

Tax-exempt organizations: taxes on remuneration exceeding \$1 million and excess parachute payments

When Congress enacted the Tax Cuts and Jobs Act of 2017, it swept some tax-exempt organizations into the world of penalties on “excess” compensation and parachute payments for the first time. Previously, tax-exempt organizations were not subject to tax-related limitations on the amount they could pay to key executives. With the advent of Internal Code Section 4960 (IRC Section 4960), new rules started applying after 2017.

The IRS has now issued IRC Section 4960 final regulations. The regulations maintain most of the provisions of the proposed regulations with some minor clarifications. The regulations became effective January 15th, 2021, but will apply for tax years that start after 2021. For now, taxpayers may rely on IRS Interim Guidance Under Section 4960 Notice 2019-09, the Proposed Regulations, or the Final Regulations, but they must apply the rules in their entirety. The IRS will allow for a reasonable and good faith interpretation of the statute.

The rules impose a 21% excise tax on tax-exempt, nonprofit, and related organizations under two circumstances:

1. Compensation in excess of \$1 million is paid to any “covered employee,” or
2. “Excess parachute payments” (see below) exceeding a specified level are paid to a covered employee who is also highly compensated.¹

The IRS issued guidance in early 2019² explaining the scope of this tax and the organizations affected by it. The guidance clarified the following:

- A *covered employee* is any employee (including any former employee) who is one of the five highest compensated employees of the organization in the current year or was a covered employee in a previous year beginning after 2016.³ This essentially means “once a covered employee, always a covered employee.” There is no minimum compensation level for being a covered employee, but the penalties under IRC Section 4960 apply only to covered employees with compensation exceeding \$1 million, or parachute payments exceeding certain defined levels. (Note that remuneration for medical services or veterinary services by licensed professionals is disregarded in determining who is a covered employee.⁴)
- A “parachute payment” is any amount that (a) is paid to a covered employee who is a highly compensated employee, (b) is “contingent on the employee’s separation from employment,” and (c) equals or exceeds three times the “base amount.”⁵
 - “Highly compensated employee” is determined under the qualified plan rules of IRC Section 414(q),⁶ which means that the determination is made every year. If the organization has no highly compensated employees in a particular year, there can be no “excess parachute payments.”⁷
 - A payment is “contingent on the employee’s separation from employment” if “the facts and circumstances indicate that the employer would not make the payment in the absence of an *involuntary* separation from employment.”⁸ In other words, the fact that the payment occurs concurrently with termination from employment does not make it “contingent”; “contingent on separation from employment” means that they must terminate employment in order to obtain the payment, and that the termination is involuntary.

- The “base amount” means the covered employee’s annualized includible compensation for the five most recent taxable years.⁹
- “Parachute payments” do not include payments from qualified plans, IRC Section 457(b) plans or IRC Section 403(b) annuities, payments that are for the performance of medical or veterinary services by a licensed professional, or payments to individuals who are not highly compensated employees as defined for the qualified plan rules.¹⁰
- An “excess parachute payment” means the amount by which the parachute payment exceeds the *base amount*.¹¹
 - Comment: one might expect that the “excess” would be the amount over three times the base amount, but that is not the case. The “three times” limit sets the threshold for reaching the status of “parachute payment” but once that threshold is reached, anything over the base amount is an “excess parachute payment.”
 - If the vesting of a benefit is accelerated because of an involuntary separation from employment, but the benefit would have been made without an involuntary separation from service, it is not an excess parachute payment except to the extent that the accelerated benefit has an increased present value. In other words, only the value that is due to the acceleration is treated as “contingent” on a separation from employment.¹²
- The excess parachute payment tax applies only if the parachute payment amounts paid are equal to or greater than three times the base amount, but the actual amount subject to the tax is the parachute payment amount in excess of the base amount. If the payment does not reach level of three times the base amount, the distribution is simply added to other compensation and considered for purposes of the \$1 million compensation limitation.

Conclusions

Tax exempt organizations who have no current or former employees earning \$1 million or more will not trigger the penalty for excess compensation, but under certain circumstances, a severance package for a terminated highly compensated executive could trigger the penalty under the “excess parachute payments” provisions. Organizations will want to take these limitations into account when planning their compensation packages.

IRC Section 457(f) plans that have date-specific vesting will not be considered “contingent on separation from employment” and, thus, would not trigger the penalty for excess parachute payments. Instead, they would be subjected only to the \$1 million compensation limit.

Generally, the IRC 457(f) plans are vest and pay, so they would not be considered contingent on separation from employment, unless vesting is accelerated as a result of an involuntary separation. If this were the case, the penalty would apply only to the excess, if any, of the present value of the accelerated benefit over the present value absent the acceleration.

Remuneration and parachute payments may include other types of compensation beyond distributions from nonqualified deferred compensation plans. This suggests that tax-exempt organizations should examine their compensation packages for their executives to see if they may be at risk for penalty taxes. Also, compensation from related companies (that might not be tax-exempt) would need to be considered since it may affect the calculations.

¹ See IRC Sec. 4960(a).

² See Notice 2019-9, 2019-4 IRB 403.

³ IRC Sec. 4960(c)(2); Notice 2019-9, A-10.

⁴ IRC Sec. 4960(c)(3)(B).

⁵ IRC Sec. 4960(c)(5)(B), 4960(c)(5)(C)(iv); Notice 2019-9, A-17(a).

⁶ IRC Sec. 4960(c)(5)(C)(iv); Notice 2019-9, A-17(b)(4). The indexed threshold amount for highly compensated employees in 2019 is \$125,000.

⁷ Notice 2019-9, Sec. I(A).

⁸ Notice 2019-9, A-20(a) (emphasis added).

⁹ IRC Secs. 4960(c)(5)(D), 280G(b)(3); Notice 2019-9, Sec. I(G).

¹⁰ IRC Sec. 4960(c)(5)(C); Notice 2019-9, A-17(b).

¹¹ IRC Secs. 4960(c)(5)(A), 4960(c)(5)(D); Notice 2019-9, A-16; A-17(a)(2)

¹² Notice 2019-9, A-20(a); A-24(b).



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