4960? Excise Taxes? What’s a Tax-Exempt to Do?

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OVERVIEW OF SECTION 4960
What it does, and when

• Section 4960(a) imposes an excise tax equal to the rate of tax on income of a corporation (currently 21%) on
  – “excess parachute payments” that are contingent on “separation from employment,” and
  – “remuneration” over $1 million other than excess parachute payments,
that are “paid” by an “applicable tax-exempt organization” for a “taxable year” with respect to the organization’s employment of a “covered employee.”
• Section 4960(b) makes the “employer” liable for the excise tax.
What it does, and when (cont’d)

• Section 4960 is intended to have a similar effect on tax-exempt organizations as
  – Section 162(m) has on public corporations that pay remuneration over $1 million, and
  – Section 280G has on corporations that provide parachute payments contingent on a change in control.

• Section 4960 is effective for “taxable years” beginning after December 31, 2017.
  – It has no express grandfather or transition rules.
  – Contrast with sections 162(m) and 280G when they were enacted.
Definition of “applicable tax-exempt organization”

• Not all tax-exempt organizations are covered, although most are.
• Section 4960(c) defines an “applicable tax-exempt organization” (“ATEO”) as
  – an organization exempt from tax under section 501(a), *i.e.*, under section
    – 501(c) (tax-exempt organizations),
    – 501(d) (religious or apostolic organizations) or
    – 401(a) (tax-qualified plans); or
  – an organization exempt from tax under section 115(l) (*i.e.*, an entity with income that accrues to
    a state or political subdivision);
  – a farmers’ co-op described in section 521(b)(1); or
  – a political organization described in section 527(e)(1) (*e.g.*, a political party).
Definition of “covered employee”

- Not all employees are covered.
- Section 4960(c) defines a “covered employee” as an employee or former employee of an ATEO who
  - is one of the 5 “highest compensated employees” for the taxable year, or
  - was such an employee of the ATEO or a “predecessor” for any taxable year beginning January 1, 2017, or later.
    - Thus, section 4960 is partly retroactive.
    - And once an individual is a “covered employee,” she always remains a “covered employee.”
- Form 990 (Part VII and Schedule J) and Form 990-PF (Part VIII) require compensation for a similar top-5 group to be reported.
- Section 162(m) applies to a somewhat similar top-5 group; post-TCJA it also applies to covered employees of predecessors.
Definition of “remuneration”

• Section 4960(c) says “remuneration” means “wages” as defined in section 3401(a), other than Roth contributions.
  – Section 3401(a) defines “wages” as all “remuneration” for services as an employee.
  – There are exceptions for most amounts not subject to income tax, and contributions to and distributions from section 401(a) and similar plans.
  – Section 3402 subjects them to income tax withholding (FITW) when they are “paid.”
    – Thus, section 457(f) deferred compensation is subject to FITW when it is paid, not taxed.
• Section 4960(c) specifically includes in “remuneration” any “amounts required to be included in gross income under section 457(f).”
• Separately, section 4960(a) also says remuneration is “paid” when it has no substantial risk of forfeiture within the meaning of section 457(f)(3)(B).
  – Not clear on its face whether this broadens the definition of “remuneration.”
Remuneration paid by “related” organizations

- Section 4960(c) says “remuneration” includes remuneration paid with respect to employment of such employee by a “related person or governmental entity.”
  - In that case, liability for the excise tax is allocated pro rata among the employers (including the ATEO) in proportion to the remuneration each pays.
- Section 4960(c) says a person or governmental entity is “related” to the ATEO if:
  - It controls, or is controlled by, the ATEO (even if it is not tax-exempt) [parent-sub situation];
  - It is controlled by one or more persons that control the ATEO [brother-sister situation]; or
  - It is a “supported organization” or a “supporting organization” with respect to the ATEO.
• Section 4960(c) also says a person or governmental entity is “related” to a VEBA if it establishes, maintains, or makes contributions to the VEBA.
  – Thus, in the case of a VEBA, related organizations could include taxable employers and unions.

