SECTION 4960: NEW EXCISE TAX ON EXCESSIVE COMPENSATION

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The new Section 4960 excise tax on tax-exempt organizations that pay excessive compensation to employees is complex and difficult to apply.

As part of the Tax Cuts and Jobs Act of 2017 (TCJA),[1] Congress added Section 4960, which imposes an annual 21% excise tax on certain tax-exempt organizations that pay "excessive" compensation to key employees. The intent of the new provision is to place exempt organizations on par with publicly-held corporations that pay "excessive" compensation to their top executives.[2] The excise tax applies to tax years beginning after 12/31/17.[3] Existing employment agreements are not grandfathered, meaning that the tax can apply to payments that have been in effect for many years.

As with many other provisions of the TCJA, the new excise tax provision includes flaws that will make it difficult to apply with confidence until technical corrections and administrative guidance are provided. Pending such action, this article points out the glitches and assesses how the law applies.

To whom does the excise tax apply?

Applicable tax-exempt organizations. In general, any employer that is an "applicable tax-exempt organization" is subject to the excise tax.[4] For ease of reference, this article sometimes refers to any such organization as a "subject organization." A subject organization includes, but is not limited to, any organization that: (1) is exempt from taxation under Section 501(a), or (2) has income excluded from taxation under Section 115(1).[5]

Organizations exempt from tax under Section 501(a) include, among others, those described in Section 501(c)(3) (e.g., religious, charitable, and educational organizations), Section 501(c)(4) (e.g., social welfare organizations), or Section 501(c)(6) (e.g., business leagues).

Under this provision, Section 501(c)(3) organizations as diverse as the American Heart Association, the Metropolitan Museum of Art, the Mayo Clinic, the Boys & Girls Club of America, the Humane Society, Centre College, the University of Kentucky Research Foundation, and the University of Louisville Athletic Association are all subject to the excise tax. Similarly, the Sierra Club and the National Rifle Association, Section 501(c)(4) social welfare organizations, are subject to the tax, as is the U.S. Chamber of Commerce, a Section 501(c)(6) business league. It should be noted, however, that none of Kentucky's public colleges and universities are tax-exempt under Section 501(a). As explained below, these or-

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ganizations are exempt from federal taxes under an entirely distinct legal principle.

The new excise tax also applies to organizations whose income is excluded from federal income tax pursuant to Section 115(1). Section 115(1) generally exempts income derived from the exercise of any essential governmental function and accruing to a state or political subdivision thereof. The IRS has held that a state university is not a "political subdivision" of the state for this purpose, due to its failure to possess the power to tax, the power of eminent domain, or the police power. Thus, in the IRS's view, the income of a public college or state university, such as the University of Kentucky or the University of Louisville, is not exempt from federal income tax under Section 115(1).[6] The income of such colleges and universities has, however, long been held to be exempt in accordance with the doctrine of intergovernmental immunity.[7] This doctrine holds that, while the federal government has the right to impose taxes on states and political subdivisions, it will refrain from doing so unless specifically directed by Congress in legislation that overrides that immunity.[8]

Accordingly, based on Section 4960(c)(1)'s express language, neither the University of Kentucky and the University of Louisville, nor any other state college or university or other entity that relies on exemption from federal income taxation under the doctrine of intergovernmental immunity rather than under Section 501(a) or Section 115(1), is subject to the Section 4960 excise tax. This has been acknowledged by counsel to Congress' Joint Committee on Taxation, who suggested that Congress could not have intended the omission and predicted a technical correction.[9] Nevertheless, as the statute is written, this oversight represents a serious flaw in the statute, and no action has been taken to this point to address the problem. All things considered, however, it would be foolhardy to proceed on the basis that corrective Congressional action will not be forthcoming and made applicable to tax years beginning after 12/31/17.

Compensation payments by related persons. Suppose that an employee of a subject organization receives remuneration from several sources, as is often the case with a university president, athletic director, or coach. According to the statute, for purposes of Section 4960, remuneration of an employee of a subject organization includes remuneration paid with respect to employment of such employee by any related person or related governmental entity.[10] In other words, in determining whether an employee is a "covered employee" of a subject organization, all remuneration paid to the employee by the subject organization and by any related person or related governmental entity must be aggregated. A person or governmental entity is considered related to a subject organization if such person or governmental entity: (1) controls, or is controlled by, the organization; (2) is controlled by one or more persons who control the organization; (3) is a supported organization with respect to the organization; (4) is a supporting organization with respect to the organization; or (5) in the case of a voluntary employees' beneficiary association, establishes, maintains, or makes contributions to such organization.[11]

Under this provision, if an individual is an employee of a subject organization, and the subject organization and two "related" parties each pay one-third of the employee's salary, the salaries must be aggregated to determine whether the 21% excise tax applies. If the tax applies, each related party is liable for its share of the tax in proportion to the remuneration paid to the covered employee by it.[12]

Related for-profits included? Suppose a subject organization owns all of the outstanding stock of a for-profit corporation, that a covered employee is employed by both the subject organization and the for-profit corporation, and that each pays one-

1 P.L. 115-97, section 13602, 12/22/17. The final version of the legislation bears the title "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2 See "Joint Explanatory Statement of the Committee of Conference" ("Joint Statement"), p. 346.

