute payment rules to determine whether an excess parachute payment was made, unless the amount that is paid is within one of the exceptions to the definition of a parachute payment (such as retirement plan benefits).

— Calculate excise tax liability if any excess parachute payments were made.

— Include any parachute payments in remuneration for any employee when determining whether remuneration exceeded $1 million in 2017 or 2018: exclude any excess parachute payment from this step (i.e., no double-counting of severance amounts subject to the excise tax).

Planning for 2019 and beyond.

— Consider consolidating all highly compensated employees into one employer such as the parent corporation or a management company. This would simplify the reporting of compensation and help improve board oversight of the executive compensation program. (The implications to Medicare reimbursement and other issues must be taken into account when considering this approach for tax-exempt hospitals.)

— Confirm that the current governance process for overseeing executive compensation is consistent with and adequately addresses the new requirements under 4960.

— Is the appropriate “authorized body” from the governing board—typically the compensation committee and articulated through a board-adopted “compensation committee charter”—overseeing all of the appropriate executive compensation arrangements and coordinating with the tax function within the organization?

— Is the compensation philosophy up to date? Should it reflect how the organization will address the implications of section 4960?

Steps to take now

• Identify
• Confirm
• Calculate
• And plan
— Is the appropriate market data used for context when making compensation decisions being developed and provided to the authorized body? This should include not only cash compensation data but data on severance and change-in-control arrangements, relocation practices, and employer-provided housing.

— Adopt the practice of annually reviewing “tally sheets” for all executives, which quantify all elements of compensation, identify those elements included in the definition of “wages,” and include an estimate of the potential excise tax liability resulting from the compensation (both for the current year and in any future year in which a material increase in compensation is anticipated to occur, e.g., when a section 457(f) arrangement vests and is paid). A tally sheet would include all supplemental executive retirement arrangements (regardless of how the benefit is delivered) and all severance terms that would apply to the employee - either via an employment agreement or severance policy.

— Maintain information on all compensation near or above the $1 million level. This includes physician compensation and all compensation of individuals in related entities.

### Conclusion

The excise tax on compensation in excess of $1 million represents both a challenge as well as an opportunity for tax-exempt organizations. It is a challenge because it will add to the compensation expense of the organization and even if it is not applicable today, it may become applicable in the future because the $1 million-dollar threshold is not indexed to inflation. In addition, for larger organizations the number of covered employees will likely increase to more than five over time.

It is an opportunity in the sense that it should prompt all tax-exempt organizations to explore compensation strategies—such as split dollar arrangements—as alternatives to traditional arrangements such as ineligible section 457(f) deferred compensation plans.

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