

PUBLICATION

Section 4960 Excise Tax Relating to Employees of Tax-Exempt Organization

Authors: William E. Robinson

March 20, 2019

In simplified terms, Section 4960 of the Internal Revenue Code now includes a new excise tax (currently at a 21 percent rate) on wages in excess of \$1 million in a year paid or treated as paid to a "covered employee." A separate excise tax (also currently at 21 percent) applies to amounts paid solely because of an involuntary separation from service. This excise tax is assessed against amounts in excess of one time the person's average yearly pay over a five-year period (base amount), if the total such payment exceeds three times the base amount.

Based on guidance in IRS Notice 2019-09, the excise tax can only apply to pay to a "covered employee." A covered employee is any person who is one of the top five paid common law employees of an "applicable tax-exempt organization" (ATEO) for a year. Importantly, because pay from the ATEO and all "related organizations" is counted, it is possible to be a covered employee even if the employee of the ATEO receives little or no pay from the ATEO. This could occur if the covered employee is a highly compensated employee of a related organization and also an employee of the ATEO.

Once the person is a covered employee, they remain a covered employee forever, even if they are no longer employed by the ATEO or by a related organization. Thus, e.g., the related organization may still owe an excise tax for each year because each entity which pays part of an excess is liable for its part of the excise tax based on the portion of an excess which it pays.

A related organization is generally one which controls or is controlled by the ATEO, and need not be tax-exempt. For example, if a taxable entity (whether public or private) or its owner controls more than 50 percent of the directors of a tax-exempt foundation, and the CFO of the taxable entity serves as an unpaid employee (perhaps an officer) of the ATEO and is or was a covered employee for any year, the excise tax could still apply based solely on pay to the CFO from the taxable entity. Covered employees began to be identified in 2017, so the CFO in this example would remain forever as a covered employee.

The includable pay under § 4960 generally includes all "wages" paid to a covered employee by or on behalf of the ATEO or a related organization. It is not necessary that any of the wages are from the ATEO. Compensation for professional medical or veterinary services, including nurses, is excluded. Thus, highly paid physicians may have no § 4960 pay if all of their pay is for medical rather than administrative services, but all wages for a highly compensated administrative officer of a tax-exempt hospital could trigger the tax.

For § 4960 purposes, the present value of compensation is included at present value when it vests. Thus, e.g., accumulated deferred compensation from a taxable related organization will all be counted at present value in the year in which it vests, even if not includable in income for decades.

ATEOs and related organizations will need to make yearly determinations of covered employee status and keep those records indefinitely. A taxable entity or its owner which controls an ATEO should be careful about whom to appoint as an employee of a related ATEO, even as an unpaid employee. Of course these rules should be taken into account in structuring deferred compensation, severance agreements, and other compensation arrangements.

At this point, IRS Notice 2019-09 was issued as interim guidance, but the IRS "intend(s) to issue proposed regulations...that will incorporate the guidance provided in this notice." The IRS is currently accepting comments on the content of the Notice.

If you have questions about the content of this alert, please contact [Bill Robinson](#) or any member of Baker Donelson's [Tax Group](#).