Defending Liberty
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Section of Taxation

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August 28, 2018

Honorable David Kautter
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20020

Re: Comments on guidance regarding sections 512(a)(7) and 4960

Dear Assistant Secretary Kautter:

Enclosed please find comments regarding guidance for sections 512(a)(7) and 4960. They are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: David Kautter, Acting Commissioner, Internal Revenue Service
Thomas West, Tax Legislative Counsel, Department of the Treasury
Carol Weiser, Acting Benefits Tax Counsel, Department of the Treasury
Christopher W. Call, Attorney Advisor, Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON SECTIONS 512(A)(7) AND 4960, AS ADDED TO THE INTERNAL REVENUE CODE OF 1986 BY PUB. L. NO. 115-97 ON DECEMBER 22, 2017

These comments (the "Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kurt Lawson and Ralph DeJong. Substantive contributions were made by Justin Lowe, Blake MacKay, Preston Quesenberry, Celia Roady, Caroline Waldner, and Donald Wellington. Additional contributions were made by Benjamin Clark and Andrew Liazos. The Comments were reviewed by Kathryn Kennedy, Chair of the Employee Benefits Committee, and Lisa Johnsen, Chair of the Exempt Organizations Committee. The Comments were further reviewed by Mark A. Bodron of the Section's Committee on Government Submissions, and by Catherine Engell, Council Director for the Employee Benefits Committee.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: August 28, 2018

SUMMARY OF RECOMMENDATIONS

These Comments address the need for published guidance regarding sections 512(a)(7) and 4960,[1] and the request for comments by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") in the Priority Guidance Plan, Third Quarter Update, issued May 9, 2018, which listed in Part 1 guidance implementing section 4960 as a near term priority.

Sections 512(a)(7) and 4960 were added to the Code on December 22, 2017, by Public Law Number 115-97 (the "Act").[2] Section 512(a)(7) is effective for amounts paid or incurred after December 31, 2017. Section 4960 is effective for taxable years beginning after December 31, 2017.[3]

In these Comments, we recommend that Treasury and the Service take the following actions regarding section 512(a)(7):

1. Issue guidance mitigating the burden on organizations that are subject to the unrelated business income tax ("UBIT") and Form 990-T filing solely as a result of section 512(a)(7) by instructing these organizations to complete only certain specified lines on the Form 990-T;

2. Allow tax-exempt organizations to apply a reasonable, consistent, good-faith interpretation of section 512(a)(7) before the date of issuance (or the stated effective

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[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."), unless otherwise indicated.

[2] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, 131 Stat. 2054.

[3] The Act was a compromise agreed to by a Conference Committee on December 15, 2017, between H.R. 1 as passed by the House of Representatives on November 16, 2017 (the "House Bill"), and H.R. 1 as passed by the Senate on December 2, 2017 (the "Senate Amendment").

Legislative history of the House Bill can be found in H.R. Rep. No. 115-409 (Nov. 13, 2017) (the "House Report"), and the summary prepared by the Ways and Means Committee majority staff and released on November 2, 2017 (the "House Section-by-Section Summary"). Legislative history of the Senate Amendment can be found in the summary prepared by the Finance Committee majority staff and released on November 16, 2017 (the "Senate Section-by-Section Summary"), and a report released by the Senate Budget Committee on November 30, 2017 (the "Senate Budget Committee Explanation") that contained an explanation of the Senate Amendment as passed by the Finance Committee. Some legislative history of the Conference Committee agreement can be found in H.R. Conf. Rep. No 115-466 (Dec. 15, 2017) (the "Conference Report").

The Tax Reform Act of 2014, H.R. 1, 113th Congress (2014), the tax reform plan developed by Ways and Means Committee Chairman Dave Camp (the "Camp Proposal"), contained an earlier version of section 4960, which was summarized by the Joint Committee on Taxation. *See* Staff of the Joint Comm. on Tax'n, 113d Cong., *Technical Explanation, Estimated Revenue Effects, Distributional Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014*, 469-70 (Comm. Print 2014) (JCS-1-14).

date, if later) of any guidance Treasury and the Service issue under that section; and provide specific relief if that is done from any underpayment, accuracy-related, and other applicable penalties attributable to tax arising under section 512(a)(7) until guidance under section 512(a)(7) has been issued and is in effect;

3. Clarify that section 512(a)(7) applies only to amounts paid or incurred for qualified transportation fringes for which a deduction is not allowable by reason of section 274(a)(4) and thus, for example, does not apply separately to a parking facility used in connection with qualified parking, or an on-premises athletic facility (provided that it is not primarily for the benefit of highly compensated employees ("HCEs"));

4. Issue guidance that the unrelated business taxable income ("UBTI") inclusion under section 512(a)(7) is the lesser of (a) the amount of the expense disallowed under section 274 that is incurred in providing the qualified transportation fringe and (b) the value of the qualified transportation fringe; and confirm that existing guidance under sections 61 and 132 for determining the value of the qualified transportation fringe applies for this purpose, and that, in applying that guidance, all users of parking facilities other than employees of the organization will be considered "customers";

5. Confirm that a qualified transportation fringe provided to an employee gives rise to UBTI under section 512(a)(7) only to the extent that the amount that is excludable under section 132(a)(5) actually is excluded from income, *i.e.*, is not treated as additional wages to the employee, and thus that a qualified transportation fringe that is treated entirely as additional wages does not give rise to UBTI at all under section 512(a)(7); and confirm that employers have the discretion to include all or a portion of the value of any benefit that otherwise would be excludable under section 132(a)(5) in an employee's wages;

6. Issue guidance that amounts paid or incurred for qualified transportation fringes for purposes of section 512(a)(7) are limited to variable expenses directly connected with providing those fringes; and that, in the case of a parking lot or commuter highway vehicle, these amounts are not deemed to include depreciation or capital expenses disallowed as deductions (and required to be capitalized) by section 263 and are limited to expenditures that relate to the use of the facility to provide qualified transportation fringes to employees; and

7. Confirm that expenses treated as UBTI under section 512(a)(7) do not necessarily constitute private business use under section 145.

We also recommend that Treasury and the Service take the following actions regarding section 4960:

1. Allow tax-exempt organizations to apply a reasonable, consistent, good-faith interpretation of section 4960 before the date of issuance (or the stated effective date, if later) of any guidance Treasury and the Service issue under that section;

2. Interpret "taxable year" in section 4960 to mean an applicable tax-exempt organization's established accounting period; and, if the organization's established accounting period is a fiscal year, allow (but not require) the organization to use the calendar year ending within that period to determine whether an employee is one of the five "highest compensated employees" of the organization, to determine the employee's remuneration, and to apply the $1 million threshold to that remuneration;

3. Issue guidance that section 4960 does not apply to remuneration or parachute payments that would have been taken into account in a prior taxable year if section 4960 had applied to the prior taxable year, based on a reasonable, consistent, good-faith interpretation of section 4960, even if, in the case of remuneration, it did not exceed $1 million, or, in the case of a parachute payment, it was not considered "excess";

4. Issue guidance limiting "remuneration" to the amounts listed in the definition in section 4960(c)(3), and treating such remuneration as "paid" when it vests only in the case of amounts actually subject to section 457(f);

5. Issue guidance that "predecessor" means a "predecessor employer" as defined in Regulation section 1.415(f)-1(c)(2), and that an organization's reasonable good-faith determination that a transaction did not result in a predecessor-successor relationship will be considered dispositive if the transaction occurred five or more years ago;

6. Issue guidance determining "highest compensated employees" for purposes of section 4960(c)(2)(A) by ranking the organization's common law employees by compensation, and using the same definition of "remuneration" as is used for other purposes under section 4960, but excluding payments that are "contingent on . . . separation from employment" within the meaning of section 4960(c)(5)(B)(i);

7. Issue guidance coordinating the definition of "highest compensated employee" in section 4960(c)(2)(A) and clauses (i) and (ii) of the definition of "related organizations" in section 4960(c)(4)(B) by treating all employees of all members of the group of related organizations as employees of the same organization for both purposes;

8. Issue guidance defining "control" for purposes of section 4960(c)(4)(B) using the controlled-group rules in section 414(b) and (c), but substituting the phrase "more than 50 percent" for the phrase "at least 80 percent" each place it appears;

9. Issue guidance providing that, for purposes of section 4960(c)(3)(B), "remuneration" does not include any form of otherwise includible compensation that is for the performance of medical services in any form, that are required to be performed by a licensed medical professional, regardless of whether the services are provided in the form of direct patient care, supervision of patient care, medical teaching, medical research, or clinical care oversight; and that, where remuneration is for services that are both included in and excluded from the excise tax calculation, the employer may use any reasonable method for allocating compensation to each form of services provided, as long as the allocation method reasonably reflects the time or effort normally expended for each form of services provided and is applied consistently;

10. Issue guidance treating a payment as "contingent" on an employee's separation from employment with the employer for purposes of section 4960(c)(5)(B) only if the payment is subject to a substantial risk of forfeiture (defined in a manner consistent with section 457(f) or 409A) and the separation from service causes the risk of forfeiture to lapse; not treating a payment as a parachute payment within the meaning of section 4960(c)(5)(B) to the extent that it remains subject to a substantial risk of forfeiture following separation from employment; and valuing parachute payments for purposes of section 4960 in a manner consistent with section 280G with respect to the acceleration of a payment date and amounts that are subject to service-based vesting or other time-based vesting schedules;

11. Issue guidance defining "separation from employment with the employer" for purposes of section 4960(c)(5)(B) the same way "severance from employment" is defined for purposes of section 457, including the severance pay plan exception in section 457(e)(11)(A);

12. Limit any guidance issued pursuant to the anti-abuse rule in section 4960(d) to arrangements the principal purpose of which is to avoid section 4960 or have no apparent non-tax business purpose; and

13. Issue guidance confirming that payment of the section 4960 excise tax is not considered in determining whether an applicable organization has paid more than reasonable compensation to a covered employee for purposes of the prohibition against private inurement and the excise tax provisions of sections 4941 and 4958.

DISCUSSION

I. Background

A. Relevant Provisions of Current Law

1. Section 162(m)

Section 162(m), commonly known as the $1 million cap, was enacted in 1993 to fulfill a Clinton campaign promise,[4] and was amended by several subsequent acts, including the Act.[5] It disallows a deduction by a "publicly held corporation" for a taxable year for any remuneration for services provided by a "covered employee" (whenever the services were performed) to the extent that the deduction exceeds $1 million.[6] A "publicly held corporation" generally means a corporation with a class of securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.[7] Generally all members of the same affiliated group of corporations (within the meaning of section 1504, but without regard to the exclusions in section 1504(b) for foreign corporations, tax-exempt organizations and certain other corporations) are treated as the same corporation, and the portion that is disallowed as a deduction is prorated among them; although if one of those members is itself a publicly held corporation, it and its subsidiaries are separately subject to section 162(m).[8] A "covered employee" generally means an employee who was the chief executive officer (CEO) or chief financial officer (CFO) of the corporation at any time during the taxable year, the three highest compensated employees for the taxable year (other than the CEO or CFO), determined on the last day of the taxable year, and any individual who was a "covered employee" of the taxpayer (or any predecessor) for any preceding taxable year beginning

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[4] *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, § 13211; Bill Clinton & Al Gore, *Putting People First: How We Can All Change America* 68 (1992); *see also* U.S. Dep't of the Treasury, *Summary of the Administration's Revenue Proposals* 40 (Feb. 1993).

[5] Act § 13601.

[6] I.R.C. § 162(m)(1), (4)(A); Reg. § 1.162-27(b), (c)(3)(i).

[7] I.R.C. § 162(m)(2); Reg. § 1.162-27(c)(1).

[8] Reg. § 1.162-27(c)(2). This aggregation rule was adopted in the regulations even though it was not in the statute. *See* EE-61-93, 58 Fed. Reg. 66310, 66311 (Dec. 20, 1993). As one comment said, this seemed necessary even though it seemed to require a technical correction "in order to avoid totally arbitrary application of Section 162(m)," such as if an individual whose compensation was described in the corporation's proxy statement actually was an officer of a subsidiary and thus beyond the reach of the statute as written. *See* New York State Bar Association Section of Taxation, Recommended Guidance Relating to $1 Million Limitation on Deductible Compensation Under Section 162(m) (Sept. 27, 1993); *cf.* 17 C.F.R. § 229.402(a)(3) (Instructions to Item 402(a)(3)) ("It may be appropriate for a registrant to include as named executive officers one or more executive officers or other employees of subsidiaries in the disclosure required by this Item.")

after December 31, 2016.[9] "Remuneration" does not include contributions to or distributions from a section 401(a) qualified plan, a qualified or tax-sheltered annuity plan subject to section 403(a) or (b), or a simplified employee plan ("SEP") described in section 408(k) (other than a salary reduction simplified employee plan), or nontaxable benefits.[10] The $1 million cap is reduced by any excess parachute payments the deduction for which is disallowed under section 280G.[11]

2. Sections 280G and 4999

Sections 280G and 4999, commonly known as the golden parachute rules, were enacted in 1984 to limit severance and other benefits paid to executives in connection with corporate takeovers by imposing tax penalties on payments Congress viewed as excessive.[12] Section 280G disallows any deduction by a payor for an "excess parachute payment."[13] Section 4999 imposes a nondeductible 20% excise tax on the recipient of any excess parachute payment.[14] If the excess parachute payment is "wages" for employment tax purposes (*e.g.*, the recipient is an employee), section 4999 also requires the employer to withhold the 20% excise tax as it would other employment taxes.[15] A "parachute payment" is any payment that (1) is in the nature of compensation, (2) is made or is to be made to a "disqualified individual," (3) is contingent on a change in the ownership of a corporation, in the effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, and (4) has (when aggregated with other parachute payments to the same disqualified individual) an aggregate present value (using a discount rate equal to 120% of the applicable federal rate ("AFR") compounded semiannually) at least three times the individual's "base amount."[16] The amount of the parachute payment is reduced by whatever portion of the payment can be shown to be reasonable compensation for services to be rendered on or after the date of the change in control.[17] Generally all members of the same affiliated group of corporations are treated

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[9] I.R.C. § 162(m)(3).

[10] I.R.C. § 162(m)(4)(C); Reg. § 1.162-27(c)(3)(ii).

[11] I.R.C. § 162(m)(4)(D).

[12] *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, § 67; Staff of the Joint Comm. on Tax'n, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 199-200 (Comm. Print 1984) (JCS-41-84); H.R. Conf. Rep. No. 98-861, at 849-50 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1537-38.

[13] I.R.C. § 280G(a); Reg. § 1.280G-1, Q&A-1.

[14] I.R.C. § 4999(a).

[15] I.R.C. § 4999(c)(1).

[16] I.R.C. § 280G(b)(2), (d)(4); Reg. § 1.280G-1, Q&A-2.

[17] I.R.C. § 280G(b)(4)(A); Reg. § 1.280G-1, Q&A-9.

as the same corporation.[18] A "parachute payment" does not include a contribution to or distribution from a section 401(a) qualified plan, a qualified annuity plan subject to section 403(a), or a SEP or savings incentive match plan for employees ("SIMPLE") described in section 408(k) or (p).[19]

An individual's "base amount" is his or her average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs that was includible in the gross income of such individual during the most recent five taxable years of the individual ending before the date of the change in ownership or control.[20] Thus, the base period for a change in control occurring in 2018 is 2013-2017. "Excess parachute payments" are the excess of an individual's aggregate parachute payments over his or her base amount (*i.e.*, one times base amount, not three times), minus whatever portion of the payments can be shown to be reasonable compensation for services rendered before the date of the change in ownership or control.[21]

A "disqualified individual" is an employee or independent contractor (including a director) of the corporation who (at any time during the 12 months prior to and ending on the date of the change in control) is either (1) a greater than one percent shareholder of the corporation, (2) an officer of the corporation (determined on the basis of all the facts and circumstances, but presuming any individual with the title of officer to be an officer, and limiting the total number of officers to no more than 50), or (3) a highly compensated individual (defined as the lesser of the highest paid one percent of the employees of the corporation, or the highest paid 250 employees of the corporation, when ranked on the basis of compensation; and generally treating an independent contractor of the corporation as an employee for this purpose).[22] Compensation for this purpose includes compensation from a "predecessor entity" or a "related entity," and the regulations define both terms.[23]

A change in the ownership of a corporation generally occurs when a person or group acquires more than 50% (by vote or value) of the stock of corporation.[24] There is a rebuttable presumption that a change in the effective control of a corporation has

[18] I.R.C. § 280G(d)(5); Reg. § 1.280G-1, Q&A-46.

[19] I.R.C. § 280G(b)(6); Reg. § 1.280G-1, Q&A-10.

[20] I.R.C. § 280G(b)(3), (d)(1); Reg. § 1.280G-1, Q&A-34, Q&A-35.

[21] I.R.C. § 280G(b)(1); Reg. § 1.280G-1, Q&A-3.

