Proskauer

IRS Releases Interim Guidance on New Excise Tax on Executive Compensation Paid by Tax-Exempt Organizations

Not For Profit/Exempt Organizations Blog on **January 14, 2019**

On December 31, 2018, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") released Notice 2019-09 (the "Notice"), which provides interim guidance under Section 4960 of the Internal Revenue Code.

Very generally, Section 4960 imposes a 21% excise tax on certain tax-exempt entities (and certain related organizations) that pay remuneration in excess of $1 million to certain highly-paid individuals or that make certain "excess parachute payments" to this class of highly-paid individuals.

The Notice indicates that Treasury and the IRS intend to issue proposed regulations under Section 4960, which will be prospective only. The Notice also provides that until Treasury and the IRS issue additional guidance, however, taxpayers may rely on good faith, reasonable interpretations of Section 4960, and that the guidance issued in the Notice will be considered reliance upon a good faith, reasonable interpretation of Section 4960. The Notice also provides several examples of interpretations of Section 4960 that would not be considered by Treasury and the IRS as good faith, reasonable interpretations.

Overview of Section 4960

Section 4960 imposes on an **employer** an excise tax equal to the corporate tax rate (currently 21%) on the sum of (1) **remuneration** paid in excess of $1 million, except for remuneration paid for **medical and veterinary services**, by an **applicable tax-exempt organization** (an "ATEO") or a **related organization** for the **taxable year** with respect to the employment of any **covered employee**, and (2) any **excess parachute payment** paid by an ATEO to a **covered employee**.

Below is a high-level summary of key issues in the guidance issued in the Notice on each of the bolded terms above and general considerations regarding compliance.

What is an "Applicable Tax-Exempt Organization"?

Section 4960 provides that an ATEO is any organization that:

- is exempt from tax under Section 501(a) (which would generally include an organization exempt from tax under Section 501(c)(3), a religious or apostolic organization exempt from tax under Section 501(d), or a trust forming part of a stock bonus, pension or profit sharing plan under Section 401(a));
- is a farmers' cooperative organization described in Section 521(b)(1);
- has income excluded from tax under Section 115(1) (which generally excludes income derived from any public utility or from the exercise of any essential governmental function and accruing to a state, any political subdivision of a state, or the District of Columbia); or
- is a political organization described in Section 527(e)(1).

Commentators questioned whether certain governmental units, or quasi-governmental units, such as public universities, are included in the definition of an ATEO because many public universities claim to be tax-exempt under the doctrine of implied statutory immunity (rather than under Section 115(1) or any of the Sections listed above).

The Notice explains that a governmental entity that is separately organized from a state or political subdivision of a state may meet the requirements to exclude income from gross income (and thereby have income excluded from taxation) under Section 115(1). However, a state, political subdivision of a state, or integral part of a state or political subdivision, often referred to as a "governmental unit," does not meet the requirements to exclude income from gross income under Section 115(1) because Section 115(1) does not apply to income from an activity that the state conducts directly, rather than through a separate entity. Instead, under the doctrine of implied statutory immunity, the income of a governmental unit generally is not taxable in the absence of specific statutory authorization for taxing that income.

Some governmental units that may not be tax-exempt under Section 115(1) may be exempt from tax under Section 501(a). The Notice clarifies that such an organization will be an ATEO if it received a determination letter from the IRS that recognizes its tax-exemption under Section 501(a), even if the governmental unit could claim that the determination letter it received was protective and not necessary because the governmental unit is exempt from tax under other authority, such as under the doctrine of implied statutory immunity. The Notice provides that a governmental unit may relinquish its Section 501(c)(3) status using procedures described in Revenue Procedure 2018-5 to avoid being an ATEO. Therefore, if a governmental unit (including a state college or university) is not tax-exempt under Section 115(1) and also is not tax-exempt under Section 501(a) (including Section 501(c)(3)), it would not be an ATEO.

Who is the "Employer"?

Section 4960 imposes an excise tax on employers (and not employees). The Notice clarifies that it is the common-law employer (as generally determined for federal tax purposes) on which the excise tax is imposed, and a common law employer cannot avoid liability for the excise tax by entering into a third-party payor arrangement, such as using a payroll agent or professional employer organization.

