Excess Parachute Payments Under Code Section 4960

Statutory Text of Code § 4960:

SEC. 4960. TAX ON EXCESS TAX-EXEMPT ORGANIZATION EXECUTIVE COMPENSATION

(a) Tax imposed.—There is hereby imposed a tax equal to the product of the rate of tax under section 11 and the sum of—

(1) so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus

(2) any excess parachute payment paid by such an organization to any covered employee.

For purposes of the preceding sentence, remuneration shall be treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such remuneration.

(b) Liability for tax.—The employer shall be liable for the tax imposed under subsection (a).

(c) Definitions and special rules.—For purposes of this section—

(1) Applicable tax-exempt organization.—The term "applicable tax-exempt organization" means any organization which for the taxable year—

(A) is exempt from taxation under section 501(a),

(B) is a farmers’ cooperative organization described in section 521(b)(1),

(C) has income excluded from taxation under section 115(1), or
(D) is a political organization described in section 527(e)(1).

(2) COVERED EMPLOYEE.—For purposes of this section, the term "covered employee" means any employee (including any former employee) of an applicable tax-exempt organization if the employee—

(A) is one of the 5 highest compensated employees of the organization for the taxable year, or

(B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

(3) REMUNERATION.—For purposes of this section:

(A) IN GENERAL. The term "remuneration" means wages (as defined in section 3401(a)), except that such term shall not include any designated Roth contribution (as defined in section 402A(c)) and shall include amounts required to be included in gross income under section 457(f).

(B) EXCEPTION FOR REMUNERATION FOR MEDICAL SERVICES. The term "remuneration" shall not include the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional.

(4) REMUNERATION FROM RELATED ORGANIZATIONS.—

(A) IN GENERAL. Remuneration of a covered employee by an applicable tax-exempt organization shall include any remuneration paid with respect to
employment of such employee by any related person or governmental entity.

(B) RELATED ORGANIZATIONS. A person or governmental entity shall be treated as related to an applicable tax-exempt organization if such person or governmental entity—

(i) controls, or is controlled by, the organization,

(ii) is controlled by one or more persons which control the organization,

(iii) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the organization,

(iv) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the organization, or

(v) in the case of an organization which is a voluntary employees' beneficiary association described in section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.

(C) LIABILITY FOR TAX. In any case in which remuneration from more than one employer is taken into account under this paragraph in determining the tax imposed by subsection (a), each such employer shall be liable for such tax in an amount which bears
the same ratio to the total tax determined under subsection (a) with respect to such remuneration as—

(i) the amount of remuneration paid by such employer with respect to such employee,

(ii) the amount of remuneration paid by all such employers to such employee.

(5) **EXCESS PARACHUTE PAYMENT.**—For purposes of determining the tax imposed by subsection (a)(2)—

(A) **IN GENERAL.** The term "excess parachute payment" means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

(B) **PARACHUTE PAYMENT.** The term "parachute payment" means any payment in the nature of compensation to (or for the benefit of) a covered employee if—

(i) such payment is contingent on such employee’s separation from employment with the employer, and

(ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such separation equals or exceeds an amount equal to 3 times the base amount.

(C) **EXCEPTION.** Such term does not include any payment—

(i) described in section 280G(b)(6) (relating to exemption for payments under qualified plans),
(ii) made under or to an annuity contract described in section 403(b) or a plan described in section 457(b),

(iii) to a licensed medical professional (including a veterinarian) to the extent that such payment is for the performance of medical or veterinary services by such professional, or

(iv) to an individual who is not a highly compensated employee as defined in section 414(q).

(D) BASE AMOUNT. Rules similar to the rules of 280G(b)(3) shall apply for purposes of determining the base amount.

(E) PROPERTY TRANSFERS; PRESENT VALUE. Rules similar to the rules of paragraphs (3) and (4) of section 280G(d) shall apply.

(6) COORDINATION WITH DEDUCTION LIMITATION.—Remuneration the deduction for which is not allowed by reason of section 162(m) shall not be taken into account for purposes of this section.

(d) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent avoidance of such tax through the performance of services other than as an employee or by providing compensation through a pass-through or other entity to avoid such tax.¹

Excise Tax on Excess Parachute Payments under Code § 4960

- Excise tax applies to "excess parachute payments" under Code § 4960(a)(2)
- Tax is at corporate rate (currently 21%)
- Tax is paid by employer, not individual
- Rules are very similar to golden parachute payment rules under Code § 280G
- Excess Parachute Payment = Parachute payment minus portion of base amount allocated to such payment.

- What is a parachute payment?
  - Any payment in the nature of compensation from ATEO or related organization to covered employee that is:
    - Contingent on separation from employment
    - Aggregate present value ≥ 3x base amount
  - Exclusions:
    - Payments from qualified and quasi-qualified retirement plans (401(a), 403(a), 403(b), SEP, SIMPLE, 457(b))
      - Note: In this context, both tax exempt and governmental 457(b) plans are excluded (versus excess remuneration, which only excludes governmental 457(b) payouts)
    - Payments to medical/veterinary professional for medical/veterinary services
    - Payments to NHCEs
      - If a covered employee is an HCE at the time of separation from employment, then the individual is considered an HCE under this exemption, even if the payment is made in a future year.
      - There was originally a question regarding whether the amount of the parachute payment itself is excluded in determining whether an individual is an HCE. However, since this will be based upon the prior year's compensation, this should become a non-issue.
  - A "payment in the nature of compensation" basically includes any payment in whatever form that arises out of an employment relationship
    - Note that this is a more expansive concept than the 3401(a) wages that are used for excess remuneration.
    - Includes payments under a noncompete
    - Includes the value of accelerated vesting
    - Includes retiree medical benefits
  - Payment is generally considered to be made in the taxable year in which it is includible in the covered employee's gross income
    - If the item is not includible in income, then it is considered made in the year of receipt
  - When is a payment contingent on separation from employment?
    - Facts-and-circumstances determination
    - Requires involuntary separation
• Includes voluntary separation for good reason (as defined in Proposed Treasury Regulation § 1.457-11(d)(2)(ii))
• Includes separations under window programs
• If there are multiple potential triggers for payment (e.g., death, disability, or involuntary separation from service), it is not a parachute payment, correct?