[22] I.R.C. § 280G(c); Reg. § 1.280G-1, Q&A-15, Q&A-17 through Q&A-20.

[23] Reg. § 1.280G-1, Q&A-21.

[24] Reg. § 1.280G-1, Q&A-27.

occurred when a person or group acquires 20% (by vote) or more of the stock of the corporation, or a majority of members of the corporation's board of directors is replaced during a 12-month period by directors whose appointment is not endorsed by a majority of the old board.[25] A change in the ownership of a substantial portion of a corporation's assets generally occurs when a person or group acquires assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value (*i.e.*, determined without regard to any liabilities associated with the assets) of all of the assets of the corporation immediately before such acquisition or acquisitions.[26] A parachute payment can be paid by the corporation undergoing the change in control, the person(s) acquiring control, or persons whose relationship is such as to require attribution of stock ownership between the parties under section 318(a).[27]

Parachute payments often take the form of cash payments, *e.g.*, severance benefits.[28] However, in-kind payments are also counted.[29] Transfers of property are treated as payments for this purpose at the time they vest (disregarding section 83(b) elections).[30] Thus, wholly or partially unvested shares of stock are treated as payments if and when they vest as a result of a change in control. Transfers of stock options (including statutory stock options) are treated as transfers of property for this purpose, and also are treated as payments when they vest.[31] The value of an option is determined under all the facts and circumstances, using a reasonable valuation method such as Black-Scholes; the value is not limited to the spread.[32]

In the case of already-vested amounts, if the change in control will merely result in an acceleration of the date of payment, the amount of the "payment" that is considered contingent on the change in control is limited to the value of the acceleration of the payment date, *i.e.*, excess of the present value of the accelerated payment over the present value of the payment absent the acceleration (using a discount rate equal to 120% of the AFR compounded semiannually).[33] This is not an issue for vested shares or stock

[25] Reg. § 1.280G-1, Q&A-28.

[26] Reg. § 1.280G-1, Q&A-29.

[27] Reg. § 1.280G-1, Q&A-10.

[28] *See* Reg. § 1.280G-1, Q&A-11(a).

[29] I.R.C. § 280G(d)(3); Reg. § 1.280G-1, Q&A-11(d).

[30] Reg. § 1.280G-1, Q&A-12.

[31] Reg. § 1.280G-1, Q&A-13.

[32] *Id.*; Rev. Proc. 2003-68, 2003-2 C.B. 398.

[33] Reg. § 1.280G-1, Q&A-24(b), Q&A-32.

options, since vesting is treated as the date of payment, but can be an issue for cash deferred compensation, for example.

In the case of unvested amounts that are subject only to service-based vesting and change-in-control vesting, if the change in control will merely result in an acceleration of the vesting date, the amount of the "payment" that is considered contingent on the change in control is limited to (1) the value of the acceleration of the payment date calculated under the preceding paragraph, if any, plus (2) the value of the acceleration of vesting, which is deemed to be one percent of the amount of the accelerated payment multiplied by the number of full months between the date that the amount vests and the date that, absent the acceleration, it would have vested.[34] (Special rules apply in the case of unvested amounts that are subject only to performance-based vesting.[35])

3. Section 457(f)

Section 457 was enacted in 1978 to impose stricter limits on deferred compensation provided by state or local governments, on the theory that there was no "tax tension" discouraging them from providing deferred rather than current compensation to their employees.[36] It was amended in 1986 to extend it to certain private tax-exempt organizations on the same theory.[37]

Section 457(f) requires a participant in a plan that is subject to section 457 but is not an "eligible deferred compensation plan" under section 457(b) to include benefits under the plan in gross income for the first taxable year of the participant when they vest, *i.e.*, no longer are subject to a "substantial risk of forfeiture."[38] The amount that must be included in gross income at that time is the present value of the future benefits, which generally means the current account balance in the case of an individual account-type

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[34] Reg. § 1.280G-1, Q&A-24(c).

[35] *See* Reg. § 1.280G-1, Q&A-24(d)(3).

[36] *See* Revenue Act of 1978 (the "1978 Act"), Pub. L. No. 95-600, 92 Stat. 2763, § 131; Staff of the Joint Comm. on Tax'n, 96th Cong., *General Explanation of the Revenue Act of 1978*, 68 (March 12, 1979) (Comm. Print 1979) (JCS-7-79); *see generally* U.S. Dep't of the Treasury, *Tax Treatment of Deferred Compensation Under Section 457*, 3-5 (Jan. 1992).

[37] *See* Tax Reform Act of 1986 ("TRA 1986"), Pub. L. No. 99-514, 100 Stat. 2085, § 1107; Staff of the Joint Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, 654 (Comm. Print 1987) (JCS-10-87) ("TRA 1986 Blue Book").

[38] I.R.C. § 457(f)(1)(A); Reg. § 1.457-11(a)(1)-(2). Proposed regulations released in 2016 would change this to the first "date" on which they no longer are subject to a substantial risk of forfeiture. Prop. Reg. § 1.457-12(a)(2), 81 Fed. Reg. 40548 (June 22, 2016) (the "Proposed Section 457 Regulations").

plan.[39] Future increases in the present value of the benefits (*i.e.*, that are credited after the date on which the compensation is includible in gross income under the basic 457(f) rule relating to the lapse of a substantial risk of forfeiture), such as future earnings in the case of an individual account-type plan, are not included in gross income on the vesting date, but instead are included in income when they are paid or made available to the participant, applying the rules of section 72 to account for the participant's basis.[40] Current law does not explain what happens if benefits that have been included in income because they no longer were subject to a "substantial risk of forfeiture" are ultimately forfeited or not paid.[41]

Section 457(f) states that compensation is subject to a "substantial risk of forfeiture" if "rights to such compensation are conditioned upon the future performance of substantial services by any individual." Current regulations under that section do not provide any further guidance.[42] However, the regulations under section 83 interpret identical statutory language to mean that property is subject to a "substantial risk of forfeiture" if "rights in [the property] are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial."[43] An obligation to perform consulting services after termination of employment can, under appropriate circumstances, constitute a substantial risk of forfeiture under that standard;[44] so can an enforceable covenant not to compete.[45] A similar standard has been assumed to apply under section 457, as well, and in fact has been proposed to be apply to section 457(f) under the Proposed Section 457(f)

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[39] *See* Reg. § 1.457-11(c), (d)(2), *Example 4*. The Proposed Section 457 Regulations would provide additional detail on how to determine these amounts. *See* Prop. Reg. § 1.457-12(c).

[40] I.R.C. § 457(f)(1)(B); Reg. § 1.457-11(a)(3)-(4); Prop. Reg. § 1.457-12(a)(4).

[41] *See* I.R.C. § 457(f)(1)(B); Reg. § 1.457-11(a)(3)-(4). The Proposed Section 457 Regulations would allow a participant in that situation to deduct the benefits if and when they are "permanently forfeited under the plan's terms or otherwise permanently lost." Prop. Reg. § 1.457-12(c)(2). The preamble states that in the case of an employee the two-percent floor on miscellaneous itemized deductions in section 67(a) would apply (and that section 1341 would not be available). 81 Fed. Reg. at 40555. This statement might have to be modified in light of the Act, which added a new section 67(g) disallowing any deductions at all for miscellaneous itemized expenses (*i.e.*, not just subjecting them to a two-percent floor), effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

[42] *See* I.R.C. § 457(f)(3)(B).

[43] Reg. § 1.83-3(c)(1).

[44] Reg. § 1.83-3(c)(2); *cf. Richardson v. Commissioner*, 64 T.C. 621 (1975) (obligation to perform post-retirement consulting services did not impose substantial risk of forfeiture where, among other things, there was "no showing that [taxpayer] had any capability of performing consultation services or that the hospital had any need or expected to have any need for such services").

[45] Reg. § 1.83-3(c)(2), (c)(4), *Example 5*; General Counsel Memorandum ("GCM") 37479 (March 29, 1978).

Regulations. By contrast, while section 409A contains identical statutory language, the regulations interpret it somewhat more narrowly (*i.e.*, more strictly) than the regulations under section 83. For example, they do not treat a non-compete covenant as imposing a substantial risk of forfeiture.[46]

Section 457(f) applies to any plan of an "eligible employer" that provides for a "deferral of compensation."[47] It does not apply to a section 401(a) qualified plan or a qualified, tax-sheltered or nonqualified annuity plan subject to section 403(a), (b) or (c).[48] It also does not apply to an interest in a trust subject to section 402(b) or property subject to section 83 (including an interest in a funded nonqualified deferred compensation plan that is not subject to section 402(b)).[49] Under various grandfather rules, it also does not apply to certain compensation deferred under a plan established by a nongovernmental tax-exempt entity before 1986,[50] or a nonelective deferred compensation plan that was in existence on December 31, 1987, and that is maintained pursuant to one or more collective bargaining agreements.[51]

"Eligible employers" are state and local governments (and their agencies and instrumentalities) and any other organizations (other than "governmental units") that are exempt from tax "under this subtitle," *i.e.*, the income tax provisions of the Code, but not

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[46] Reg. § 1.409A-1(d)(1). The Proposed Section 457 Regulations would define a substantial risk of forfeiture in much the same way as Reg. § 1.409A-1(d)(1), except that they would recognize a substantial risk of forfeiture based on a non-compete covenant as long as certain requirements were satisfied, including a requirement that the employer make reasonable ongoing efforts to verify compliance with the covenant, a requirement that the employer have a substantial and bona fide interest in preventing the employee from competing with it, and that the condition be legally enforceable and actually likely to be enforced by the employer. Prop. Reg. § 1.457-12(e)(1), (3).

[47] I.R.C. § 457(f)(1); Reg. § 1.457-11(a).

[48] I.R.C. § 457(f)(2)(A)-(B); Reg. §§ 1.457-2(k)(2), 1.457-11(b).

[49] I.R.C. § 457(f)(2)(B)-(D); Reg. §§ 1.457-2(k)(2), 1.457-11(b). Although section 457 does not apply to an actual transfer of property subject to section 83, it does apply to a promise to transfer property in the future, unless the transfer occurs on or before the date the promise becomes vested, because such a promise is considered deferred compensation to which no exemption applies. Reg. § 1.457-11(d)(1). The Service has said that this principle could apply to split-dollar arrangements that are taxed under the "economic benefit" regime (mostly endorsement-type arrangements). T.D. 9092, 68 Fed. Reg. 54336 (Sept. 17, 2003). It also has said that split-dollar arrangements that are taxed under the "loan regime" (mostly collateral assignment arrangements) could give rise to deferred compensation under section 409A if there is an "agreement under which the service recipient will forgive the related indebtedness," *see* REG-158080-04, 70 Fed. Reg. 57929, 57941 (Oct. 4, 2005), although because the forgiveness would be taxable presumably most or all such arrangements would be exempt under the short-term deferral rule.

[50] TRA 1986 § 1107(c)(3); Reg. § 1.457-2(k)(4)(i); Notice 87-13, 1987-1 C.B. 432, Q&A-28.

[51] *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, § 6064(d)(2); H.R. Conf. Rep. No. 100-1104, at 217 (1988), *reprinted in* 1988 U.S.C.C.A.N. 5048, 5214; Reg. § 1.457-2(k)(4)(ii); Notice 88-98, 1988-2 C.B. 421.

churches and certain church-controlled organizations.[52] While churches are exempt from 457, it is not entirely clear what rules apply to them.[53]

Neither section 457 nor the existing regulations defines a "deferral of compensation." Notice 2005-1[54] provided that employers subject to section 457 may not rely on the definition of a "deferral of compensation" under section 409A for this purpose. However, the Proposed Section 457 Regulations would define a "deferral of compensation in much the same way it is under section 409A, and, consistent with that, would exclude "short-term deferrals."[55] Section 457 also states that "bona fide" vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefits plans are not treated as providing deferred compensation, and thus are not subject to section 457.[56] There is little guidance on the meaning of these terms, other than some sub-regulatory guidance and guidance under analogous provisions of the Code or other laws.[57] However, the Proposed Section 457 Regulations would define many of these terms; some, like "severance pay," would be defined in much the same way they are under section 409A.[58]

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[52] I.R.C. § 457(e)(1), (13); Reg. § 1.457-2(e), (ℓ)-(m). International organizations are considered governmental units that are not states for this purpose. *See* TRA 1986 Blue Book at 654.

[53] In 1978, Treasury and the Service published a proposed regulation that would have treated employees and independent contractors as actually having received any portion of their "basic or regular compensation" in the year in which they otherwise would have received it if receipt of the compensation had been deferred pursuant to an individual election. Prop. Reg. § 1.61-16, 43 Fed. Reg. 4638 (Feb. 3, 1978). Congress responded in section 132 of the 1978 Act by exempting taxable employers from the proposed regulation and making section 457 available to state and local governments (thus effectively exempting them from the proposed regulation). It did not exempt other tax-exempts from the proposed regulation at that time, but extended section 457 to most other tax-exempts in TRA 1986 (again effectively exempting them). *See* TRA 1986 Blue Book at 653-54. However, it never expressly exempted tax-exempts that are not subject to section 457.

[54] 2005-1 C.B. 274.

[55] Prop. Reg. § 1.457-12(d)(2). The definition of "substantial risk of forfeiture" in the Proposed Section 457 Regulations would be used for this purpose instead of the one in the regulations under section 409A.

[56] I.R.C. § 457(e)(11)(A)(i); *see also* Notice 88-68, 1988-1 C.B. 556.

[57] *See, e.g.*, IRS Exempt Organizations CPE Technical Instruction Program Textbook: Part II, Chapter H: *Severance Pay Plans of State and Local Government and Tax-Exempt Employers* (Aug. 24, 1995) (Cheryl Press & A. Thomas Brisendine); *cf.* Announcement 2000-1, 2000-1 C.B. 294 (arrangements that, among other things, are designed to provide supplemental income for a transitional period rather than retirement income, may be treated as severance pay plans for reporting purposes).

[58] *See, e.g.*, Prop. Reg. § 1.457-11(d) (severance pay), (e) (death and disability plans), (f) (sick or vacation leave); *see also* Prop. Reg. § 1.457-12(d)(4) (other exceptions).

4. Sections 115 and 501(c)

Section 115(1) exempts from tax any "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia." Section 501(a) exempts from tax any organization described in section 501(c) (tax-exempt organizations) or (d) (religious or apostolic organizations) or section 401(a) (tax-qualified plans).

Not all tax-exempt entities rely or need to rely on section 115(1) or 501(a) for their tax exemption. For example, income of a state or political subdivision of a state, or an entity that is an integral part of either (a "governmental entity"), generally is exempt from income tax under long-standing administrative practice, based on the doctrine of implied intergovernmental tax immunity.[59] That doctrine provides that income of a governmental entity is "generally not taxable in the absence of *specific* statutory authorization for taxing such income."[60] It has been applied to excise as well as ordinary income taxes.[61] The Service has issued guidance stating that neither section 115[62] nor section 501(c)(3)[63] can apply to a governmental entity that is not a separate organization. However, it has on occasion treated such organizations as exempt under section 501(c)(3),[64] and we understand that some seek exemption letters because they believe it helps with fundraising. By contrast, according to this guidance income of an

[59] *See* GCM 14407 (Jan. 28, 1935), XIV-1 C.B. 103, *superseded by* Rev. Rul. 71-131, 1971-1 C.B. 28, and Rev. Rul. 71-132, 1971-1 C.B. 29; *see also* Rev. Rul. 77-261, 1977-2 C.B. 45.

[60] *See* Rev. Rul. 87-2, 1987-1 C.B. 18 (emphasis added). The ruling states that an example of such an authorization is section 511(a)(2)(B).

[61] *E.g.*, PLR 200238001 (April 15, 2002).

[62] *E.g.*, Rev. Rul. 77-261, 1977-2 C.B. 45 ("the predecessor section of [section 115] was intended to refer, not to the income of a State or municipality resulting from its own direct participation in industry, but rather to that part of the income of a corporation engaged in the operation of a public utility or the performance of some governmental function that accrued to a State or municipality"); GCM 37657 (Aug. 31, 1978) (because a state university was a political subdivision of the state, "we necessarily must conclude that section 115 does not apply").

[63] *E.g.*, Rev. Rul. 60-384, 1960-2 C.B. 172 (a "wholly-owned state instrumentality" may be granted an exemption under section 501(c)(3), but "[a] state or municipality itself, however, would not qualify as an organization described in section 501(c)(3) since its purposes are clearly not exclusively those described in section 501(c)(3)"); GCM 34535 (June 28, 1971) ("an unincorporated division of mental health, created by statute as a unit within a state governmental department, . . . cannot, therefore, qualify as an exempt organization under section 501(c)(3)"); GCM 34502 (May 21, 1971) ("An indispensable characteristic, *i.e.*, a characteristic that the instrumentality must have to achieve section 501(c)(3) exemption[,] is that it must be a separately organized entity and not a mere integral part of the state or local government itself.").

