What's News in Tax

Analysis that matters from Washington National Tax

Interim Guidance on Taxing "Excess" Executive Compensation of Exempt Organizations

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Tax reform created a new excise tax on certain employee compensation and severance payments paid by tax-exempt organizations. Imposition of the new tax as a practical endeavor has been challenging for these organizations, but uncertainty has been eased by recent guidance that addresses many key outstanding questions and concerns.

Section 4960,[1] which imposes an excise tax equal to the corporate tax rate (21 percent) on certain "remuneration" and "excess parachute payments" paid to the five highest compensated employees of certain tax-exempt organizations, represents one of the most controversial provisions of the law often referred to as the "Tax Cuts and Jobs Act."[2] Numerous defined terms used in section 4960 were—until recently—undefined or ambiguous, resulting in exempt organizations struggling during the past year in attempting to determine whether and to what extent they are subject to the excise tax. However, before the ball dropped on December 31, 2018, the IRS issued Notice 2019-09, providing interim guidance addressing frequently asked questions on the application of section 4960.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] *See* Pub. L. No. 115-97, § 13602 (Dec. 22, 2017).

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This article summarizes certain questions raised by select terms in section 4960 that were outstanding prior to the notice's release and explains how the notice attempts to resolve these issues.[3] As a general matter, while tax-exempt organizations may rely on the notice's various interpretations,[4] the notice does not prescribe any mandatory rules and makes clear that taxpayers may base their positions upon good-faith, reasonable interpretations of the statute until further guidance is issued. Nevertheless, the notice identifies several positions that Treasury and the IRS have determined are not consistent with a good-faith, reasonable interpretation of the statute. In addition, the notice clarifies that any future guidance under section 4960 will be prospective and will not apply to tax years beginning before the issuance of that guidance.

Tax Year

The notice provides that the excise tax will be determined based on remuneration paid and excess parachute payments made in the calendar year ending with or within the tax year of the employer.[5] This is generally welcome news for fiscal-year organizations, as it prevents the potential increased administrative burden these organizations would have borne relative to their calendar-year counterparts if the IRS had required them to determine remuneration based on wages paid during their tax year as opposed to the amounts reported on the employees' Forms W-2.

The notice also makes clear that the effective date of the excise tax is the first tax year *of the employer* beginning after December 31, 2017, and that remuneration paid or vested prior to the start of that year is not subject to the excise tax.[6] Combining this effective date with the rule that remuneration be determined on a calendar-year basis, one may reasonably conclude that a fiscal-year organization need only look at those months of 2018 that fall within its tax year ending in 2019 when determining whether and the extent to which it paid remuneration in excess of $1 million for its first tax year beginning after December 31, 2017.

Common Law Employer Liable for the Excise Tax

The notice provides that the common-law employer, as determined generally for federal tax purposes, is liable for the excise tax imposed under section 4960.[7] A payment to an employee from a related or unrelated entity for services rendered to the common-law employer is considered a payment to the employee from the common-law employer for purposes of calculating remuneration and determining liability for the excise tax. Accordingly, the entity that provides an employee with a Form W-2 for remuneration is not necessarily considered the payor of that remuneration for purposes of section 4960.

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[3] For a detailed discussion of numerous section 4960 issues identified prior to the release of Notice 2019-09, see the following article authored by Alexandra O. Mitchell, Preston J. Quesenberry, and Randall S. Thomas: *An Excess of Uncertainty: The New Tax on Tax-Exempt Compensation*, 159 Tax Notes 1933 (Jun. 25, 2018).

[4] Specifically, taxpayers may rely on the rules in Notice 2019-09 effective from December 22, 2017 (the date of section 4960's enactment). Notice 2019-09, p. 91.

[5] Notice 2019-09, Q/A-2, p. 37.

[6] Notice 2019-09, Q/A-39, p. 88.

[7] Notice 2019-09, Q/A-3, p. 37.

