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IRS Issues Guidance on Nonprofit Executive Compensation, but Challenges Remain for Tax-Exempt Health Care Systems

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On December 31, 2018, the Internal Revenue Service (IRS) issued highly anticipated guidance regarding the 21% excise tax on certain nonprofit executive compensation.

Section 4960 of the Internal Revenue Code, enacted as part of the Tax Cuts and Jobs Act in late 2017, imposes a 21% tax on compensation over $1 million and on excess parachute payments paid by tax-exempt employers with respect to covered employees for tax years beginning after December 31, 2017. Even before its enactment, as this provision made its way through House and Senate deliberations, nonprofit health care systems were concerned that the new excise tax would be both costly and challenging to implement.

Comments submitted to the Treasury throughout 2018 raised many questions about how Section 4960 should be applied, particularly in the context of complex, multi-entity tax-exempt systems. With the release of Notice 2019-09 (the "Notice"), the IRS has answered some of these questions. Unfortunately, many of the answers are unfavorable to tax-exempt employers, particularly in the nonprofit health care sector. Not only does the excise tax impose a substantial economic burden on nonprofit health care systems as compared to privately-owned health care systems, but significant resources will likely need to be devoted to establish internal systems to implement the new tax.

What tax is imposed on tax-exempt organizations by Section 4960?

Section 4960 contains two components, both triggered by compensation paid to "covered employees." First, a tax-exempt organization is now required to pay an annual 21% excise tax on compensation exceeding $1 million paid to a covered employee.[1] To provide $2 million of reasonable compensation to a covered employee in 2019, an exempt organization will owe $210,000 in tax.

In addition, a tax-exempt employer must pay a 21% excise tax on any "excess parachute payment" made to a covered employee. This refers to any payment that is contingent on an employee's separation from employment, where the aggregate payment is three times or more the employee's average annual taxable compensation in the preceding five years. The tax applies to the amount of the payment that exceeds the annual average amount. If a covered employee's annual average compensation is $500,000, and the covered employee receives a parachute payment of $1.5 million or more, the tax applies to the portion of the payment exceeding $500,000.

When is the tax effective?

The new excise tax applies beginning with the first day of the tax-exempt organization's taxable year beginning after December 31, 2017. If the employer's taxable year began July 1, 2018, that is when the new tax went into effect for that employer. Special rules for compensation paid before the effective date are provided in the Notice and explained below.

Who is a "covered employee"?

This question has been the focus of much discussion and debate since Section 4960 was enacted. The definition of "covered employee" is key to understanding the impact of the 21% excise tax. A covered employee for this purpose is defined as an employee who is one of the five highest compensated employees of the organization in any tax year beginning after December 31, 2016. This definition, while simple on the surface, is not easy to apply in the context of a multi-corporate health care system, as discussed below. It is important to note that each tax-exempt organization has to determine its own covered employees; a group of related exempt organizations is not permitted to have one set of covered employees for the entire group of organizations (unless of course only one organization is the common law employer of all employees for all organizations).

Can an individual earning less than $1 million be a covered employee?

Yes. There is no minimum dollar threshold for an employee to be a covered employee. If in any tax year beginning after December 31, 2016, an individual was one of the organization's five highest paid employees, covered employee status occurs and remains in place forever. The excise tax liability can occur even if compensation is less than $1 million—an excess parachute payment paid to any covered employee is subject to the 21% excise tax, even if the annual average compensation amount (which is where the tax starts) is less than $1 million.

When does covered employee status end?

Never. The Notice confirms that once an employee is classified as a covered employee, that status is permanent. The employee must be tracked indefinitely for Section 4960 purposes, even as compensation and services may vary over time. As a result, each tax-exempt employer within a system must identify its covered employees annually and add them to a log of covered employees. All compensation paid to those covered employees by that organization and by all related organizations has to be tracked and counted.

When is compensation counted for purposes of the excise tax?

Compensation is anything that, when paid, is treated as wages subject to federal income tax withholding. This is roughly equivalent to W-2 income, but will exclude certain types of taxable benefits that are treated as W-2 income but are not subject to tax withholding.

An item of compensation (provided to a covered employee) is subject to the new excise tax when it is "vested." The rules for deferred compensation plans apply when determining whether and when something becomes vested—it means that the employee has a legally binding right to the compensation item, and that the item is no longer subject to a substantial risk of forfeiture. When that occurs, the compensation item is vested, and is treated as paid. If that occurred before the effective date of the new tax, then that compensation amount is not subject to the tax, even if it has not yet been paid to the employee.

