

IRS Issues Interim Guidance under Notice 2019-09 on Section 4960 Excise Tax for Tax-Exempt Organizations and Certain Governmental Entities

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JUNE, 2019

The Internal Revenue Service (IRS) has issued interim guidance in Notice 2019-09 (the "Notice") regarding the application of section 4960 of the Internal Revenue Code (the "Code"). Code section 4960 imposes an excise tax on applicable tax-exempt organizations (ATEOs) that pay covered employees either compensation in excess of \$1,000,000 in a taxable year or an excess parachute payment. The rate of the excise penalty tax is based on the corporate income tax rate under Code section 11, which is currently 21 percent. (For a comprehensive discussion of Code section 4960, see our February 2018 newsletter article: [Tax-Exempt Organizations Face New Tax Penalty on Excess Compensation – Due Diligence and Minimization.](#))



Background

An ATEO is defined broadly to include organizations that are exempt from federal income tax under Code section 501(a), governmental instrumentalities exempt from federal income tax under Code section 115, Code section 521(b)(1) farmers' cooperatives, and Code section 527(e)(1) political organizations.

A "related organization" is defined as any person or governmental entity that is related to the ATEO in one of the following ways:

- Controls or is controlled by the applicable tax-exempt organization;

- Is controlled by one or more persons that control the applicable tax-exempt organization;
- Is a supported organization (as defined in Code section 509(f)(3));
- Is a supporting organization (as defined in Code section 509(a)(3)); or
- In the case of a voluntary employee benefit association (VEBA): establishes, maintains, or makes contributions to the VEBA.

A “covered employee” is defined as one of the five highest compensated employees of an ATEO for any taxable years after December 31, 2016. Once an employee is determined to be a covered employee, the employee is a covered employee of the ATEO for all future taxable years. For that reason, tax-exempt organizations may eventually have more than five covered employees.

The excise tax applies to the following compensation:

- The portion of remuneration paid to a covered employee (other than an excess parachute payment) that is in excess of \$1,000,000 in any taxable year beginning after December 31, 2018; or
- Any excess parachute payment.

An “excess parachute payment” is the amount by which payment of a “parachute payment” exceeds the base amount. A parachute payment is remuneration that is contingent on termination of employment and exceeds three times the covered employee’s base amount. The base amount is the employee’s average wages over the previous five-year period (or shorter, if applicable).

For purposes of Code section 4960, remuneration means wages subject to federal income tax withholding under Code section 3401(a). Excluded from this definition are payments from tax-qualified plans, Code sections 403(b) and 457(b) plans, payments for medical or veterinary services performed by a medical professional, and payments to a non-highly compensated employee as determined by Code section 414(q). Unlike excess parachute payments under Code section 280G, a parachute payment under Code section 4960 is not contingent on a change of control of the company, but on the employee’s separation from employment with the employer. With respect to the base amount, Code section 4960(c)(5)(D) states the base amount should be determined using rules similar to Code section 280G(b)(3).

Notice 2019-09

The Notice states that the Department of the Treasury (“Treasury”) and IRS intend to issue proposed regulations for Code section 4960 that will incorporate the guidance in the Notice, but it clarifies that any further guidance under Code section 4960 will be prospective and not apply to prior tax years. In the meantime, the Notice states that taxpayers may base their positions on good faith, reasonable interpretations of Code section 4960, and that taxpayers may rely on the positions in the Notice as a good faith, reasonable interpretation of the statute. The Notice consists of thirty-two pages of preamble followed by fifty-three pages of guidance in the form of Q&A and examples. Of the thirty-nine questions and answers, this article discusses the key takeaways.

Taxable Year

ATEOs should use the calendar year ending with or within the taxable year of the ATEO to calculate any excess remuneration or excess parachute payments. As a practical matter, this means that ATEOs will use the covered employees' calendar year taxable wages, which generally should be the same as the amount reported in Box 1 of the covered employees' Form W-2.

Applicable Tax-Exempt Organization

Government Entities

The Notice clarifies that a government entity (including a state college or university) is not an ATEO if the organization does not have a determination letter recognizing it as tax-exempt under Code section 501(a) or is not a governmental instrumentality that excludes income from taxation under Code section 115(1). Entities that are "government units" are not subject to income tax based on the doctrine of implied statutory immunity — a government unit is not subject to a tax unless there is a specific statutory provision authorizing the taxation. The Notice points out that a governmental entity will be treated as an ATEO if it has obtained a determination letter granting the entity tax exempt status under Code section 501(a). Some governmental entities have obtained determination letters granting them status as a 501(c)(3) organization because it affords better treatment for certain fundraising activities. According to the Notice, a governmental entity may voluntarily relinquish its tax exempt status pursuant to Revenue Procedure 2018-5 (or any successor procedure). However, the Notice points out that an entity that is a governmental unit may still be subject to the excise tax as a related organization.