• Similar definitions of “related” are found in section 4968 and in the instructions to Form 990, Part VII and Schedule J.
  – Thus, Form 990 filers have some experience calculating and reporting remuneration paid by these related entities.
  – But there is no analogous requirement to calculate or report this remuneration for Form 990-PF filers.
Definition of “excess parachute payment”

• Section 4960(c) defines an “excess parachute payment” as the portion of a “parachute payment” that exceeds 1X the employee’s “base amount.”

• A “parachute payment” means a payment that is
  – “in the nature of compensation” and
  – “contingent on [the] employee’s separation from employment with the employer.”

• The excise tax applies only if total parachute payments are at least 3X the employee’s “base amount.”
  – Note that they do not have to exceed $1 million.

• This structure is similar to that of section 280G, except there the contingency is a change of control.
Definition of “excess parachute payment” (cont’d)

• Parachute payments do not include payments to or from
  – tax-qualified section 401(a) plans,
  – annuity plans subject to section 403(a) or (b),
  – SEPs or SIMPLEs described in section 408(k) or (p), or
  – section 457(b) plans.

• Section 280G has the same exceptions, other than sections 403(b) and 457(b).

• Parachute payments also do not include amounts paid to an employee who is not a “highly compensated employee” within the meaning of section 414(q).
  – Section 280G also applies only to highly compensated individuals, but the definition is broader.
Definition of “excess parachute payment” (cont’d)

• Section 4960(c) cross-references the rules in section 280G dealing with
  – the definition of the “base amount” (generally average annual taxable compensation for the preceding 5 years),
  – property transfers (generally included if they vest as a result of the event that triggers the parachute), and
  – the determination of present value (generally based on the federal AFR).
Treatment of medical and veterinary services

• Section 4960(c)(3)(B) excludes from “remuneration” and “parachute payment” amounts paid to a “licensed medical professional” for “medical or veterinary services.”
  – Section 4960(c)(5)(C)(iv) excludes the same amounts from “parachute payments.”

• The Conference Report says a “medical professional” includes a doctor, nurse, or veterinarian.

• The Conference Report also says remuneration “directly related to the performance of medical or veterinary services” is not taken into account in determining whether the individual is a “covered employee.”
  – This is noteworthy, because the statute itself does not use “remuneration” to identify “covered employees.”
Anti-abuse rules

• Section 4960(d) directs the Treasury Department to issue such regulations as might be necessary to prevent avoidance of the excise tax.
  – This could give it additional authority to issue rules that are not merely interpretive.

• Abuses mentioned include the performance of services as an independent contractor and providing compensation through another entity.

• There is a similar but broader anti-abuse provision in section 280G(f).
GUIDANCE UNDER SECTION 4960
Congressional guidance

• Legislative History
  – House Ways and Means Committee majority staff section-by-section summary (Nov. 2, 2017)
  – Senate Finance Committee majority staff section-by-section summary (Nov. 16, 2017)
  – Senate Budget Committee Explanation of the Bill (Nov. 30, 2017)

• Post-enactment guidance
  – Staff of the Joint Committee on Taxation, 109th Cong., General Explanation of Public Law 115-97 (Dec. 20, 2018) (JCS-1-18)
Administrative guidance

- Form 4720 and Instructions for Form 4720 (posted Nov. 28, 2018)
- *Policy Statement on the Tax Regulatory Process* (March 5, 2019)
  - Describes the Administration’s policy on the use of temporary regulations, the authority of subregulatory guidance, and when proposed regulations are expected to be issued.
IMPORTANT ISSUES ADDRESSED BY SECTION 4960 GUIDANCE
Definition of “taxable year”

• Neither Section 4960 nor Notice 2019-9 defines an ATEO’s “taxable year.”
  – But other provisions indicate it means the organization’s annual accounting period (i.e., fiscal year).

