

## ASAE Issue Brief

### *Section 4960: Excise Tax on Employer-Employee Contracts Paid by Tax-Exempt Organizations*

**The American Society of Association Executives (ASAE) and its 46,000 members urge Congress to enact an exemption, retroactive to November 2, 2017, for the 21-percent tax on employment contracts.**

#### **BACKGROUND**

The Tax Cuts and Jobs Act (TCJA), signed into law December 2017, created **Section 4960** to levy a **21-percent excise tax on tax-exempt organizations that – through annual compensation AND certain retirement benefits – provide individual employees over \$1 million per year**. Congressional intent at the time was to ensure parity between tax-exempt organizations and for-profit, public companies.

In 1994, Congress enacted Section 162(m), which provides that a publicly traded corporation (i.e., for-profit, public company) may not deduct from tax liability compensation in excess of \$1 million per year paid to any “covered employee” of the corporation. The TCJA expanded Section 162(m) to eliminate a performance-based compensation exception (i.e., bonuses) and broaden the definition of “covered employee.” **This expansion was “grandfathered,” retroactive to November 2, 2017.**

As Section 4960 relates to annual compensation, tax-exempt organizations are subject to the tax each year, beginning in 2018. But, in the year an executive retires and receives his or her deferred compensation, **the sum of retirement benefits (in the form of 457(f) deferred compensation plans) are combined with annual compensation** to determine the organization’s tax liability. Any amount that exceeds \$1 million is subject to the 21-percent tax. **Employment contracts for tax-exempt organizations were not grandfathered by the TCJA.**

Critically, tax-exempt organizations in many cases will have no recourse but to deplete reserve funds to meet this tax obligation—often in the hundreds of thousands of dollars. Due to the grandfather rule in Section 162(m), however, for-profit entities will owe \$0 on pre-existing employment contracts.

#### **DEFINITIONS**

The following table outlines terms used in this document:

TERM	DEFINITION
<b>Covered Employee</b>	According to the IRS, Section 4960 defines a covered employee as “any employee who is one of the [organization’s] five highest-compensated employees for the current taxable year or who was a covered employee of the [organization] for any preceding taxable year beginning after December 31, 2016.”
<b>457(f) Plans</b>	The 457(f) is a deferred compensation plan that allows eligible employers to contribute money on a pre-tax basis into accounts that provide certain executives a future retirement benefit. Participation in a 457(f) plan is typically limited to a select group of executives, and plan funds are generally distributed when an executive retires from an organization or passes away. Benefits are taxable in the year they are vested regardless of when the benefit is earned or paid.
<b>Grandfather Rule</b>	A clause that exempts certain classes of people or things from the requirements of a piece of legislation that affects their previous rights, privileges or practices.

## **KEY MESSAGING**

- **ASAE and its members urge Congress to enact a grandfather rule for Section 4960, retroactive to November 2, 2017. This is fundamentally an issue of fairness in tax policy.**
- Tax-exempts that had employment contracts in place prior to November 2, 2017 must comply with an “ex post facto” tax—current tax implications did not exist during contract negotiation.
- Since the last major tax reform in 1986, associations and nonprofits have dutifully complied with applicable tax law.
- In December 2018, IRS issued interim guidance to help clarify aspects of Section 4960. ASAE submitted public comments regarding the interim guidance, but critical questions remain.
- The Treasury Department will not establish a grandfather rule for Section 4960. Only legislation can correct the issue.
- **A tax-exempt organization – not an individual employee – must pay the 21-percent tax.**
- ASAE and its members believe the scope of this excise tax is ambiguous, especially as it relates to 457(f) deferred compensation plans.
- ASAE urges IRS, in future guidance or rulemaking, to confirm 457(f) plan benefits that vested before 2018 are exempt from Section 4960.
- It is nearly impossible to modify existing 457(f) plans to mitigate the impact of Section 4960.
- **Establishing a grandfather rule for Section 4960 will ensure tax fairness across the nonprofit and for-profit sectors.**

## **DRAFT GRANDFATHER LANGUAGE**

**ASAE advocates the following be used in legislation to establish a grandfather rule for Section 4960:**

*The amendments made by this section shall not apply to amounts paid pursuant to a written binding contract or employment agreement which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date.*

## **ASAE POLICY POSITION STATEMENT**

**ASAE’s Board of Directors approved the following policy position statement in August 2019:**

*ASAE specifically opposes statutory interpretations that retroactively tax compensation plans and other contracts that were negotiated in good faith prior to changes in tax law. In many cases, associations are unable to renegotiate contracts established before changes in federal tax policy and are therefore required to pay exorbitant taxes under laws or statutory interpretation that simply did not exist when contracts were established. ASAE seeks fairness in tax policy, particularly as it relates to the treatment of associations and other nonprofits compared to their for-profit peers. As such, ASAE calls for grandfather provisions that would apply to all employment contracts negotiated prior to change in federal tax policy.*

## **LEGISLATION**

There is no legislation to establish a grandfather rule for Section 4960.

## **RESOURCES**

1. [IRS Interim Guidance Under Section 4960](#) (December 2018)
2. [ASAE public comments on IRS Interim Guidance](#) (April 2019)
3. [IRS Overview of 457 Deferred Compensation Plans](#)

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