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ADVISOR BLOG

# Practical Nuggets for Tax-Exempt Employers


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## Clues for Compliance with IRC Section 4960

May 15, 2019 is the initial deadline for calendar year tax-exempt employers to file their Forms 990 and corresponding excise tax returns for 2018. Because of this, many tax-exempt organizations are in a race to understand, address, and comply with the complex new excess remuneration and excess parachute payment excise rules under Internal Revenue Code (IRC) Section 4960.

We've collected a few practical pointers for tax-exempt organizations to keep in mind along the road to compliance.

### Identifying your "covered employees" can be a convoluted exercise—don't underestimate the time and complexity involved.

Knowing who are the "covered employees" of your organization (i.e., the five highest paid employees) is the foundation for complying with the new excise tax. Employers should keep in mind:

- If there are multiple employers within a tax-exempt system, each tax-exempt employer must separately determine which of its employees are covered employees, rather than determining the highest paid employees of the entire group; and
- There is no minimum dollar threshold for an employee to be considered a covered employee, so every tax-exempt organization will have covered employees.

April 2019

## Develop internal systems for tracking covered employees.

Once an employee is a covered employee for a year, that employee will continue to be a covered employee in all future years—even after the employee is no longer one of the five highest compensated.

This rule, coupled with the above requirement to identify covered employees at each separate tax-exempt employer within the group, means the number of covered employees to track may exceed five employees and will likely continue to expand over time. Tracking compensation will be critical since the excise tax can apply to payments made after an employee is no longer one of the highest paid, has been terminated, or is retired. As a result, developing good internal systems will be imperative on a go-forward basis.

## Remuneration is reported based on the calendar year not fiscal year.

Remuneration used to determine an entity's covered employees and for determining the pay subject to the annual $1 million limit ("excess remuneration"), is generally determined based on the calendar year ending within the taxable year of the tax-exempt employer. For example, an organization with a June 30th fiscal year would determine the remuneration based on amounts paid for the calendar year ending on the prior December 31st. Practically, the use of the calendar year as the reporting period means the timing of the Section 4960 calculations more closely align with the reporting of compensation required on Forms W-2 and 990.

## Remuneration counts when it vests.

But beware! Although the reporting of compensation is similar to what is required on Form W-2 and the Schedule J of Form 990, *it's not the same*. Remuneration is generally taken into account for Section 4960 purposes when it *vests* rather than when it is paid. Amounts *cannot* be taken directly from Form W-2 box 1 or 5. Therefore, a bonus earned in 2018 but paid in early 2019 can count toward the excise tax in 2018 even though the bonus would not typically be included in the employee's income until 2019.

## Pay that vested prior to the effective date of Section 4960 is not counted.

Compensation that vested prior to January 1, 2018, or the beginning of the tax-exempt organization's first taxable year beginning after December 31, 2017, is *not* remuneration for Section 4960 purposes. However, earnings on these amounts after the effective date are included as pay for Section 4960 purposes. For fiscal year-end filers this will be an important consideration.

## Pay triggered by an involuntary termination can subject an organization to the excess parachute excise tax.

Tax-exempt organizations will also need to report and pay the 21% excise tax on any "excess parachute payments" made to a covered employee. An excess parachute payment is the amount by which any parachute payment exceeds a covered employee's base amount.

- A parachute payment is any compensatory payment made by a tax-exempt organization to (or for the benefit of) a covered employee that is contingent on the employee's separation of employment for which the aggregate present value equals or exceeds three times the employee's base amount.
- A covered employee's base amount is generally the average annualized compensation includible in the employee's gross income for the five taxable years ending before the date of the employee's separation from employment.

The definition of parachute payment picks up most payments that are triggered by an involuntary separation of employment, including accelerated vesting of a right to a payment or continued health benefits.

## The excise tax liability is reported on Form 4720.

Tax-exempt employers should report and pay any excess remuneration and excess parachute excise tax liabilities annually on IRS Form 4720. The Form 4720 is due on the 15th day of the fifth month after the end of the employer's taxable year, as is the Form 990, and can be extended in a similar manner to that of the Form 990. However, the payment of the excise tax cannot be extended and is due by the initial deadline of the Form 4720. No quarterly estimated tax payments are required to be paid on the excise tax liability.

For further information, please see our January article *"IRS Year-End Guidance on Executive Compensation Excise Tax at Tax-Exempt Organizations"* for an in-depth summary of Notice 2019-09 released by the IRS on December 31, 2018 which provides interim guidance on IRC Section 4960.

## About the Authors

Margaret Black is a managing director in the Los Angeles office and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.

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## About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose.

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