February 2019

TCJA Alert: Unexpected Effect of § 4960 Excise Tax

New Code § 4960 imposes a 21% tax on excess compensation (over $1,000,000) paid to the current and former top-5 paid employees of tax-exempt organizations. Congress was targeting high-paid executives at non-profit organizations, such as university executives and football coaches (although due to a technical glitch it may not actually reach many of them).

Under initial IRS guidance, however, the additional tax could ensnare corporations (public and private) and plan sponsors. This is because the IRS interprets the tax to apply to all entities "related to" tax-exempt entities and § 4960 counts compensation from those related taxable entities toward whether an employee is a top-5 paid employee of the tax-exempt entity and has excess compensation. Because the tax is apportioned among the related entities, taxable companies may be subject to unexpected additional tax if they have:

- **Private Foundations**
- **Voluntary Employee Benefit Associations (VEBAs)**
- **Political Action Committees (PACs)**
- **Pension Trusts**

The tax could apply if a company employee is – or ever has been – an employee of the foundation, VEBA, trust, or other tax-exempt entity and earns more than $1,000,000 in year (even if $0 of it is paid by the tax-exempt entity). Complicating this issue:

- It is common for company employees to serve as officers or otherwise work for private foundations, VEBAs, or PACs. In some cases, these individuals may be employees of the tax-exempt entity (and listed on the Form 990 as such).
- The § 4960 tax applies only to top-5 paid employees. But an employee could be top-5 paid even without receiving any compensation from the tax-exempt entity.
- Once an individual is a top-5 paid employee of the tax-exempt entity, he or she retains covered employee status forever. This means that a company could have exposure to § 4960 tax if it staffs a private foundation with a lower-paid employee who eventually gets promoted at the company and begins to earn more than $1,000,000 (even if that employee subsequently stops serving at the private foundation).
- Compensation under § 4960 is a unique definition that deviates from W-2 pay. For example, it includes newly vested deferrals under a Section 409A plan.
- The tax does not apply to amounts already subject to disallowance due to § 162(m). But the § 162(m) disallowance differs in scope: it applies only to public companies and a specific subset of their executives, and it uses a different measure of compensation.

Contact us. If you have questions or would like to participate in an Ivins comment letter to the IRS on this or other § 4960 issues, we would be happy to hear from you. Please contact any member of the Ivins Compensation & Benefits or Exempt Organizations practices.

TCJA Alert:
Unexpected Effect of § 4960 Excise Tax

Examples

Example 1. AB Corporation establishes DE Foundation as a private foundation. Employees of ABC serve as officers of DEF and members of its Board of Directors.

1.A. The Chief Operating Officer of ABC serves without pay as President of DEF. ABC pays the COO $1,500,000 salary and $1,000,000 bonus.

> *Assuming the officer status results in the COO being considered an employee of DE Foundation, then the pay from ABC counts for purposes of determining whether the COO is a top-five employee of DEF and whether the COO's pay exceeds the $1,000,000 threshold.* ***ABC may be subject to a 21% tax on $1,500,000 (the pay exceeding the $1,000,000 threshold), for a tax of $315,000.***

1.B. The General Counsel of ABC serves without pay as Vice President of DEF. ABC pays the General Counsel $500,000 salary and $250,000 bonus and contributes $500,000 to a fully vested deferred compensation arrangement payable when the General Counsel retires.

> *Assuming the officer status results in the General Counsel being considered an employee of DEF, then the pay from ABC counts for purposes of determining whether the General Counsel is a top-five employee of DEF and whether the General Counsel's pay exceeds the $1,000,000 threshold.* ***ABC may be subject to a 21% tax on $250,000 (the pay exceeding the $1,000,000 threshold), for a tax of $52,500. This true even though the deferred compensation is not paid and would not be deducted by ABC until a future tax year.***

1.C. The Treasurer of ABC serves without pay as Treasurer of DEF. ABC pays the Treasurer $750,000 in salary, bonus, and other pay. The Treasurer does not have more than $1 million in pay while she serves as Treasurer of DEF. The Treasurer rotates out of the DEF position at the end of 2019. In 2021, ABC promotes the Treasurer to CFO and doubles her salary.

> *Assuming the officer status resulted in the Treasurer being considered an employee of DEF, and her then $750,000 in pay resulted in her being a top-5 paid employee of DEF, then she retains her § 4960 covered employee status for all future years. It therefore appears that future pay from ABC could still be subject to the 21% tax.* ***In 2021, ABC therefore may be subject to a 21% tax on $500,000 (the pay exceeding the $1,000,000 threshold), for a tax of $105,000.***

Example 2. XYZ Corporation funds its active and retiree medical benefits through a VEBA. The Treasurer of XYZ Corporation is listed on the VEBA's Form 1024p and/or 990 as its Treasurer. The VEBA does not pay the Treasurer any salary but XYZ Corporation pays the Treasurer $1.5 million in salary, bonus, and other pay.

> *Assuming the officer status results in the Treasurer being considered an employee of the VEBA, then the Treasurer pay from XYZ counts for purposes of determining whether the Treasurer is a top-five employee of the VEBA and whether the Treasurer's pay exceeds the $1,000,000 threshold.* ***XYZ Corporation may be subject to a 21% tax on $500,000 (the pay exceeding the $1,000,000 threshold), for a tax of $105,000.***