3 See Joint Statement, p. 348. See Section 162(m).

4 Section 4960(a).

5 Section 4960(c)(1). Subject organizations also include farmers' cooperatives described in Section 521(b)(1) and political organizations described in Section 527(e)(1).

6 Rev. Rul. 77-165, 1977-1 CB 21.

7 Rev. Rul. 87-2, 1987-1 CB 18.

8 See, e.g., Section 511(a)(2)(B), which provides that the tax on unrelated business income "shall apply in the case of any college or university which is an agency or instrumentality of any government or political subdivision thereof...." Without this express directive, the unrelated business income of a state college would be exempt from federal income tax under the doctrine of intergovernmental immunity.

9 See statement of Veena K. Murthy to the District of Columbia Bar Taxation Community on 1/25/18, as reported by *Daily Tax Report*, 1/26/18.

10 Section 4960(c)(4)(A).

11 Section 4960(c)(4)(B).

12 Section 4960(c)(4)(C).

half of the employee's compensation. Under the statute, the subject organization clearly "controls" the for-profit corporation, so the two are "related" for Section 4960 purposes. Does this mean that the for-profit corporation, which is not by definition a "subject organization," is liable for one-half of the 21% excise tax that may be due on the covered employee's total compensation? If so, any such tax will not be deductible by it,[13] although the compensation paid by it should be, at least to the extent it is reasonable and paid for services actually rendered.[14]

Payments subject to the tax

Under Section 4960, a subject organization is liable for a tax equal to 21% of the sum of (1) any remuneration in excess of $1 million paid to any covered employee for the tax year (other than any excess parachute payment), and (2) any excess parachute payment paid to any covered employee.[15] For example, if a subject organization pays a covered employee a $2 million salary, the organization is subject to a tax of $210,000 ($2 million – $1 million = $1 million × .21 = $210,000) with respect to every tax year in which such salary is paid.

A "covered employee" is any employee, including any former employee, of a subject organization if the employee: (1) is one of the subject organization's five highest compensated employees for the tax year, or (2) was a covered employee of the subject organization (or any predecessor) for any preceding tax year beginning after 12/31/16.[16] Thus, once a person becomes a covered employee after 12/31/16, the person will remain a covered employee as long as the person receives compensatory payments from the subject organization.[17]

"Remuneration" is synonymous with "wages"[18] but does not include remuneration paid to a licensed medical professional for the performance of medical or veterinary services.[19] "Remuneration" includes any amount required to be included in gross income under Section 457(f).[20] In general, Section 457(f) causes nonqualified deferred compensation that is payable under an ineligible plan of a subject organization to be taxed to the employee in the first tax year in which the employee's right to the compensation is no longer subject to a substantial risk of forfeiture.[21] As will be seen, the rules of Section 457(f) play a critical role in the application of Section 4960.

Applying the excise tax in practice

Suppose that in 2018 a subject organization (X) enters into an agreement with a covered employee (A) whereby X agrees to pay A an annually increasing amount of up to $3 million on the first to occur of A's death, disability, or separation from employment, but only if A continues to work for X until 1/1/22. Because A's right to the payment does not become absolute until 1/1/22, the right to the potential $3 million payment remains subject to a substantial risk of forfeiture until that date. Under Section 457(f)(1)(A) and the Proposed Regulations promulgated thereunder,[22] the 1/1/22 present value of the potential $3 million payment is includable in A's gross income as wages on 1/1/22.

So what are the 2022 excise tax consequences to X? Assume that the 2022 present value of the vested $3 million payment is $1.2 million, that X pays A, a covered employee, a $600,000 salary in 2022, and that A's average annual compensation for the five years preceding 2022 (the base period) is $450,000 (the base amount). Under Section 4960(a), the excise tax applies to the sum of A's 2022 compensation, exclusive of any excess parachute payment, in excess of $1 million, plus any excess parachute payment paid to A. Since A's $600,000 2022 salary does not exceed $1 million, no excise tax is payable on A's salary. In addition, as discussed below, since the $1.2 million present value of the vested $3 million payment is less than three times A's $450,000 base amount, X is not liable for any excise tax on the $1.2 million deemed payment.

