Tax-Exempt Employers May Owe New Excise Taxes Starting in 2018

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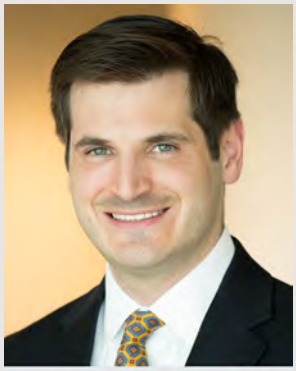

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In this article, Kroh and Fogleman analyze interim guidance implementing the new excise tax under section 4960 on executive compensation paid by tax-exempt employers.

The federal government may have been shut down, but the IRS pressed forward with guidance implementing the Tax Cuts and Jobs Act. On December 31, 2018, the IRS celebrated the new year with Notice 2019-9, which provides more than 90 pages of interim guidance for tax-exempt employers regarding the new excise tax on some compensation under section 4960.

With the 2018 tax year closed for calendar-year taxpayers, now is a good time for tax-exempt employers to familiarize themselves with the new rules under section 4960. Although parts of the interim guidance likely will require taxpayers to go through additional administrative hurdles and compliance steps, the notice appears relatively taxpayer-friendly and may even minimize the impact of section 4960. For example, the notice provides that taxpayers may rely on "good faith, reasonable interpretations of the statute" and legislative history. (It also notes several positions that are deemed not to be reasonable.) While the guidance touches on just about every aspect of the statute, this article provides a high-level discussion of several key concepts.

I. Statutory Background

Section 4960 imposes an excise tax on compensation paid by some tax-exempt organizations to a covered employee. The tax applies to:

- remuneration paid to a covered employee in excess of $1 million for a tax year; and
- excess parachute payments made to a covered employee contingent on separation from employment.

The rate of the excise tax mirrors the corporate income tax rate, which is now 21 percent, and the employer is liable for the tax. The excise tax is applicable for tax years beginning after December 31, 2017.

II. Key Terms in the Notice

A. ATEOs, Related Organizations, and Control

Generally, under section 4960, the excise tax applies to compensation paid to a covered employee either by an applicable tax-exempt organization (ATEO) or a related organization. Section 4960 identifies four types of ATEOs:

- tax-exempt organizations under section 501(a);
- farmers' cooperatives under section 521(b)(1);
- governmental entities with excludable income under section 115(1); and
- political organizations under section 527(e)(1).

Further, a person or government entity is related to an ATEO if it:

- controls, or is controlled by, the ATEO;
- is a supported or supporting organization (as defined in section 509(f)(3) and (a)(3), respectively) of the ATEO during the tax year; or
- establishes, maintains, or contributes to an ATEO that is a voluntary employees' beneficiary association.

Although the concepts of "supported" and "supporting" organization are more clearly defined in the code, Notice 2019-9 clarifies which definition of control applies to section 4960. For purposes of the statute, an organization controls another organization when it possesses 50 percent or greater ownership of stock (for a corporation), profits interests (for a partnership), or beneficial interest (for a trust). If the organization does not have owners or persons with beneficial interests, "control" means that more than 50 percent of the directors or trustees of the organization are either representatives of, or directly or indirectly controlled by, the other entity. This rule tracks the control test in section 512(b)(13)(D), and the rules of constructive ownership under section 318 also apply. Taxpayers should take note that Notice 2019-9 addresses and declines to follow the narrower controlled group rules under section 414(b) and (c) for determining control, which generally use an 80 percent threshold rather than the 50 percent threshold. The notice also clarifies that an organization related to an ATEO is liable for the excise tax even if the organization is a taxable entity (for example, a for-profit corporation).

Significantly, the IRS explains in Notice 2019-9 that a governmental entity that is separately organized from a state or political subdivision may meet the requirements to exclude income from gross income under section 115(1), and therefore may be an ATEO. However, the agency notes that section 115(1) generally does not apply to income attributable to activity that a state or political subdivision (generally referred to as a governmental unit) conducts directly. Thus, the IRS states that a governmental unit, including a state college or university, that does not have a determination letter recognizing its exemption from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO. This position stands in contrast to that of the Joint Committee on Taxation, which clarified in its recently released "blue book" explanation of the TCJA that section 4960 was intended to include state colleges and universities as ATEOs. Possibly in response to the IRS position, the blue book notes that a technical correction may be necessary to reflect this intent.

B. Covered Employees

A covered employee includes any of the five highest-compensated employees (including former employees) of the organization for the tax year, as well as any individual who was a covered employee in any tax year beginning after December 31, 2016. Thus, once an individual is a covered employee of an organization, he will always be a covered employee of the organization.

Notice 2019-9 provides that the definition of highly compensated employees is based on section 414(q), which is the qualified plan rule (up to $125,000 compensation in 2019). However, the notice also emphasizes that there is no minimum dollar threshold for an employee to be a covered employee. Notice 2019-9 provides that in determining the five highest-compensated employees for a tax year, employers must consider "remuneration" (discussed below) paid by the ATEO or a related organization to an employee for the calendar year ending with or within the ATEO's or related organization's tax year.

