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Key Take-Aways from the Final IRS Regulations for Tax-Exempt Organizations

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On January 19, 2021, the Internal Revenue Service (IRS) published the final regulations of the Internal Revenue Code (IRC) Section 4960 of the Tax Cuts and Jobs Act of December 2017. Section 4960 imposes a 21 percent excise tax on an “applicable tax-exempt organization” (ATEO), or a related organization, if that ATEO pays (1) remuneration in excess of \$1 million to a “covered employee,” one of the top five highest-paid employees at the organization, or (2) parachute payments in excess of three times the base salary of a covered employee. These regulations will apply for tax years starting after December 31, 2021. See the copy of the final regulations, which varied from the proposed regulations in a few minor ways, [here](#).

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A summary of the key take-aways from the final regulations and how they may impact executive compensation practices follows:

- **No Grandfathering:** The 21 percent excise tax under Section 4960 will apply to compensation that has been paid or becomes vested during taxable years starting after December 31, 2017, the year Section 4960 was passed. The IRS rejected proposals for grandfathering contracts existing before this date.
- **Review Aggregate Compensation:** ATEOs may pay covered employees through multiple entities of their organization or through “related organizations” (where the threshold for relatedness is 50 percent). Under the final regulations, the compensation a covered employee receives through all entities or related organizations is aggregated in the remuneration calculation. If this aggregate amount exceeds \$1 million, the ATEO will pay a 21 percent excise tax.
- **Once Covered, Always Covered Rule:** Under this rule, once an individual has been identified as a “covered employee” of an ATEO, this status stays with them indefinitely, even after retiring from the ATEO. As a result, any backloaded arrangements to defer compensation to a covered employee shortly past the date of retirement is still subject to the \$1 million cap. In addition, payment for service at a related ATEO is counted. As an example, suppose a former covered employee of a tax-exempt entity works for a related organization after such employee’s retirement from the prior entity. Future remuneration paid for service at the related organization would be subject to the \$1 million cap.
- There are two exceptions to this rule: (1) nonexempt funds exception and (2) limited hours exception. These exceptions are meant to help ATEOs avoid paying the excise tax on behalf of their employees who provide them with limited services.
 - Under the “nonexempt funds” exception, an employee’s time spent providing service to the ATEO over the applicable and preceding year must not exceed 50 percent of their total service time to the related organizations during that same period.
 - Under the “limited hours” exception, an employee’s time spent providing services to the ATEO over the applicable year must be less than 10 percent of their total time for the related organizations during that same year.
- **Special Timing Rule for Remuneration:** This new rule states that deferred compensation must be included in the remuneration calculation the year it is vested (i.e., when the remuneration is no longer subject to a substantial risk of forfeiture), rather than the year it is paid out. For instance, if a covered employee is granted a \$1 million dollar retention bonus that has a service requirement of five years, the bonus will be counted as remuneration in the fifth year. Alternatively, if the retention bonus vests ratably at \$200,000 each year for five years, \$200,000 will be counted as remuneration in each vesting year until the full retention bonus is fully vested.
- **Remuneration Excludes Pay for Medical Services:** The remuneration calculation disregards compensation that hospitals pay to doctors and nurses for medical services. Therefore, the “medical services” portion of compensation to a “covered employee,” such as Chief Surgeon, is not accounted for in the remuneration calculation. In contrast, compensation that is paid for an employee’s administrative services is included in the remuneration calculation.
- **Split-Dollar Life Insurance Arrangements:** Under the new regulations, ATEOs, especially those that are private foundations or Section 509(a)(3) supporting organizations, are cautioned from entering into split-dollar life insurance arrangements with their covered employees. Such loans to certain employees “may constitute an act of self-dealing under Section 4941 or an excess benefit transaction under Section 4958(c)(3).” The new regulations consider this type of compensation as a part of the remuneration calculation. *De minimis* loans, or loans under \$10,000, are an exception.

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