• Making “excess remuneration” and other determinations based on fiscal years rather than calendar years would be difficult.
  – Notice 2019-9 instead determines “excess remuneration” and “excess parachute payments,” and identifies “covered employees,” based on amounts paid during the calendar year ending with or within the ATEO’s taxable year.
  – This approach is consistent with the reporting requirements under Form 990.
  – The ABA Tax Section comments requested this approach, but also requested that it be optional.
Definition of ATEO

- The definition of ATEO does not expressly include an organization that is exempt under a provision or doctrine not listed in section 4960(c), such as
  - the implied statutory immunity doctrine (e.g., a state or political subdivision, or an integral part of either),
  - the International Organizations Immunities Act (e.g., International Committee of the Red Cross or the Organization of American States), or
  - IRS administrative practice (e.g., Indian tribal governments).
Definition of ATEO (cont’d)

• Notice 2019-9 acknowledges that government entities that are exempt under the implied statutory immunity doctrine generally are not ATEOs.
  – It notes that this includes most state colleges and universities.
  – The Blue Book, by contrast, says state colleges and universities are ATEOs even if they are not covered by section 115(1), but that “[a] technical correction may be necessary to reflect this intent.”

• Nevertheless, Notice 2019-9 would treat government entities with their own section 501(c)(3) determination letters as ATEOs.
  – Government entities sometimes obtain these to help with fundraising or borrowing, and non-educational government entities sometimes obtain them to maintain section 403(b) plans.
    – What will the consequences be for entities that relinquish their letters?
Definition of ATEO (cont’d)

• Notice 2019-9 says employees of a disregarded entity (DRE) owned by an ATEO are treated as employees of the ATEO.

• This is consistent with the “check-the-box” regulation under section 7701.
  – That regulation says DREs are not treated as separate entities except for purposes of employment taxes and certain excise taxes.

• This implies that a DRE cannot be either an ATEO or a “related organization.”
  – That would be consistent with the reporting requirements under Form 990.

• An entity that elects to be a corporation cannot be a DRE under the “check-the-box” regulation even if it has only one owner.
  – That regulation treats an entity with its own section 501(c)(3) determination letter as having made that election.
Definition of “covered employee”

• Section 4960(c) does not define “employee.”

• Notice 2019-9, Q&A-3, defines “employer” using the common-law test.
  – The Overview says Q&A-9 defines “employee” using that test, too.

• The common-law approach means that excise tax cannot be avoided simply by paying an individual through another organization such as a PEO.

• The Form 990 instructions also use the common law definition of “employee,” and contain a similar warning.
  – They also separately require reporting of directors, trustees and independent contractors.
Definition of “covered employee” (cont’d)

• Corporate officers are not necessarily employees under the common law test.
  – Control must still exist, although the type of control might be different, as it is in the case of a professional employee.
  – Officers that perform significant services often are considered employees. *E.g.*, *Spicer Accounting, Inc. v. U.S.* (9th Cir. 1990).

• Section 3401(c) defines “employees” to include officers for FITW purposes, although there is an exception if they:
  – do not perform any services or perform only minor services, and
  – neither receive nor are entitled to receive, directly or indirectly, any remuneration.

• The Form 990 instructions incorporate this exception by reference.
The Notice 2019-9 Overview says “only an ATEO’s common law employees (including officers)” can be “covered employees.”

- Informal comments by IRS representatives suggest this is meant to mean officers always are employees.
  - The rationale seems to be the definition in section 3401(c).
  - If so, that makes other references to “employee” in section 4960(c) superfluous.
- This can be significant when management companies provide CFO and other officer services to smaller ATEOs.
- This also can be significant when employees of corporations serve as officers of corporate foundations, often for little or no pay.
  - The 10% exception discussed later generally will not help because some other ATEO in the group must pay him 10% or more.
Definition of “covered employee” (cont’d)

• Volunteers, too, are not necessarily employees under the common law test.
  – The IRS historically has treated volunteers as employees only if sufficient control exists.
  – Compare Juino v. Livingston Parish Fire Dist. No. 5 (5th Cir. 2013) with Sister Michael Marie v. American Red Cross (6th Cir. 2014) (Title VII).

• The Form 990 instructions have an exception for compensation paid to volunteers by related for-profit organizations.

• Notice 2019-9 does not say whether volunteers can be “employees.”
  – As with officers, this can be significant when employees of corporations play significant roles in corporate foundations, often for little or no pay.

• It also does not say whether plan or VEBA fiduciaries can be “employees.”
Definition of “covered employee” (cont’d)

• Section 4960(c) does not say what “compensation” is used to determine an ATEO’s 5 highest-compensated employees.