The Notice also provides that the excise tax is based on remuneration paid to a covered employee by an ATEO and also by "any related person or governmental entity." Some commentators suggested that only other ATEOs should be treated as related. The Notice, however, states that the phrase "any related person or governmental entity" includes all related organizations, regardless of whether the related organization is a tax-exempt organization, a governmental entity or a taxable organization. The Notice specifically states that a taxpayer's interpretation that does not include taxable organizations and governmental entities as related organizations would not be a good faith, reasonable interpretation of Section 4960.

Section 4960 provides that if a covered employee is employed by both an ATEO and one or more employers related to the ATEO, then all employers are liable for their portion of the excise tax. The Notice confirms that if an ATEO has a covered employee who receives compensation not only from the ATEO, but also from related organizations that employ the covered employee, which can include a tax-exempt organization, a governmental entity or a taxable organization, the related organizations may also be liable for their portion of the excise tax as allocated in accordance with the Notice.

What is a "Related Organization"?

Section 4960 provides that the following persons and governmental entities are treated as organizations related to ATEOs:

- organizations that control or are controlled by the ATEO;
- organizations that are controlled by one or more persons which control the ATEO;
- organizations that are a "supported organization" (as defined in Section 509(f)(3)) during the taxable year with respect to the organization;
- organizations that are a "supporting organization" (as described in Section 509(a)(3)) during the taxable year with respect to the organization; and
- if the ATEO is a voluntary employees' beneficiary association, organizations established, maintained, or that make contributions to such voluntary employees' beneficiary association.

Section 4960 does not define the term "control" for purposes of determining an ATEO's related organizations. The Notice clarifies for taxable entities that control is defined as ownership of more than 50% of the stock of a corporation based on vote or value, profits interests or capital interests of a partnership, and beneficial interests in a trust. For nonprofit organization or other organizations without owners or persons with beneficial interests (a "nonstock organization"), the Notice defines control as more than 50% of the directors or trustees of the ATEO or nonstock organization being either representatives of or being controlled by the other entity, or more than 50% of the directors or trustees of the nonstock organization being either representatives of or being controlled by one or more persons that also control the ATEO.

The Notice clarifies that if an employer becomes or ceases to be a related organization of an ATEO during the calendar year ending with or within the ATEO's taxable year, only the remuneration that the related organization paid to a covered employee with respect to services performed during the portion of the calendar year when the employer was a related organization is included for purposes of calculating the excise tax liability.

Who is a "Covered Employee"?

Section 4960(c)(2) defines a "covered employee" as any current or former employee of an ATEO who (1) is one of the five highest-compensated employees of the ATEO for the taxable year, or (2) was a covered employee for any taxable year beginning after December 31, 2016 (*i.e.*, once an individual becomes a covered employee of an ATEO, the individual will always remain a covered employee). There is no minimum dollar threshold for an employee to be determined to be a covered employee.

The Notice clarifies that the five highest-compensated employees are determined based on remuneration paid for services performed as an employee of the ATEO, including remuneration for services performed as an employee of an organization related to the ATEO during a calendar year ending with or within the ATEO or related organization's taxable year. Importantly, these related organizations could include not only other tax-exempt organizations, but also for-profit or governmental entities. However, if an ATEO pays less than 10% of an employee's total remuneration for services performed for the ATEO and all related organizations during a calendar year, under the Notice, the employee is not considered to be one of that ATEO's five highest-compensated employees (and, thus, may not be required to be added to the list of covered employees for that ATEO). However, if the ATEO and no other related ATEOs pay 10% or more of the employee's compensation and the employee would otherwise be a covered employee then, under the Notice, this exception would not apply to the ATEO that pays the employee the most remuneration during that year (and that ATEO could be subject to the excise tax).

Whether an employee is one of an ATEO's five highest-compensated employees is determined separately for each ATEO and not for the entire group of related organizations. Therefore, each ATEO will have its own set of five highest-compensated employees. It is possible that a group of related organizations may have more than five covered employees. The Notice specifically states that a taxpayer's interpretation that a group of related organizations with more than one ATEO has a single set of five highest-compensated employees would not be a good faith, reasonable interpretation of Section 4960.