Related Organizations

A related organization may be a nonstock organization, a taxable entity or a governmental entity, according to the Notice. Taxable entities include public and private corporations, partnerships, and trusts. The Notice makes clear that a related organization can be another ATEO.

Liability for Proportional Share of Excise Tax

In general, each organization in a related group of organizations is liable for its proportionate share of the excise penalty tax. The applicable amount is based on the ratio of the remuneration the organization paid over the total remuneration paid by all the organizations in the related group. Where an ATEO is also a related employer with respect to a covered employee, it is only liable for the greater of the tax it would pay as an ATEO or the related employer.

Meaning of Control

As mentioned above, under Code section 4960(c)(4)(B)(i) and (ii), a related organization is defined as any person or governmental entity that controls the ATEO, or is controlled by the ATEO or one or more person who controls the ATEO. The Notice clarifies that "control" means a greater than fifty percent threshold with respect to: ownership in a corporation, profits or capital interest in a partnership, and ownership of a beneficial interest in a trust with beneficial interests. For nonstock corporations (including tax-exempt organizations and governmental entities), control means that more than fifty percent of the directors or trustees of the ATEO or nonstock organization are

either representative of, or are directly or indirectly controlled by, the other entity or control one or more persons who control the ATEO.

Constructive Ownership

The Notice further explains that for purposes of determining whether an entity is a related organization, the general rules relating to constructive ownership under Code section 318 apply.

Covered Employees

Limited Services Exception

The limited services exception is applicable to remuneration paid to a covered employee who is a covered employee of at least two entities within a group of related organizations. In such instances, an organization may not have to count the covered employee as one of the five highest compensated employees of the ATEO if the ATEO pays less than ten percent of the employee's total remuneration as compared to that paid for by all related employers services he or she performed. However, the limited services exception is not applicable if there are no ATEOs in the group of related entities that pay the employee remuneration above ten percent of his or her total remuneration. In other words, the limited services exception only applies if at least one ATEO is responsible for paying the covered employee at least ten percent of his or her total remuneration.

Liability of Common-Law Employer

The common-law employer, as defined generally under federal tax law, is liable for the penalty under Code section 4960. The Notice states that only an ATEO has covered employees. However, a covered employee may have more than one common-law employer. If an employee has a common-law employer that pays his or her remuneration, and that common-law employer is related to the ATEO that employs the employee, then that related organization is liable for its proportionate share of the excise penalty tax.

Third-party Arrangements, Disregarded Entities, and Personal Service Corporations

The Notice states that liability for the excise penalty tax cannot be avoided by common-law employers paying remuneration to common-law employees through a third-party. The Notice also states that in the case of employment by a disregarded entity as defined under Treasury Regulation section 301.7701-3, the sole owner of the disregarded entity is treated as the common-law employer and, thus, is liable for the excise penalty tax. While the Notice does not treat a personal service corporation (PSC) as a common-law employee, it does caution that the IRS may assert that the individual owner of a PSC is, in fact, a common-law employee of the ATEO based on all the facts and circumstances.

Remuneration

Definition of Remuneration

As stated in Code section 4960(3)(c), remuneration is generally considered to be wages as defined under Code section 3401(a), excluding designated Roth contributions, and including

amounts required to be included under Code section 457(f) when the compensation is no longer subject to a substantial risk of forfeiture. The Notice directs the taxpayer to Code section 3401(a) (1) through (a)(23) for more exceptions to gross income. As such, those exceptions to gross income under Code section 3401(a) are also excluded from the definition of remuneration for purposes of determining whether the covered employee is one of the five highest compensated and whether the covered employee has excess remuneration.

Director's Fees as Remuneration

The Notice states that compensation paid to a member of the board of directors for serving in that capacity is not remuneration. However, if the individual also performs services for the organization for which he or she serves as a member of the board of directors, then compensation related to the performance of those services is treated as remuneration. Compensation that an employer pays to an employee to serve as a director of another organization is also remuneration.

Excess Parachute Payments Subject to Code Section 4960 Not Remuneration

In general, remuneration includes parachute payments. However, a parachute payment is not counted in remuneration if it is also subject to the excise penalty tax in its capacity as an excess parachute payment. In other words, the remuneration will not be subject to the penalty for being both an excess parachute payment and a payment in excess of \$1,000,000.

Timing – Substantial Risk of Forfeiture

In general, remuneration is treated as paid on the date on which the right to the remuneration is not subject to a substantial risk of forfeiture as described under Code section 457(f)(3)(B). It is important to note that the Notice states that this timing rule is without regard to whether the arrangement under which the amount is to be paid is subject to Code sections 457(f) or 409A. In other words, the timing rule for determining when remuneration is treated as paid applies to all forms of remuneration. The Notice explains, in Q&A-13 and the examples thereunder, that the amount of remuneration treated as paid upon vesting is the present value of the future payments to which the participant has a legally binding right. Where the present value must be determined using reasonable actuarial assumptions, for example, those described in Treasury Regulation sections 1.457-12(c)(1) or 1.409A-1(c)(2)(i)(C) may be applied.