Notably, Notice 2019-9 does not aggregate a group of related ATEOs for purposes of identifying covered employees: Each ATEO within the group has its own covered employees. Further, because remuneration from all related organizations must be considered, it is possible for an individual to be a "covered employee" of multiple ATEOs within the group. The notice provides limited relief for employers who pay relatively small amounts to a covered employee. For example, an employee is not a covered employee of an ATEO if the ATEO paid less than 10 percent of total remuneration from all related organizations in the calendar year. However, if no single ATEO pays the employee at least 10 percent of remuneration, then the exception does not

apply to the highest-paying ATEO. Thus, for example, an employee who receives 5 percent of remuneration from an ATEO and 95 percent from taxable related organizations may be considered a covered employee of the ATEO.

C. Remuneration

Generally, under Notice 2019-9, remuneration includes wages as defined for income tax withholding purposes, other than designated Roth contributions to an employer's qualified defined contribution plan. Moreover, remuneration generally includes amounts includable in income under a section 457(f) deferred compensation plan. Notably, as discussed in more detail below, the notice's definition of remuneration, including what amounts are to be included and when, differs from the definition of compensation used for Form W-2 reporting, as well as the definition for Form 990 reporting. Thus, tax-exempt employers will likely need to establish procedures and systems to track section 4960 remuneration separately.

Because remuneration is defined by reference to the income tax withholding rules that define wages under section 3401(a), contributions to, and distributions from, most tax-favored retirement plans — including all qualified plans, section 403(b) plans, governmental section 457(b) plans, and savings incentive match plan for employees IRA arrangements — are excluded from remuneration under section 4960. However, an important exception applies to section 457(b) plans of tax-exempt employers, which are commonly maintained for "top hat" groups. Fortunately, pre-2018 vested accumulations under the latter are excluded from remuneration, although post-2017 contributions and earnings will be included.

Remuneration does not include compensation paid to a medical or veterinary professional directly for medical or veterinary services. However, compensation paid to the professional for any other services, such as administrative and management services, is considered remuneration. Notice 2019-9 explains that the employer must make a reasonable, good-faith allocation between compensation for medical services and other services. If an employment agreement or similar written arrangement describes the amounts to be paid for particular services, then such allocation must be followed unless the facts and circumstances indicate that the allocation for medical services is unreasonable or the arrangement was entered into in order to avoid the section 4960 excise tax. Notice 2019-9 includes detailed examples of how to allocate between compensation for medical services and other services.

Directors fees are not regarded as remuneration (even if the director is also an employee) because they are considered self-employment income rather than wages. Further, any amount of remuneration for which a deduction is not allowed by reason of section 162(m) is not considered for purposes of section 4960.

III. Remuneration Exceeding $1 Million

Generally, if a covered employee's remuneration from an ATEO or related organization exceeds $1 million in a tax year, the employee's common law employer (as determined for federal tax purposes) is liable for the excise tax on the excess remuneration.

A. When Remuneration Is Paid

Notice 2019-9 explains that remuneration paid in a calendar year ending in an organization's tax year is considered paid in that tax year. Remuneration is considered paid when the amount is no longer subject to a substantial risk of forfeiture as defined in section 457(f)(3)(B) (that is, when the amount is vested), regardless of whether the amount is subject to section 457(f). For example, remuneration deferred under a taxable related organization's deferred compensation plan is considered paid for section 4960 purposes when it is vested, even if it remains deferred for income tax purposes. If an amount is not paid until after vesting, the amount included in remuneration on the vesting date is the present value of a future payment (rather than the full amount of the payment), plus earnings accrued through the vesting date. Subsequent earnings on this previously vested remuneration are included in the employee's remuneration for the calendar year in which the earnings accrue.

Notice 2019-9 clarifies that amounts vested, but not yet paid, in a tax year before the year in which section 4960 takes effect are considered paid in the previous year, and therefore are not subject to the excise tax. This is particularly helpful for eligible section 457(b) plans — many long-service employees accumulated substantial amounts in these plans before 2018. Similarly, amounts that become vested in a calendar year ending before the tax year in which the employee first becomes a covered employee are not subject to the excise tax. However, earnings on such amounts that accrue in a year in which the employee is a covered employee, and during which section 4960 is effective, are potentially subject to the excise tax.

Application of these timing principles effectively results in a grandfathering of amounts previously vested and otherwise allows for accruals under a nonqualified arrangement to be spread over multiple years, which likely reduces the overall impact of section 4960 (which has no express grandfather rule).

Notably, Notice 2019-9 indicates that these timing principles apply for purposes of section 4960(a)(1) (regarding excess remuneration exceeding $1 million). However, the notice does not clearly explain whether they also apply for purposes of determining whether an individual is a covered employee.

B. Proportionate Liability

When a covered employee is employed by more than one entity, each employer is liable for the tax on its proportionate share of the total excess remuneration paid by all the employers, based on the ratio of the remuneration paid by the employer to the remuneration paid by all the employers.