• Notice 2019-9 uses the same definition of “remuneration” as is used for other purposes under section 4960.
  – The Form 990 instructions take the same approach.
  – Consequently, remuneration paid for medical services is not taken into account.

• It also takes remuneration from a related organization into account.
  – It does so even if the remuneration is solely for services performed for the related organization, not services for the ATEO.
  – The Blue Book, by contrast, says “[a] technical correction may be necessary to reflect that the related organization rules also apply . . . for purposes of determining covered employees.”
Definition of “covered employee” (cont’d)

• Section 4960(c) does not say whether the 5 highest-compensated employees are determined separately for each ATEO in a group.
• Notice 2019-9 makes this determination separately for each ATEO, i.e., not on a controlled-group basis.
  – The Form 990 instructions take the same approach.
  – Notice 2019-9 treats any different approach as inconsistent with a good faith interpretation.
• This has the potential of multiplying the number of “covered employees” in a group.
• However, Notice 2019-9 excludes an employee if
  – the ATEO paid less than 10% of his/her total remuneration for services for the ATEO and the related organizations, and
  – another ATEO in the group paid at least 10%.
Definition of “covered employee” (cont’d)

• Section 4960(c) does not say whether remuneration from a related organization is taken into account only if it is indirect remuneration for services to an ATEO.
• Taking all remuneration from related organizations into account plus determining covered employees separately for each ATEO means the same remuneration paid to the same employee can be subject to excise tax multiple times.
  – Notice 2019-9 provides that if an employer would be liable for the excise tax as an ATEO and as a related organization for the same remuneration paid to the same employee, it is liable only for the excise tax it would owe as an ATEO or as a related organization, whichever is greater.
  – This prevents double taxation in many but not all situations.
Definition of “covered employee” (cont’d)

• Example 1:
  – ATEO 1, ATEO 2 and ATEO 3 are related organizations that have only one employee. ATEO 1 pays her $400,000, ATEO 2 pays her $500,000, and ATEO 3 pays her $600,000. As a covered employee of each ATEO: Her total remuneration is $1,500,000, her excess remuneration is $500,000, and the excise tax on that remuneration is $105,000 (21% x $500,000). Because of this rule ATEO 1, ATEO 2 and ATEO 3 owe only $28,000, $35,000 and $42,000, respectively.

• Example 2:
  – The facts are the same except ATEO 3 is replaced with a taxable entity, TE. ATEO 1 and ATEO 2 still owe only $28,000 and $35,000, respectively. However, TE owes $84,000 (2x$42,000) because it is related to both ATEOs and shares an employee but is not an ATEO itself.
Definition of “remuneration”

• The significance of section 4960(a)’s statement that remuneration is “paid” when it has no substantial risk of forfeiture under section 457(f) is unclear.

• Because of frequent references to “payment” in section 3401(a) and the regulations, payment arguably is an essential part of being “wages.”
  – This is consistent with the section 3401(a) definition of compensation under section 415.
  – This is consistent with the IRS’s frequent statement that “wages” should correspond to taxable income, e.g., Rev. Rul. 56-632 (exempting health plan premiums from FITW).
Definition of “remuneration” (cont’d)

• “Wages” defined this way would be similar to Box 1 wages on Form W-2 and “reportable compensation” on Form 990.
  – Section 4960(c) seems to take this view by adding “amounts required to be included in gross income under section 457(f)” to “remuneration.”
  – But this view would make the statement apply to nothing except amounts subject to section 457(f), and make it unnecessary as applied to those amounts.
Definition of “remuneration” (cont’d)

• Alternatively, an amount may be “wages” regardless of when it is paid, as long as it is paid eventually.
  – “Wages defined in this way would be consistent with TAM 199903032, which says section 457(f) plan benefits are “wages” albeit not subject to FITW until paid.
  – But it would make section 4960(c)’s addition of “amounts required to be included in gross income under section 457(f)” unnecessary.