[64] *E.g.*, GCM 39860 (Sept. 26, 1991) (noting that previous letters concluded that a university's "proper classification" was section 501(c)(3), but also that the "University was an integral part of the State, and thus section 115 did not apply").

organization that is separate from (*i.e.*, not an "integral part" of) a governmental entity can be subject to income tax unless an exclusion or exemption applies, even if it is controlled by the governmental entity or carries out government functions.[65]

Likewise, international organizations like the Organization of American States are exempt from tax by reason of the International Organizations Immunities Act rather than the Code,[66] but, like governmental entities, some also seek exemption letters.

Some tax-exempts are not covered by section 501(a) directly but derive some of their tax exemption from it. For example, a group trust described in Rev. Rul. 81-100 (as amended) is exempt from tax under section 501(a) with respect to funds that equitably belong to participating trusts described in section 401(a).[67] And income of a tax-exempt entity that invests in a common trust fund described in section 584 or in an ordinary flow-through entity like a partnership generally is subject to tax at the partner level as if it had realized the income directly, but the common trust fund or partnership is not itself a tax-exempt organization.[68]

An organization applies for a tax exemption under section 501(c)(3) on Form 1023. Part VII and Schedule G to Form 1023 ask whether the organization is a "successor" to another organization, whether for-profit or non-profit. The instructions explain that an organization is a "successor" if it (1) has taken over the activities that were previously conducted by another organization, (2) has taken over 25% or more of the fair market value of the net assets of another organization, or (3) was established upon the conversion of another organization from for-profit to non-profit status.

5. Sections 511-513

Section 511(a) generally subjects organizations that otherwise are exempt from taxation under section 501(a), and certain state colleges and universities, to UBIT on their UBTI. Section 512(a)(1) generally defines an organization's UBTI as the gross income derived by the organization from any "unrelated trade or business" regularly carried on by it, less any deductions directly connected with the trade or business. Section 513 generally defines an "unrelated trade or business" as a trade or business that is not

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[65] *E.g.*, GCM 37657, *supra* note 62 ("Because the immunity generally extends only to states and their political subdivisions, a threshold consideration with respect to the applicability of this doctrine to [a state university] is the question whether [it] constitutes a political subdivision of [the state] or an integral part thereof.").

[66] *See* I.R.C. § 7701(a)(18).

[67] *See* Rev. Rul. 81-100, 1981-C.B. 326, as modified by Rev. Rul. 2004-67, 2004-2 C.B. 28, and Rev. Rul. 2011-1, 2011-2 I.R.B. 251.

[68] Reg. § 1.584-2(c)(3).

substantially related to the organization's exempt purpose or function. An organization that is subject to UBIT and that has $1,000 or more of gross income that is included in UBTI for a taxable year must report that income on Form 990-T (Exempt Organization Business Income Tax Return).[69] The form is filed on the basis of the organization's "tax year," which the instructions define as either the calendar year or, if the organization has established a fiscal year accounting period, the fiscal year.

6. Sections 3401-3402

Section 3402(a)(1) requires every employer to deduct and withhold income tax from any "payment of wages" to an employee. Section 3401(a) generally defines "wages" for federal income tax withholding ("FITW") purposes as "all remuneration for services performed by an employee for his [or her] employer," whether paid in cash or in kind, unless an exception exists. Most of the relevant exceptions are in section 3401(a) itself. For example, they exclude contributions to and distributions from a section 401(a) qualified plan, a qualified or tax-sheltered annuity plan subject to section 403(a) or (b), a SIMPLE described in section 408(p), or a section 457(b) plan maintained by a state or local government; contributions to (but not distributions from) a section 457(b) plan maintained by a private tax-exempt employer; and section 414(h) government pick-up payments.[70] There also is an implied exception for remuneration that is not subject to income tax, such as coverage under an employee health plan.[71] The amounts required to be reported in Box 1 of Form W-2 generally are the same as FITW wages, although there are some differences.[72]

Wages are "paid" and thus the FITW obligation arises when they are actually or constructively received by the employee.[73] The Service has concluded that the same timing rule applies to amounts deferred under a section 457(f) plan, even though they are subject to tax under that section when they vest, because there is no special timing rule

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[69] Reg. § 1.6012-2(e).

[70] I.R.C. § 3401(a)(12); *see* Rev. Rul. 70-453, 1970-2 C.B. 287 (section 403(b) plans); Notice 2003-20, 2003-1 C.B. 894 (section 457(b) plans). Distributions from a nonqualified annuity subject to section 403(c) also should be exempt. *See* Reg. § 31.3401(a)-1(b)(1)(i) ("no withholding is required with respect to amounts paid to an employee upon retirement which are taxable as annuities under the provisions of section 72 or 403").

[71] *See, e.g.*, CCA 201205008 (Jan. 11, 2012); CCA 201622031 (April 14, 2016).

[72] For example, Box 1 includes taxable group-term life insurance, third-party sick pay, payments of annuities to an employee and supplemental unemployment compensation benefits ("SUB pay"), even though they are not considered FITW wages, and income from the disqualifying disposition of a statutory stock option, even though it is not subject to income tax withholding. The instructions to Form W-2 also require amounts deferred under a section 457(f) plan to be reported in Box 1 when they vest.

[73] Reg. § 31.3402(a)-1(b).

under section 3402 analogous to section 457(f).[74] It has reached the same conclusion on property subject to tax under section 83.[75] Deferred compensation subject to tax under section 409A is included in FITW wages under a specific provision.

"Employee" for this purpose means an individual who is an employee of the employer based on the common law standards.[76]

Even though a disregarded entity ("DRE") is generally treated as part of the owner of the entity for income tax and most excise tax purposes, it is treated as a separate entity for employment tax purposes.[77] Therefore, it has its own employer identification number (EIN) and is responsible for complying with the employment tax withholding, reporting and other requirements for its employees.

Section 6001 requires employers to keep payroll tax records for at least four years after the due date of the payroll tax for the return period to which the records relate, or the date the tax is paid, whichever is later.[78]

In the tax-exempt sector, perhaps even more often than in the taxable sector, many employers use third-party providers—such as management companies, leasing companies, professional employer organizations ("PEOs"), section 3131(s) common paymasters, section 3504 reporting agents and payroll service providers ("PSPs")—to

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[74] *E.g.*, TAM 199903032 (Oct. 2, 1998). Also, in a different context the Service concluded that a vested interest in a nonexempt employees' trust should be treated as *paid* for withholding purposes on the last day of the taxable year of the trust, which is consistent with the timing rule in section 402(b)(4), because "[a]ligning the rule for Federal income tax withholding with the rule for determining the amount and timing of compensation included in the employee's gross income will result in the amount of Federal income tax withheld more precisely approximating the employee's income tax liability." Rev. Rul. 2007-48, 2007-2 C.B. 129.

[75] *E.g.*, Coordinated Issue Paper: *Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons* (Oct. 21, 2004) ("There is no authority that provides that section 83 principles shall apply in this determination."); March 14, 2003, Field Directive ("while [section 83 and the regulations thereunder] generally point to exercise date as the trigger for inclusion of income from exercise of nonqualified stock options, the FICA and income tax withholding provisions do not impose a withholding obligation on the employer until wages are actually or constructively paid"); *see* GCM 38069 (Aug. 28, 1979) (stock placed in a trust for the benefit of employees should not be included in wages for employment tax purposes until employees were able to withdraw the stock five years later).

[76] *See* Reg. § 31.3401(c)-1(b), (e); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992) (when Congress uses "employee" in a statute without including a helpful definition of the term, it should be presumed to have intended to refer to "the conventional master-servant relationship as understood by common-law agency doctrine").

[77] *Compare* Reg. § 301.7701-2(c)(2)(i) and (v) with Reg. § 301.7701-2(c)(2)(iv).

[78] Reg. § 31.6001-1(e)(2); *see also* IRS Publication 4221, *Compliance Guide for 501(c)(3) Public Charities* ("If an organization has employees, it must keep employment tax records for at least four years after filing the fourth quarter for the year.").

obtain individual services and/or carry out their employment tax and reporting obligations. Sometimes under these arrangements the individuals involved are properly treated as common law employees of the provider. Often, however, especially in the case of individuals serving as corporate officers, they are properly treated as common law employees of the employer. When a provider reports compensation paid to an individual who is a common law employee of the employer rather than the provider, it might be required to use the employer's EIN rather than its own to report the individual's compensation to the Service (such as in the case of a provider that is neither a section 3504 reporting agent nor a section 3401(d) statutory employer), or might be allowed to use its own EIN but with a note that it is acting as the employer's agent (such as in the case of a section 3504 reporting agent), or might be allowed to use its own EIN generally (such as in the case of a section 3401(d) statutory employer, certified professional employer organization or section 3131(s) common paymaster). In each case, though, the same tax rules apply as would apply if the employer had paid the individual directly, because the individual remains the employer's own common law employee.[79] Consistent with this, the instructions for the Form 990-series returns remind filers to "treat employees of [a provider] as the organization's own employees if such persons are common law employees of the filing organization under state law."[80]

7. Sections 4941 and 4958

Section 4941 was added to the Code by the Tax Reform Act of 1969.[81] It imposes excise taxes on "disqualified persons" who receive compensation from a private foundation unless it is "reasonable and necessary to carrying out the foundation's exempt purposes" and is not "excessive" within the meaning of section 162, and on any managers who knowingly approved such compensation.[82] "Disqualified persons" include substantial contributors to the foundation, foundation managers, and certain other persons who are in a position to influence the affairs of the foundation, including certain members of a substantial contributor's family. Whether compensation is excessive is based, among other things, on the assets of the foundation.[83]

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[79] *See, e.g.*, *Blue Lake Rancheria v. United States*, 653 F.3d 1112 (9th Cir. 2011) (FUTA exemption for services performed for Indian tribe does not apply not when tribe is merely a "statutory employer" that operates as common paymaster); *cf.* I.R.C. § 3511(c)(2) (exemption that would apply to client employer also applies to certified PEO). Regulations under former section 199, and proposed regulations under new section 199A, apply a similar rule. Reg. § 1.199-2(a)(1)-(2); Prop. Reg. § 1.199A-2(b)(2)(ii), 83 Fed. Reg. 40884 (Aug. 16, 2018).

[80] *E.g.*, 2017 Instructions for Form 990 (Jan. 18, 2018) ("Instructions for Form 990"), 27-28.

[81] Pub. L. No. 91-172, 83 Stat. 487 (1972), § 101(b).

[82] I.R.C. § 4941(d)(2)(E); Reg. § 53.4941(d)-3(c).

[83] *See, e.g.*, *Kermit Fischer Found. v. Commissioner*, 59 T.C.M. (CCH) 898 (1990).

Section 4958 was added to the Code by the Taxpayer Bill of Rights 2 in 1996.[84] It imposes excise taxes on certain "disqualified persons" who receive "excess benefits" from an organization that is tax-exempt under section 501(c)(3) or section 501(c)(4) (other than a private foundation), and on any managers who approved the benefits. "Disqualified persons" are persons who are in a position to influence the affairs of the tax-exempt organization, including its executive officers and chief financial officer. An "excess benefit" is compensation—including deferred compensation subject to section 457—to the extent that it exceeds the value of the services performed. Payments of compensation that have been approved by an independent compensation committee or similar authorized approval body after obtaining and reviewing a comparability study (and that meet other standards in the section 4958 regulations) are presumed to be reasonable. The regulations provide that section 4958 does not apply to a governmental unit or an affiliate of a governmental unit if it is exempt from tax without regard to section 501(a) or does not have to file a Form 990 as a governmental entity,[85] or to a foreign organization if it receives substantially all of its support from sources outside of the United States.[86] They provide that, while section 4958 applies to churches, the restrictions on church tax inquiries and examinations in section 7611 must be followed.[87]

As a result of these provisions, most section 501(c)(3) and section 501(c)(4) organizations, including many private foundations, have adopted a review and approval process that is designed to qualify for the rebuttable presumption of reasonableness in the section 4958 regulations, and using that process will approve compensation for their top employees by using data showing that the proposed compensation is comparable to that of similar employees of similar organizations.

An organization or individual that is subject to an excise tax under one of these provisions must report it on, and pay it with, Form 4720 (Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code).

8. Returns of tax-exempt organizations

Most organizations exempt from tax under section 501(a), except organizations that are churches or governmental entities (including Indian tribal governments) or affiliated with churches or governmental entities, must file a Form 990 with the Service

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[84] Pub. L. No. 104-168, 110 Stat. 1452 (1996), § 1311(a).

[85] Reg. § 53.4958-2(a)(2)(ii).

[86] Reg. § 53.4958-2(b)(2).

[87] Reg. §§ 53.4958-2(a)(3), 53.4958-8(b), 301.7611-1, Q&A-19.

on an annual basis.[88] The form is filed on the basis of the organization's "tax year," which the instructions define as either the calendar year or, if the organization has established a fiscal year accounting period, the fiscal year.

The parent of a group that has received a group exemption ruling[89] may file a single Form 990 return on behalf of any subordinate organizations (generally any organizations affiliated with it that are subject to its general supervision or control) that agree to be included in the consolidated return.

Part VII and Schedule J to the Form 990 require extensive information on "reportable compensation" and "other compensation" provided to current and former officers, directors, trustees, key employees, and "highest compensated employees" of the organization by the organization or by a "related organization." The instructions provide guidance on where and when to report these amounts.[90] A former officer, director, trustee or key employee is reported only if he or she also was reported on the organization's Form 990 for one of the previous five years, with special dollar thresholds that apply to all former listed individuals and a special reporting rule for former "highest compensated employees."

"Reportable compensation" means compensation reported on Form W-2, in Box 1 *or* Box 5 (whichever is larger). As noted above, the amounts required to be reported in Box 1 generally are the same as FITW wages, although there are some differences.[91] For example, the instructions to Form W-2 specifically require benefits under a section 457(f) plan to be reported in Box 1 when they vest. The amounts required to be reported in Box 5 are wages subject to Medicare taxes. A major difference between Box 1 and Box 5 is that Box 5 includes elective deferrals to qualified plans and nonqualified deferred compensation subject to section 3121(v)(1) and (2), respectively, even if they are not subject to section 457(f).

"Other compensation" means (1) "deferrals of compensation" under any deferred compensation plans that are not reported in Box 1 or Box 5, such as stock options and unvested awards, employer contributions to section 401(a) plans, unvested benefits under section 457(b) and 457(f) plans, and (for defined benefit plans only) a reasonable estimate of increase or decrease in actuarial value, and (2) "nontaxable benefits" (other

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[88] *See* Reg. § 1.6033-2(a), (g)-(h); Rev. Proc. 96-10, 1996-1 C.B. 577; Rev. Proc. 95-48, 1995-2 C.B. 418.

[89] *See generally* Rev. Proc. 80-27, 1980-1 C.B. 677.

[90] *See generally* Instructions for Form 990, 24-36; 2017 Instructions for Schedule J (Form 990) (June 8, 2017).

[91] *See* note 72 *supra*.

than certain disregarded benefits), such as the value of employer-provided health benefits. Consistent with this scheme, deferrals that are not treated as deferred compensation under section 409A or 457 because they are paid within the section 409A short-term deferral period or are bona fide severance pay or other welfare benefits are "reportable compensation" when they are paid rather than "other compensation" when they accrue or otherwise are promised.[92]

Part VII breaks out reportable compensation based on whether it was paid by the organization (column (D)) or a related organization (column (E)) and has a single column for all other compensation (column (F)). Schedule J breaks out reportable W-2 compensation based on whether it is "base compensation" (column B(i)), "bonus and incentive compensation" (column B(ii)), or "other reportable compensation" (column B(iii)); and breaks out other (nontaxable) compensation based on whether it is "retirement and other deferred compensation" that is not reportable compensation (column C), or "nontaxable benefits" (column D). For example, amounts includible in income under section 83 or 457(f) are listed as "reportable compensation" in Part VII and "other reportable compensation" in Schedule J.[93]

A DRE generally is treated as part of the organization rather than as related organizations for purposes of the Form 990-series returns.[94]

"Highest compensated employees" means the five highest compensated employees other than officers, directors, trustees, and key employees, ranked by *reportable* compensation as defined above.[95] Compensation for this purpose is determined for the calendar year ending within the organization's fiscal year. Another organization is "related" to the organization (regardless of whether the other organization is tax-exempt) if it (1) controls, or is controlled by, the organization, (2) is controlled by one or more persons that control the organization, (3) is a supported organization (as defined in section 509(f)(3)) during the organization's fiscal year, (4) is a supporting organization described in section 509(a)(3) during the organization's fiscal year, or (5) in the case of an organization that is a voluntary employees' beneficiary association ("VEBA"), establishes, maintains, or makes contributions to the VEBA.[96] "Control" can exist at the more-than-50% ownership level.[97] Compensation paid to an individual by a related organization is required to be included in the amount reported, regardless of

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[92] *See* Instructions for Form 990 at 30-32.