When an employee is a covered employee of two or more related ATEOs, Notice 2019-9 includes a helpful rule so that an ATEO will not be liable for two separate excise taxes on the same amount of compensation. In that situation, each ATEO is liable for the greater of the excise tax it would owe as an ATEO or the excise tax it would owe as a related organization regarding that covered employee. The notice also provides that if an employer is related to an ATEO for only part of a tax year, only remuneration that vests while the employer is a related organization with regard to the ATEO is taken into account.

IV. Excess Parachute Payments

Generally, if a covered employee receives an excess parachute payment, the employee's common law employer (as determined for federal tax purposes) is liable for the excise tax on the payment.

A. Parachute Payments

An excess parachute payment includes the excess of a parachute payment over the base amount attributable to the parachute payment. A parachute payment is a payment in the nature of compensation by an ATEO (or a predecessor) or related organization to a covered employee if the payment is contingent on the employee's separation from employment with the employer, and the aggregate present value of that payment equals or exceeds three times the base amount.

Notice 2019-9 also provides that amounts paid (a) under qualified retirement plans, section 403(b) and 457(b) plans (which includes all section 457(b) plans in this context, including tax-exempt employer plans); (b) to licensed medical or veterinary professionals for the performance of medical or veterinary services; and (c) to individuals who are not considered highly compensated employees under section 414(q) at the time of separation are not considered parachute payments.

B. Payments in the Nature of Compensation

Notice 2019-9 defines a payment in the nature of compensation differently from remuneration. A payment is considered in the nature of compensation if it arises out of an employment relationship, including holding oneself out as available to perform services and refraining from performing services. This definition includes wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation, as well as amounts payable under a noncompete arrangement, but excludes attorneys' fees and court costs incurred in connection with paying a parachute payment, as well as reasonable interest accrued during any period in which the parachute payment is

contested. Further, while remuneration is considered paid when it vests, a payment in the nature of compensation is generally considered paid when it is included in the employee's gross income (disregarding any section 83(b) or (i) election made on property transfers). However, stock options and stock appreciation rights are treated as paid when they vest.

C. Payments Upon Separation From Employment

Notice 2019-9 helpfully clarifies that a payment is considered "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 the employee's involuntary separation from employment (although a special rule applies to some "window programs"). Thus, amounts of deferred compensation are generally not considered parachute payments if they are vested at the time of the involuntary separation. However, Notice 2019-9 also clarifies that if the facts and circumstances indicate that vesting or payment would not have occurred but for the involuntary separation (for example, the employer accelerates vesting shortly before the involuntary separation), then the amount is considered contingent on a separation from employment. Moreover, even where the payment of an amount is not contingent on an involuntary separation, if the payment timing is accelerated because of an involuntary separation, the value caused by the acceleration is considered contingent on separation. For purposes of this rule, a separation from employment generally tracks the section 409A definition of separation from service.

D. Base Amount

The base amount generally includes the covered employee's average annual compensation includable in income during the base period for services performed for the ATEO (or a predecessor), or the related organization, with respect to which there has been a separation from employment. Note that some nontaxable benefits, such as excludable fringe benefits and healthcare benefits, are excluded from the base amount determination, even though they may constitute parachute payments if paid in connection with separation.

The base period generally refers to the employee's five most recent tax years (that is, calendar years) ending before the date of separation. However, if the employee was not an employee of an ATEO for the entire five-year period, the portion of this period during which the employee performed services for the ATEO (or a predecessor), or a related organization, is the employee's base period.

V. Reporting and Paying Excise Taxes

Section 4960 excise taxes apply for a tax year in which an excess remuneration or excess parachute payment is paid. The taxes must be paid by the 15th day of the fifth month after the close of the tax year (May 15 for calendar-year taxpayers), although an employer may elect to prepay the present value of the excise tax on an excess parachute payment during the tax year of the covered employee's separation or a later tax year before the year in which the parachute payment is actually paid. The taxes are reported using Form 4720, "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code." Each ATEO and related organization (including taxable organizations) must file a separate Form 4720 and report its share of the liability.

VI. No Impact on Section 4941 or 4958

In addition to the detailed guidance described above, Notice 2019-9 clarifies that payment of section 4960 excise taxes does not necessarily constitute an act of self-dealing under section 4941 or an excess benefit transaction under section 4958. Further, the notice explains that remuneration does not necessarily constitute reasonable compensation under section 4941 or 4958 merely because the remuneration to a covered employee is not subject to an excise tax under section 4960.

VII. Next Steps

The IRS has indicated that it anticipates issuing further guidance in the form of proposed regulations. However, Notice 2019-9 provides that those regulations will apply only

prospectively. Until then, taxpayers may rely on the guidance in the notice. The IRS has requested that comments be submitted by April 2.

Tax-exempt organizations that have tax years following the calendar year should begin the process of determining whether any excise tax is owed for 2018 as soon as possible. While Notice 2019-9 is welcome and timely guidance, these complex rules will require significant time and expertise to navigate. ■