While commentators asked for a rule that would allow an individual who becomes a covered employee of an ATEO to cease being a covered employee after a certain number of years, the Notice does not provide any such relief. To the contrary, the Notice states that a covered employee will never cease to be a covered employee and that a taxpayer's contrary interpretation will not be a good faith, reasonable interpretation of Section 4960.

What is the Applicable "Taxable Year"?

Section 4960(a)(1) provides that relevant period during which remuneration is measured to determine if it exceeds $1 million is the "taxable year." However, Section 4960 does not indicate whose taxable year is relevant (*i.e.*, the employer's or employee's taxable year). The Notice clarifies that the taxable year used to calculate amount of remuneration paid to determine if there is an excise tax is the *calendar year* ending with or within the employer's taxable year.

Because Section 4960 applies to tax years beginning on or after January 1, 2018, if an employer that uses a calendar year as its taxable year, the excise tax described in Section 4960 could apply to all remuneration paid in 2018. For an employer with a non-calendar fiscal year, the results will be different. For example, if an employer uses a taxable year that begins on July 1, any remuneration that was paid between January 1 and June 30, 2018, was paid in a taxable year that is not covered by Section 4960. For 2018, only remuneration that was paid between July 1 and December 31, 2018, will be subject to Section 4960.

What is "Remuneration"?

Section 4960 defines remuneration to mean wages as defined in Section 3401(a), but excluding designated Roth contributions and including nonqualified deferred compensation required to be included in gross income under Section 457(f).

The Notice clarifies that remuneration does not generally include qualified retirement benefits (such as benefits from a 403(b), 401(k) or qualified pension plan) because these payments are excluded from the definition of wages in Section 3401(a). Remuneration also generally does not include director's fees because director's fees are generally treated as self-employment income and not wages under Section 3401(a).

Section 4960 states that remuneration is deemed paid when the right to the remuneration is no longer subject to a substantial risk of forfeiture. The Notice uses the definition of "substantial risk of forfeiture" under Section 457(f) (which is interpreted in proposed Treasury Regulations issued in 2016). In general, these proposed Treasury Regulations provide that remuneration is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the remuneration if the possibility of forfeiture is substantial. The Notice clarifies that this rule is not limited to remuneration that is otherwise subject to Section 457(f) or nonqualified deferred compensation under Sections 457(f) or 409A. When remuneration is no longer subject to a substantial risk of forfeiture, its present value is treated as remuneration regardless of when the amount is actually paid.

Employers that are ATEOs (and their related organizations) may now have to consider when amounts are no longer subject to a substantial risk of forfeiture, which may not have been relevant before the enactment of Section 4960. For example, if an employee becomes entitled to a bonus in December, but the bonus is not paid until the following January, the bonus will be treated as paid in December because that is when it is no longer subject to a substantial risk of forfeiture. Likewise, if an employer agrees to pay an employee 12 months' salary as severance upon an involuntary termination of employment, when the employee involuntarily terminates employment, the present value of all 12 months of severance payments will be treated as remuneration that is paid upon the employee's involuntary termination of employment because the amounts will no longer be subject to a substantial risk of forfeiture.

The Notice specifically states that the $1 million excess remuneration threshold is not adjusted for inflation.

Who is a Licensed Medical or Veterinary Professional and How Do You Determine What Amounts are Paid for "Medical and Veterinary Services"?

Section 4960 excludes from remuneration and excess parachute payments amounts paid to a licensed medical or veterinary professional for the performance of medical or veterinary services.

The Notice defines licensed medical and veterinary professionals to include individuals who are licensed under state or local law to perform medical or veterinary services (which includes dentists and nurse practitioners).