[93] *Id*.

[94] *Id.* at 27.

[95] *Id.* at 26.

[96] *Id.* at 70.

[97] *Id.* at 57-58, 70; *see also* 2017 Instructions for Schedule R (Form 990) (Nov. 3, 2017).

whether it relates to the individual's services for the filing organization. This can result in duplicative reporting of the same compensation where the same individual is one of the five highest compensated employees of multiple organizations.

Lines 31–32 require an organization to fill out Schedule N if it liquidated, terminated, dissolved, ceased operations, or engaged in a "significant disposition of net assets" during its tax year. A "significant disposition of net assets" generally means a transfer of more than 25% of net assets.

An organization's Form 990 and Form 990-T, if any, generally are available for public inspection as required by section 6104.

Small tax-exempt organizations may be able to file Form 990-EZ, a short form of Form 990, or even Form 990-N, an annual electronic notice. Also, many tax-exempt organizations file different returns in lieu of Form 990.[98] None of these simplified or different forms requires information on individual compensation paid by related organizations, or the detailed breakdown of compensation required by the regular Form 990 and Schedule J.

B. Changes Made by Act

1. Section 512(a)(7)

Section 512(a)(7) was added by the Act.[99] It increases the UBTI of a tax-exempt organization by any amount "paid or incurred by [the] organization for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B))," but only to the extent that "a deduction is not allowable" for the amount by reason of section 274.[100] Section 512(a)(7) is effective for amounts paid or incurred after December 31, 2017. It does not apply if the amount is "directly connected" with an unrelated trade or business regularly carried on by the organization, presumably because section 274 applies directly to deny a deduction in that case.

Section 274 limits employers' deductions for meals, entertainment and certain other expenses. It was added to the Code in 1962 based on a proposal by the Kennedy

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[98] Private foundations file Form 990-PF; employee benefit trusts file Form 5500; black lung benefit trusts file Form 990-BL; and religious and apostolic organizations described in section 501(d) file Form 1065.

[99] Act § 13703.

[100] *See also* House Report at 266; Conference Report at 408-10.

administration.[101] It was substantially revised by the Act.[102] Section 274(a)(4) now disallows any "deduction . . . for the expense of any qualified transportation fringe (as defined in section 132(f))" that is provided to an employee, except to the extent that the expense is treated as taxable income to the employee.[103]

Section 274 does not categorically disallow deductions for a parking facility. The House Bill would have amended section 274 to disallow—in the very same subparagraph—any deduction for an amount paid or incurred for "a qualified transportation fringe (as defined in section 132(f)) *or* . . . a parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C))" (emphasis added), but the Act followed the Senate Amendment, which disallowed only the first. However, the Act did amend section 274 to disallow any deduction for any expense incurred for providing any transportation (directly or by reimbursement) for commuting purposes to an employee, except as necessary to ensure the safety of the employee.[104]

Similarly, section 274 does not categorically disallow deductions for an on-premises athletic facility. However, section 274(a)(1)(B) disallows any deduction "for an item . . . with respect to a facility" that is used in connection with entertainment, amusement, or recreation. That could include an employer's on-premises athletic facility unless it is exempt because it is "primarily for the benefit of employees (other than employees who are highly compensated employees (within the meaning of section 414(q))."[105] The regulations interpret this standard to mean that it must be primarily for the benefit of "employees generally," other than HCEs.[106] The House Bill would have amended section 274 to disallow categorically any deduction for "an on-premises athletic facility as defined in section 132(j)(4)(B)," but the Act followed the Senate Amendment, which again did not provide for a categorical disallowance.[107]

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[101] *See* H.R. Rep. No. 82-1447, at 19 (1962).

[102] Act § 13304.

[103] I.R.C. § 274(a)(4), (e)(2). The Conference Report describes this provision as "disallow[ing] a deduction for expenses *associated with* providing any qualified transportation fringe to employees of the taxpayer" (emphasis added). *See* Conference Report at 406.

[104] I.R.C. § 274(ℓ).

[105] I.R.C. § 274(a)(1), (e)(4). The Camp Proposal would have repealed the present law exception for recreational, social, or similar activities primarily for the benefit of employees, but that did not make it into the House Bill or the Senate Amendment.

[106] Reg. § 1.274-2(f)(2)(v). The Tax Court has upheld discriminatory treatment of rank-and-file employees so long as no favoritism was shown to the prohibited group and the discrimination was based on a reasonable classification of employees. *American Bus. Serv. Corp. v. Commissioner*, 93 T.C. 449 (1989).

[107] *See* Conference Report at 406-07.

The "items" that are disallowed by section 274(a)(1)(B) when a "facility" is involved include depreciation and operating costs, such as rent and utility charges, maintenance expenses, and salaries paid to caretakers.[108] However, section 274(a)(4) does not disallow deductions with respect to all "items," but only deductions with respect to "expenses." The legislative history of section 274(a)(1)(B) made it clear that "expenses" are a lesser included part of "items," and do not include depreciation or losses, when it explained that "[i]n addition to items commonly regarded as expenses with respect to a facility, such as expenditures for the maintenance, preservation, or protection of the facility, this provision also relates to depreciation and losses realized on certain sales of entertainment facilities."[109] No such reference to depreciation or losses exists in the legislative history of section 274(a)(4).

2. Section 4960

a) Subsections (a) and (b)

Section 4960 also was added by the Act.[110] Section 4960(a) imposes an excise tax equal to the rate of tax on income of a corporation (currently 21%) on (1) "excess parachute payments," and on (2) "remuneration" over $1 million (other than excess parachute payments), that are "paid" by an "applicable tax-exempt organization" for an applicable taxable year with respect to the tax-exempt organization's employment of a "covered employee." It applies to taxable years beginning after December 31, 2017; however, "taxable year" is not defined specifically for this purpose in section 4960. Section 4960(b) states that the excise tax is imposed on the "employer."

b) Subsection (c)

Section 4960(c) contains definitions and special rules. An "applicable tax-exempt organization" means an organization that is exempt from taxation under section 501(a) (*i.e.*, one that is exempt from taxation under section 501(c) (tax-exempt organizations) or (d) (religious or apostolic organizations) or section 401(a) (tax-qualified plans)); a farmers' co-op described in section 521(b)(1); an entity with income that is excluded

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[108] Reg. § 1.274-2(e)(3)(i).

[109] *See* H.R. Rep. No. 87-1447, at 21-22 (1962); S. Rep. No. 87-1881, at 31 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3297, 3333; *see also W.L. Schautz Co. v. United States*, 567 F.2d 373, 375 (Ct. Cl. 1977) (noting that "the absence of the word 'expenses' from section 274(a) is significant" and that "Congress has demonstrated that it can limit disallowance provisions to expenses when it so intends"); *cf. Elwood v. Commissioner*, 72 T.C. 264, 266 (1979) (holding that "depreciation is not an expense paid within the meaning of section 213"); *Gordon v .Commissioner*, 37 T.C. 986, 987 (1962) (holding that "any allowance for depreciation is not an 'expense paid' or 'amount paid.'").

[110] Act § 13602.

under section 115(1); or a political organization described in section 527(e)(1).[111] A "covered employee" is an employee or former employee who 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.[112] "Parachute payments" and "remuneration" do not include amounts paid to a licensed medical professional for medical or veterinary services.[113] The tax also does not apply to "excess parachute payments" to an employee who is a non-HCE.[114]

Section 4960(c) states that "remuneration" means "wages" as defined in section 3401(a), excluding Roth contributions, and including "amounts required to be included in gross income under section 457(f)."[115] The second sentence of section 4960(a) states that remuneration is "treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B))."[116]

The Senate Amendment added the reference to amounts required to be included in gross income under section 457(f) and the requirement that remuneration be treated as paid when there is no substantial risk of forfeiture. The Conference Committee added the cross-reference to section 457(f), and explained that the addition

> clarifies that "substantial risk of forfeiture" is based on the definition under section 457(f)(3)(B) which applies to ineligible deferred compensation subject to section 457(f). *Accordingly*, the tax imposed by this provision can apply to the value of remuneration that is vested (and any increases in such value or vested remuneration) under this definition, even if it is not yet received.[117]

The authority for the parenthetical in the last sentence is unclear since, as explained in Section A.3, increases in the value of vested benefits under a section 457(f) plan, after the date of initial income inclusion (due to amounts no longer being subject to a substantial risk of forfeiture) are not taxed until they are paid or made available to the participant. Perhaps the reason for the parenthetical was to make it clear that the amount at the time of vesting, which would be treated as taxable income and as remuneration under section 4960, could consist of principal (the originally deferred compensation amounts) and

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[111] I.R.C. § 4960(c)(1).

[112] I.R.C. § 4960(c)(2).

[113] I.R.C. § 4960(c)(3)(B), (5)(C)(iii).

[114] I.R.C. § 4960(c)(5)(C)(iv).

[115] I.R.C. § 4960(c)(3)(A).

[116] I.R.C. § 4960(a).

[117] *See* Conference Report at 493-94 (emphasis added).

income (any earnings or other increases in value)—but all occurring only to the vesting date.

Section 4960(c) states that remuneration also includes amounts "paid with respect to employment of such employee by any related person or governmental entity."[118] A person or governmental entity is "related" to the organization for this purpose if it

> (i) controls, or is controlled by, the organization [apparently regardless of whether the potentially related person or governmental entity is itself tax-exempt], (ii) is controlled by one or more persons which control the organization, (iii) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the organization, (iv) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the organization, or (v) in the case of an organization which is a [VEBA], establishes, maintains, or makes contributions to such [VEBA].[119]

Where remuneration is paid by multiple employers, liability for the excise tax is allocated pro rata among them in proportion to the remuneration each pays, the same way section 162(m) operates.[120]

An "excess parachute payment" is similar to an excess parachute payment under section 280G, except that it is contingent on a separation from service by the covered employee rather than on a change of control of the employer. Specifically, a "parachute payment" means a "payment in the nature of compensation" to, for the benefit of, a covered employee that is "contingent on [the] employee's separation from employment with the employer."[121] As under section 280G, the excise tax applies only if total parachute payments exceed three times the employee's "base amount," and, if they do, the excise tax applies to the portion of the parachute payment that exceeds one times the employee's base amount (called the "excess parachute payment"). For purposes of the excess parachute payment excise tax, payments under tax-qualified plans, SEPs or SIMPLEs, payments under plans described in section 403(b) or 457(b), and payments to a licensed medical professional for the performance of medical services by the professional are excluded. The provision specifically cross-references the rules in section 280G dealing with the definition of the "base amount" (which generally means average annual taxable compensation for the preceding five years), the rules regarding property

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[118] I.R.C. § 4960(c)(4)(A).

[119] I.R.C. § 4960(c)(4)(B). An identical definition of "related organization" is found in section 4968 (excise tax based on investment income of private colleges and universities), and presumably will be interpreted the same way.

[120] I.R.C. § 4960(c)(4)(C); Reg. § 1.162-27(c)(1)(ii).

[121] I.R.C. § 4960(c)(5).

transfers (which are included to the extent they vest as a result of the event) and the determination of present value (which generally uses the federal AFR).

c) Subsection (d)

Section 4960(d) directs Treasury to issue "such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent avoidance of such tax through the performance of services other than as an employee or by providing compensation through a pass-through or other entity to avoid such tax."

d) Reporting requirements

Section 4960 does not specify the due date for taxes imposed by the section, or how to report them. Section 4960 is in Chapter 42 of Subtitle D of the Code. Other excise taxes imposed on tax-exempt organizations by Chapter 42 are reported on and paid with Form 4720, which must be filed by the due date for the organization's Form 990-PF, 990, 990-EZ, or 5227,[122] or the fifteenth day of the fifth month after the organization's accounting period ends if it is not required to file such a form. By contrast, excise taxes imposed on qualified plans by Chapter 43 are reported on and paid with Form 5330, which has a variety of due dates depending on the excise tax involved but for many taxes is the last day of the seventh month after the organization's tax year ends, which also is the due date for the plan's Form 5500 (before any extensions).

II. Recommendations

A. Section 512(a)(7)

1. Compliance burden on organizations that have UBTI solely as a result of section 512(a)(7)

a) Issue

Many tax-exempt organizations have never previously generated UBTI, and, indeed, some have made deliberate decisions to avoid all activities that could generate UBTI. These include smaller tax-exempt organizations that are unfamiliar with the Form 990-T. Many such organizations provide qualified transportation fringes and might in fact be required to do so under state and local laws.[123] Consequently, depending on how section 512(a)(7) is interpreted, these organizations could have a significant additional administrative burden placed upon them for what might be very small amounts of tax.

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[122] Normally the fifteenth day of the fifth month after the organization's accounting period ends.

[123] For example, New York City, Washington, D.C., San Francisco and many other jurisdictions in the Bay Area require employers to offer transportation benefits to their employees.

b) Recommendation

We recommend that Treasury and the Service issue guidance mitigating the burden on organizations that are subject to UBIT and Form 990-T filing solely as a result of section 512(a)(7) by instructing these organizations to complete only certain specified lines on the Form 990-T.

c) Explanation

The Form 990-T is complex by necessity, in order to accommodate the various UBIT rules. However, this results in significant burdens on taxpayers, with the Service estimating that on average the time needed to complete and file the entire form is 138 hours.[124]

Based on their experience in this area, the drafters believe that in many cases the time and cost associated with preparing a Form 990-T far exceeds the tax paid. In other contexts, filing a Form 990-T provides the Service with useful information even if there is no significant tax due, such as allowing the Service to scrutinize organizations that record large unrelated business gross income, but even larger deductions connected with the production of that income. Such considerations generally will not be present for organizations that have UBTI solely as a result of section 512(a)(7), as there are minimal deductions available to offset this income.

To relieve any unnecessary burden or confusion, we recommend that the Service amend the instructions to Form 990-T to provide that taxpayers that have UBTI only by reason of section 512(a)(7) need complete only Blocks A through J on the first page of Form 990-T—with "Section 512(a)(7)" reported in Block H—along with lines 12 and 32-34 (and, if applicable, lines 20, 30, and 31[125]) in Part I of the Form 990-T.[126] The instructions also would need to make clear that no schedule is needed if the only income reported on line 12 of Part I is UBTI resulting from section 512(a)(7).

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[124] *See* 2017 Instructions for Form 990-T (March 27, 2018), 27.

[125] If any other deductions are allowed against UBTI resulting from section 512(a)(7), the instructions also would need to explain a simplified way to claim such deductions.

[126] The Service's website currently says only that organizations with a fiscal tax year beginning in 2017 should "enter the amount of any increase in UBTI on line 12 of the 2017 Form 990-T." *See* https://www.irs.gov/forms-pubs/increase-in-unrelated-business-taxable-income-by-disallowed-fringe-benefits.

This relief would be consistent with principles set forth in Executive Order 13789 on reducing tax regulatory burdens, which states that "[t]he Federal tax system should be simple, fair, efficient, and pro-growth."[127]

2. Application of section 512(a)(7) before guidance is issued

a) Issue

Section 512(a)(7) made significant changes to the UBTI rules, which in many cases will significantly increase the amount of UBIT the organization is required to pay or require it to pay UBIT for the first time. As detailed in other sections of these Comments, there are numerous uncertainties as to how section 512(a)(7) should be applied. Even if these uncertainties are resolved by the time the UBIT (or additional UBIT) is due, in many cases estimated UBIT that takes into account section 512(a)(7) will have to have been paid before then.[128] Moreover, it appears unlikely that comprehensive guidance will be issued by the due date of the first Form 990-T on which UBIT resulting from section 512(a)(7) will have to be reported (which for organizations with tax years ending June 30, for example, will be as early as November 15, 2018).

b) Recommendations

We recommend that Treasury and the Service allow tax-exempt organizations to apply a reasonable, consistent, good-faith interpretation of section 512(a)(7) before the date of issuance (or the stated effective date, if later) of any guidance Treasury and the Service issue under that section.

We also recommend that Treasury and the Service provide specific relief from any underpayment, accuracy-related, and other applicable penalties attributable to tax arising under section 512(a)(7) until guidance under section 512(a)(7) has been issued and is in effect.

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[127] Executive Order 13789, *Identifying and Reducing Tax Regulatory Burdens* (April 21, 2017), 82 Fed. Reg. 19317 (April 26, 2017). The drafters considered limiting this recommendation to organizations with *de minimis* amounts of UBTI as a result of section 512(a)(7). However, they rejected that alternative because of the difficulty of determining an appropriate amount, and because they believed that the burden of completing Form 990-T in its entirety in such a situation generally would outweigh the benefit to the Service regardless of the amount of UBTI.

