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Executive Compensation Under Section 4960: FAQs for Tax-Exempt Organizations

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Section 4960 of the Internal Revenue Code imposes an excise tax on certain executive compensation paid by applicable tax-exempt organizations. While the basic framework of Section 4960 has remained in place since 2017, Congress amended the statute in 2025 to expand the definition of a covered employee and provide for annual inflation adjustments to the remuneration threshold. The IRS has also issued Notice 2026-36 providing initial guidance on how it intends to interpret these changes. Below are answers to some common questions about Section 4960.

What is Section 4960?

Section 4960 imposes a 21% excise tax on applicable tax-exempt organizations that pay:

- Annual remuneration to a covered employee in excess of the applicable statutory threshold; or
- Certain excess parachute payments in connection with a covered employee's separation from employment.

The excise tax is imposed on the employer, not the employee. For taxable years beginning before January 1, 2027, the threshold is $1 million, and the tax is applied on the amount in excess of that threshold. Beginning with taxable years after December 31, 2026, the threshold will be adjusted annually for inflation. The threshold is applied separately to each covered employee.

What organizations are subject to Section 4960?

Section 4960 generally applies to applicable tax-exempt organizations (ATEOs), including:

- Organizations exempt from tax under Section 501(a);
- Farmers' cooperative organizations described in Section 521(b)(1); and
- Certain governmental entities (including state colleges and universities) whose income is excluded from taxation under Section 115(1).

In some circumstances, related organizations may also have responsibilities under Section 4960 if they pay compensation to a covered employee of an Applicable Tax-Exempt Organization (ATEO).

Who is a covered employee?

Beginning with taxable years after December 31, 2025, the One Big Beautiful Bill Act expanded the definition of a covered employee to include any employee of an ATEO during the taxable year, regardless of the individual's compensation level. This is a significant change from the prior rule, under which covered employee status was generally limited to an organization's five highest-compensated employees for the taxable year and individuals who had previously become covered employees.

Notice 2026-36 clarifies that this expanded definition applies prospectively. Once an individual becomes a covered employee, either under the prior rule or the new rule, that status generally continues in future years. However, covered employee status alone does not mean that the Section 4960 excise tax applies. Whether the tax is actually imposed depends on the amount and type of remuneration paid to the covered employee.

What counts as remuneration?

For purposes of Section 4960, remuneration generally includes wages and other compensation paid to a covered employee that are subject to federal income tax withholding. Remuneration may include compensation paid by both the ATEO and certain related organizations.

Importantly, remuneration is not limited to an employee's base salary. Depending on the facts and circumstances, remuneration may also include bonuses, taxable fringe benefits, and deferred compensation that becomes taxable during the year.

For example, amounts that become taxable under a Section 457(f) deferred compensation plan are generally included in remuneration when the employee's substantial risk of forfeiture lapses (generally when the benefit becomes vested), even if payment is made at a later date. As a result, a significant vesting event under a 457(f) plan may cause an executive's remuneration for the year to exceed the applicable Section 4960 threshold.

However, not all compensation is included in remuneration under Section 4960. For example, designated Roth contributions, compensation paid to licensed medical professionals for the direct performance of medical services, and certain amounts paid to individuals who are not employees are generally excluded from remuneration for purposes of Section 4960.

What is an excess parachute payment?

An excess parachute payment is generally a compensation payment that is contingent upon an employee's separation from employment and exceeds the statutory limits under Section 4960. The statutory limit is met when the aggregate present value of the separation-related payments equals or exceeds three times the employee's "base amount." The base amount is the employee's average annual taxable compensation from the organization for the five taxable years preceding the employee's separation from employment. If this threshold is met, the excess parachute payment is the portion of the separation-related payment that exceeds the employee's base amount allocated to that payment.

If a payment qualifies as an excess parachute payment, the ATEO may owe the 21% excise tax even if the employee's annual remuneration does not exceed the applicable remuneration threshold.

How is compensation paid by related organizations treated?

Section 4960 generally requires organizations to consider remuneration paid by both the ATEO and certain related organizations.

As a result, compensation paid through affiliated taxable entities, supporting organizations, or other related employers may need to be aggregated when determining whether the remuneration threshold has been exceeded. Related organizations that pay remuneration may also be responsible for paying a portion of any excise tax based on the remuneration they provide.

What should tax-exempt organizations be doing now?

Tax-exempt organizations should consider reviewing:

- How they identify covered employees under the expanded statutory definition;
- Executive employment agreements, deferred compensation arrangements, and severance agreements; including Section 457(f) and other nonqualified deferred compensation plans;
- Compensation paid through related organizations; and
- Internal procedures for monitoring compliance with Section 4960 as additional IRS guidance is issued.

Organizations should also monitor future IRS guidance, including proposed regulations implementing the amended statute and annual inflation adjustments to the remuneration threshold.

If you have any questions about how Section 4960 may impact your organization, please contact a Boutwell Fay attorney.