



Tax Insights
from Exempt Organization
Tax Services

Forthcoming Section 4960 regulations will address expanded covered employee definition

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In brief

What happened?

The IRS and Treasury on June 5 issued [Notice 2026-36](#), announcing their intent to issue proposed regulations under Section 4960 addressing the effective date of the One Big Beautiful Bill Act (OBBBA) amendment and proposing exceptions to the “covered employee” definition. The notice also solicits public comments on these matters.

Under prior law, “covered employee” was limited to an applicable tax-exempt organization’s (ATEO) five highest-compensated employees. OBBBA expanded this definition to generally include any current employee or former employees, effective for tax years beginning after December 31, 2025. The exceptions are anticipated to be similar to the limited hours and nonexempt funds exceptions in the existing Section 4960 regulations.

The notice provides favorable transition relief: for tax years beginning on or before December 31, 2025, prior law continues to apply in determining whether an individual became a covered employee. As a result, a former employee who was not a covered person under the prior law generally will not become one solely because of the expanded definition.

Why is it relevant?

The expanded definition could significantly increase the number of individuals that ATEOs must track for Section 4960 purposes. While the tax generally applies only when covered employee remuneration exceeds \$1 million or when an excess parachute payment is made, the shift from a “top five” framework to a potentially all-employee framework could require changes to compensation tracking, related-organization data gathering, and Form 4720 compliance processes.

Until proposed regulations are issued, ATEOs can rely on the anticipated rules described in the notice, including the effective-date interpretation and the anticipated limited hours and nonexempt funds exceptions.

Actions to consider

Tax-exempt organizations may want to:

- review historical covered employee determinations for tax years beginning after December 31, 2016 and on or before December 31, 2025;
- identify employees who may become covered employees for tax years beginning after December 31, 2025;
- reassess arrangements involving employees of related taxable or non-ATEO organizations who perform services for an ATEO;
- evaluate whether limited hours or nonexempt funds exceptions may apply and whether positions are sufficiently supported;
- update Section 4960 compliance processes, including compensation aggregation across related organizations;
- model potential excise tax exposure under the expanded definition; and
- submit comments by August 4, 2026, particularly on how the limited hours and nonexempt funds exceptions should be adapted and whether they should apply to officers.

In detail

Background

Section 4960 generally imposes a 21% excise tax on remuneration in excess of \$1 million paid by an ATEO or related organization for a tax year, as well as on excess parachute payments. Before OBBBA, covered employees generally were limited to the five highest-compensated employees of the ATEO for the year and any individual who had been a covered employee in a prior tax year beginning after December 31, 2016.

Existing regulations include limited hours, nonexempt funds, and limited services exceptions that can affect covered person determinations involving employees of related organizations.

For tax years beginning after December 31, 2025, OBBBA expands the definition of a “covered

employee” from an ATEO’s five highest-compensated employees to generally include any employee or certain former employees.

Notice 2026-36 explains that the existing limited hours, nonexempt funds, and limited services exceptions were designed for the “five highest-compensated employees” framework and therefore no longer apply by their terms under the amended definition.

Observation: The expanded definition could substantially increase the number of individuals that ATEOs must evaluate for Section 4960 purposes. This expansion could be particularly important for large health systems, universities, research organizations, and other exempt organization groups with complex related-entity structures.

Effective-date interpretation

The notice provides that the expanded covered employee definition applies for tax years beginning after December 31, 2025. Prior law continues to apply for tax years beginning on or before that date, including for purposes of determining whether a former employee was a covered employee before 2026.

As a result, individuals who worked for an ATEO on or before December 31, 2025 generally are covered employees only if they obtained covered person status under prior law. Employees of an ATEO in tax years beginning after December 31, 2025, could become covered persons subject to future guidance exceptions.

Observation: This interpretation prevents a broad retroactive sweep of all former employees who worked for an ATEO after 2016. Instead, pre-2026 former employees generally remain covered employees only if they became covered employees under the prior “top five” rules.

Forthcoming exceptions

Treasury and the IRS anticipate that forthcoming proposed regulations will remove references to an ATEO’s five highest-compensated employees and make conforming changes. The proposed regulations are expected to include covered employee exceptions similar to the existing limited hours and nonexempt funds exceptions. However, the notice indicates that the agencies do not expect to include a limited services exception because the displacement concern underlying that exception no longer applies once all employees are potentially covered.

Observation: The anticipated continuation of limited hours and nonexempt funds exceptions could be particularly relevant for organizations with shared-service, dual-employment, management company, medical group, university-affiliated, or taxable subsidiary structures.

Reliance before proposed regulations

Until proposed regulations are issued, ATEOs can rely on the rules described in Notice 2026-36 that are expected to be incorporated into the regulations, including the effective-date interpretation and the anticipated limited hours and nonexempt funds exceptions.

The notice confirms that covered employee status remains permanent once attained. The notice also illustrates that an individual satisfying the limited hours exception could avoid covered employee status in 2026, and that a former employee who worked for an ATEO in 2020 but was not a covered employee under prior law does not become one in 2026 solely by reason of that prior employment.

Comment opportunity

Treasury and the IRS request comments on issues raised by the notice, especially changes needed to adapt the limited hours and nonexempt funds exceptions to the new definition of covered employee, the appropriateness of applying those exceptions to officers of an ATEO, and other issues that should be addressed in forthcoming proposed regulations. Written comments are due by August 4, 2026.

The takeaway

Notice 2026-36 provides important transition guidance for ATEOs preparing for the expanded Section 4960 covered employee definition. The notice preserves prior-law treatment for pre-2026 years and indicates that limited hours and nonexempt funds exceptions are expected to continue in some form. At the same time, the loss of the five-highest-compensated-employee framework could significantly expand the population that organizations must evaluate.

ATEOs should consider using the period before proposed regulations are issued to review historical covered employee lists, assess related-organization service arrangements, strengthen documentation for potential exceptions, and update compliance systems for the post-2025 rules.

Let's talk

For a deeper discussion of how these developments may affect your organization, please reach out to your PwC engagement team or a member of our Exempt Organization Tax Services practice:

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