[128] Large corporations generally cannot base estimated UBIT for the 2018 tax year on the UBIT they owed for the 2017 tax year, and organizations that are not large corporations cannot do so if they owed no UBIT for the 2017 tax year. I.R.C. § 6655(d).

c) Explanation

A tax-exempt organization must pay quarterly estimated tax on UBTI if it expects its tax for the year to be $500 or more and must deposit the UBIT with a government depository. An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business income for a taxable year must report that income on Form 990-T. An organization that does not pay the estimated tax when due may be charged an underpayment penalty under section 6655.[129] It may also be charged with failure-to-pay and failure-to-deposit penalties under sections 6651 and 6656. An organization that does not file Form 990-T to report the UBTI may be charged a failure-to-file penalty under section 6651. If it files the Form 990-T, but does so incorrectly, it may also be charged with accuracy-related penalties under section 6662.

We believe that it would be unfair to tax-exempt organizations for Treasury and the Service to apply guidance under section 512(a)(7) on a retroactive basis, given the variety of possible interpretations of that section, and that organizations should be able to rely on a reasonable, consistent, good-faith interpretation of the statute at least until final regulations are issued. Treasury and the Service have given employers a similar reasonable good-faith reliance period to comply with the numerous statutory provision in the past, often times lasting even after final regulations were issued.[130]

We also believe it would be inequitable to impose penalties on underpayments caused by unexpectedly large section 512(a)(7) income until more guidance is received and organizations have time to comply with the new rules. The Service has the authority to grant relief based on reasonable cause from the failure-to-file, failure-to-pay, failure-to-deposit and accuracy-related penalties imposed by sections 6651, 6656 and 6662.[131] As an administrative matter, the Service also provides broad relief from the failure-to-file, failure-to-pay and failure-to-deposit penalties for first-time filers.[132] The Service already has granted estimated tax penalty relief under that section in connection with section 965 and the repeal of section 958(b)(4) by the Act.[133]

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[129] *See* I.R.C. § 6655(g)(3)(A) (treating tax-exempt organizations as corporations).

[130] *See*, *e.g.*, Reg. §§ 1.162-27(j)(2)(i), (iii), 1.401(a)(4)-13(a)(3), 1.401(a)(5)-1(h)(3), 1.401(a)(17)-1(d)(3), 1.401(ℓ)-6(a)(2)(iii), 1.410(b)-10(c), 1.414(s)-1(j)(3), 1.457-12(b), 1.501(r)-7(b), 31.3121(v)(2)-1(g)(2); Notice 2005-1, *supra* at note 54; Notice 2007-86, 2007-46 I.R.B. 990.

[131] Reg. §§ 301.6651-1(c), 1.6664-4.

[132] *E.g.*, IRM 20.1.1.3.3.2.1 (11-21-2017).

[133] Notice 2018-26, 2018-16 I.R.B. 480, § 6.

3. Applicability of section 512(a)(7) to parking facilities and on-premises athletic facilities

a) Issue

The way that section 512(a)(7) is drafted has created considerable uncertainty regarding its scope. As explained in Section I.B.1, the language of section 512(a)(7) comes from the House Bill and provides that UBTI shall be increased by any amount for which a deduction is not allowable by reason of section 274 and that is paid or incurred for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)). These three items mirrored language in the House Bill which also would have amended section 274 to disallow any deduction for amounts paid or incurred for each of these three items. However, the section 274 amendment in the Act did not follow the House version of the section 274 amendment. Instead, it followed the Senate Amendment and amended section 274 to disallow a deduction only for the expense of a qualified transportation fringe (as defined in section 132(f)) or expense incurred to provide transportation for commuting purposes to an employee.

Notwithstanding the fact that section 274 was not amended by the Act to disallow deductions for parking facilities or on-premises athletic facilities, and that section 512(a)(7) includes in UBTI only amounts "for which a deduction is not allowable . . . by reason of section 274," section 512(a)(7) as enacted continues to refer specifically to amounts paid or incurred for those facilities. In addition, in language also taken from the House Bill, section 512(a)(7) directs Treasury to "issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations or other guidance providing for the appropriate allocation of depreciation and other costs with respect to facilities used for parking or for on-premises athletic facilities."

b) Recommendation

We recommend that Treasury and the Service clarify that section 512(a)(7) applies only to amounts paid or incurred for qualified transportation fringes for which a deduction is not allowable by reason of section 274(a)(4) and thus, for example, does not apply separately to a parking facility used in connection with qualified parking, or an on-premises athletic facility (provided that it is not primarily for the benefit of HCEs).

c) Explanation

Some deductions for expenses of parking facilities could be disallowed by section 274 as expenses for qualified transportation fringes, but the latter expenses already are listed separately in section 274. Thus, section 512(a)(7)'s reference to parking facilities adds nothing to the scope of that section, and we believe that section 512(a)(7) does not apply to expenses of parking facilities except to the extent they also are expenses of qualified transportation fringes.

Furthermore, as explained in Section I.B.1, deductions for expenses of on-premises athletic facilities are not disallowed categorically by section 274, as amended by the Act, and are not disallowed at all as expenses for recreational expenses of facilities as long as they are primarily for the benefit of employees other than HCEs within the meaning of section 414(q). Thus, we believe that section 512(a)(7) does not apply to expenses of on-premises athletic facilities as long as they are not primarily for the benefit of HCEs.

Section 512(a)(7) applies to expenses of qualified transportation fringes for which a deduction is not allowable under section 274. Section 274(a)(4) applies specifically to qualified transportation fringes. Section 274 contains another rule—section 274(ℓ), which disallows a deduction for "any expense incurred for providing any transportation . . . to an employee of the taxpayer in connection with travel between the employee's residence and place of employment"—which could apply to some of the same fringes. We believe that section 274(ℓ) does not apply to the expense of a parking facility because a parking facility does not "provide any transportation." We also believe that, given the specificity of section 274(a)(4) and its use of exactly the same language as section 512(a)(7), the best reading of section 512(a)(7) is that it is limited to expenses disallowed under section 274(a)(4) and not section 274(ℓ).

4. Amount of UBTI inclusion where expense does not correspond to value of qualified transportation fringe

a) Issue

Section 512(a)(7) provides that an organization has UBTI in the "amount for which a deduction is not allowable under this chapter by reason of section 274 and which is paid or incurred by such organization for any qualified transportation fringe (as defined in section 132(f))." Section 274(a)(4), in turn, provides that "no deduction shall be allowed under this chapter for the expense of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer."[134]

In many cases, the amount paid or incurred for a qualified transportation fringe will be more or less than the value of the qualified transportation fringe as defined in

[134] Regulation section 1.162-25T also generally limits the deduction an employer may take when it includes the value of a noncash fringe benefit in an employee's income to the "costs incurred by the employer in providing the benefit."

section 132(f). This has created considerable uncertainty regarding the amount of the UBTI inclusion in such cases.

b) Recommendations

We recommend that Treasury and the Service issue guidance that the UBTI inclusion under section 512(a)(7) is the lesser of (a) the amount of the expense disallowed under section 274 that is incurred in providing the qualified transportation fringe and (b) the value of the qualified transportation fringe.

We also recommend that Treasury and the Service confirm that existing guidance under sections 61 and 132 for determining the value of the qualified transportation fringe applies for this purpose, and that, in applying that guidance, all users of parking facilities other than employees of the organization, including university students, hospital patients, and other recipients of goods and services from the organization will be considered "customers."

c) Explanation

As noted above, section 512(a)(7) provides that an organization has UBTI in the amount for which a deduction is disallowed under section 274, but only if the amount is paid or incurred for a "qualified transportation fringe," and section 274(a)(4) disallows the relevant deduction only if it is for a "qualified transportation fringe" provided to an employee. As discussed below, we believe it is both reasonable and appropriate to read this language to mean that there are two separate limits on the amounts included in UBTI: one is the amount disallowed as a deduction under section 274, which is based on the employer's cost to provide the qualified transportation fringe, and the other is the amount of the qualified transportation fringe received by the employee, *i.e.*, its value. If both limits apply to the amount included in UBTI, then logically the limit must be the lesser of those limits.

We believe that this is consistent with the language of section 512(a)(7). If Congress wanted to include all expenses incurred in providing a qualified transportation fringe, it could have said so clearly, as it did in section 274(o), which disallows "any expense for the operation of a facility described in section 132(e)(2),"[135] or section 274(ℓ)(1), which disallows expenses for commuting transportation assistance without referring to section 132 at all. We are unaware of any other provision in the Code that denies a deduction (or requires an income inclusion) for an expense of an excludable "fringe" benefit received by an employee and that does so by cross-referencing section 132, the sole purpose of which is to allow employees to exclude the value of fringe

[135] By contrast, section 274(a)(4) does not refer to any expense for the operation of a facility used in connection with, or in providing, a qualified transportation fringe.

benefits from income. We believe this unique reference to a "fringe" described in section 132 can reasonably be interpreted as describing the amount received by the employee.

We also believe that this is consistent with the legislative history of the provision. In particular, the House Section-by-Section Summary states that

> Under this provision, tax-exempt entities would be taxed on the *values* of providing their employees with transportation fringe benefits . . . by treating the funds used to pay for such benefits as unrelated business taxable income, thus subjecting the *values* of those employee benefits to a tax equal to the corporate tax rate.[136]

We also believe that capping the amount included in UBTI at the value of the fringe results in a simpler, more administrable rule, which does not open up avenues for abuse and provides greater parity between employers that provide qualified transportation fringes directly and those that provide qualified transportation fringes through third parties or employee reimbursement arrangements. It results in a simpler, more administrable rule because, as noted below, there is considerable guidance on how qualified transportation fringes are valued, with which most employers are familiar and which we believe the Service will find easier to enforce than one based exclusively on expenses. It does not open up avenues for abuse because the guidance on how qualified transportation fringes are valued was not designed to undervalue those benefits but rather to approximate the cost incurred by an employee or employer in obtaining the benefits, and therefore the difference between cost and value in most cases is unlikely to be very significant.[137] It provides greater parity between employers because employers that provide qualified transportation fringes through third parties (*e.g.*, by leasing spaces in a parking lot) or employee reimbursement arrangements (*e.g.*, by reimbursing employees for their parking expenses) already incur costs that are closely tied to the way those fringes are valued.

The guidance noted above on how qualified transportation fringes should be valued includes the following:

- Regulation section 1.61-21(b) provides general guidance on the valuation of fringe benefits. It states that generally an employer's expense in

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[136] House Section-by-Section Summary at 41 (emphasis added).

[137] When significant differences seem to exist between expenses related to qualified transportation fringes and the value of those fringes, it often is the result of the employer having to incur expenses that are not really necessitated by those fringes. For example, a suburban church might need to provide a parking lot to its congregants and staff, but allow local shoppers to use it during the week. Or an organization might be required by local law to purchase a certain number of mass transit passes based on the number of its employees, in an effort to reduce vehicle volume, but not every pass might be claimed or used by an employee. An approach that is based on the value of the benefits provided to employees avoids these problems.

providing a fringe is not taken into account in valuing the fringe unless the relevant provision specifically refers to cost.

- Regulation section 1.132-9(b), Q&A-21(e), provides that transportation in an employer-provided commuter highway vehicle may be valued under the automobile lease valuation rule in Regulation section 1.61-21(d), the vehicle cents-per-mile rule in Regulation section 1.61-21(e), or the commuting valuation rule in Regulation section 1.61-21(f).

- Notice 94-3, Q&A-10a,[138] provides that the value of parking provided by an employer to an employee is based on the cost (including taxes or other added fees) that an individual would incur in an arm's-length transaction to obtain parking at the same site, or, if that cost is not ascertainable, the cost of a space in the same lot or a comparable lot in the same general location under the same or similar circumstances. The Notice provides an example of an employer operating in a rural area in which no commercial parking is available and furnishing ample parking for its employees on the business premises, free of charge, and concludes that such parking has a fair market value of $0 because an individual other than an employee ordinarily would not pay to park there.

- Notice 94-3, Q&A-10c, provides that employer-provided parking that is available primarily to customers of the employer, free of charge, will be deemed to have a fair market value of $0 provided the employer does not maintain "preferential" reserved spaces for employees (meaning spaces more favorably located than the spaces available to the employer's customers).

We have no reason to believe that valuation rules different from the above should or will apply for purposes of section 512(a)(7), but request confirmation from Treasury and the Service that tax-exempt organizations may continue to rely on them. However, some ambiguities arise in applying these rules to tax-exempt organizations. In particular, the use of "customers" in Notice 94-3 could be interpreted to mean retail customers only. Therefore, we request confirmation that, in applying those rules, university students, hospital patients, and other recipients of goods and services from the organization also will be considered "customers."

Finally, we understand that some government representatives have suggested that, if the amount withheld from an employee's salary pursuant to a salary reduction

[138] 1994-1 C.B. 327.

arrangement described in Regulation section 1.132-9[139] exceeds the employer's parking cost (determined as described above), the excess itself could be subject to section 512(a)(7). We request confirmation that this will not be the case: By its terms, an amount is subject to section 512(a)(7) only if it is a cost for which is a deduction is disallowed by section 274. By contrast, in such circumstances the excess is not a cost but a savings to the employer.

5. Treatment of transportation fringe benefit as compensation to employee

a) Issues

Section 512(a)(7) applies to amounts paid or incurred for qualified transportation fringes as defined in section 132(f) for which a deduction is not allowable by reason of section 274. Paragraph (1) of section 132(f) defines a "qualified transportation fringe" to mean certain specified transportation-related benefits provided by an employer to an employee. Separately, paragraph (2) limits the extent to which a qualified transportation fringe may be excluded from gross income under section 132(a)(5). Section 512(a)(7)'s reference to the definition in section 132(f) suggests that UBTI might include the entire amount of a qualified transportation fringe, even if only a portion of that amount is excluded from income under section 132(a)(5).

Section 274(e)(2) provides that section 274(a) shall not apply to "expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee" on the employer's income tax return as originally filed and as wages for FITW purposes.[140] However, it is not entirely clear whether an employee who receives a qualified transportation fringe is, under section 274 as incorporated into section 512(a)(7), considered a recipient of "entertainment, amusement, or recreation" for this purpose. Furthermore, in the case of a tax-exempt organization it is not clear whether any income tax return is necessary, in that such organizations do not ordinarily file tax returns. Because section 132(a) contains language that suggests that income exclusion is mandatory when a benefit is described in section 132—stating that gross income generally "shall not include" these amounts—it also is not clear whether an employer can unilaterally treat a qualified transportation fringe as wages. Finally, it is not clear how the section 274(e)(2) exclusion applies to a qualified transportation fringe that is partially subject to tax, *i.e.*, to the extent its value exceeds the amount excludable under section 132(a)(5).

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[139] *See* Reg. § 1.132-9(b), Q&A-11(b), Q&A-13, Q&A-14(b).

[140] *See also* Reg. § 1.274-2(f)(2)(iii).

b) Recommendations

We recommend that Treasury and the Service confirm that:

A qualified transportation fringe provided to an employee gives rise to UBTI under section 512(a)(7) only to the extent that the amount that is excludable under section 132(a)(5) actually is excluded from income, *i.e.*, is not treated as additional FITW wages to the employee, and thus that a qualified transportation fringe that is treated entirely as additional FITW wages does not give rise to any UBTI under section 512(a)(7); and

Employers have the discretion to include all or a portion of the value of any benefit that otherwise would be excludable under section 132(a)(5) in an employee's FITW wages.

c) Explanation

(1) Limit to amount excluded from income

We have two alternative grounds for making the first recommendation. As discussed in Recommendation 4 in this Section II.A., we believe it is both reasonable and appropriate to read section 512(a)(7) as referring to a qualified transportation fringe that actually is excluded from income under section 132(a)(5). Not only is the phrase "qualified transportation fringe" commonly used (in our experience) to refer to the amount that actually is excluded from income, but we understand that some individuals who helped draft the Act have described it in that way (and explained that section 274(ℓ) was added, in part, to disallow deductions for amounts that were not excludable). Furthermore, we note that sections 512(a)(7) and 274(a)(4) cross-reference section 132(f) in its entirety, including paragraph (2) (limitations), and do not merely cross-reference paragraph (1). If section 512(a)(7) is properly interpreted as applying only to a qualified transportation fringe that actually is excluded from income under section 132(a)(5), then it should not apply to (1) a transportation fringe to the extent that the exclusion is not available because the value of the fringe exceeds the limits in section 132(f)(2), or (2) a transportation fringe to the extent that the exclusion—although available—is not used.