Assume further that A retires from X on 1/1/27, at a time that A is entitled to a $2.2 mil-

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13 Section 275(a)(6).

14 Section 162(a)(1).

15 Section 4960(a).

16 Section 4960(c)(2).

17 This rule should be of great interest to the University of Louisville, which terminated both its athletic director, Tom Jurich, and its men's basketball coach, Rick Pitino, in 2017. As these men were no doubt two of the school's five highest-compensated employees at the time of their termination, if it is ultimately determined that the school owes either or both of them compensation, the school not only will be required to pay them, it will also have to pay their replacements, it will incur a multi-million dollar excise tax liability for the privilege of doing so! This result would follow notwithstanding that Section 4960 was not enacted until after Jurich and Pitino were terminated.

18 Section 4960(c)(3).

19 Section 4960(c)(3)(B).

20 Section 4960(c)(3)(A).

21 Section 457(f)(1)(A).

22 Prop. Reg. 1.457-12(a)(2).

lion payment under A's deferred compensation agreement with X. Under Section 457(f)(1)(B) and applicable Proposed Regulations,[23] A will be required to include in A's 2027 gross income the excess of the $2.2 million payment over the amount, $1.2 million, that A was required to include in income in 2021. Thus, A has compensation income of $1 million in 2027 as a result of the payment. As for the Section 4960 consequences to X of the 2027 payment, the results are unclear.

As stated in the first paragraph of this section, Section 4960(a) imposes a 21% tax on the sum of (1) any remuneration exceeding $1 million paid to any covered employee for the tax year, other than any excess parachute payment, and (2) any excess parachute payment paid to any covered employee. Thus, in calculating a subject organization's liability for the tax, one must look to the year in which remuneration or an excess parachute payment is "paid." In this regard, Section 4960(a) provides that, for purposes of making this calculation, remuneration shall be treated as paid when the right to the payment vests.[24]

On the basis of this rule, X could take the position that its liability for the 21% excise tax arising from any parachute payment "paid" to A was determined finally and conclusively in 2022 when A's right to the parachute payment vested. While this may strike some as a too aggressive reading of the statute, it seems to comply with the express language of Section 4960(a). However, there are alternatives.

Suppose that A receives no salary from X in 2027, and that, pursuant to the deferred compensation agreement, X pays A $2.2 million on 1/1/27. Assume that A's annual salary for the preceding five years (the base period) has averaged $800,000 (the base amount). Since the $2.2 million is paid to A due to A's separation from employment and would not have been paid to A in 2027 but for A's 2027 separation from employment, it is a "parachute payment," so it must be determined whether such payment is an "excess parachute payment." So how much, if any, of the $2.2 million payment made to A

[23] Prop. Reg. 1.457-12(a)(5).

[24] Section 4960(a) last sentence.

on A's retirement is to be taken into account by X in determining whether the payment constitutes an "excess parachute payment?"

According to the statute, "parachute payment" means any payment in the nature of compensation to a covered employee if: (1) the payment is contingent on such employee's separation from employment, and (2) the aggregate present value of all such payments equals or exceeds three times the base amount.[25] Section 4960(c)(5)(D) says that rules similar to the rules of Section 280G(b)(3) will apply for purposes of determining the base amount. Under Section 280G(b)(3) and its implementing Treasury Regulations,[26] an individual's base amount is the average annual compensation of such individual during the base period. The latter term is defined as the most recent five full tax years ending before the separation from employment.[27] Thus, the base period and base amount cannot be determined until there has been a separation from employment.

In the example, A's base amount is $800,000, representing A's average annual compensation during the five-year period ending on 12/31/26. Three times the $800,000 base amount exceeds the $2.2 million payment that X made to A on 1/1/27 by $200,000 (3 × $800,000 = $2,400,000 − $2,200,000 = $200,000). Because the parachute payment does not equal or exceed $2.4 million, the $2.2 million payment is not an excess parachute payment, so the 21% excise tax does not apply to the payment.

Section 115(1) generally exempts income derived from the exercise of any essential governmental function and accruing to a state or political subdivision thereof.

