KPMG

TaxNewsFlash

United States

No. 2021-027
January 13, 2021

KPMG report: Final section 4960 regulations on excise tax for excess remuneration and excess parachute payment for applicable tax-exempt organizations

The IRS this week posted to its website a version of the final regulations (T.D. 9938) concerning the excise tax imposed regarding excess tax-exempt organization executive compensation.

The **final regulations** [PDF 656 KB] (176 pages) implement section 4960 as added to the Code by the 2017 tax law (Pub. L. No. 115-97)—the law that is often referred to as the "Tax Cuts and Jobs Act" (TJCA).

Section 4960 provides that an "applicable tax-exempt organization" (ATEO) that pays a "covered employee" remuneration in excess of $1 million or any excess parachute payment in an applicable year is subject to an excise tax. Section 4960 is applicable for tax years beginning after December 31, 2017. Once published in the Federal Register, these final regulations are set to apply to tax years beginning after December 31, 2021.

KPMG observation

Notably, this version of the final regulations has not yet been published in the Federal Register, and the regulations will not be effective unless and until they are published. According to a legend on the document, the published regulations "may vary slightly" from the version released if "editorial changes are made during the OFR [Office of the Federal Register] review process." In such case, the document that is published in the Federal Register will be the official document. It is expected that the final regulations will be published before the new administration takes office on January 20, 2021, but if they are not published by then, there could be a more significant delay in publication while the incoming administration reviews the regulations.

This report focuses on the modifications made in the final regulations.

ATEO

- Treasury and the IRS will continue to consider whether section 4960 should apply to federal instrumentalities for which the enabling acts provide for exemption from all current and future federal taxes. Until further guidance, a federal instrumentality for which an enabling act provides for exemption from all current and future federal taxes may treat itself as not subject to tax under section 4960 as an ATEO or related organization. However, if it is a related organization of an ATEO, the remuneration it pays must be taken into account by the ATEO.

Covered employee

- The excise tax potentially applies only to amounts paid to a "covered employee" of an ATEO. A covered employee is defined in the statute as any employee (including any former employee) of an ATEO if the employee "is one of the 5 highest compensated employees of the organization for the taxable year" or "was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016." The final regulations include the following clarifications and modifications related to the determination of covered employees.

- The preamble makes clear that taxable fringe benefits—such as employer-provided parking in excess of the value excluded under section 132—are considered for purpose of determining an ATEO's five highest-compensated employees and applying the exceptions from covered employee status. The proposed regulations had requested comments on this issue, but none was received.

- The final regulations maintain the exceptions in the proposed regulations that permit an ATEO to disregard individuals for purposes of determining the ATEO's five highest-compensated employees (that is, its covered employees) for an applicable year. Under the broadest of these exception—the "nonexempt funds exception"—individuals may be disregarded if they have not received remuneration (or any legally binding right to nonvested remuneration) from the ATEO, any related ATEOs, or any taxable related organizations controlled by the ATEO and/or related ATEOs for services provided to the ATEO; and did not perform services for the ATEO and related ATEOs in excess of 50% of the individual's total hours worked for the ATEO and all of its related organizations. This exception also requires that any related organization that paid remuneration to the individual must not have provided services for a fee to the ATEO, to any related ATEOs or to any taxable related organizations controlled by the ATEO and/or related ATEOs. The final regulations modified this exception in two respects:

    - The relevant measurement period for applying the 50%-of-total hours threshold (as well as other requirements) is increased from one applicable year to two applicable years (with the current applicable year and the preceding applicable year being treated as a single measurement period). This change allows flexibility for an employee who rotates to an ATEO for a period that extends longer than six months or when an employee unexpectedly provides services beyond six months.

    - In determining whether a taxable related organization is "controlled by the" ATEO for purposes of this exception, ATEOs may disregard the application of "downward attribution" in applying section 318(a)(3) to corporations and other entities and in applying section 318 principles to nonstock organizations. This modification is only for the nonexempt funds exception and not for purposes of determining whether an organization is related generally.