Furthermore, even if this interpretation is incorrect, and section 512(a)(7) does not apply solely to a qualified transportation fringe that is excluded from income, section 512(a)(7) applies only to the extent a deduction is disallowed under section 274(a)(4), and section 274(a) does not disallow deductions for entertainment, amusement or recreation that is properly treated as compensation under section 274(e)(2).[141] In

[141] When section 274(e)(2) applies, the expenses at issue generally are not subject to section 274(a) at all, *i.e.*, not merely exempt from section 274(a) to the extent of the amount that is included in the employee's income. *See Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 TC 197 (2000), *aff'd*

Recommendation 2 in this Section II.A., we explain why we believe that the reference to section 274 in section 512(a)(7) should be read as a specific reference to section 274(a)(4). The regulations under section 274 define "entertainment" broadly enough to apply to employer-provided transportation for commuting and other purely personal purposes. Specifically, it provides that

> The term *entertainment* may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing . . . an automobile to a business customer or his [or her] family. The term *entertainment* does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as . . . an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work.[142]

Consistent with this analysis, too, we believe the amount included in UBTI is zero to the extent that the exclusion in section 132(a)(5) is not available or is not used.

(2) When amount is excluded from income

We believe that an employer can unilaterally treat a qualified transportation fringe as compensation to the employee for this purpose, even if the fringe otherwise would qualify for the exclusion in section 132(a)(5), because section 274(e) expressly contemplates such treatment. We believe this can be done by including the amount in FITW wages,[143] because the other requirement is to treat it as compensation on the employer's income tax return, and tax-exempt organizations do not routinely file income tax returns.[144]

If Treasury and the Service do not agree that an employer can unilaterally treat a qualified transportation fringe as compensation, then we request guidance on how that treatment can be achieved. We understand that one possibility is to increase the employee's wages by the value of the fringe and then require or permit the employee to

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per curiam, 255 F.3d 495 (8th Cir. 2001), *acq*. AOD 2002-02 (Feb. 11, 2002). An exception to the general rule is when the employee receiving the item is a "specified individual" described in section 274(e)(2)(B).

[142] Reg. § 1.274-2(b)(1)(i) (emphasis in original); *cf. Commissioner v. Flowers*, 326 U.S. 465 (1946) (commuting costs are nondeductible personal expenses).

[143] An employer may choose to treat noncash fringe benefits as paid by the pay period, by the quarter, or on any other basis it chooses as long as it treats the benefits as paid at least once a year. Announcement 85-113, 1985-31 I.R.B. 31.

[144] Alternatively, a tax-exempt organization could be required to report it as compensation on the organization's Form 990 or other applicable information return, but only to the extent required by that return. (Form 990-N, for example, does not include any compensation information.)

pay for the fringe with post-tax wages.[145] However, we are concerned that such an arrangement will not satisfy requirements under local law to offer transportation benefits to employees. Requiring actual cash payments (and the resulting circular flow of funds) also would impose additional administrative burdens on employers and employees. Another might be to intentionally violate the detailed requirements for qualified transportation fringe benefits under the applicable regulations.[146] However, in our view requiring intentional violations of the requirements in the regulations, would not make sense from a tax administration perspective and could lead to unnecessary disputes over whether the requirements were sufficiently violated.

6. Treatment of indirect expenses

a) Issue

Section 274(a)(1) draws a distinction between entertainment activities and entertainment facilities. Section 274(a)(1)(A) disallows a deduction for any "item" with respect to an entertainment activity. Similarly, section 274(a)(1)(B) disallows a deduction for any "item" with respect to a facility that is used in connection with an entertainment activity. Even though the Code uses the term "item," the regulations use the term "expenditure."[147] The regulations also make it clear that section 274(a)(1)(B) applies to a facility that is used—to any extent—in connection with an entertainment activity. Consequently, deductions for expenditures with respect to such a facility are completely disallowed even if the facility also is used for other purposes.[148] However, there is an exception from this all-or-nothing rule for "a transportation type facility (such as an automobile or an airplane), . . . to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment."[149]

The regulations define "expenditures" generally as "expenses paid or incurred for goods, services, facilities, and items (including items such as losses and depreciation)."[150] They define "expenditures" with respect to an entertainment facility—which as explained are subject to a stricter rule—as "depreciation and operating costs, such as rent and utility

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[145] *See*, *e.g.*, INFO 2017-0007 (Jan. 25, 2017) ("Arrangements where an employer purchases parking spots from a parking vendor and then, in turn, permits employees who wish to use the parking spots to pay the employer for the parking spots using the employees' own after-tax compensation do not meet the definition of qualified parking in the Code and Regulations.").

[146] *See generally* Reg. § 1.132-9(b).

[147] Reg. § 1.274-2(a).

[148] Reg. § 1.274-2(e)(2)(i); *Ireland v. Commissioner*, 89 T.C. 978 (1987).

[149] Reg. § 1.274-2(b)(1)(iii)(c)(1).

[150] Reg. § 1.274-2(b)(2)(i).

charges (for example, water or electricity), expenses for the maintenance, preservation or protection of a facility (for example, repairs, painting, insurance charges), and salaries or expenses for subsistence paid to caretakers or watchmen [as well as] losses realized on the sale or other disposition of a facility."[151] However, according to the regulations any out-of-pocket costs incurred contemporaneously with the use of the facility, other than "operating costs and other expenses referred to in [the previous sentence]," are not considered expenditures with respect to the facility and thus are not subject to the stricter rule.[152]

Section 274(a)(4) does not disallow deductions for "items" (or "expenditures") but rather disallow deductions for "expenses." As explained in Section I.B.1, the term "expenses" is a lesser included part of the term "items" (or "expenditures") and does not include depreciation or losses realized on sales of facilities.

Many employers incur indirect expenses in providing qualified transportation fringes, in addition to direct expenses. Tax-exempt employers will need to know whether and to what extent these indirect expenses are considered amounts paid or incurred for qualified transportation fringes for purposes of section 512(a)(7) and, relatedly, whether these are considered expenses of qualified transportation fringes for purposes of section 274(a)(4).[153]

Some of these interpretive issues pre-date the Act, but the changes to sections 274 and the addition of 512(a)(7) by the Act have made them much more significant.

b) Recommendations

We recommend that Treasury and the Service issue guidance that amounts paid or incurred for qualified transportation fringes for purposes of section 512(a)(7) are limited to variable expenses directly connected with providing those fringes. Specifically, we recommend that they not include indirect overhead expenses associated with administering the employer's qualified transportation fringes or any costs that do not vary with the amount of qualified fringes that are provided.

We also recommend that, in the case of a parking lot, commuter highway vehicle or other transportation facility, amounts paid or incurred for qualified transportation

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[151] Reg. § 1.274-2(e)(3)(i).

[152] Reg. § 1.274-2(e)(3)(iii)(a).

[153] If the approach suggested in Recommendation 5 in this Section II.A. is adopted, the amount included in UBTI would be capped at the value of the qualified transportation fringes that are excluded from employee income by reason of section 132(f). Nonetheless, tax-exempt employers still will need to determine the amount paid or incurred for the qualified transportation fringe to determine whether such amount or the value excluded from employee income is higher.

fringes not be deemed to include depreciation or capital expenses disallowed as deductions (and required to be capitalized) by section 263. If the latter recommendation is not accepted, in the case of a transportation facility, we recommend that those amounts be limited to expenditures that relate to the use of the facility to provide qualified transportation fringes and not extend, for example, to use by non-employees such as students, patients or visitors, or use by employees for non-commuting purposes.

c) Explanation

Like many other employee benefits, qualified transportation fringes require considerable effort to administer. The related administrative and overhead costs (including allocable portions of employee salaries, administrative buildings and related utilities, payments to independent contractors for program administration) do not directly benefit employees and, in many cases, are not separated out from other administrative or overhead expenses for accounting or other purposes. We believe it is reasonable to read sections 274(a)(4) and 512(a)(7) as not including such indirect administrative and overhead expenses. We reach that conclusion because neither the concept of an "item" (or "expenditure") under section 274(a)(1) nor that of an "expense" under section 274(a)(4) requires them to be included, and because not including them would be consistent with the focus, explained in Recommendation 5 in this Section II.A., on the value of qualified transportation fringes in the legislative history of the provisions.

Moreover, an employer that owns or leases a parking lot, commuter highway vehicle or other transportation facility may incur not only direct, variable costs connected with providing qualified transportation fringes to employees who use the facility but also indirect costs that do not vary with the amount of qualified fringes that are provided. These include expenses like insurance and depreciation. We believe it is both reasonable and appropriate to read sections 274(a)(4) and 512(a)(7) as not including such indirect expenses. We reach that conclusion not only because many of these are the kinds of administrative and overhead expenses that we concluded should be excluded in the previous paragraph, but also for three additional reasons. First, as explained above, section 274(a)(4) disallows deductions for "expenses," which—unlike "items" and "expenditures" used in section 274(a)(1) and the regulations thereunder—do not include depreciation or losses.[154] Second, although the initial cost of constructing the lot or other facility could be viewed as an "expense," such an expense would be disallowed as a deduction (and required to be capitalized) under section 263, not under section 274, and for existing facilities would have been paid or incurred long before the effective date of section 512(a)(7). And, finally, these are the kinds of expenses that the existing regulations under section 274 associate specifically with entertainment *facilities* as

[154] *See* note 109 *supra* and the text accompanying note 109.

opposed to entertainment *activities*; but when it adopted the final version of the Act, Congress deliberately dropped the reference in the House Bill to a parking *facility*.

An employer that owns or leases a transportation facility often allows it to be used by non-employees such as students, patients or visitors, or by employees for non-commuting purposes. For example, a parking lot might be used by visitors to a hospital or by maintenance personnel to park their vehicles; and a bus system might be used during the day for transportation between buildings or campuses. Even if the recommendation in the previous paragraph is not accepted, we believe it is both reasonable and appropriate in the case of a transportation facility to include only expenditures that relate to the use of the facility to provide qualified transportation fringes, and not to such other uses. We reach that conclusion because there is nothing in section 274(a)(4) like the strict all-or-nothing rule in section 274(a)(1)(B), and even under section 274(a)(1)(B) there is an exception from that rule for transportation facilities. For this purpose, at least until further guidance is provided, we recommend that Treasury and the Service allow employers to use any reasonable allocation method that is applied consistently—for example, based on the number of spaces reasonably determined to be used by employees as a proportion of the total number of spaces and/or the number of hours in the day that the facility is used by employees.

7. Treatment of expenses as private business use under section 141

a) Issue

A bond issued on behalf of a section 501(c)(3) organization will be a qualified private activity bond, and the interest thereon exempt from tax, only if not more than five percent of the net bond proceeds are for an unrelated trade or business use described in section 513(a). Although expenses giving rise to UBTI under section 512(a)(7) are not an unrelated trade or business described in section 513(a) and therefore should not constitute private business use within the meaning of section 145, the inclusion of such expenses in UBTI could create concern and confusion amount tax-exempt organizations.

b) Recommendation

We recommend that Treasury and the Service confirm that expenses treated as UBTI under section 512(a)(7) do not necessarily constitute private business use under section 145.

c) Explanation

A bond issued on behalf of a section 501(c)(3) organization is a private activity body and thus is not tax exempt unless the bond is "qualified." Section 145 provides that a private activity bond is qualified if (1) all property provided by the net proceeds is owned by a section 501(c)(3) organization or government unit, and (2) not more than five percent of the net bond proceeds go toward (i) private business use, or (ii) for an unrelated trade or business described in section 513(a). Section 513(a) defines an "unrelated trade or business" as "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501(a) . . . ." This definition of unrelated trade or business does not encompass expenses treated as UBTI by section 512(a)(7), nor does anything in section 512(a)(7) suggest that paying or incurring amounts for a qualified transportation fringe is an unrelated trade or business. We believe that such expenses therefore should not be treated as private business use for purposes of determining whether a bond is a qualified activity bond.

8. Other issues under section 512(a)(7)

It also would be useful for Treasury and the Service to:

- Clarify, that a tax-exempt employer can take other deductions against UBTI incurred by reason of section 512(a)(7), such as related expenses not disallowed by section 274 (for example, indirect expenses of the sort described in Recommendation 6 in this Section II.A.), net operating losses carried forward from years beginning prior to January 1, 2018, and/or charitable contribution deductions as described in section 512(b)(6) and (10)-(11), respectively; and

- Confirm that transportation, *e.g.*, by shuttle buses, from one location to another solely on the premises of the employer is not an amount paid or incurred for a qualified transportation fringe but rather is an ordinary and necessary business expense.

B. Section 4960

1. Definition of "taxable year"

a) Issue

Section 4960 applies "to taxable years beginning after December 31, 2017." The $1 million threshold applies to "remuneration paid . . . for the taxable year." Also, under section 4960, an organization is an "applicable tax-exempt organization," and an employee is one of the five "highest compensated employees" of the organization, "for the taxable year." It is not entirely clear what a tax-exempt organization's "taxable year" is for this purpose, because generally it does not pay taxes, and because section 4960 does not contain its own definition of taxable year.

b) Recommendation

We recommend that Treasury and the Service interpret "taxable year" in section 4960 to mean the organization's established accounting period.

c) Explanation

Section 7701(a)(23) defines the term "taxable year" as "the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A." Although a tax-exempt organization does not have to compute its regular taxable income, it does have to compute its UBTI. For that purpose, the taxable year is determined under section 441 without regard to the fact that the organization is tax-exempt.[155] Section 441(b)(1) defines an organization's "taxable year" as its annual accounting period if it is a calendar year or a fiscal year.[156] The regulations also require Form 990-T to be filed on the basis of the organization's "taxable year."

2. Application of section 4960 before guidance is issued

a) Issue

Section 4960 is likely to impose significant taxes on many tax-exempt organizations. As explained in more detail in other sections of these Comments, many of the terms and concepts used in section 4960 are not only unfamiliar to most tax-exempt organizations, but also are susceptible to multiple different reasonable interpretations. We know that Treasury and the Service are working hard to provide guidance on section 4960 as soon as practicable. However, it appears likely that comprehensive guidance will not be issued before the end of the first taxable year to which it applies, or by the due date of whatever return on which the taxes are required to be reported.

b) Recommendation

We recommend that Treasury and the Service allow tax-exempt organizations to apply a reasonable, consistent, good-faith interpretation of section 4960 before the date of issuance (or the stated effective date, if later) of any guidance Treasury and the Service issue under that section.

c) Explanation

We believe it would be equitable to tax-exempt organizations for Treasury and the Service to apply guidance under section 4960 on a prospective basis, given the variety of

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[155] Reg. § 1.511-3(c).

[156] Reg. § 1.6012-2(e).

possible interpretations of numerous provisions of that section. If the organization interprets section 4960 incorrectly, and is subject to the excise tax, it could be subject to penalties and interest and also could be required to file amended returns and might have to revise its financial statements. Treasury and the Service gave employers a similar reasonable good-faith reliance period to comply with the complex provisions of section 409A, which lasted even after final regulations were issued.[157]

3. Application of section 4960 to taxable years before 2018

a) Issue

As noted in Section II.B.1, section 4960 applies "to taxable years beginning after December 31, 2017," and, in any year to which it applies, it subjects "remuneration paid . . . for the taxable year" (to the extent it exceeds $1 million) and "any excess parachute payment" to tax. It is not clear when, if ever, remuneration and excess parachute payments earned before the effective date are subject to section 4960.

b) Recommendation

We recommend that Treasury and the Service issue guidance confirming that section 4960 does not apply to remuneration or parachute payments that would have been taken into account in a prior taxable year if section 4960 had applied to the prior taxable year, based on a reasonable, consistent, good-faith interpretation of section 4960, even if, in the case of remuneration, it did not exceed $1 million, or, in the case of a parachute payment, it was not considered "excess."

c) Explanation

Exempting remuneration and parachute payments that would have been taken into account under section 4960 in a prior taxable year if section 4960 had applied to the prior taxable year ensures equal treatment of remuneration and parachute payments attributable to years to which section 4960 does apply, and years to which it did not apply. For example, section 4960 takes deferred compensation subject to section 457(f) into account when it vests, *i.e.*, when it no longer is subject to a "substantial risk of forfeiture," and does not take the same deferred compensation into account again in a later year. If the deferred compensation vested in a year to which section 4960 did not apply, and therefore would been taken into account under section 4960 but for the effective date, we believe it also should not be taken into account again in a later year just because section 4960 applies to that year. Remuneration and parachute payments would be "taken into

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[157] *See* note 130 *supra*.

account" for this purpose not only if they actually would have exceeded the limits, but also any time the limits would have applied to them.

We also believe it is fair and appropriate to allow a tax-exempt organization to use a reasonable, consistent, good-faith interpretation of section 4960 to determine whether remuneration or parachute payments would have been taken into account in a prior taxable year for this purpose, because they had no notice at that time that the amounts might eventually be subject to an excise tax under section 4960, much less any notice of any guidance that Treasury and the Service might adopt interpreting that section, and therefore had no opportunity to modify them in any way. This is consistent with Recommendation 2 in this Section II.B., which suggests that, after the effective date of section 4960 but before guidance is issued, tax-exempt organizations should be allowed to apply that section using any reasonable, consistent, good-faith interpretation.

