What You Need to Know About the New Tax on "Excess" Nonprofit Compensation

January 11, 2019

On the last day of 2018, the IRS issued Notice 2019-09 clarifying how the new 21 percent tax on "excess" compensation impacts nonprofits. The tax is effective for compensation paid in tax years beginning after December 31, 2017.[1]

For most nonprofits, the biggest impact will be the need to keep track of whether they have any employees whose compensation may be subject to the tax. This process can be complicated for organizations with shared employees. And some nonprofits will owe the tax or may wish to structure payments to avoid it. Here are the top 4 things a nonprofit should know about the tax:

1. Compensation that is "reasonable" under other federal tax rules can still be taxed as "excess" compensation. The "excess" compensation tax is imposed on:

- excess remuneration, i.e., annual compensation paid to a "covered employee" by a nonprofit and its related entities that totals to more than $1 million; and
- excess parachute payments, i.e., payments to a "covered employee" by a nonprofit and its related entities that, in total, equal at least three times the employee's annual compensation (averaged over five years) when the payment is contingent on the employee's separation from employment.

The tax on excess parachute payments means that nonprofits can still be subject to tax on severance payments even if they pay their top executives well under $1 million a year.

2. To know whether it might pay compensation that triggers the tax, a nonprofit needs to know if it has "covered employees." To know that, it must keep track of its "related" entities and any compensation paid by those entities to shared employees.

A nonprofit's related entities include: (1) organizations that control it or are controlled by it; (2) organizations controlled by persons that control it; and (3) its supported organizations and supporting organizations. "Control" means greater than 50 percent control, as it does under the Form 990 and Form 990-PF definitions of controlled entities. Any type of organization--regardless of whether it is tax-exempt—may be a related entity.

[1] The tax under section 4960 of the Internal Revenue Code was enacted as part of the Tax Cuts and Jobs Act of 2017. It applies to all organizations exempt under sections 501(c) and 527 and to governmental units that exclude income under section 115. Governmental entities that haven't been recognized under section 501(c)(3) (including many state colleges and universities) are not subject to the tax, although observers expect that Congress will amend the statute to cover them as well.

To determine if it has "covered employees," a nonprofit must identify employees who receive more than $125,000 in total "remuneration" each year from it and its related entities. The top five of those count as "covered employees" in the year they are identified and for all time (even if they are not in the top five in future years).

3. Calculation of "remuneration" determines not only whether an employee is a "covered employee" but also whether compensation is "excess" and which entity pays any tax owed. "Remuneration" is generally the same thing as "wages" under the income tax provisions of the Code. Some amounts are excluded, including amounts paid by a nonprofit for service on its board and amounts paid to a licensed professional for the performance or supervision of medical or veterinary services (but not for services such as teaching, research and administration).

"Remuneration" counts once there is no substantial risk of forfeiture. When awards vest over time, remuneration includes the present value of vested amounts in each year and accounts for earnings and losses on those amounts in the calculation of remuneration in years subsequent to the year of vesting.

4. Each common-law employer, whether it is the nonprofit or a related entity, must pay its share of the tax based on its proportional share of remuneration paid to a covered employee. However, if liable for double tax, entities must pay only the greater amount due—double tax would otherwise be possible when an employee is a covered employee for more than one nonprofit. In addition, there is a limited *de minimis* exception for nonprofits that pay less than 10 percent of a covered employee's total remuneration: they are not required to pay tax so long as another nonprofit accounts for a greater proportionate liability.

Each employer must pay the tax directly, even if compensation is paid through third-party payors such as payroll agents or common paymasters. Each nonprofit and each related entity (including a related taxable organization) must file its own separate Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*, to report and pay its pro rata share of liability.

For more information on this Alert or more general information on compensation reporting requirements, please contact a member of Caplin & Drysdale's Exempt Organizations team.

Caplin & Drysdale
ATTORNEYS

About Caplin & Drysdale

Having celebrated our 50th Anniversary in 2014, Caplin & Drysdale continues to be a leading provider of legal services to corporations, individuals, and nonprofits throughout the United States and around the world. We are also privileged to serve as legal advisors to accounting firms, financial institutions, law firms, and other professional services organizations.

The firm's reputation over the years has earned us the trust and respect of clients, industry peers, and government agencies. Moreover, clients rely on our broad knowledge of the law and our keen insights into their business concerns and personal interests. Our lawyers' strong tactical and problem-solving skills—combined with substantial experience handling a variety of complex, high stakes, matters in a boutique environment—make us one the nation's most distinctive law firms.

With offices in New York City and Washington, D.C., Caplin & Drysdale's core practice areas include:

- Bankruptcy
- Complex Litigation
- Corporate Law
- Corporate, Business & Transactional Tax
- Employee Benefits
- Exempt Organizations
- International Tax
- Political Law
- Private Client
- Tax Controversies
- Tax Litigation
- White Collar Defense

For more information, please visit us at www.caplindrysdale.com.

Washington, DC Office:
One Thomas Circle NW
Suite 1100
Washington, DC 20005
202.862.5000

New York, NY Office:
600 Lexington Avenue
21st Floor
New York, NY 10022
212.379.6000

Disclaimer

This communication does not provide legal advice, nor does it create an attorney-client relationship with you or any other reader. If you require legal guidance in any specific situation, you should engage a qualified lawyer for that purpose. Prior results do not guarantee a similar outcome.

Attorney Advertising

It is possible that under the laws, rules, or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.