The Notice defines medical and veterinary services to mean direct medical care as described under Section 213(d), which includes the diagnosis, cure, mitigation, treatment, or prevention of disease, including services for the purpose of affecting any structure or function of the human body (Section 213(d) applies by analogy for veterinary services). Activities related to medical services, such as administrative, teaching, and research services are not considered medical or veterinary services unless the medical or veterinary professional performs direct medical or veterinary care while performing those activities. When an employer pays remuneration for both direct medical or veterinary services and other non-direct medical or non-direct veterinary services, the employer must allocate the remuneration between the two categories of services.

The Notice specifically states that amounts paid to a licensed medical or veterinary professional for the performance of medical or veterinary services should not be taken into account when determining the employer's five highest-compensated employees and that a contrary interpretation would not be a good faith, reasonable interpretation of Section 4960.

What are "Excess Parachute Payments"?

Generally

Section 4960 imposes an excise tax on any excess parachute payment paid by an ATEO or a related organization to a covered employee. This excise tax is reminiscent of the concepts contained in Section 280G with respect to excess parachute payments paid in connection with a change of control, except that instead of the parachute payments being paid in connection with a change of control, Section 4960 applies to amounts that are contingent on and paid in connection with an involuntary separation from employment.

Contingent on the Employee's Separation from Employment

The Notice generally treats payments as contingent on a covered employee's separation from employment if the facts and circumstances indicate that the employer would not make the payment in the absence of an ***involuntary*** separation from employment (including payments made in connection with a window program). Section 4960 gave no indication that separation from employment meant an involuntary separation from employment.

The Notice provides that an involuntary separation from employment means a separation from employment due the independent exercise of the employer's unilateral authority to terminate the employee's services, other than due to the employee's implicit or explicit request, if the employee was willing and able to continue performing services. Thus, an involuntary separation from employment may include a termination because an employer chooses not to renew an employment contract when it expires. The Notice also provides that a termination by an employee for "good reason" may be treated as an involuntary separation from employment. A payment does not fail to be contingent on a separation from employment merely because the payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirements.

Parachute Payments

Under Section 4960, parachute payments include any payments in the nature of compensation to (or for the benefit of) a covered employee if (i) the payments are contingent on the employee's separation from employment with the employer, and (ii) the aggregate present value of the payments equals or exceeds three times the covered employee's "base amount."

The “base amount” is determined by applying the current rules of Section 280G, which generally will provide that a covered employee’s base amount is the individual’s average annual taxable income from the organization over the five-year period immediately preceding the year in which the separation from service occurs (or any shorter period of service with the organization if less than five years).

Section 4960 provides that the following payments generally are excluded when determining the amount of a parachute payment:

- payments to or from certain retirement plans (including defined contribution plans, defined benefit plans, Section 403(b) plans and Section 457(b) plans);
- payments to a licensed medical professional (including a veterinary professional) to the extent that such payments are for the performance of medical or veterinary services by such professional; and
- payments to an individual who is not a highly compensated employee (as defined in Section 414(q), the threshold for which is $125,000 for 2019, subject to annual adjustment).

Payment in the Nature of Compensation

The Notice clarifies that any payment is considered a payment in the nature of compensation if the payment arises out of an employment relationship. This includes payments made under a covenant not to compete, wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension payments and other deferred compensation. Payments are considered made in the taxable year in which they are includible in the covered employee’s gross income or when received for non-taxable benefits.

If a payment is accelerated or a substantial risk of forfeiture lapses as a result of an involuntary separation from employment, the additional value arising due to the acceleration is treated as a payment contingent on a separation from employment, but only the value arising due to the acceleration is treated as contingent on a separation from employment.

Paying the Excise Tax

Taxpayers report and pay the excise tax imposed under Section 4960 using Form 4720, *Return of Certain Excise Taxes Under Chapter 41 and 42 of the Internal Revenue Code*. Each ATEO and related organization must file a separate Form 4720 to report its share of the excise tax liability. Form 4720 is due by the 15th day of the fifth month after the end of the employer's taxable year, which may be extended by filing a Form 8868, *Application for Automatic Extension of Time to File an Exempt Organization Return*. There is not a requirement for the employer to pay estimated taxes.

View Original

Related Professionals

- **Amanda H. Nussbaum**
  Partner
- **David S. Miller**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Tyler Forni**
  Associate