Patterson Belknap

Employee Benefits and Executive Compensation Alert
July 14, 2026

IRS Clarifies Application of the Non-Profit $1 Million Tax Post-OBBBA

The Internal Revenue Service ("IRS") released Notice 2026-36 (Notice of Intent to Issue Regulations under Section 4960), (the "Notice") relating to the tax on executive compensation under Internal Revenue Code ("Code") Section 4960, as modified by the One Big Beautiful Bill Act (the "OBBBA"). The Notice clarifies the IRS's interpretation of the changes the OBBBA made to Section 4960.

Background

Prior to the passage of the OBBBA, Section 4960 of the Code imposed a 21% excise tax on remuneration paid to "covered employees," which included the top five (5) highest compensated employees of a tax exempt organization (with a "once-in-always-in" rule that swept in any individuals who were previously in the "top five" for tax years beginning after December 31, 2016). Final regulations issued by the IRS define the term "five highest-compensated employees" of a tax-exempt organization, and provide "limited hours," "nonexempt funds," and "limited services" exceptions to this definition.[1] These exceptions are typically relevant where employees are shared between both a tax-exempt organization and a related taxable corporation.

As discussed in our prior alert (available here), the OBBBA changed the definition of covered employees for purposes of Section 4960. For taxable years beginning after December 31, 2025, the term "covered employee" means any employee of a tax-exempt organization and any former employee who was a covered employee during any taxable year beginning after December 31, 2016. Accordingly, after the OBBBA, the definition of covered employee for taxable years starting after December 31, 2025, (i) is no longer limited to the "top five" and (ii) could be interpreted to retroactively include all individuals who were employees in any taxable year beginning after 2016. In addition, it is unclear whether the three exceptions to the five highest compensated employees rule which were previously available for tax-exempt organizations under the regulations continued to be available under the OBBBA.

IRS Interpretation of Covered Individuals Subject to Section 4960 Excise Tax

Applicability of Prior Definition

As stated in the Notice, the IRS interprets this effective-date provision in the OBBBA "to broaden the definition of covered employee *only for* taxable years of a [tax-exempt organization] beginning after December 31, 2025, and to retain the prior definition of covered employee for taxable years beginning on or before December 31, 2025, including for purposes of determining for a taxable year beginning after December 31, 2025, whether a former employee was a covered employee in a taxable year beginning on or before December 31, 2025" (emphasis added).

Accordingly, under this interpretation, the definition of covered employee under section 4960(c)(2), as amended by the OBBBA, includes only—

> "• Any individual who was an employee of [a tax-exempt organization] in any taxable year beginning after [2016], and on or before [2026], if the individual was a covered employee for the taxable year under prior law, and

[1] Treas. Reg. Section 53.4960-1(d)(2)(ii), (iii), and (iv).

- Any individual who is an employee of [a tax-exempt organization] in any taxable year beginning after [2025] (subject to any exceptions provided in future guidance, such as those described in section 4.01 of [the] notice).”

Applicability of the Three Exceptions

The Notice indicates that two of the three exceptions (the exception for limited hours and the exception for nonexempt funds) are expected to continue to apply to tax exempt entities. The Notice clarifies that the IRS does not anticipate that the forthcoming regulations will include the exception for limited services, as the motivation for that exception (displacement of employees who otherwise would have been one of the top five compensated employees) and thus a covered employee is no longer relevant.

Forthcoming Proposed Regulations

The IRS also announced in the Notice that it expects to issue proposed regulations under Section 4960 to remove references to the “top 5” highest paid employees and make other conforming changes in light of the OBBBA, including clarification of the timing issues and available exception for tax-exempt entities.

It is also anticipated that the effectiveness of any changes to the tax regulations would be prospective after the final regulations are issued.

Next Steps

Until the forthcoming proposed regulations are issued, tax-exempt organizations may rely on the Notice’s provisions relating to the anticipated exceptions to be provided for limited hours and nonexempt funds. The IRS has requested comments on the issues raised in the Notice, and the comment period is open until August 4, 2026.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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