• Notice 2019-9 takes the latter view, i.e., it
  – includes an amount in “wages” and thus “remuneration” (at present value) if it’s described in section 3401(a), and
  – treats all such “remuneration” as paid when it’s no longer subject to a substantial risk of forfeiture under section 457(f)(3)(B).
Definition of “remuneration” (cont’d)

• This means section 4960 applies, for example to
  – short-term deferrals and bona fide severance pay when they accrue not when they are paid,
  – deferrals under church plans, and plans that are grandfathered under section 457, and
  – post-retirement health benefits (to the extent taxable).

• Also note that amounts that are cliff-vested are taken into account all at once, not over the vesting period as on Form 990.

• This will require ATEOs to keep new records that are not based on their payroll or Form 990 systems in order to apply section 4960 correctly.
Definition of “remuneration” (cont’d)

- This approach is similar to the approach in section 3121(v)(2), except that the latter applies only to “deferred compensation.”

- However, unlike section 3121(v)(2), Notice 2019-9 also includes future earnings and increases in present value in “wages” as they accrue.
  - This is how earnings on amounts taxed under sections 409A and 402(b) are treated.
  - However, it is not how earnings on amounts taxed under section 457(f) are treated.
  - It also generally is not how they are reported on Form W-2 or 990.

- Again, this will require ATEOs to keep new records that are not based on their payroll or Form 990 systems in order to apply section 4960 correctly.
Remuneration paid by “related” organizations

- Section 4960(c) does not define “control” for purposes of the first two subsets of “related” organizations.
- Notice 2019-9 defines “control” using the rules in section 512(b)(13)(D), including the constructive ownership rules of section 318.
  - The section 512(b)(13)(D) rules are the same ones used to define “control” for Form 990 reporting purposes.
- Notice 2019-9 also adds a definition of control for non-stock organizations.
  - Very similar definitions are found in sections 1.512(b)-1 and 1.414(c)-5 of the regulations.
- The second subset of “related” organizations is a “brother-sister” rule.
  - Similar rules are found in section 1.414(c)-2 of the regulations and the instructions to Form 990.
  - Not clear whether control by 5 or fewer individuals, estates or trusts is necessary.
Treatment of medical and veterinary services

• Section 4960(c) does not define “remuneration . . . for medical or veterinary services.”

• Notice 2019-9 defines “medical services” as services that constitute “medical care” under section 213(d).
  – This will exclude services that are merely beneficial to the general health of an individual.
Treatment of medical and veterinary services (cont’d)

• Notice 2019-9 further requires the services to be performed “directly.”
  – Arguably all employees of an organization that provides “medical care” help provide that care, although not all do so directly.
  – Notice 2019-9 says this means documenting the care of a patient and being present when another professional performs medical services are covered, but not managing an organization’s operations.
  – The “directly” requirement is taken from the Conference Report’s explanation of the “covered employee” carve-out.

• Notice 2019-9 allows an ATEO to make a reasonable, good faith allocation between remuneration for medical services and other services.
  – Allocations in employment agreement must be applied unless they are unreasonable.
  – Other allocations will require new analysis and record-keeping by hospitals and other providers.
Definition of “excess parachute payments”

• Section 4960(c) does not say when a payment is “in the nature of compensation.”

• Like the section 280G regulations, Notice 2019-9 says it is if it “arises out of an employment relationship.”

• Also like the section 280G regulations, Notice 2019-9 says such payments do not include attorney’s fees, court costs or interest.
  – Such amounts also are not considered “wages” for employment tax purposes, because they are not remuneration for services.
  – Notice 2019-9 does not address other, similar payments that also are not considered “wages,” including tort-type recoveries or liquidated or punitive damages.
Definition of “excess parachute payments” (cont’d)

• Section 4960(c) does not define “separation from employment.”

• Notice 2019-9 generally defines it the same way as “separation from service” in section 409A, except that:
  – it treats a bona fide change from employee to independent contractor status as a separation from employment, and
  – it does not allow an ATEOs to vary from the default 80% and 50% levels.

• Consequently a payment to an employee who is merely demoted rather than terminated cannot be a parachute payment.
Definition of “excess parachute payments” (cont’d)

• Section 4960(c) does not say when a payment is “contingent on” a separation from employment.