What if A's base amount is $700,000? Since in that case the $2.2 million payment to A exceeds three times the base amount by $100,000, one could conclude that the $2.2 million payment is an excess parachute payment. If that is the correct position, then X will owe a 21% tax on the amount by which the $2.2 million payment exceeds the $700,000 base amount, resulting in a $315,000 excise tax liability ($2,200,000 − $700,000 = $1,500,000 × .21% = $315,000).[28]

Since a parachute payment is, by definition, a payment that is contingent on a separation from employment, neither the base period nor the base amount can be determined until there has been a separation from employment. In addition, the amount of the "payment" cannot be known until that time.[29] Finally, it is the aggregate present value of any such payments, determined at the time of the separation from service, that determines whether there is an excess parachute payment.[30] These factors appear to create a serious disconnect between Section 457(f) and Section 4960.

While the statutory language specifically dealing with excess parachute payments seems to require the result described in the next preceding paragraph, this position fails to take into account that a significant portion (i.e., $1.2 million) of A's parachute payment was deemed to have been paid to A in 2022, when A's right to the potential $3 million payment became vested. This raises the very important question of whether X should be allowed to take credit for the 2022 deemed payment in calculating X's liability for the 21% excise tax in 2027, the year in which X actually made the $2.2 million parachute payment to A.

As this example illustrates, in determining A's income tax consequences of the receipt of the $2.2 million payment in 2027, A gets to offset the $2.2 million payment with the $1.2 million deemed payment that A was required to include in A's 2022 gross income.[31] As a result, A was required to include only $1 million in income in 2027, the year in which A received the $2.2 million parachute payment.

Should X receive similar treatment? Maybe. Maybe not. On one hand, unlike A, X suffered no tax consequence as a result of X's deemed $1.2 million payment to A in 2022. So perhaps X should not receive the benefit of that deemed $1.2 million payment in calculating X's excise tax liability in the year the parachute payment is in fact paid. On the other hand, based on the facts and the application of the express terms of the statute, X incurred no excise tax liability

[25] Section 4960(c)(5). Under Section 4960(c)(5)(A), an "excess parachute payment" results if a "parachute payment" exceeds the base amount.

[26] Reg. 1.280G, Q: A34.

[27] Reg. 1.280G, Q: A35.

[28] Section 4960(c)(5)(A). The key language appearing at Section 4960(c)(5) mimics language appearing in Section 280G(b), on which Section 4960(c)(5) is based. If the rules are intended to be analogous, then it is clear that if a payment is an excess parachute payment, the 21% excise tax applies to the amount by which such payment exceeds one times the base amount, not three times the base amount. See Reg. 1.280G-1, Q & A 38.

[29] Section 4960(c)(5)(B)(i).

[30] Section 4960(c)(5)(B)(ii).

[31] Section 457(f)(1)(B); Reg. 1.457.12(a)(5).

from its deemed parachute payment to A in 2022. Accordingly, it is fair to conclude that, at worst, X will not be required to include the full \$2.2 million payment made to A in 2027, but should only have to consider an amount that corresponds to the amount taxed to A in 2027.

As this illustration shows, X's 2027 liability for the 21% excise tax could depend on any of three possible interpretations of Section 4960:

1. X's liability is determined finally and conclusively in the tax year in which A's right to the deferred compensation vested.
2. X's liability is determined without regard to the fact that a portion of A's deferred compensation was taxed to A prior to the tax year in which it was actually paid.
3. X's liability is determined by giving X credit to the extent that a portion of A's deferred compensation was taxed to A prior to the tax year in which it was actually paid.

Each of these interpretations has merit. Until Congress makes technical corrections or interpretive regulations are issued, however, subject organizations will be in the dark concerning this question.

Examples

It has been reported that Duke University, a Section 501(c)(3) organization, pays its head basketball coach, Mike Krzyzewski, an annual salary of approximately \$9 million.[32] Presumably, this makes "Coach K" a "covered employee" as to Duke. Assuming this report is correct, paying that salary will cost Duke an annual 21% excise tax of \$1.68 million beginning in 2018.

Meanwhile, Nick Saban is said to receive an annual salary of more than \$11 million to serve as head football coach at the University of Alabama.[33] Saban is likely a "covered employee" of the University and, assuming that the University is a subject organization, paying that salary will cost the University an annual excise tax of \$2.1 million beginning in 2018. It has also been reported that the University would have to pay Saban almost \$27 million if it chooses to terminate Saban.[34] Exercising that option could cost the University as much as \$5.67 million in excise tax, depending on Saban's base amount.