4. Calendar-year election

a) Issue

As explained in Section I.B.2, an employee's remuneration for purposes of section 4960 includes "wages" as defined in section 3401(a); and, due to the expansive nature of that term, in most cases wages will comprise the bulk of that remuneration. Wages are calculated and reported on the basis of the calendar year, not the employer's fiscal year.

b) Recommendation

We recommend that, if the organization's established accounting period is a fiscal year, Treasury and the Service allow, but not require, the organization to use the calendar year ending within that period to determine whether an employee is one of the five "highest compensated employees" of the organization, to determine the employee's remuneration, and to apply the $1 million threshold to that remuneration.

c) Explanation

Payroll systems typically are built to feed directly into the Forms W-2 and other reports required to comply with an employer's employment tax reporting obligations. Modifying payroll systems and possibly even payroll dates to capture remuneration for periods other than the calendar year for this limited purpose is likely to be expensive, and the resulting measurements are likely to be less accurate than they would be if they also were used for employment tax reporting purposes. Presumably that is a major reason why, as explained in Section I.A.8, the remuneration that is reported on Form 990 and is used to determine whether an employee is one of the "highest compensated employees" is calculated on the basis of the calendar year ending in the organization's fiscal year, or that a calendar-year election is available for determining whether individuals are HCEs.[158]

We would not expect an organization to elect to use the calendar year ending within a period, however, if that would result in having to include remuneration for a period prior to the effective date of section 4960 (*i.e.*, the first day of the organization's taxable year beginning after December 31, 2017). Thus, we suggest that organizations be allowed to elect this method at any time, or at least within the first several years after the effective date, without restriction. We also suggest that, if an individual's remuneration or parachute payments would subject the organization to an excise tax both in the applicable fiscal year and in the calendar year ending in that fiscal year, the excise tax be calculated and applied only once.

5. Definition of "remuneration" subject to $1 million threshold

a) Issue

As explained in Section I.B.2, the $1 million threshold in section 4960(a) applies to "remuneration paid . . . for the taxable year." Section 4960(c)(3) defines "remuneration" as FITW wages (other than Roth contributions) plus amounts subject to tax under section 457(f), and section 4960(a) states that remuneration is "treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)." The Conference Report states that, because of the cross-reference to section 457(f)(3)(B), "the tax imposed by [section 4960] can apply to the value of remuneration that is vested (and any increases in such value or vested remuneration)."

It is not entirely clear what "remuneration" or "remuneration paid" means in this context. In particular, it is not entirely clear whether "remuneration" includes anything more than the amounts listed in the definition in section 4960(c)(3), or whether such remuneration is "paid" when it vests only in the case of amounts subject to section 457(f).

b) Recommendation

We recommend that Treasury and the Service issue guidance limiting "remuneration" to the amounts listed in the definition in section 4960(c)(3) and treating such remuneration as "paid" when it vests only in the case of amounts actually subject to section 457(f). Thus, it would mean approximately the same thing as "reportable compensation" on Form 990 and would not include "other compensation."

[158] *See* Notice 97-45, 1997-2 C.B. 296, Part IV; *cf.* Reg. § 1.414(q)-1T, Q&A-14(b) (pre-SBJPA guidance).

c) Explanation

As noted in Section I.B.2, the second sentence of section 4960(a) states that remuneration is treated as "paid" when there is no substantial risk of forfeiture within the meaning of section 457(f). We interpret that sentence as a mere clarification that, when section 4960(a) refers to remuneration that is "paid," it is not intended to exclude amounts that—under the express definition in section 4960(c)(3)—are remuneration when they vest rather than when they are actually or constructively paid. We think this represents the best reading of section 4960, and one that is closest to the intended special rule for section 457(f) amounts (*i.e.*, inclusion in remuneration upon vesting).

We believe it would not be appropriate to interpret the sentence to include anything more than the amounts listed in the definition in section 4960(c)(3), or to require remuneration that is not actually subject to section 457(f) to be taken into account when it vests. That is primarily because the sentence does not actually modify section 4960(c)(3), but rather the phrase "remuneration paid," which appears only in section 4960(a).

This interpretation is further supported by the canon of statutory and regulatory construction that a specific provision in a statute (like a definition) normally overrides a general provision unless that would frustrate the purpose of the statute.[159] Here the reverse would be true: an expansive reading of the sentence would change the definition of FITW wages into something almost unrecognizable, because the concept of actual payment is integral to the concept of FITW wages. Section 3401(a) requires them to be either "cash"—as in "cash method of accounting"—or "paid in [a] medium other than cash"; and, as explained in Section I.A.6, the regulations interpret "payment" in the usual way to mean actual or constructive payment. When section 3401(a) includes other amounts—such as amounts subject to tax under section 409A—in wages, it does so expressly, and Treasury and the Service have had to provide extensive guidance on what that means. It also would extend a section 457(f) concept to amounts to which that section does not apply, despite a long history of Congress, Treasury and the Service of limiting the scope of that section to arrangements where it made sense and excluding arrangements—such as bona fide welfare benefits and short-term deferrals—where it made no sense or where the complexities outweighed the benefits.

Consistent with our interpretation of the sentence, we believe it would be both reasonable and appropriate for Treasury and the Service to read it to require the inclusion of amounts treated as compensation under sections 83 and 402(b). As explained in Section I.A.6, those provisions—like section 457(f)—subject individuals to tax on certain

[159] *See, e.g.*, *Colautti v. Franklin*, 439 U.S. 379, 392 (1979); *Lawson v. Suwannee S.S. Co.*, 336 U.S. 198, 201 (1949).

amounts before they are actually or constructively received, and it is not clear whether those amounts are additional FITW wages.

We believe that this interpretation represents a fair and administrable approach. It is based on well-understood concepts and takes into account amounts that include can be measured accurately. As explained in Sections I.A.6 and I.A.8, these amounts also make up the bulk of the compensation reported in Box 1 of Form W-2 (for all employees), as well as on Form 990, Part VII and Schedule J (for employees reported there), and are routinely calculated for those purposes.

This interpretation also makes the scope of section 4960 more consistent with that of section 162(m). In particular, it means that severance pay, and earnings and increases in actuarial value after the vesting date of deferred compensation, are not taken into account until they are paid;[160] and that nontaxable benefits are not be taken into account at all.[161]

This interpretation also includes most compensation provided to an employee by an agent of the employer because, as explained in Section I.A.6, wages paid by an agent of the common law employer such as a PSP generally are considered wages paid by or on behalf of the common law employer. However, we believe it would be reasonable for Treasury and the Service to include, specifically, compensation provided by a section 3401(d) statutory employer or section 3131(s) common paymaster since, as explained in Section I.A.6, such compensation is not reported using the common law employer's EIN or in other ways that would make the compensation easy to track back to the common law employer. As explained in Section I.A.8, that, too, would make the definition more consistent with the definition of "reportable compensation" used on Form 990.

This interpretation excludes compensation payable to nonresident aliens on account of services performed outside the United States, because such compensation is not FITW wages and is not subject to United States tax, as well as section 457(f) amounts attributable to those services.

If, contrary to our recommendation, the sentence is interpreted as a broader rule that amounts not otherwise considered as either FITW wages or subject to section 457(f)

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[160] As explained in Section I.A.3, bona fide severance pay, and earnings and increases in actuarial value, are not wages and are not subject to tax under section 457(f) until they are paid. They are not subject to section 162(m) until paid because generally no deduction is available until that time. I.R.C. § 404(a)(5); Temp. Reg. § 1.404(b)-1T, Q&A-2; *see* Rev. Rul. 94-77, 1994-2 C.B. 19.

[161] As explained in Section I.A.6, nontaxable benefits generally are not wages; they also are not subject to section 457(f). As explained in Section I.A.1, nontaxable benefits also are not subject to section 162(m).

will be included in the $1 million threshold when they vest, then significant questions will arise including:

- How should deferred amounts and in-kind benefits not subject to sections 457(f) or 3401(a) be valued?

- Will there be a discount to present value, and will later increases in present value be taken into account again under section 4960? What about decreases in present value?

- What about benefits that are vested but are not certain to be received, such as sabbaticals, vacation pay, severance pay and access to health care?

- Will there be any exception for *de minimis* fringes or working condition fringes such as office support or reimbursements for business travel or business entertaining, or for short-term deferrals like last year's bonuses and paychecks?

Even after these questions are answered, a broader rule would require tax-exempt organizations to create systems to capture and measure these amounts on an ongoing basis, if for no other reason than to avoid a possible violation of section 4960. Although generally speaking smaller tax-exempt organizations that lack the resources to create these systems are less likely to pay compensation over $1 million, that is not always true. Therefore, we believe that many tax-exempt organizations will not apply section 4960 correctly unless workable rules based on existing, well-understood concepts with significance in other areas can be adopted.

For the foregoing reasons, we urge Treasury and the Service to limit the definition of "remuneration" as described above.

6. Definition of "predecessor"

a) Issue

Section 4960 applies to any employee or former employee who was a covered employee of the organization or any "predecessor" for any preceding taxable year beginning after December 31, 2016. "Predecessor" for this purpose is not defined.

b) Recommendation

We recommend that Treasury and the Service issue guidance that "predecessor" means a "predecessor employer" as defined in Regulation section 1.415(f)-1(c)(2), and that an organization's reasonable good-faith determination that a transaction did not result in a predecessor-successor relationship will be considered dispositive if the transaction occurred five or more years ago.

c) Explanation

We believe it is important for there to be a substantial continuity of operations between a tax-exempt organization and a possible "predecessor." Although the reason for including an employee who was a covered employee in a preceding year is not clear from the legislative history or from other sources, one plausible reason is that the employee's prior status indicates an influential or otherwise close relationship with the organization which is expected to continue and therefore potentially affect any future payments to the employee.[162] This suggests to us that an organization should be considered a "predecessor" only in situations where a close relationship with that organization will continue with its successor. Such close relationships are required in similar contexts. For example, as noted in Section I.A.4, the instructions to Form 1023 describe a "successor" as one that has taken over the activities previously conducted by another organization or over 25% or more of the fair market value of the net assets of another organization. We believe that Regulation section 1.415(f)-1(c)(2) provides an appropriate standard. It states that:

> With respect to an employer of a participant, a former entity that antedates the employer is a predecessor employer with respect to the participant if, under the facts and circumstances, the employer constitutes a continuation of all or a portion of the trade or business of the former entity. This will occur, for example, where formation of the employer constitutes a mere formal or technical change in the employment relationship and continuity otherwise exists in the substance and administration of the business operations of the former entity and the employer.

We also believe it is important for the concept of a "predecessor" to be workable and not create unreasonable exposure for a tax-exempt organization that is attempting in good faith to comply. An employee's status as a covered employee is based on his or her compensation from the organization. As explained in Section I.A.6, section 6001 requires an employer to keep payroll records for at least four years after the relevant return period, and few employers keep them for significantly longer periods. Furthermore, payroll records often are destroyed in a sale-of-assets or similar situation unless there is significant continuity between the previous employer and the successor. This means that it would be difficult for an organization to "prove the negative" that an

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[162] If that was not the reason, it is not clear why section 4960 does not simply apply to any employee who was a covered employee of any tax-exempt organization at all—even an unrelated one.

employee was not a covered employee where that status was based on events that occurred five or more years ago and related to a different entity.[163]

However, we understand that the rule that is adopted should not encourage careless recordkeeping. Therefore, we suggest that the five-year rule apply only to organization that make the determination reasonably and in good faith. Good faith in our view would require the organization to follow industry-standard and legally mandated record-retention policies regarding payroll records.

7. Compensation used to identify "highest compensated employees"

a) Issue

Section 4960 does not define "highest compensated employees" or specify the definition of compensation to be used for that purpose.

b) Recommendation

We recommend that Treasury and the Service issue guidance determining "highest compensated employees" for purposes of section 4960(c)(2)(A) by ranking the organization's common law employees (including employees of DREs) by compensation, and using the same definition of "remuneration" as is used for other purposes under section 4960, but excluding payments that are "contingent on . . . separation from employment" within the meaning of section 4960(c)(5)(B)(i).

c) Explanation

We believe that, as explained in Sections I.A.6 and I.A.8, limiting "employees" to common law employees of the tax-exempt organization and of any DREs is generally consistent with standard practice and the approach used by the instructions to Form 990 to determine "highest compensated employees." While FITW wages comprise the bulk of "remuneration" as defined in section 4960(c)(3), and the separate existence of DREs is recognized for FITW purposes, we do not believe it would be appropriate to determine "highest compensated employees" separately for DREs because (1) DREs do not have their own separate tax exemptions[164] and therefore cannot be "applicable tax-exempt organizations" in their own right, and (2) as noted above, that is not done for Form 990 purposes. This approach means that the "highest compensated employees" of an organization do not include employees of partnerships and other pass-through entities in

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[163] Reg. § 1.280G-1, Q&A-21(b), contains a broad definition of "predecessor," but it is part of a definition of "compensation" that reaches back only five years.

[164] *See* Announcement 99-102, 1999-2 C.B. 545.

which the organization invests, even though a share of their compensation might be reflected on the organization's Schedule K-1 received from the partnership.

We also believe that generally using the same definition of "remuneration" for this purpose as is used for other purposes under section 4960, taking into account Recommendations 4 and 5 in this Section II.B., will reduce the administrative burden on tax-exempt organizations as well as Treasury and the Service by avoiding the need to develop a new definition of compensation. Again, our suggested approach is the same as the approach used by the instructions to Form 990 to determine "highest compensated employees," which, as explained in Section I.A.8, is based on the same reportable compensation that is disclosed in Part VII and on Schedule J.

However, we believe that including severance payments and other amounts that are potential parachute payments could misleadingly include many mid-level employees in this category, even if they had no meaningful influence over the tax-exempt organization and merely received large one-time payments because they terminated employment. Therefore, we would exclude those payments.

8. Application of section 4960 when there are "related organizations"

a) Issues

As explained in Section I.B.2, section 4960 defines a "covered employee" as an employee or former employee who 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. "Highest compensated employees of the organization" is not defined.

Section 4960(c)(4)(A) provides that remuneration of a covered employee by an applicable tax-exempt organization includes "remuneration paid with respect to employment of such employee by any related person or governmental entity." It is not clear whether "with respect to employment of such employee" modifies "remuneration paid"—which would limit remuneration to compensation that is paid for services performed for the organization itself, but that is paid by a related person—or instead modifies "by any related person or governmental entity" (or perhaps both phrases)—which would allow remuneration to include compensation that is paid for services performed for a related organization, even if they were distinct from the services she performed for the organization.

When remuneration from related organizations is taken into account, section 4960(c)(4)(C) allocates liability for the excise tax pro rata among them and the applicable tax-exempt organization in proportion to the remuneration that each pays. It is not clear how that allocation is done when the employee is one of the five "highest compensated employees" of multiple related organizations.

b) Recommendation

We recommend that Treasury and the Service issue guidance coordinating the definition of "highest compensated employee" in section 4960(c)(2)(A) and clauses (i) and (ii) of the definition of "related organizations" in section 4960(c)(4)(B) by treating all employees of all members of the group of related organizations as employees of the same organization for both purposes.

c) Explanation

(1) Authority for interpretation

We believe that Treasury and the Service have the authority to determine "one of the 5 highest compensated employees" on a related-group basis. Section 4960 refers to the "highest compensated employees of the organization." It does not require the group to be determined separately for each organization in a related group, but instead merely requires such a group to exist for each such organization. In a similar situation, as explained in Section I.A.1, Treasury and the Service determined that they had the authority to define "compensation" and "highest compensated" on a related-group basis for purposes of the $1 million cap in section 162(m) when they issued regulations under that section.

(2) Purpose of section 4960

We believe that such an interpretation is consistent with the purpose of section 4960. Section 4960(c) requires the remuneration subject to section 4960 to include amounts paid by related persons and entities. To us, this appears to assume that the employee or the organization(s) for which he or she works will have a level of control or influence over those related persons and entities that is sufficient to induce them to pay the remuneration. Also, as explained in Recommendation 6 in this Section II.B., section 4960 appears to us to be directed at employees with influential relationships with tax-exempt organizations. As a practical matter, such meaningful influence usually is exercised at the related-group level. Determining "highest compensated employee" separately for each organization in a related group could, we believe, result in very large numbers of mid-level employees being covered by section 4960,[165] and potentially even triggering excise taxes under that section if either their remuneration from one

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[165] This is particularly true once the unlimited look-back rule, including "predecessor" employers, is taken into account.

organization occasionally exceeded permitted levels or their combined remuneration from related persons and entities where they performed other jobs did so.

(3) Structure of section 4960

We believe that such an interpretation also is consistent with the overall structure of section 4960. Consider a situation in which the same individual, A, receives a total of \$1.2 million from an applicable tax-exempt organization and two related persons in a taxable year. The excise tax on the \$200,000 excess over \$1 million is \$42,000 (21%×(\$1,200,000-1,000,000)). If section 4960 were to apply separately to each organization, it would impose that tax on the applicable tax-exempt organization and on each person that is itself an applicable tax-exempt organization, for a total of \$126,000 (3×\$42,000). Section 4960(c)(4)(C) would allocate each \$42,000 amount pro rata among the organizations, but the total would remain \$126,000. Perhaps guidance under section 4960 could require the tax to be determined only once, but that would require section 4960 to be applied on related-group basis for one purpose but not for others, which strikes us as inconsistent and needlessly complex. Although this kind of "double-counting" occurs on Form 990 (unless the group has a group exemption ruling and files a single Form 990), there it results in duplicative reporting of the same compensation, and not multiple taxation of the same remuneration.