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Applicable Tax-Exempt Organizations

The excise tax applies to "applicable tax-exempt organizations" ("ATEOs"), which is any one of the following four categories of organizations: (1) an organization exempt from tax under section 501(a); (2) an exempt farmers' cooperative (section 521(b)(1)); (3) a political organization (section 527); or (4) an organization that has income excluded from gross income under section 115(1). The last category has been controversial until recently, with practitioners and government officials debating whether state universities and other state and local governmental entities that do not have a section 501(c)(3) determination letter and that do not rely on section 115 to exclude their income from federal income tax constitute ATEOs. The notice clarifies that a governmental entity, including a state college or university, that is not recognized as exempt from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO. The notice also points out that a governmental entity that sought and received a determination letter recognizing its tax-exempt status under section 501(c)(3) may relinquish this status pursuant to procedures described in section 3.01(12) of Revenue Procedure 2018-5.[8]

Related Organizations

Section 4960 provides that remuneration paid by an ATEO includes any remuneration paid with respect to employment of an employee by any related person or governmental entity.[9] The notice confirms that Treasury and the IRS interpret the phrase "any related person or governmental entity" to include not only related ATEOs but also related taxable organizations and related governmental units or other governmental entities and notes that any interpretation to the contrary is not a good-faith, reasonable interpretation of the statute.[10]

Pursuant to the statute, a person or governmental entity is related to an ATEO if the person or governmental entity controls, or is controlled by, the ATEO or is controlled by one or more persons that control the ATEO.[11] For these purposes, the notice provides a definition of "control" based on section 512(b)(13)(D), which subjects certain payments from controlled entities to the unrelated business income tax.[12] Accordingly, with respect to stock corporations, partnerships, and trusts, control means ownership (either directly or indirectly by applying the principles of section 318) of more than 50 percent of an entity's stock (by vote or value), profits or capital interests, or beneficial interests, respectively. In the case of nonstock organizations (including governmental entities), control means that either: (1) more than 50 percent of the directors or trustees of the ATEO or nonstock organization are either representatives of, or are directly or indirectly controlled by, the other entity; or (2) more than 50 percent of the directors or trustees of the nonstock organization are either representatives of, or are directly or

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8 2018-1 I.R.B. 233, 239.

9 Section 4960(c)(4)(A).

10 Notice 2019-09, pp. 8, 10.

11 The statute also provides that a person or governmental entity is related to an ATEO if it is a supporting or supported organization with respect to the ATEO or, in the case of an ATEO that is a voluntary employees' beneficiary association ("VEBA"), establishes, maintains, or makes contributions to the VEBA.

12 Notice 2019-09, Q/A-8, p. 41.

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indirectly controlled by, one or more persons that control the ATEO. For these purposes, a "representative" means a trustee, director, agent, or employee, and control includes the power to remove a trustee or director and designate a new trustee or director.

Determination and Scope of Covered Employees

The excise tax applies only to remuneration or excess parachute payments paid to a "covered employee" of an ATEO. A covered employee is defined in the statute as any employee (including any former employee) of an ATEO if the employee "is one of the 5 highest compensated employees of the organization for the taxable year" or "was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016."[13] The notice confirms that this language means that once an employee is a covered employee, he or she continues to be a covered employee for all subsequent tax years, and states that the position that a covered employee ceases to be a covered employee after a certain period of time is not consistent with a good-faith, reasonable interpretation of the statute.[14] Section 4960 itself contains no rules for identifying an ATEO's five highest compensated employees for a tax year, and the notice provides helpful guidance with respect to this determination.

Each ATEO Determines Its Covered Employees Separately

The notice provides that each ATEO in a system of related organizations including multiple ATEOs will determine its covered employees separately, and states that the position that a group of related organizations with more than one ATEO has a single set of five highest compensated employees is not consistent with a good-faith, reasonable interpretation of section 4960.[15] Thus, one system of related ATEOs may have many more than five covered employees.

Compensation of Related Organizations Is Taken into Account

Notwithstanding that each ATEO in a system of related ATEOs must determine its five highest compensated employees separately, the notice provides that, in doing so, the ATEO must take into account compensation paid by each of its related organizations.[16] This means that the same individual could end up taking up a "slot" on the list of five highest compensated employees for multiple related ATEOs, bumping off the list other individuals whose remuneration might otherwise be taxed. To limit this effect, the notice provides that an employee is not one of an ATEO's five highest compensated employees for a tax year if, during the calendar year ending with or within the tax year, the ATEO paid less than 10 percent of the employee's total remuneration for services performed as an employee of the ATEO and all related organizations. However, if no ATEO in a group of related ATEOs paid at least

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[13] Section 4960(c)(2).

[14] Notice 2019-09, p. 12.

[15] Notice 2019-09, pp. 14-15.