Medical and Veterinary Services by a Licensed Medical Professional

Remuneration paid to a licensed medical professional for medical or veterinary services is excluded from remuneration for purposes of determining excess remuneration and excess parachute payments.

Licensed Medical Professional

For purposes of Code section 4960, a licensed medical professional is an individual licensed under state or local law to perform medical services (including nursing services) or veterinary services.

Medical Care Defined by Code Section 213(d)(1)(A)

The Notice defines medical care as that defined by Code section 213(d)(1)(A) and the regulations thereunder. Practically speaking, this definition constitutes services for the diagnosis, cure, treatment or prevention of disease, including services for the purpose of affecting any structure or function of the body. With respect to veterinary services, because there is no Code section on point, the Notice instructs the taxpayer to use the rules for medical care and analogize them to services performed for an animal to determine if such services result in remuneration exempt from Code section 4960.

The Notice distinguishes medical service from administrative, managerial or teaching services, and instructs that a covered employee who receives remuneration for both medical and non-medical services must make a good faith, reasonable allocation between each. Furthermore, the Notice states that if an employment agreement or similar agreement sets forth the allocation, then that allocation must be applied unless the facts and circumstances demonstrate its use would be unreasonable, or unless the allocation was established for purposes of avoiding Code section 4960.

Excess Parachute Payments

A “parachute payment” is a payment contingent on an employee’s separation from employment with the employer that equal or exceed three times the employee’s base amount. The Notice clarifies that an “excess parachute payment” is the amount of parachute payment in excess of the base amount even though three times the base amount is the definitional threshold for a parachute payment. To be clear, the Notice points out that the excise tax is not calculated based on the amount of the parachute payment, but based on the amount of the excess parachute payment. However, the excise tax is not calculated based on the amount of the parachute payment, but based on the amount of the excess parachute payment. This is similar to the Code section 280G rules, and the Notice even incorporated some rules from the Code section 280G regulations. The Notice also provides a five-step process for identifying and calculating the penalties on excess parachute payments.

Contingent on a Separation from Employment

The preamble to the Notice explains that, in general, a payment is contingent on an employee’s separation from employment if the payment is subject to a substantial risk of forfeiture, as defined in a manner consistent with Code sections 457(f) and 409A, at the time of separation and if the separation from employment causes the substantial risk to lapse. However, the Notice clarifies that the test is not applied similarly to the 280G “but for” analysis; instead, the analysis focuses on whether separation causes remuneration to vest or accelerates payment. The Notice states that a payment is contingent on a separation from employment only if there is an involuntary separation from employment, but it noted that this standard may be expanded in future guidance. It also clarifies that if a payment or benefit vested prior to separation from service, even if the payment or benefit will be paid upon separation from service, the payment of benefit is generally not contingent on the separation from employment unless the facts and circumstances demonstrate that the vesting actually was triggered or accelerated due to the involuntary termination. The Notice points out that there is no presumption similar to that under 280G that any payment

made within 12 months is contingent. However, the acceleration of vesting of a payment in close proximity to the time of termination is taken into account in determining if the payment is a contingent payment. According to the Notice, there is no exclusion for reasonable compensation after the event; however, payments after termination of employment (such as post-termination consulting services) would not be treated as contingent if the employee is required to provide services to obtain the payments.

Reporting and Miscellaneous Items under Notice 2019-09

Notice 2019-09 instructs taxpayers that the taxes under Code section 4960 are reported and paid using IRS Form 4720. Each ATEO or related organization must file a separate Form 4720 by the 15th day of the fifth month following the end of the employer's taxable year, with the possibility of an extension. No estimated payments are due, rather the excise penalty tax is reported and paid annually.

In its penultimate Q&A, the Notice explains that, with respect to a related organization, remuneration paid by a publicly held corporation within the meaning of Code section 162(m)(2) or by a covered health insurance provider within the meaning of Code section 162(m)(6)(C) is taken into account for purposes of determining the excise penalty tax under Code section 4960. However, the amount of remuneration for which a deduction is disallowed under Code section 162(m) is not taken into account for purposes of the excise penalty tax under Code section 4960.

Conclusion

The Notice provides answers to many questions practitioners had about implementing Code section 4960, and it gives some clarity as to when the penalty will apply and how to calculate it. With this guidance, ATEOs can begin developing more comprehensive compensation policies and procedures beyond merely identifying who will be a covered employee and how much the potential excise penalty tax may apply. Because the guidance in the Notice is retroactive to 2018, ATEOs should consider whether this guidance can provide any relief with respect to the penalties last year. ATEOs need to think about potential changes to their compensation structure to identify compensation that may trigger this excise tax and determine whether alternate payments or benefits can be structured to avoid it. Also, ATEOs can review their organizational structures to potentially limit the number of covered employees subject to these penalties. Strategies to minimize application of the excise tax were previously discussed in the firm's [February 2018 newsletter](#).

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