

Proposed Section 4960 Excise Tax Rules for Tax-Exempts: Highlights and Key Features

PUBLISHED: June 17, 2020

The Treasury Department (the “Department”) and Internal Revenue Service (“IRS”) recently released detailed proposed rules (the “Proposed Regulations”) interpreting Section 4960 of the Internal Revenue Code (the “Code”). 85 Fed. Reg. 35746 (June 11, 2020). The Proposed Regulations provide additional detail about recently enacted tax penalties on tax-exempt employers and entities treated as related to those organizations paying certain employees remuneration in excess of \$1,000,000 or excess payments contingent upon an employee’s separation from employment. The Proposed Regulations largely incorporate interim guidance published on December 31, 2018 in Notice 2019-9 (the “Notice”), with some changes based on comments received by the Department in response to the Notice. Taxpayers may rely upon the Proposed Regulations until final regulations become applicable.¹

If you have any questions, please do not hesitate to contact your regular Groom attorney or the authors listed below:

Charles A. Filips
cfilips@groom.com
(202) 861-0177

Daniel Hogans
dhogans@groom.com
(202) 861-5414

Jeffrey Kroh
jkroh@groom.com
(202) 861-5428

¹ For more information on changes to the tax aspects of executive compensation brought about by the Tax Cuts and Jobs Act, please refer to our January 12, 2018 article at <https://www.groom.com/resources/tax-reform-series-iii-executive-compensation-provisions/>, and for more information on the Notice, please refer to an article written by Groom attorneys Jeffrey Kroh and William Fogleman that was published by Tax Notes on February 18, 2019 at <https://www.groom.com/wp-content/uploads/2019/03/Tax-Notes-Tax-Exempt-Employers-May-Owe-New-Excise-Taxes-Starting-in-2018.pdf>

Background

Although tax-exempt organizations are not subject to the limitations under Code Sections 162(m) and 280G, Code Section 4960 applies key features of these Code Sections to certain tax-exempt organizations. However, instead of a deduction limitation, Code section 4960 imposes an excise tax on these tax-exempt organizations (or related entity) at a rate of tax (21%) on (1) “remuneration” in excess of \$1 million for “a tax year” or (2) any “excess parachute payments” contingent on separation from the employer. We highlight below several key features of the Proposed Regulations, but do not attempt to discuss the Proposed Regulations in their entirety.

Applicable Tax-Exempt Organizations Include Some Government Entities

Under the Proposed Regulations and the statutory language of Code Section 4960, an applicable tax-exempt organization (“ATEO”) is defined to include any organization that (1) is exempt from taxation under Code Section 501(a), (2) is a farmers’ cooperative described in Code Section 521(b)(1), (3) has income excluded from taxation under Code Section 115(1), or (4) is a political organization described in Code Section 527. Additionally, the Proposed Regulations clarify that certain foreign organizations are exempted from the definition of an ATEO if such foreign organizations receive substantially all of their support (other than gross investment income) from sources outside of the United States.

The Proposed Regulations clarify that Federal instrumentalities exempt from tax under Code Section 501(c)(1) and governmental entities, such as public universities, with an IRS determination letter recognizing their tax-exempt status under Code Section 501(c)(3) are governmental entities exempt from tax under Section 501(a), and thus are ATEOs. A governmental entity that excludes all or part of its income from gross income under section 115(1) is an ATEO regardless of whether it has a private letter ruling to that effect. The preamble explains, however, that a governmental entity that is not separately organized from 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 Code Section 115(1), and thus is not an ATEO. Examples of governmental units include counties or municipalities and their agencies or departments. However, a governmental unit may be liable for excise tax under Code Section 4960 if it is a related organization with respect to an ATEO. Further, the Department noted that it considers Federal instrumentalities as distinct from such governmental units and thus subject to Code Section 4960, but has requested further comments regarding the application of Code Section 4960 to Federal instrumentalities.

Consistent with Notice 2019-9, the Proposed Regulations further confirm that a person or government entity is related to an ATEO if it: (1) controls, or is controlled, by the ATEO (with control meaning greater than 50% ownership of stock (for corporation), beneficial interest (for a trust), profits interest (if a partnership), or 50% of the directors or trustees (if the organization does not have owners or persons with beneficial interests), (2) is supported or a supporting organization of the ATEO (with supporting

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defined in Code Section 509(f)(3) and (a)(3)), or (3) establishes, maintains, or contributes to an ATEO that is a voluntary employees' beneficiary association.