• Notice 2019-9 says it is if the employer would not have made the payment in the absence of an involuntary separation from employment.
  – It defines an “involuntary separation from employment” in essentially the same way as the regulations under section 409A.
  – The Blue Book, by contrast, says parachute payments include “deferred compensation plans (including supplemental executive retirement plans).”

• Unlike the section 280G regulations, Notice 2019-9 does not presume that an agreement within 12 months of separation results in a parachute payment.
  – But it says it might, based on all of the facts and circumstances.
Definition of “excess parachute payments” (cont’d)

• Notice 2019-9 says a “parachute payment” can include payments by a related or predecessor organization.
  – The Blue Book, by contrast, says “[a] technical correction may be necessary to reflect that the related organization rules also apply to excess parachute payments.”
  – Notice 2019-9 also appears to cover involuntary terminations by ATEOs’ related organizations.

• Unlike the section 280G regulations, Notice 2019-9 says the increase in value from accelerating the payment date of a vested amount is not a parachute payment.

• Notice 2019-9 also says group premiums may be used to determine the present value of an obligation to provide coverage under a group health plan.
Notice 2019-9 does not grandfather any existing arrangements or future earnings on existing deferred compensation.

However, it treats remuneration that was vested in a year before the effective date, or in a year before an individual became a covered employee, as having been paid in that year and thus exempt from section 4960.

- The ABA Tax Section comments requested a similar approach.

Notice 2019-9 points taxpayers to the definition of substantial risk of forfeiture in the proposed regulations under section 457(f)(3)(B).

- Can taxpayers rely on the proposed regulations for effective date purposes if they did not do so for income tax purposes?
Good faith reliance

• Notice 2019-9 allows taxpayers to take positions based on reasonable, consistent, good-faith interpretations of section 4960 until regulations are issued.
  – The rules in the Notice are deemed to be based on reasonable, good faith interpretations.
  – Thus, it might function as a safe harbor.

• Notice 2019-9 does not rule out other reasonable, good faith interpretations even after the Notice was issued, with four specific exceptions.

• The exceptions are:
  – determining an ATEO’s 5 highest-compensated employees on a group basis,
  – taking remuneration for medical services into account in determining “covered employees,”
  – treating an employee as ceasing to be a covered employee after a certain period of time, and
  – treating a related for-profit or governmental entity as not being liable for its share of the tax.
• Notice 2019-9 confirms that there is no particular relationship between liability under section 4960 and liability under sections 4941 and 4958.
  – The ABA Tax Section comments asked for confirmation of this.

• Notice 2019-9 confirms that there is no requirement for ATEOs or related organizations to pay estimated taxes on excise taxes imposed by section 4960.

• REG-107163-18 and the instructions to Form 4720 require the form to be filed by the 15th day of the 5th month after the end of the year.
  – Form 4720 contains a new Schedule N to be used to report section 4960 excise taxes.
  – The instructions to the draft form require the form to be filed by each ATEO, even if it is part of a related group.

• Will filing Form 990 be enough to start the statute of limitations?
  – That is true for other Chapter 42 taxes.
REMAINING ISSUES AND FUTURE GUIDANCE UNDER SECTION 4960
## Remaining issues

- Notice 2019-9 asks for comments on a number of issues.
- One of these is the meaning of “predecessor,” on which Notice 2019-9 provides no guidance.
  - The ABA Tax Section comments recommended that “predecessor” mean a “predecessor employer” as defined in section 1.415(f)-1(c)(2) of the regulations.
  - Another possibility is the FICA rule in section 3121(a)(1).
In addition to the definition, some questions include:

- Must the organization be a predecessor of the ATEO itself, and not merely a predecessor of any related organization?
- Must the covered employee have transferred to the ATEO directly from the predecessor, or are re-hires included?
- Can an ATEO rely on an employee’s representation of his or her employment history when hired?
- Due diligence and document retention issues.
  - Reg. § 31.6001-1 requires employment tax records to be kept for 4 years only.
Future guidance

• Additional sub-regulatory guidance or transition relief.
• Date when proposed regulations under section 4960 are expected to be issued.
• Relationship between issuance of proposed regulations and finalization of proposed regulations under section 457(f).
Questions