

Guidance on Excess Compensation Rules for 501(c)(3) Execs

02.07.19 | Linda J. Rosenthal, JD



The new excise tax on excess compensation of nonprofit execs is ambiguous and confusing, but the IRS has issued some interim guidance.

The Tax Cuts and Jobs Act (TCJA) was enacted at the end of December 2017. It was a rushed effort, with little or none of the usual thoughtful drafting and committee hearings. Voting was so rushed that many lawmakers candidly admitted they had not had a chance to read much of the legislation before it came up for a vote. What emerged is a comprehensive overhaul of the federal tax code that is – frankly and generally acknowledged to be – a big mess.

To make matters worse, most of the new or amended provisions became effective immediately – on January 1, 2018. Generally, there is a delayed or staggered effective date to make planning and transition easier. Also – ordinarily – there is clean-up legislation – that is, “technical corrections” measures – enacted in the months immediately following passage of major new laws. Here, even by the end of December 2018, there were few of these remedial statutes offered or scheduled for a vote.

Among the statutory changes affecting tax-exempt organizations, there were several notable areas of concern by affected groups. Senators and representatives of both parties acknowledge that this confusion, uncertainty, and outright – and justified – opposition to some of these provisions. Among them are the changes to the unrelated business income law related to fringe benefits as well as the new excise tax on executive compensation in excess of \$1 million.

In December 2018, the IRS and Treasury issued guidance and notice of possible upcoming proposed regulations on the highly contentious fringe-benefits issue that adversely affects a wide swath of 501(c)(3) organizations.

On the final day of December 2018, these officials issued another set of guidance – a 90-page behemoth – on the excess compensation law, that is, new section 4960 of the Internal Revenue Code.

Excess Compensation Guidance Notice

This document, Notice 2019-09, was published on December 31, 2018. It is formatted primarily in a question-and-answer format; its purpose is to clarify many ambiguities in the 2017 legislation. How well this information satisfies that goal is an open issue.

These federal officials write that they intend to issue proposed regulations at some time, but with an important caveat: any future regulations will be effective prospectively; they will not apply to any taxable years or periods before that date. Until there is additional guidance, either in the form of future notices or proposed regulations, nonprofit employers may act on “a good faith, reasonable interpretation of section 4960.” What is a good faith, reasonable interpretation? Affected organizations should look to the positions and interpretations of the government in Notice 2019-19.

Excess Compensation Issues

In a nutshell, new Internal Revenue Code Section 4960 imposes an excise tax equal to the corporate tax rate, which is currently 21 percent. So far so good. Now it gets confusing. Who is affected? The tax is imposed on certain tax-exempt organizations – unhelpfully called “applicable tax-exempt organizations” or ATEOs – and related organizations that pay excess compensation to employees of the ATEO.

The tax is triggered if, during the taxable year, the ATEO pays remuneration in excess of \$1 million or any “excess parachute payment” to any of the ATEO’s employees who are among the highest paid for the current year and any prior taxable year beginning after December 31, 2016. These targeted employees are called “covered employees” for purposes of section 4960.

Compensation paid by any related organization to an ATEO employee is taken into account in determining whether such employee is a covered employee and in determining total compensation subject to the excise tax.

Just a quickest glance at the statutory language reveals many vagaries that need to be explained further – or perhaps reconsidered entirely. This is not, suffice it to say, an example of excellent or even adequate statutory draftsmanship.

Notice 2019-09 takes a welcome swipe at some general clarifications, including more precise definitions of basic terms like “taxable year” and “effective date.”

The Notice also discusses the meaning of the phrases “government entities” and “related organizations.” This point addresses an issue that was immediately flagged by astute observers as a huge inconsistency: that is, whether certain state colleges and universities are affected. Football coaches at some major institutions are among the highest paid employees with remuneration well in

excess of the \$1 million cut-off. The answer given is not entirely satisfactory, though.

There is also a purported clarification of the term “covered employees” as well as guidance on the “limited service exemption” and the “medical services exemption.”

The seemingly simple phrase “remuneration in excess of \$1 million” gets attention as well by federal officials including: what is or is not “remuneration”; the timing of the remuneration; and the “amount” if it is “subject to substantial risk of forfeiture.” Also further defined are “excess parachute payments.”

There are also additional details beyond the language on the face of the statute about issues of payment and reporting.

Conclusion

In the Notice, federal officials request comments by April 2, 2019. While “comments on all aspects of this notice” are invited, there are specific areas about which the government seeks advice beginning at Part III on page 89.

There is, of course, the mandatory “Paperwork Reduction Act” statement comprising three additional paragraphs of text that make the Notice almost an entire page longer than it would be without said declaration.