

Employee Benefit ■ Plan Review

Preparing Tax-Exempt Organizations for the New Covered Employee Rules for the Expanded Code §4960 Excise Tax

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The One Big Beautiful Bill Act (OBBBA) amended Code §4960, which imposes an excise tax on certain excess compensation and excess parachute payments paid by applicable tax-exempt organizations. The IRS recently released Notice 2026-36, which announces the intent of the Department of the Treasury and the IRS to issue proposed regulations under Code §4960 and provides interim reliance guidance for tax-exempt organizations. The new covered employee rules generally apply to taxable years beginning after December 31, 2025.

WHAT IS CODE §4960?

Code §4960 imposes an employer-paid excise tax on an applicable tax-exempt organization (ATEO), as defined below, applicable tax-exempt organization or certain related organizations of ATEOs, that pay a covered employee either remuneration in excess of \$1 million for a taxable year or an excess parachute payment. The tax equals the corporate income tax rate (currently 21%) multiplied by (i) remuneration in excess of \$1 million paid to a covered employee, and (ii) any excess parachute payment paid to such employee.

An ATEO generally includes organizations exempt under Code §501(a), farmers'

cooperatives described in Code §521(b)(1), certain enumerated governmental entities¹ and political organizations described in Code §527(e)(1).

WHO WAS A COVERED EMPLOYEE BEFORE THE OBBBA CHANGE AND WHAT CHANGED UNDER THE OBBBA?

Before the OBBBA, a covered employee generally meant any employee, including a former employee, of an applicable tax-exempt organization if the employee was one of the organization's five highest-compensated employees for the taxable year or had been a covered employee of the organization, or a predecessor, for any prior taxable year beginning after December 31, 2016. Once an individual became a covered employee, that status generally remained permanent for purposes of Code §4960.

The existing regulations included limited hours, nonexempt funds and limited services exceptions for purposes of determining an organization's five highest-compensated employees. Those exceptions were designed largely for situations involving employees of related non-tax-exempt organizations who performed limited or temporary services for a related tax-exempt

organization, or who received only minimal remuneration from the tax-exempt organization.

For taxable years beginning after December 31, 2025, the covered employee definition is no longer limited to the five highest-compensated employees of an applicable tax-exempt organization. As amended, Code §4960 expands the definition of covered employee to include any employee (or former employee) of an ATEO who receives remuneration exceeding \$1 million for the taxable year or receives an excess parachute payment, in addition to individuals who are covered employees under the statute's continuing covered employee rules. Code §4960 also includes any former employee who was such an employee during any taxable year beginning after December 31, 2016. Additionally, while the proposed regulations would eliminate the temporary services exception, the limited hours exception will remain in effect.

In practical terms, the excise tax continues to apply only if the individual has remuneration over \$1 million or receives an excess parachute payment. However, the number of employees that must be reviewed for potential application of the tax is substantially broader. Tax-exempt organizations can no longer focus solely on their top five compensated employees for post-2025 taxable years.

PRACTICAL IMPLICATIONS FOR TAX-EXEMPT ORGANIZATIONS

Although the excise tax continues to apply only to remuneration exceeding \$1 million and excess parachute payments, the OBBBA's expanded covered employee definition significantly broadens the group of employees that organizations must monitor for Code §4960 purposes.

Tax-exempt organizations should review compensation arrangements, including deferred compensation plans and separation agreements, and consider whether existing payroll, tax

reporting and compliance processes are sufficient to identify employees who may now fall within the expanded covered employee definition. Additionally, governmental entities should assess whether they are treated as ATEOs based on their status as organizations either excluded from taxation under §115(1) or exempt from taxation under §501(a).

Notice 2026-36 provides helpful transition guidance, including:

- *Effective date interpretation.* The Department of the Treasury and the IRS interpret the effective date of the new definition to mean that the prior-law definition of covered employee continues to apply for taxable years beginning on or before December 31, 2025, and the new covered employee definition applies only for taxable years beginning after December 31, 2025. As a result, former employees will not become covered employees solely because they were employed by the organization during years before the amended definition becomes effective.
- *Continuation of existing exceptions.* The limited-hours exception and the nonexempt-funds exception will remain in effect.
- *Anticipated regulatory updates.* The forthcoming proposed regulations are expected to include covered employee exceptions similar to the current limited hours and nonexempt funds exceptions in addition to removing references to the five highest-compensated employee standard and other conforming changes.

The proposed regulations are not expected to include the current limited services exception because this exception was intended to address potential displacement from the five highest-compensated employee group, and that concern is no longer relevant under the expanded covered employee definition.

Treasury and the IRS have indicated that the forthcoming proposed regulations will apply prospectively. Until those regulations are issued, ATEOs may rely on Notice 2026-36, including its interpretation of the amended covered employee definition and its continued recognition of the limited-hours and nonexempt-funds exceptions.

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WHAT COUNTS AS REMUNERATION FOR DETERMINING WHO IS A "COVERED EMPLOYEE?"

Remuneration generally includes wages and amounts required to be included in income under Code §457(f). Remuneration excludes designated Roth contributions and excludes amounts paid to licensed medical professionals, including veterinarians, for the performance of medical or veterinary services. Remuneration from related organizations is aggregated for purposes of Code §4960, and any resulting excise tax liability is allocated among the employers that paid the remuneration.

Many nonprofit and tax-exempt organizations use nonqualified deferred compensation arrangements to recruit and retain senior executives and other key employees. These arrangements may include non-governmental Code §457(b) plans, Code §457(f) supplemental executive retirement plans, deferred bonus arrangements, retention plans and certain severance arrangements.

A non-governmental Code §457(b) plan can provide tax-deferred compensation to employees

of a tax-exempt organization. These plans must remain unfunded, and plan assets generally remain the property of the employer and subject to the claims of the employer's general creditors. Annual contributions (employee and employer) are limited to the applicable elective deferral limit for that year (\$24,500 for 2026).

A Code §457(f) plan is an "ineligible" deferred compensation plan. Non-governmental tax-exempt organizations often use Code §457(f) arrangements when the intended benefit exceeds the limit for contributions to a Code §457(b) plan. Tax deferral generally depends on the participant's rights being subject to a substantial risk of forfeiture; when that risk lapses, the deferred amount generally becomes taxable.

These arrangements are especially important under Code §4960 because remuneration includes amounts required to be included in income under Code §457(f). Code §4960 also treats remuneration as

paid when there is no substantial risk of forfeiture, even if actual payment occurs later. As a result, a large Code §457(f) vesting event can create Code §4960 exposure in a single taxable year.

WHAT'S NEXT?

Proposed regulations are expected. In the meantime, tax-exempt organizations should review compensation, deferred compensation, top hat and severance arrangements now so they are prepared for the expanded Code §4960 rules.

IN SUMMARY

- The OBBBA significantly expanded Code §4960 for taxable years beginning after December 31, 2025, broadening the scope of employees that tax-exempt organizations must evaluate for potential excise tax exposure.
- The definition of "covered employee" for tax-exempt organizations now covers any

employee of a tax-exempt organization who receives remuneration exceeding \$1 million or an excess parachute payment during the applicable taxable year — extending Code §4960 beyond the prior focus on an organization's five highest-compensated employees.

- Tax-exempt organizations should review compensation arrangements, deferred compensation plans and compliance processes before the new rules take effect, particularly where compensation may approach or exceed the \$1 million threshold. 🌀

NOTE

1. See Section 4960(c)(2)(C) which includes entities whose income is excluded from federal income taxation under Code §115(1).

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