- Generally requires the payment to have been subject to a substantial risk of forfeiture (under Code Section 457(f) principles) at the time of the involuntary separation from employment.
  - However, if an amount is already vested, the increased value of accelerating payment of those amounts upon an involuntary termination is considered to be contingent upon a separation from employment.

- A payment does not fail to be contingent on separation from employment merely because the payment is conditioned upon a release of claims, noncompete, or similar arrangement.
  - However, note that a noncompete may provide a SROF for 457(f) purposes, and therefore will delay when the amounts are taken into account for excess remuneration purposes.

- If a covered employee terminates and continues to provide services as an independent contractor, payments for those services are not considered to be contingent on separation from employment to the extent they are reasonable in light of the services rendered.

- If a covered employee involuntarily separates before the end of a contract term and is paid damages for breach of contract, those damages are treated as a payment that is contingent on a separation from employment.
  - Does it matter whether these are paid pursuant to a judgment or settlement?
  - Does it matter whether the judgment/settlement is paid by the employer or an insurance company?
  - If such amounts are not a parachute payment, would they still count as remuneration?

- Amounts previously included in income and/or excess remuneration are not contingent on separation from employment (and thus not a parachute payment) merely because they are actually paid to the covered employee because of separation from employment.
  - However, see the note below regarding the inclusion of the value of any acceleration of the payments.

- What is a separation from employment?
  - Essentially based on Code § 409A rules for "separation from service," except independent contractor rules are disregarded.
  - Must use defaults for treating anticipated reduction in future services as termination of employment:
    - Reduction < 50% → No separation from employment
- 50% ≤ Reduction ≤ 80% → Based on facts and circumstances
- Reduction > 80% → separation from employment
  - Not a separation from employment unless employee separates employment with all employers in controlled group
- If either payment or vesting is accelerated due to an involuntary separation from employment, only the value of the acceleration is treated as contingent on separation from employment.
  - If involuntary separation accelerates payment of vested amounts, the amount contingent on the separation from employment is the present value of the acceleration.
  - If the future value of the payment is not readily ascertainable, and
    - The acceleration does not "significantly increase the present value of the payment" → nothing is treated as contingent on separation from employment
    - The acceleration "significantly increases the present value of the payment" → the whole thing is treated as contingent on separation from employment
  - Acceleration by 90 days or less is treated as not significantly increasing the present value
- If a payment:
  - Vests as a result of an involuntary separation,
  - Disregarding the separation from employment, was contingent only upon the performance of future services, and
  - Is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made,
  - Then the portion that is contingent on separation from employment is equal to the value of the accelerated payment (described above) if any, plus the value of the lapse of the obligation to continue performing services (calculated as 1% of the accelerated payment multiplied by the number of months of increased vesting).
  - If the payment was subject to vesting conditions aside from the future performance of services (e.g., attainment of a goal), then these special rules don’t apply and the whole payment is treated as being contingent on separation from service.
- Determining whether aggregate present value ≥ 3× base amount
  - The present value of all payments made to a covered employee from an ATEO and all related organizations that are contingent upon separation from employment are aggregated.
  - Determining present value
    - Generally determined as of the earlier of date of separation from employment or date payment is made
Deferred payments calculated based on reasonable actuarial assumptions and a discount rate equal to 120% of the applicable Federal rate under Code § 1274(d)

Obligation to provide future health care benefits should be valued in accordance with GAAP methods.

If future payment is contingent upon uncertain future events, employer must estimate odds of making payment.
  - If ≥ 50%, the full amount is considered
  - If < 50%, not considered
  - If the ATEO later determines that the estimate was incorrect, then it must re-run tests

Determining base amount

- A covered employee’s base amount is the average annual compensation included in gross income for the employee’s five most recent taxable years ending before the date on which the separation from employment occurs.
  - Note that items excludable from gross income are ignored in calculating base amount (but may count toward parachute payment)
  - Note that amounts paid in the year of separation do not count toward base amount
- If less than five years, period of employment is used as base period.
- If the base period includes a short year, compensation must be annualized, and nonrecurring payments (e.g., signing bonus) should be ignored.
- If covered employee did not perform services for ATEO prior to year of separation, base amount is equal to annualized compensation for the portion of the year prior to separation (which was not contingent on separation form employment).

- Computing the excess parachute payment amount
  - The excess parachute payment amount is equal to the amount of the parachute payment over the base amount allocated to that payment
    - Note that this is 1x the base amount, not 3x!
    - The portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the PV of the parachute payment bears to the aggregate PV of all parachute payments made to a covered employee.

- Excise Tax is 21% of the amount of the excess parachute payments.