What about earnings on old vested compensation amounts that have not yet been paid?

This is one bit of good news in the guidance for many organizations. The Notice states that, when compensation has vested before the effective date of the new tax, any earnings on that compensation, up to the effective date, are also excluded from the tax. Earnings are treated as accruing at the end of each year before the effective date. For this purpose, "earnings" means any increase in value that reflects the investment performance or the passage of time, and is not related to earning an additional benefit with additional contributions, additional benefit accruals, or changes in service or compensation. For older vested arrangements that cannot be paid out until termination of employment, this is a significant exception to the scope of the tax.

Is compensation for medical services excluded from the excise tax?

The medical services exclusion, which had provided a glimmer of hope to nonprofit health care systems when Section 4960 was enacted, has now been very narrowly defined in a manner that creates operational difficulties. The statute provides that compensation paid to a licensed medical professional for medical services is disregarded for purposes of determining covered employees and amounts subject to the excise tax. The Notice interprets this to mean that only compensation paid for the "direct performance" of medical services to patients is excluded, not compensation for teaching, research, or administration. Even payments for medical supervision services are not excluded, unless the physician is accompanying another medical professional (such as a resident) in providing services to patients. In effect, it is likely that only payments for direct patient care can be excluded under this narrow interpretation. If a Chief Medical Officer's employment agreement does not explicitly state what portion of overall compensation is paid for direct medical services, the employer must make a reasonable, good faith allocation using billing records, timesheets, comparable salaries for employees providing such non-medical services, or other reasonable bases.

How does the excise tax apply when an employer uses a fiscal year different from the calendar year?

The Notice clarifies that the excise tax is determined on a calendar year basis, not based on the taxable year of the employer, thereby aligning the Section 4960 tax with Form W-2 and Form 990 reporting. This is a helpful clarification because it should reduce the administrative burden that would arise if non-calendar year employers were required to allocate compensation paid during a single calendar year across multiple fiscal years.

How does the excise tax apply when there are multiple employers within a tax-exempt system?

Answers to this question are perhaps the most controversial and complicated portions of the Notice.

- As Section 4960 has been analyzed since its passage, some have advocated that a group of related tax-exempt employers should only need to identify its five highest-compensated employees systemwide. The Notice flatly rejects this approach. Each tax-exempt employer must separately determine its covered employees. Health care systems with extensive organizational structures could easily have dozens of employees, in total, who are earning compensation that triggers the excise tax.
- Multiple entities within a tax-exempt system may be liable for a portion of the excise tax, according to rules set forth in the Notice. A tax-exempt employer may owe excise tax for its own covered employees and additionally as a related organization, subject to limited relief to avoid double counting compensation payable to the same employee.
- Covered employee status is determined based on compensation paid by the tax-exempt employer as well as by related organizations, whether or not tax-exempt. As a result, each tax-exempt employer within a system must determine the extent to which compensation must be imputed to its employees from related organizations. An organization is related if it controls more than 50% of, or is more than 50% controlled by, the tax-exempt organization, or if it is in a supporting relationship (under the nonprivate foundation rules) with respect to the tax-exempt organization. For example, if the tax-exempt organization controls more than 50% of the governing board positions of another nonprofit corporation, such as by having the power to appoint and replace those board members, then the two organizations are related for purposes of this excise tax. Being related means that all compensation provided by those organizations is aggregated, and each organization shares liability for the tax in proportion to the share of total compensation paid.

The Notice contains many detailed examples designed to illustrate these principles.

Tax-exempt organizations will be required to file their excise tax forms and pay the tax before the 15th day of the fifth month following the end of the taxable year that began in 2018. Quarterly estimated payments of the excise tax are not required.

The Notice was issued as interim guidance before the issuance of proposed regulations under Section 4960. Despite the challenges for health care systems raised by portions of the Notice, tax-exempt organizations should welcome the effort by the IRS to address ambiguities under the statute. The Treasury and IRS have requested additional comments before regulations are issued, acknowledging that open issues remain. Affected organizations are likely to encounter significant difficulties as they interpret the Notice, determine the tax liability, and seek to create workable solutions going forward.

[1] The excise tax rate under Section 4960 is equal to the corporate income tax rate, which is currently 21%. *See* IRC Sec. 4960(a).

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