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Tax-Exempt Alert: Interim Guidance on Excess Executive Compensation

By Tony Dasilva, Managing Director, Total Compensation Practice

On New Year's Eve, the IRS and Treasury Department released much-sought-after excise tax guidance (Notice 2019-09) for executive compensation of tax-exempt organizations (the "Guidance").

The Guidance addresses various elements of the excise tax, which applies to (i) compensation to a covered employee in excess of \$1 million, and (ii) excess parachute payments. The Guidance is lengthy, complex and contains numerous examples throughout to help explain its provisions.

As expected, the IRS confirmed there is no grandfathering for deferred compensation plan 457(f) benefits that were unvested and untaxed as of December 31, 2017.

Background

The Tax Cuts and Jobs Act made significant changes to tax rules that apply to highly compensated employees of tax-exempt organizations. Among these changes are restrictions (in the form of excise taxes) on compensation of certain highly-paid employees.

For tax years beginning after December 31, 2017, new Code Section 4960 imposes a 21 percent excise tax on Applicable Tax-Exempt Organizations (ATEOs) for:

- Any remuneration (other than an excess parachute payment) in excess of \$1 million paid to a covered employee by an ATEO for a taxable year (Excess Remuneration)
- Any Excess Parachute Payment paid by an ATEO to a covered employee

In general, ATEOs include 501(c) organization, political organizations, farmers' cooperatives as well as federal, state, and local governmental entities with income that is exempt from tax under specific code sections. A covered employee is an employee (or former employee) that is one of the five highest-compensated employees for any taxable year beginning after December 31, 2016. Both Excess Remuneration and Excess Parachute Payments are explored in more detail later in this paper.

Key elements of the Guidance: Generally

- The Guidance is “interim” guidance and the IRS has requested additional comments and intends to issue proposed regulations in the future.
- Until future guidance is issued, taxpayers can rely on the Guidance, and future guidance will apply only to prospective tax years.
- Taxpayers can make reasonable and good faith interpretations of the Section 4960 excise tax rules based on the relevant facts and circumstances unless the Guidance expressly states a position is not reasonable or in good faith.
- Common-law employers are liable for the excise tax. Only an ATEO has covered employees, but a covered employee may also be an employee of a related organization. An ATEO can’t avoid liability by having a third party payor arrangement.
- Governmental entities that received determination letters recognizing tax-exempt status under Section 501(c)(3) may relinquish that status.
- Related organizations to ATEOs are those that: (i) control or are controlled by the ATEO; (ii) are controlled by a person that controls the ATEO; or (iii) are a supported or supporting organization with respect to the ATEO. In general, control means a greater than 50 percent ownership or governance oversight.
- When determining ATEO’s five highest-compensated employees, compensation includes remuneration paid for the taxable year by any related organization, including for-profit organizations or governmental entities, for services performed as an employee of such related organization. The five highest-compensated employees are determined separately for each ATEO and are not subject to any minimum dollar thresholds. Remuneration strictly for medical services is not taken into account.

Guidance on Excess Remuneration

- Excess remuneration for each covered employee is the excess for a taxable year of the remuneration that is paid (other than any excess parachute payment) by an ATEO, including remuneration paid by a related organization, over \$1 million for the taxable year.
- “Remuneration” has the same meaning as “wages” under IRC § 3401(a) but excludes Roth contributions and includes deferred compensation required to be included in gross income under Section 457(f). Remuneration does not include the portion of any remuneration paid to a licensed medical professional that is directly related to the performance of the medical services by the professional, or to other amounts exempted from wages (e.g., qualified plan benefits or tax-sheltered annuities).

- Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to the remuneration. Vested remuneration, including vested but unpaid earnings on deferred amounts, treated as paid before January 1, 2018, is not subject to the excise tax under 4960, but subsequent earnings are treated as remuneration.
- If an ATEO and related organization both pay remuneration as separate employers, they share the excise tax proportionately.
- Compensation directly related to the performance of medical or veterinary services to a licensed medical professional is not taken into account for purposes of determining a covered employee. When compensated for both medical services and other services, the employer must allocate remuneration between the two using a reasonable, good faith method.

Guidance on Excess Parachute Payments

- Parachute payment means a payment in the nature of compensation to a covered employee if such payment is contingent on the employee's separation from employment and exceeds three times the base amount (see below). Retirement plans, certain payments to licensed medical professionals and payments to non-highly compensated employees, and 457(b) payments are not included.
- The amount of the excess parachute payment equals the excess of any parachute payment over the portion of the base amount allocated to such payment. The base amount is average of includable compensation for the five-year period (or period of service if shorter) ending before the separation from service.
- Payment is contingent on a separation from employment if the payment would not have been made in the absence of an involuntary separation, or if the payment vests as a result of an involuntary separation. Conditions such as executions of releases or noncompete provisions do not remove "contingent on separation" treatment.
- Payments that vest for other reasons (e.g., meeting a years of service threshold) that are later paid on separation are not contingent and not included, such as under many post-retirement medical plan designs. An anti-abuse provision provides that if facts and circumstances show vesting or payment would not have occurred without involuntary separation, payment may be contingent on separation (e.g., employer exercising discretion to accelerate vesting of an amount shortly before an involuntary separation).
- The rules under Code Section 409A (i.e., deferred compensation plans) relating to a separation from service generally apply, but: (i) a bona fide change from employee to independent contractor is a separation, and (ii) decreasing service levels below 20

percent is considered separation and between 20-50 percent is based on facts and circumstances.

- If a payment is accelerated or a substantial risk of forfeiture lapses as a result of an involuntary separation, a formulaic calculation is required to determine the value that must be treated as a payment contingent on separation. For contingent health care benefits, the value may be determined by projecting the cost of premiums for health care insurance, or actual premiums if applicable.

Miscellaneous

- Excise tax is reported on Form 4720 by each ATEO or related organization subject to the tax.
- Excise tax must be paid and reported by filing Form 4720 by the 15th day of the fifth month after the end of the employer's taxable year. Automatic extensions allowed by filing Form 8868.
- There is no requirement to pay estimated taxes.
- There is no particular relationship between 4960 excise taxes and intermediate sanctions.
- Section 4960 applies to taxable years beginning after December 31, 2017.
- List of tax positions that are not consistent with a good faith, reasonable interpretation of the statute:
 - For-profit or governmental entities that are related organizations to an ATEO are not liable for its share of the excise tax.
 - A covered employee ceases to be a covered employee after a certain period of time.
 - Remuneration directly for medical services is taken into account for purposes of identifying the five-highest compensated employees.
 - A group of related organizations with more than one ATEO has a single set of five highest-compensated employees.

What Should You Do Now?

Given the potential financial costs, risks and governance implications, ATEOs need to take action and evaluate whether any covered employee will receive or may excess remuneration or excess parachute payments.

The unique compensatory programs, philosophy and arrangements of each ATEO should heavily influence the depth and scope of the evaluation and action plan. As a starting point,



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however, we suggest a structured, fact-based approach that answers the following questions:

- Are you an ATEO or a related organization?
- Is your ATEO related to another organization?
- Who are your covered employees and who are the covered employees of related organizations?
- Applying the definition of remuneration in the Notice, do you have or may have in the future excess remuneration?
- After gaining a detailed understanding of the actual or potential entitlements and rights of covered employees, do you have or might you have in the future excess parachute payments?
- Are you ready to report to the Board or Compensation Committee the potential impact of the new excise taxes and have you prepared articulated recommendations for consideration?

In closing and in light of the potential adverse consequences, organizations should carefully and proactively evaluate the impact of these new rules.

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