Covered Employee Excludes “Volunteers”

In accordance with Code Section 4960(c)(2), the Proposed Regulations define “covered employee” to mean any individual who is one of the five highest compensated employees (including former employees) of the ATEO for a taxable year or any individual who was a covered employee in any preceding taxable year beginning after December 31, 2016. Consistent with Code Section 4960 and the Notice, the Proposed Regulations do not set a minimum dollar threshold for an employee to be a covered employee. Thus, an employee of an ATEO may be designated as a covered employee even if they are not paid excess remuneration or an excess parachute payment. The Department rejected comments to the Notice suggesting that a “covered employee” should no longer be a “covered employee” if he or she ceases to be an active employee of the organization and a set period of time elapses. Therefore, as anticipated, the Proposed Regulations require that once an employee is a covered employee of an organization, he or she will always be a covered employee of that organization.

Many commenters expressed concern that the rules in the Notice for identifying an ATEO's five highest-compensated employees might subject a related non-ATEO to the excise tax for excess remuneration if one of that non-ATEO's employees (who receives remuneration only from the non-ATEO) performs limited or temporary services, typically as a volunteer, for a related ATEO. The Notice provides that the determination of whether an employee is one of the five highest-compensated employees of an ATEO is made on the basis of his or her remuneration for services performed as an employee of the ATEO, including remuneration for services performed as an employee of a related organization with respect to the ATEO. Under the broad definition of “employee” included in Notice 2019-9, officers of an ATEO who operate in a voluntary capacity, but are full time employees of a related non-ATEO and receive no compensation from the ATEO can be considered employees of the ATEO. Because the excise tax is paid proportionally, a non-ATEO could owe an excise tax on compensation exceeding \$1 million, even though the non-ATEO's employees performed voluntary services for the ATEO.

In order to avoid this result, the Proposed Regulations include several helpful provisions. The Preamble to the Proposed Regulations explains that these exceptions are intended to alleviate concerns that employees of a non-ATEO performing volunteer services for a related ATEO may subject that non-ATEO to a risk of excise tax under Code Section 4960. See Proposed Regulation Section 53.4960-(1)(d)(2)(iv)(B)(3)(v) (Example 5).

- A “limited hours exception” under which an individual is disregarded for purposes of determining an ATEO's five highest compensated employees for a taxable year if: (1) neither the ATEO nor any related ATEO paid remuneration or gave a legally binding right to non-vested remuneration to the individual for services the individual performed as an employee of the ATEO, and (2) the individual performed services as an employee of an ATEO and all

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related ATEOs for no more than 10 percent of the total hours the individual worked as an employee of the ATEO and all related organizations.

- The Proposed Regulations also include a “safe harbor” exception, which will treat an individual who performed no more than 100 hours of service for the ATEO and all related ATEOs during the applicable year as an employee for no more than 10% of the total hours the individual worked for the ATEO and all related ATEOs.
- Further, under the “nonexempt funds exception,” an individual is disregarded for purposes of determining an ATEOs’ five highest paid employees for a taxable year if he or she was not paid or granted a legally binding right to nonvested remuneration by the ATEO or any related ATEO for his or her services and the individual performed services for less than 50% of the total hours worked for the ATEO and all related organizations.

Remuneration

The Proposed Regulations indicate that an ATEO’s five highest compensated employees will be determined by reference to the total remuneration paid from an ATEO or related organizations during the taxable year for services performed as an employee of the ATEO or related organization. Code Section 4960 defines remuneration to include wages (as defined in Code Section 3401(a)), but excludes designated Roth contributions (as defined in Code Section 402A(c)). Remuneration does not include the portion of any remuneration paid to a licensed medical professional that is paid for the performance of medical services, and the Proposed Regulations provide various examples for determining how to allocate remuneration for medical services and non-medical services. If remuneration does exceed \$1 million for a taxable year, each ATEO or related organization will be liable for tax on excess remuneration (at a rate of 21%) in proportion with the amount of remuneration it paid to the covered employee.

The Proposed Regulations confirm that an amount of compensation can be considered for calculation of whether remuneration in excess of \$1 million was paid only when such amount is not subject to a substantial risk of forfeiture under Code Section 457. In general, an amount is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services or the occurrence of a condition related to the purpose of the compensation where the risk of forfeiture is substantial. In addition, the Proposed Regulations clarify that Code Section 4960 applies to remuneration received under certain split-dollar loan programs.