[16] Notice 2019-09, Q/A-10, p. 43. The staff of the Joint Committee on Taxation ("JCT") opined that a technical correction to the statute may be necessary to reflect that the related organization rules apply for purposes of determining covered employees. *See* Joint Committee on Taxation, *General Explanation of Public Law 115-97* (JCS-1-18), at 265 n.1256 (Dec. 20, 2018).

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10 percent of an employee's total remuneration during a calendar year, then this exception does not apply to the ATEO that paid the employee the most remuneration during that year.

Compensation is Defined as Remuneration

In contrast to remuneration, the statute does not define compensation for purposes of determining an ATEO's five highest compensated employees. The notice fills this gap by defining "compensation" for these purposes as being the same as the "remuneration" taken into account in determining whether an ATEO is liable for the excise tax imposed on remuneration in excess of $1 million. More specifically, compensation is defined as that remuneration paid to an employee during the calendar year ending with or within the ATEO or related organization's tax year.[17] Guidance on the definition of "remuneration" is discussed below and, as noted there, excludes remuneration paid to a licensed medical professional for the performance of medical services. Correspondingly, the notice provides that remuneration paid for medical services is not taken into account for purposes of identifying the five highest compensated employees and further states that any position to the contrary is not consistent with a good-faith, reasonable interpretation of section 4960.[18]

Remuneration

Section 4960 taxes "remuneration" in excess of $1 million and defines "remuneration" for these purposes as wages within the meaning of section 3401(a) (which in turn defines compensation that is subject to federal income tax withholding) plus "amounts required to be included in gross income under section 457(f)."[19] With respect to timing, the statute provides that remuneration is "treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such remuneration."[20] The notice resolves a number of questions with respect to remuneration.

When Remuneration Is Considered Paid

The notice provides that the definition of "substantial risk of forfeiture" in the proposed regulations under section 457 applies for purposes of determining when remuneration is paid.[21] Under this definition, an amount generally is subject to a substantial risk of forfeiture (and thus not treated as "paid") only if entitlement to the amount is conditioned on the future performance of substantial services or on the occurrence of a condition that is related to a purpose of the remuneration if the possibility of forfeiture is substantial.[22] Remuneration is treated as paid on the first date that the right to it is not subject to a substantial risk of forfeiture—or, put otherwise, when the remuneration "vests"—regardless of whether the arrangement under which the amount is or will be paid is subject to section 457(f) or section 409A. For a payment that will be made over time or at a later date, the amount of remuneration treated as paid upon vesting is generally the present value (on the vesting date) of the future payments to which

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[17] Notice 2019-09, Q/A-10, p. 43.

[18] Notice 2019-09, p. 13.

[19] Section 4960(c)(3)(A).

[20] Section 4960(a).

[21] Notice 2019-09, Q/A-13, pp. 46-47.

[22] Proposed section 1.457-12(e)(1).

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the participant has a legally binding right, using reasonable actuarial methods. Any net earnings on vested amounts previously treated as paid are treated as paid at the close of the calendar year in which they accrue, not the later year when paid.

Remuneration from Multiple Related Organizations

Consistent with the statute, the notice provides that each ATEO calculates liability for the excise tax with respect to a covered employee by including remuneration paid by the ATEO and any related organization that employs the covered employee and then allocating that excise tax liability among each of the employers proportionally, based on the amount of remuneration that each employer paid. The notice clarifies that if an employer is liable for the excise tax both as an ATEO and as a related organization for the same remuneration paid to a covered employee, the employer is not liable for the excise tax in both capacities.[23] Moreover, if the ATEO is a related organization to more than one other ATEO, the notice instructs the ATEO to treat its highest share of liability with respect to a covered employee as a related organization as its excise tax liability with respect to that covered employee.

The Medical Services Exception

Section 4960 provides that remuneration does not include remuneration paid to a licensed medical professional for the performance of medical services.[24] The notice narrowly interprets this carve-out from remuneration as excluding only remuneration paid for the "direct performance" of medical services to patients, not compensation for teaching, research, or managing medical operations (including scheduling, staffing, appraisal, and similar functions).[25] On the other hand, the notice provides that accompanying another licensed medical professional as a supervisor while that medical professional performs medical services is part of the direct performance of medical services, as is documenting the care and condition of a patient.