Remuneration

- Remuneration does not include amounts that are not includible in gross income pursuant to the $10,000 de minimis exception under section 7872(c)(3), which provides foregone interest

attributable to any day on which the aggregate outstanding amount of loans between the borrower and the lender does not exceed $10,000 is not includible in gross income.

Remuneration for medical services

- Remuneration does not include remuneration paid to a licensed medical professional for the performance of medical services. With respect to a covered employee who provides both medical and non-medical services, the final regulations provide that an employer may make a reasonable, good faith allocation between remuneration for medical and non-medical services, regardless of the form of compensation, and may apply the same principles with respect to contributions and earnings under a deferred compensation plan.

Remuneration treated as paid

- In the case of remuneration other than regular wages, the amount of remuneration treated as paid by the employer is generally the present value of such remuneration that vested during the applicable year. However, if the amount of this remuneration is scheduled to be actually or constructively paid within 90 days of vesting, the employer may use the future amount that is to be paid, rather than computing the present value at vesting. This rule of administrative convenience was only applied to remuneration under a nonaccount balance in the proposed regulations but contains no such restriction in the final regulations.

Coordination with section 162(m)

- Treasury and the IRS continue to consider the issues raised by the coordination between section 4960 and section 162(m) but have not yet determined the appropriate manner of implementation. The final regulations reserve a section for future guidance. Taxpayers may use a reasonable, good faith approach with respect to coordination of section 4960 and section 162(m) in circumstances in which it is not known whether a deduction for remuneration will be disallowed under section 162(m) by the due date (including extensions) of the relevant return on which the excise tax is reported (Form 4720).

- A reasonable, good faith approach must have a reasonable basis for anticipating that the compensation that a particular employee will be paid in the future may be subject to the deduction limitations of section 162(m). It is not reasonable to anticipate that an ATEO may become a public corporation by the date the compensation will be paid, absent facts indicating that is a realistic potentiality.

- The two approaches regarding deferred compensation described in the preamble to the proposed regulations[1] are treated as reasonable, good faith approaches. This includes allowing an employer to exclude an amount from remuneration if reasonably expected to be disallowed under section 162(m) and offsetting remuneration subject to section 4960 in a later tax year by an amount equal to the amount that was treated as an excess remuneration under section 4960 in a previous tax year for which a deduction is subsequently disallowed.

Applicability date

- The final regulations apply to tax years beginning after December 31, 2021 (with the first applicable year generally being the 2022 calendar year). Prior to the effective date of the final regulations, taxpayers may rely upon the guidance in Notice 2019-09 in its entirety or the proposed regulations

[1] See Section III.F of the Explanation of Provisions of the proposed regulations, titled "Remuneration Paid to a Covered Employee for Which a Deduction Is Disallowed Under Section 162(m)."

in their entirety. Alternatively, taxpayers may choose to apply the final regulations to tax years beginning after December 31, 2017, and on or before December 31, 2021, provided they apply the final regulations in their entirety and in a consistent manner. Taxpayers may also base their positions upon a reasonable, good faith interpretation of the statute that includes consideration of any relevant legislative history. If the position is inconsistent with Notice 2019-09, the proposed regulations or the final regulations, the answer to the question whether the position constitutes a reasonable, good faith interpretation of the statute is based upon all the relevant facts and circumstances, including whether the taxpayer has applied the position consistently and the extent to which the taxpayer has resolved interpretive issues based on consistent principles and in a consistent manner. However, Notice 2019-09 provides certain positions that are not consistent with a reasonable, good faith interpretation, and the proposed and final regulations reflect this view.

For more information, contact a tax professional with KPMG's Washington National Tax practice:

Compensation and benefits

Robert Delgado | +1 (858) 750-7133 | rdelgado@kpmg.com

Erinn Madden | +1 (202) 533-3757 | erinnmadden@kpmg.com

Terri Stecher | +1 (202) 533-4830 | tstecher@kpmg.com

Exempt organizations

Ruth Madrigal | +1 202 533 8817 | ruthmadrigal@kpmg.com

Preston Quesenberry | +1 202 533 3985 | pquesenberry@kpmg.com