We believe that this interpretation also is consistent with the rule in section 4960(c)(5)(C)(iv) that excess parachute payments do not include payments to individuals who are not HCEs under section 414(q), because HCE status is determined on a controlled-group basis.[166]

We recognize that the "double counting" problem is more likely to occur if remuneration from related organizations is taken into account not only in determining the amount of the tax but also in determining which employees are the "highest compensated employees" of an organization, because in that case the same employee has the same remuneration when making the second determination at each employer that is an applicable tax-exempt organization. However, it could happen even if that was not the case if employees frequently perform substantial services for multiple members of the group.

Two other ways to avoid this problem would be to require each employee to be allocated to only one member of a related group, or to discourage the sharing of services. However, the first does not seem to us to be justified by the statutory language, and the second seems to us potentially to interfere with the related group's legitimate employment practices.

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[166] Reg. § 1.414(q)-1T, Q&A-6.

(4) Alternative approach

One internally consistent alternative to applying section 4960 on a related-group basis would be to limit section 4960(c)(4)(A) to indirect payments for the same services. Thus, for example, if an individual, B, received $900,000 from an applicable tax-exempt organization for services as its CEO, and an additional $300,000 from a supporting organization for the same services, the entire $1.2 million would be taken into account, but if the additional $300,000 could be justified by the supporting organization as reasonable compensation for different services performed for that organization, it would be disregarded and only $900,000 would be taken into account. However, we believe that such an approach would be more difficult for organizations to apply and for the Service to enforce than the approach we recommend above.

9. Identification of "related organizations"

a) Issues

As explained in Section I.B.2, section 4960(c)(4)(B), clauses (i) and (ii), provide that a person or governmental entity is treated as related to an applicable tax-exempt organization if such person or governmental entity controls, or is controlled by, the organization, or is controlled by one or more persons which control the organization.[167] "Control" is not defined.

b) Recommendation

We recommend that Treasury and the Service issue guidance defining "control" for purposes of section 4960(c)(4)(B) using the controlled-group rules in section 414(b) and (c) but substituting the phrase "more than 50 percent" for the phrase "at least 80 percent" each place it appears.

c) Explanation

The section 414(b) and (c) rules represent the most commonly applied federal tax law rules in determining when organizations are related and should be treated as a single employer. Taxpayers are accustomed to applying these rules, particularly for purposes of applying employee benefit nondiscrimination rules. The regulations interpreting section 414(b) and (c) also are the result of lengthy rulemaking processes over the past 30 years.

We suggest using a 50% rather than a 80% standard because the definition of "related organizations" in section 4960 closely resembles the definition in the instructions to Form 990, and that definition uses a 50% rather than 80% test for control. We suggest

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[167] Clauses (iii)-(v) include supported and supporting organizations and organizations that sponsor or contribute to VEBAs.

that the definition in those instructions not be applied directly, because it lacks the specificity and long history of the section 414(b) and (c) rules. However, we suggest that—consistent with those instructions—the section 414(b) and (c) rules be applied at a 50%, rather than an 80%, level, as they are when applying the compensation limits in section 415.

10. Exclusion of remuneration paid to licensed medical professional for performance of medical services

a) Issue

As explained in Section I.B.2, section 4960(c)(3)(B) provides that remuneration of a covered employee by an applicable tax-exempt organization does not include "the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional." The Conference Report adds that the remuneration must be "directly related to the performance of medical or veterinary services."[168] There is no other guidance on how that portion is determined.

b) Recommendations

We recommend that Treasury and the Service issue guidance providing that, for purposes of section 4960(c)(3)(B), remuneration does not include any form of otherwise includible compensation that is for the performance of medical services in any form, that are required to be performed by a licensed medical professional, regardless of whether the services are provided in the form of direct patient care, supervision of patient care, medical teaching, medical research, or clinical care oversight.

We also recommend that the guidance provide that, where remuneration is for services that are both included in and excluded from the excise tax calculation, the employer may use any reasonable method for allocating compensation to each form of services provided, as long as the allocation method reasonably reflects the time or effort normally expended for each form of services provided and is applied consistently.

c) Explanation

Physicians who are employed by tax-exempt hospitals and health systems perform many types of services that relate in some way to the performance of medical services and that require a licensed and trained physician to perform them. These medical services include providing medical care directly to patients, supervising the care provided by other licensed medical professionals, teaching medical students and residents,

[168] Conference Report at 494.

conducting medical research, and administering the manner in which clinical care is provided (such as by serving as medical director of a particular medical service line for a hospital). Physicians who serve in these roles also might serve in, and be compensated for, a management position, and that position might be one that does not necessarily require that it be held by a licensed and trained physician.

Congress created an exception for remuneration for the performance of medical services, and not for the performance of patient care services. The implication of this distinction is that excludable services of a licensed medical professional mean more than providing services only for direct care to patients, and that any services relating to the manner in which medical care is provided by the organization must fall within the exception.

Because it can be difficult to determine which types of services (by a licensed medical professional) are "medical services," we recommend that Treasury and the Service use, as the basis distinguishing between them, whether the services require a licensed and trained medical professional to perform them (and then exclude from the excise tax the remuneration that reasonably relates to such medical services). If the services could be performed by an individual who is not a licensed and trained medical professional (such as where a physician is the chief executive officer of the hospital), we believe the remuneration for such services should be included in the calculation of the excise tax. If, on the other hand, the services require a licensed and trained medical professional to perform them (such as where a physician is the medical director of a cardiac catheterization lab, or where a physician is supervising the patient care provided by nurse practitioners or physician assistants, or where a physician serves as the chief medical officer of the hospital), we believe the remuneration for such services should be excluded from the calculation of the excise tax.

Where remuneration is provided to a licensed medical professional for multiple services, some of which are includible for purposes of the excise tax, we believe the employer should be permitted to use any reasonable method for allocating the remuneration between or among includible administrative services and excludible medical services that is applied consistently. The allocation methodology would have to be based on an objective measure of the relative services provided, such as the time scheduled for each of the services, the actual time expended for each of the services, or a similar objective measure.

11. Definition of amounts "contingent" on separation from employment

a) Issue

As explained in Section I.B.2, section 4960 provides that a parachute payment is, among other things, a payment that is "contingent on [the] employee's separation from employment with the employer." Section 4960 does not define this phrase.

b) Recommendations

We recommend that Treasury and the Service issue guidance treating a payment as "contingent" on an employee's separation from employment with the employer for purposes of section 4960(c)(5)(B) only if the payment is subject to a substantial risk of forfeiture (defined in a manner consistent with section 457(f) or 409A) and the separation from service causes the risk of forfeiture to lapse.

We also recommend the guidance not treat such a payment as a parachute payment within the meaning of section 4960(c)(5)(B) to the extent that it remains subject to a substantial risk of forfeiture following separation from employment.

We further recommend that the guidance value parachute payments for purposes of section 4960 in a manner consistent with section 280G with respect to the acceleration of a payment date and amounts that are subject to service-based vesting or other time-based vesting schedules.

c) Explanation

Separation from employment in one form or another frequently is used as a payment event under compensation arrangements. For example, amounts deferred under a nonqualified deferred compensation plan, and earnings on those amounts, frequently are payable upon a separation from employment, even if the right to the amount is not contingent upon the separation. Treating any amount payable at the time separation from employment occurred as a potential parachute payment would expand the notion of a "parachute payment" well beyond its ordinary meaning as a payment in a particular kind of separation situation. Even treating only the portion attributable to any acceleration of the timing of the payment would require a difficult—if not impossible—determination of when separation from employment otherwise might have occurred.[169]

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[169] For example, if an executive told her board that her general plan was to leave around age 60, and another opportunity arose causing her to leave at age 55, would that be considered a five-year acceleration?

Therefore, we believe it would be both reasonable and appropriate to limit the excess parachute payment prong of section 4960 to amounts that are provided only because of the particular circumstances of the employee's separation from employment, *i.e.*, to severance-type payments and not all forms of deferred compensation. Severance-type payments are distinguished by being subject to a substantial risk of forfeiture which separation from employment causes to lapse. Because separation from employment cannot, in itself, be the basis of a substantial risk of forfeiture because it is certain to occur eventually and in any event is under the employee's control, it must be limited to separation from employment under certain circumstances, such as involuntary separation or separation for good reason.

Consistent with this, we also believe that payments that are subject to a "double trigger" that includes separation from employment but that remain subject to a substantial risk of forfeiture following separation from employment are not parachute payments. For example, under this approach a payment that is contingent on performing consulting services after separation from employment or complying with an enforceable covenant not to compete, would not be treated as a parachute payment.

In some cases, only a portion of a payment might be contingent on a separation from employment. For example, a payment might be subject to service-based vesting or other time-based vesting schedules. Consistent with section 280G, we suggest that the amount of the payment that is considered contingent on separation from employment be limited to (1) the value of the acceleration of the payment date, if any, plus (2) the value of the acceleration of vesting, which under section 280G is deemed to be one percent of the amount of the accelerated payment multiplied by the number of full months between the date that the amount vests and the date that, absent the acceleration, it would have vested.

12. Definition of "separation from employment"

a) Issue

Section 4960 provides that a parachute payment is, among other things, a payment that is contingent on an employee's "separation from employment with the employer." Section 4960 does not define "separation from employment," and the phrase is used only occasionally elsewhere in the Code.[170] It is not the same as a "severance of employment"

[170] For example, it is part of the definition of SUB pay in section 3402(o). The district court in *CSX* concluded that "separation from employment" in that context "refers to a discontinuance in the performance of service by the employee for the employer rather than . . . a discontinuance of the employer-employee relationship in its entirety." *CSX Corp., Inc. v. United States*, 52 Fed. Cl. 208 (Fed. Cl. 2002), *rev'd on other issues*, 518 F.3d 1328 (Fed. Cir. 2008).

or “severance from employment” as used in sections 401(a) and 401(k),[171] or a “separation from service” as used in old section 402(e).[172]

b) Recommendation

We recommend that Treasury and the Service issue guidance defining “separation from employment with the employer” for purposes of section 4960(c)(5)(B) the same way “severance from employment” is defined for purposes of section 457, including the severance pay plan exception in section 457(e)(11)(A).

c) Explanation

As explained in Recommendation 11 in this Section II.B., we believe that the primary target of the excess parachute payment prong of section 4960 is severance-type payments, not all forms of deferred compensation. The term “severance from employment” is familiar to tax-exempt organizations because it is used in section 457 and the regulations under that section. Therefore, we believe this approach would be consistent with the purpose of section 4960, and also avoid the need to create a new definition for this limited purpose.

13. Anti-abuse regulations

a) Issue

Section 4960(d) directs Treasury to issue “such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent avoidance of such tax through the performance of services other than as an employee or by providing compensation through a pass-through or other entity to avoid such tax.” No specific examples are provided of when these practices might amount to the avoidance of tax.

b) Recommendation

We recommend that Treasury and the Service limit any guidance issued pursuant to the anti-abuse rule in section 4960(d) to arrangements the principal purpose of which is to avoid section 4960 or have no apparent non-tax business purpose. We would be pleased to continue our dialogue with Treasury and the Service about what situations should be addressed by these rules.

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[171] *See* GCM 39824 (July 6, 1990); Notice 2002-4, 2002-1 C.B. 298.

[172] *See* Rev. Rul. 79-336, 1979-2 C.B. 187.

c) Explanation

The regulations under section 414(b) and (c), and many of the other rules discussed above, contain their own anti-abuse rules or are based on the substance rather than the form of a transaction, which make them difficult to manipulate. That is one of the reasons we recommend using, where possible, principles and concepts drawn from existing guidance when developing guidance under section 4960. For example, an attempt to break up a controlled group by holding an option rather than an ownership interest would not work because, under the option attribution rules, if a person has an option to acquire an interest in an entity, the interest underlying the option is considered to be owned by such person.[173] Similarly, an attempt to avoid section 4960 by characterizing an employee as an independent contractor would not work because whether an employment relationship exists under the common law is determined based on the control exercised (or able to be exercised) by the employer, not what the individual is called.[174]

However, we recognize that there could be potentially abusive situations that might not be reached by those rules. For example, an individual might provide employee-type services to a tax-exempt organization through a limited liability company created only for that purpose, or a tax-exempt hospital or health system might obtain services from physicians, including some that perform non-medical administrative functions, through PCs or practice groups which it controls through a shareholder agreement.[175] Or a medical school might pay its president a stated amount, but trustees might arrange for her to hold a position on the board of a medical insurance company.

We would be pleased to continue our dialog with Treasury and the Service about what situations should be addressed by these rules, and meanwhile urge Treasury and the Service not to issue rules that are unduly broad. For example, we believe that treating

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[173] *See* I.R.C. § 1563(e)(1); Reg. § 1.414(c)-4(b)(1).

[174] *See*, *e.g.*, Reg. § 31.3401(c)-1(b) (a common law employment relationship exists "when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished"), (e) ("If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial."); *see also* Internal Revenue Service, *Independent Contractor or Employee?- Training Materials* (Oct. 30, 1996) ("Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency . . . and depends on the principal's right to direct and control the agent.").

[175] Even if the affiliated service group rules in section 414(m) are applied, it is not clear that they would reach this situation. *Cf.* Reg. § 1.1563-1(a)(6) (stock may be disregarded for purposes of determining affiliated status if it is subject to an express or implied agreement under which the stock is not voted, and may be attributed to an individual if the owner of the stock has agreed to vote his or her stock in the manner specified by the individual); *Achiro v. Commissioner*, 77 T.C. 881 (1981) (applying this rule under section 414(b)).

individuals who are employed by a partnership of which a tax-exempt organization such as a section 401(a) plan is a member, *e.g.*, a fund in which it invests, as employees of the organization simply because the organization is allocated a share of the deductions for their wages, would apply section 4960 to individuals with no meaningful relationship with the organization.

14. Effect of section 4960 on what is considered reasonable compensation for purposes of sections 4941 and 4958

a) Issue

As explained in Section I.A.7, certain organizations that are exempt from federal income tax under section 501(a) are prohibited from permitting their net income to inure to the benefit of certain private individuals. The prohibition on private inurement can be implicated by the payment of more than reasonable compensation to a private individual. Organizations exempt under section 501(c)(3) or (c)(4) are further subject to section 4958 intermediate sanctions excise taxes for defined excess benefit transactions involving disqualified persons, which transactions include the payment of more than reasonable compensation to any such individual. Exempt organizations that are classified as private foundations are further subject to section 4941 excise taxes for defined transactions involving disqualified persons, which transactions also include the payment of more than reasonable compensation to any such individual. We request guidance on the issue of whether the payment of the section 4960 excise tax would be a consideration in determining whether these standards for payment of reasonable compensation (and the consequences of paying more than reasonable compensation) might be implicated.

b) Recommendation

We recommend that Treasury and the Service issue guidance confirming that payment of the section 4960 excise tax is not considered in determining whether an applicable organization has paid more than reasonable compensation to a covered employee for purposes of the prohibition against private inurement and the excise tax provisions of sections 4941 and 4958.

c) Explanation

There is no evidence that Congress intended the section 4960 excise tax to be anything other than a financial consequence to tax-exempt organizations for providing certain types and levels of remuneration. The excise tax is not additional compensation, because it is levied on and paid by the employing exempt organization directly to the federal government and is not paid on behalf of the covered employee. Congress did not state any intent to consider the excise tax as additional compensation to the covered employee, nor was there any stated intent to include the tax in considering whether the remuneration provided to a covered employee is reasonable compensation for the services provided to the exempt organization. A variety of existing laws already impose a duty on an exempt organization to assure that compensation provided to its employees is reasonable for the services provided, and most organizations have processes in place to ensure that requirement is met. We recommend that those processes not be changed, and that those determinations not be made more difficult to support, simply because a tax has been levied on a portion of that compensation.

Consequently, to provide clarity to exempt organizations, we recommend a simple statement in the applicable guidance that the section 4960 excise tax not taken into account in determining whether compensation is considered reasonable, including but not limited to for purposes of the prohibition on private inurement and the excise tax provisions of section 4941 and 4958.

III. Conclusion

We appreciate this opportunity to provide comments and suggestions for critical guidance on these tax law provisions. If there are any questions regarding these comments, or if members of Treasury and the Service believe it would be beneficial to discuss these comments in greater detail, please contact the individuals listed on the cover page. On behalf of the American Bar Association Section on Taxation, thank you for your consideration.