Applicable Year

Code Section 4960(a)(1) refers to remuneration paid “for the taxable year” but does not specify whether the tax year of the ATEO, the related organization, or the covered employee controls in the event of a mismatch in tax years. The Proposed Regulations help resolve any ambiguities by providing that remuneration is paid for a taxable year if it is paid during the “applicable year,” which the Proposed

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Regulations define as the calendar year ending with or within an ATEO's taxable year. For example, if an ATEO uses the calendar year as its taxable year, the ATEO's applicable year for 2021 is the period from January 1, 2021 through December 31, 2021 (i.e., the Calendar year). However, an ATEO or related organization often will be a fiscal year taxpayer, so the tax year does not coincide with the calendar year. For example, for many colleges and universities whose fiscal year runs from July 1, 2020 to June 30, 2021, the applicable year will be the 2020 calendar year. Therefore, in the event of a mismatch in the taxable year, the Proposed Regulations' introduction of the applicable year concept helps resolve any potential administrative burdens that would arise in the event that ATEOs and related organizations liable for excise tax were required to allocate remuneration paid during a single calendar year to multiple non-calendar taxable years. In addition, the Proposed Regulations provide that this applicable year concept should be used in determining covered employees.

Excess Parachute Payment

Code Section 4960 provides that an excess parachute payment means an amount equal to the excess of any "parachute payment" over the portion of the "base amount" allocated to such payment. A parachute payment is a payment in the nature of compensation to (or for the benefit of) a covered employee if the payment is contingent on separation from the employer. The Proposed Regulations require that any amounts paid to a covered employee for damages due to an involuntarily separation from employment (i.e., severance) or pursuant to a covenant not to compete are considered contingent on a separation from employment. Notably, the treatment of non-compete payments differs from Code Section 280G, under which such payments are treated as reasonable compensation for services and thus, are excluded from the calculation of parachute payments. Further, in determining what constitutes a payment contingent on separation from employment, the Proposed Regulations take into consideration the value of acceleration when the separation from employment (1) accelerates the lapse of a substantial risk of forfeiture with respect to the right to payment or (2) accelerates the right to payment.

If the aggregate present value of an individual's parachute payments equals or exceeds three times the base amount, then under Code Section 4960, such payments result in an "excess parachute payment" which is the amount by which the value of the payments exceeds one times the individual's base amount. The Proposed Regulations provide that the base amount is the average of an individual's annual compensation over the five most recent taxable years during which the individual was an employee of the ATEO (or predecessor or related organization) or the portion of the five-year period during which the employee was an employee of the ATEO (or predecessor or related organization).

The amount of tax owed on an excess parachute payment is the amount equal to the rate of tax (21%), multiplied by the sum of any excess parachute payments paid to a covered employee. The Proposed Regulations offer differing guidance from the Notice with respect to the allocation of tax on excess parachute payments between the ATEO and related organization. The Notice provided that an ATEO or related organization may be liable for tax on excess parachute payments based on the aggregate

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parachute payments made by the ATEO and its related organization, including parachute payments based on separation from employment from a related organization. Under the Proposed Regulations, however, only an excess parachute payment paid by an ATEO is subject to the excise tax on excess parachute payments. However, consistent with the Notice, the Proposed Regulations require that payments from related organizations still be used to calculate the base amount and total payments in the nature of compensation that are contingent on a covered employees' separation from employment with the employer. Ultimately, this means that base amount calculation and parachute payment calculation will include all remuneration from ATEOs and related organizations, but only the ATEO is liable for the excise tax for payments made by the ATEO.

Key Effective Dates and Next Steps

The Proposed Regulations will apply to tax years beginning on or after the date the final regulations are published in the Federal Register. Until the applicability date of the final regulations, taxpayers may rely on the guidance provided in Notice 2019-9 or on the guidance provided in the Proposed Regulations. The Preamble to the Proposed Regulations advises that taxpayers may also base any positions taken in connection with Code Section 4960 on a good faith interpretation of the statute, subject to the specific positions identified in the Notice and confirmed in the Proposed Regulations to be inconsistent with such interpretation.

Comments on the Proposed Regulations may be submitted through August 10, 2020. Tax-Exempt organizations should be analyzing the potential for applicable excise taxes under Code Section 4960 as well as potential mitigation strategies. Although the Proposed Regulations offer taxpayer favorable exceptions with respect to which employees qualify as "covered employees," non-ATEOs with employees performing services for related ATEOs will need to carefully monitor whether those employees are compliant with one of the applicable exceptions. This will require that a non-ATEO identify the hours worked, the scope of services performed, and remuneration received (if any) by its employees in connection with related ATEOs.

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