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Tax Insights
from Exempt Organization
Tax Services

IRS guidance interprets limits on remuneration for tax-exempt organization compensation excise tax

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In brief

What happened?

The IRS on January 29 issued Generic Legal Advice Memorandum 2026-001 (GLAM) concluding that an applicable tax-exempt organization (ATEO) must include certain nondeductible compensation in calculating the Section 4960 excise tax even if the ATEO is part of an affiliated group with a covered health insurance provider (CHIP) that is subject to the Section 162(m)(6) compensation deduction limitation. Notably, the IRS stated that relying on Chief Counsel Advice 201752008 (the 2017 CCA) does not constitute a reasonable, good-faith interpretation for refund claims seeking to exclude such compensation.

Why is it relevant?

Many exempt organizations—particularly healthcare systems with taxable affiliates— have grappled with how Section 4960 interacts with Section 162(m). The GLAM addresses refund claims by ATEOs that attempt to exclude compensation from the Section 4960 calculation based on the $500,000 deduction limitation in Section 162(m)(6) when the ATEO had no taxable income and therefore could not claim deductions for compensation expenses. The GLAM rejects that position and makes clear that unless a deduction was actually disallowed under Section 162(m), the compensation must be included for Section

4960 purposes. The GLAM also signals a strict view of what constitutes a reasonable, good-faith interpretation in this area.

Actions to consider

ATEOs within healthcare or insurance-affiliated groups should review prior Section 4960 filings and any refund positions taken based on the 2017 CCA. They also should consider whether their coordination of Sections 4960 and 162(m) reflects the IRS position that only compensation actually disallowed as a deduction is excluded from the Section 4960 excise tax base.

In detail

Background

Section 4960, enacted as part of the 2017 Tax Cuts and Jobs Act, imposes a 21% excise tax on:

- Remuneration paid by an ATEO to a covered employee in excess of $1 million, and
- Excess parachute payments.

As originally enacted, covered employees generally included the five highest-compensated employees for the year and anyone who was a covered employee in a prior year beginning after 2016. Section 4960 has since been amended to provide that all employees of an ATEO are covered employees, without the five-employee-per-year limitation. This change is effective for tax years beginning after December 31, 2025.

Section 4960(c)(4)(A) provides that remuneration paid by a related organization, including a related taxable organization, is treated as paid by the ATEO.

The statute includes a coordination rule in Section 4960(c)(6), which provides that if a portion of the remuneration would be deductible, but the deduction is disallowed by Section 162(m), then that portion is not counted in the Section 4960 calculation.

Section 162(m)(6) limits the deductible compensation paid by a CHIP to an applicable individual to $500,000, with aggregation rules applying across related entities.

GLAM hypothetical example

The GLAM describes a hypothetical ATEO in an affiliated group that includes a taxable CHIP. The ATEO paid compensation to covered employees solely in connection with its tax-exempt activities and, therefore, did not claim business expense deductions for the employees' salaries.

The ATEO filed Forms 4720 and paid Section 4960 excise tax for 2018-2021, then filed refund claims asserting that remuneration paid by ATEOs within the group in excess of $500,000 should not be treated as remuneration for Section 4960 purposes.

The ATEO's argument relied on the 2017 CCA, which had concluded in the Section 162(m)(6) context that remuneration paid by a tax-exempt member of an aggregated group could be considered "otherwise deductible" for purposes of allocating the $500,000 deduction limit—even if the exempt entity could not actually use the deduction.

Compensation must be included if deduction not actually disallowed under Section 162(m)

The IRS rejected the refund position on the basis that a deduction was not actually disallowed under Section 162(m) and explained that taxpayers could not rely on the 2017 CCA. The IRS emphasized the statutory distinction between the terms "allowable" (used in Section 162(m)(6)) and "not allowed" (used in Section 4960(c)(6)).

Drawing on Supreme Court and Tax Court precedent, the GLAM notes that a deduction is "allowed" if it is claimed and not challenged, while "allowable" more broadly refers to whether the deduction would be permissible under the Internal Revenue Code.

Because the ATEO did not (and could not) claim a deduction for compensation allocable to its exempt activities, no deduction was actually disallowed under Section 162(m) and Section 4960(c)(6) did not apply. Therefore, the compensation had to be included in the Section 4960 excise tax calculation.

The GLAM emphasizes that the purpose of Section 4960(c)(6) is to prevent double taxation—i.e., a deduction disallowance under Section 162(m) in combination with an excise tax under Section 4960—not to eliminate the excise tax where no deduction was ever claimed.

The IRS also warned that accepting the ATEO's interpretation would allow any ATEO affiliated with a CHIP to avoid Section 4960 entirely, which would be inconsistent with congressional intent to level the playing field between for-profit and tax-exempt employers regarding excess executive compensation.

Observation: If a covered employee of the ATEO, who is also an applicable individual under Section 162(m)(6), performed services related to the ATEO's unrelated trade or business, then the ATEO would have properly allocated a portion of its remuneration as a deduction from unrelated business income under Section 512(a)(1). If any part of that deduction was disallowed under Section 162(m)(6), that portion would be excluded from remuneration for Section 4960 purposes under Section 4960(c)(6).

Observation: Section 162(m) contains other compensation deductibility limitations, including a general $1 million limit on deductibility for compensation paid to covered employees of publicly traded corporations under Section 162(m)(1). The GLAM's reasoning could extend to exclude compensation paid to employees of an ATEO with a related publicly traded corporation under Section 4960(c)(6).

The GLAM also expressly states that relying on the 2017 CCA to treat remuneration allocable to tax-exempt income as applicable individual remuneration for Section 162(m)(6) allocation purposes was incorrect.

The IRS concluded that reliance on the 2017 CCA does not constitute a reasonable, good-faith interpretation of Section 4960 for refund claims, for the following reasons:

- The 2017 CCA predates the enactment of Section 4960 and did not interpret Section 4960;
- Chief Counsel Advice has no precedential value;
- Notice 2019-9 and related proposed regulations, final regulations, and legislative history limit the exclusion to remuneration disallowed under Section 162(m).

Citing *Kraft Foods N. Am., Inc. v. United States*, the IRS concluded that a taxpayer cannot ignore the most authoritative available guidance and still claim reasonable, good-faith reliance.

Practical implications for exempt organizations

This GLAM sends several important signals:

Strict interpretation of Section 4960(c)(6): Only compensation that is actually disallowed as a deduction under Section 162(m) is excluded from the Section 4960 excise tax base.

Limited reliance protection: Reliance on pre-TCJA Chief Counsel Advice or reasoning not directly addressing Section 4960 might not satisfy the reasonable, good-faith standard.

Heightened scrutiny of refund claims: Organizations that filed protective or substantive refund claims based on aggressive coordination theories could be challenged.

For ATEOs in healthcare systems or other structures involving CHIPs and taxable affiliates, careful modeling of compensation, aggregation, and allocation remains essential. The IRS position reinforces that Section 4960 serves as a backstop when no corporate deduction limitation applies.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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