Without knowing the contents of these coaches' employment contracts, it is difficult to suggest how or if they could be restructured in a manner that both gives the coaches the benefit of their bargains and eliminates, or at least reduces, their employers' exposure to the 21% excise tax. Of course, these are simply two examples of contracts providing what Congress apparently considers excessive compensation to successful coaches. Only recently, *USA Today* reported that colleges are paying 78 head football coaches and 41 head men's basketball coaches at least \$1 million salaries.[35] The author has not seen an estimate of how much excise tax subject organizations will be required to pay under existing contracts, but it must be in the tens, if not hundreds, of millions. Colleges with their highly-paid coaches are not the only subject organizations that will feel the sting of the new excise tax. According to an article that appeared in the *Wall Street Journal* in early 2017, some 2,700 employees of Section 501(c)(3) organizations were paid in excess of \$1 million in 2014.[36] That number has increased since 2014, and that examination included Section 501(c)(3) organizations only.

Unfortunately, until Congress acts again to clean up the new law, most tax-exempt organizations will struggle to apply it.

Planning Considerations

As an initial matter, both subject organizations and their covered employees may find it beneficial to attempt to restructure existing agreements in a manner that addresses the adverse impact of the new excise tax. In particular, the parties could consider modifying existing agreements in an effort to: (1) avoid the \$1 million annual cap, and (2) restructure any parachute payments in a manner that prevents them from equaling or exceeding three times the base amount. The parties will want to ensure that any modifications to existing agreements do not violate the nonqualified deferred compensation rules of Section 409A.

As for compensation arrangements to be agreed to in the future, presumably the market for prized coaches and executives will reflect the

[32] Schwartz, "The 5 highest-paid coaches in college basketball," *USA Today*, 3/1/18, ftw.usatoday.com/2018/03/5-highest-paid-coaches-in-college-basketball-coach-k-calipari.

[33] *Id.*

[34] *Id.*

[35] "College coaches' salaries increase despite threat of new tax," *USA Today*, 12/13/17, www.usatoday.com/story/sports/ncaaf/2017/12/13/college-coaches-salaries-increase-despite-threat-of-new-tax/108562894/.

[36] Fuller, "Charity Officials Are Increasingly Receiving Million-Dollar Paydays," *Wall Street Journal*, 3/6/17, www.wsj.com/articles/charity-officials-are-increasingly-receiving-million-dollar-paydays-1488754532.

fact that new agreements will need to be negotiated with due regard for the cost of the 21% excise tax. While the tax is by law the responsibility of the subject organization, one would expect that any such cost will be shared by the subject organization and the covered employee. In addition, the parties will want to consider the extent to which compensation payments to highly-compensated employees can be structured in a way that avoids, or at least minimizes, imposition of the excise tax on future payments.

It has been noted that the term "remuneration" does not include remuneration paid to a licensed medical provider for medical or veterinary services.[37] In the typical healthcare system, physicians will be the highest-paid employees. To the extent a physician is compensated for performing medical services, that compensation will be excluded in determining the subject organization's excise tax liability. On the other hand, if the physician is paid to perform managerial or administrative services, that compensation will need to be taken into account in determining the physician's covered-employee status. Thus, in such circumstances, the subject organization may want to modify its payroll system to enable it to track the physician's services so that the physician's compensation can be appropriately segregated.

In the case of a subject organization that is "controlled by" a corporation whose stock is publicly traded, due consideration will need to be given to the interaction between Section 4960 and the excess compensation limitation of Section 162(m). Basically, in such situation, Section 4960(c)(6) provides that, to the extent the publicly-traded corporation is barred by Section 162(m) from deducting compensation, such compensation is disregarded in determining whether the compensated employee of the related subject organization is a covered employee. Compensation that is deductible by the publicly-traded corporation will, however, need to be taken into account under Section 4960.

Also, in the context of mergers and acquisitions involving subject organizations, the acquiring/surviving organization will want to review the other organization's compensation arrangements to gauge that organization's potential liability for the excise tax. Otherwise, the acquiring/surviving organization may find itself liable for the 21% excise tax on payments made to the former target organization's covered employees.

Finally, it must be noted that the 21% excise tax imposed by Section 4960 is separate and distinct from the excise taxes imposed by Section 4958. In general, Section 4958 levies excise taxes on "excess benefit" transactions, including compensation arrangements.

Conclusion

Section 4960 is a mess. Many would agree that too many employees of tax-exempt organizations are overpaid. Sadly, however, in Congress's haste to get the Tax Cuts and Jobs Act enacted, many mistakes were made in drafting the legislation, which has drawn heavy criticism by many factions across the country. Section 4960 is just one of the numerous targets of such criticism. Unfortunately, until Congress acts again to clean up the new law, most tax-exempt organizations will struggle to apply it. For that reason, every potential subject organization should consult its tax and other advisors to gauge how Section 4960 will affect it.

[37] See Section 4960(c)(3)(B).