Medical services are defined as "medical care" within the meaning of section 213(d) and the regulations thereunder and include the diagnosis, cure, mitigation, treatment, or prevention of disease, including services affecting any structure or function of the body. If a covered employee receives remuneration for both medical services and other services, the employer may use any reasonable, good-faith method to allocate remuneration between medical services and other services.

Excess Parachute Payments

Section 4960 also imposes an excise tax on "excess parachute payments" paid to covered employees of an ATEO.[26] The statute generally defines a "parachute payment" as a payment in the nature of compensation contingent on an employee's separation from employment if the aggregate present value of the payment equals or exceeds three times the employee's "base amount."[27] If an ATEO makes a

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[23] Notice 2019-09, Q/A-14, p. 56.

[24] Section 4960(c)(3)(B).

[25] Notice 2019-09, Q/A-15, pp. 59-60.

[26] Section 4960(a)(2).

[27] Section 4960(c)(5)(B).

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parachute payment to a covered employee, the excess of that payment over the portion of the base amount allocated to the payment is an "excess parachute payment" and is subject to the excise tax.

The notice contains a number of important clarifications with respect to excess parachute payments. Because the excess parachute payment rules under section 4960 are modeled after section 280G (which disallows a deduction for any excess parachute payments), these clarifications generally incorporate many of the details contained in the regulations under section 280G (specifically, the questions and answers (Q/As) under section 1.280G-1), with modifications to reflect the statutory differences between sections 280G and 4960.

The Base Amount

The notice generally defines the "base amount" for these purposes as the average annual compensation for services performed as an employee of the ATEO (including a predecessor of the ATEO)—or a related organization from which there has been a separation from employment—if the compensation was includible in the gross income of the individual for the five most recent tax years ending before the date on which the separation from employment occurs.[28]

Related Organizations Are Taken into Account

In addition to providing that compensation paid by related organizations from which there has been a separation from employment may be included in the base amount, the notice also states that payments contingent on an employee's separation from employment made by related organizations are taken into account in determining whether there is, and the amount of, a parachute payment.[29]

Only Involuntary Separation Triggers the Excise Tax

The notice generally provides that a payment is "contingent on an 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.[30] These payments may include payments that are also conditioned on the execution of a release of claims, noncompetition or nondisclosure provisions, or similar requirements, or that are damages for breach of contract pursuant to an employment agreement. An involuntary separation from employment for this purpose generally includes termination of an employee's employment without cause, an employer's failure to renew a contract, and a bona fide good reason employment termination by an employee.[31] The notice also contains special provisions broadly defining separation from service (as compared with section 409A) to include certain changes to the service relationship, even if an employee is still employed by a tax-exempt employer.[32]

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[28] Notice 2019-09, Q/A-29, p. 80.

[29] Notice 2019-09, Q/A-17, pp. 62-63. The staff of the JCT has opined that a technical correction to the statute may be necessary to reflect that the related organization rules apply to excess parachute payments. See Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18), at 265 n.1256 (Dec. 20, 2018).

[30] Notice 2019-09, Q/A-20, p. 66.

[31] Notice 2019-09, Q/A-22, p. 70.

[32] Notice 2019-09, Q/A-23, p. 70-71.

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If a payment is accelerated or a substantial risk of forfeiture lapses as a result of an involuntary separation from employment, only the value due to the acceleration is treated as contingent on a separation from the employment, and the notice describes special valuation rules that apply in these cases.[33] The notice also makes clear that any amount that was included in gross income in a previous year and any excess remuneration that was treated as paid for purposes of section 4960 before the separation from employment will not be considered "contingent on the separation from employment," even if actual or constructive payment is contingent upon separation.[34]

Observations and Next Steps

The notice addresses many of the key outstanding section 4960 questions and concerns. Some of these positions (particularly with respect to requiring each ATEO in an affiliated group to separately determine its five highest compensated employees) will require significant procedures and coordination to accurately identify covered employees and compute overall (and proportionate) section 4960 liability.

Nonetheless, the notice provides that a "good faith, reasonable interpretation" of section 4960 is sufficient until future guidance is issued. There will undoubtedly be open questions based on specific facts, and ATEOs will need to consider consistent and reasonable approaches to comply with section 4960 based on all of the facts and circumstances.

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[33] Notice 2019-09, Q/A-24, p. 72-75.
[34] Notice 2019-09, Q/A-20, pp. 68-69.

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