Introduction

On December 31, 2018, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) issued Notice 2019-09 (Notice) providing comprehensive interim guidance under section 4960 of the Internal Revenue Code (Code). Section 4960, which was added to the Code by the Tax Cuts and Jobs Act (TCJA), imposes an excise tax on (i) remuneration that exceeds $1 million, and (ii) “excess parachute payments” paid to covered employees of certain tax-exempt organizations. Although the guidance appears generally designed to minimize both the incidence and amount of tax imposed under this section, it creates a potentially complex administrative scheme for counting compensation that could affect a significant number of tax-exempt organizations and related organizations, including related for-profit companies.

The Notice explains that the Treasury Department and the IRS intend to propose regulations that will incorporate the rules in the interim guidance and that any future guidance will be prospective. Until further guidance is issued, taxpayers can apply section 4960 based on a good faith, reasonable interpretation of the statute. The Notice confirms that compliance with the interim guidance provided in the Notice constitutes a good faith, reasonable interpretation of the statute. The Notice also warns that certain positions are not consistent with a good faith, reasonable interpretation of the statute.

This legal alert summarizes the statutory provisions of section 4960 and the more significant aspects of the interim guidance.

The statute

Section 4960 is modeled on section 162(m), which disallows a deduction to publicly held corporations for remuneration in excess of $1 million paid to covered employees in a taxable year, and section 280G, which disallows a deduction for excess parachute payments that are contingent on a change in the ownership or control of a company. The House of Representatives’ Report of the Committee on Ways and Means expressly states that one of the purposes of section 4960 is the “alignment of the tax treatment of executive compensation . . . between for-profit and tax-exempt employers.” The excise tax is effective for taxable years beginning on and after January 1, 2018.

Under the statute, certain tax-exempt organizations (referred to as “applicable tax-exempt organizations” or ATEOs) and any related person or governmental organization (a “related organization”) are subject to an excise tax equal to the corporate tax rate (currently 21%) multiplied by (i) “remuneration” in excess of $1 million paid to a “covered employee” in a taxable year or (ii) any “excess parachute payment” made to a covered employee. A covered employee for this
Purpose is one of the five highest compensated employees of an ATEO for the taxable year, and anyone who was a covered employee in a prior taxable year.

**ATEO.** An ATEO is defined in the statute as any organization that (i) is exempt from tax under section 501(a) (which includes all section 501(c) organizations, among others), or (ii) has income excluded from tax under section 115(1) (which generally exempts from federal tax the income of a state or political subdivision of state derived from activities that it conducts directly). Some farmers' cooperatives and political organizations are also ATEOs.

**Related organizations.** A person or government entity is generally related to an ATEO if it:

- controls or is controlled by the ATEO,
- is controlled by one or more persons that control the ATEO,
- is a supported organization (as defined in section 509(f)(3)), or
- is a supporting organization (as described in section 509(a)(3)).

Related organizations can include for-profit companies.

**Remuneration.** Remuneration, which is relevant under the statute for purposes of determining whether a covered employee has been paid more than $1 million in a taxable year, is defined as wages under section 3401(a) (that is, wages for withholding purposes), subject to some adjustments. Remuneration under section 4960 does not include designated Roth contributions to a retirement plan or amounts paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services. However, remuneration does include amounts that must be included in income under section 457(f), which governs the taxation of deferred compensation provided by tax-exempt organizations.

Importantly, remuneration includes not only amounts paid to a covered employee by an ATEO, but also amounts paid to the covered employee by any related organization, including a related organization that is a for-profit company. A related organization might pay amounts to the covered employee of an ATEO if, for example, the covered employee is an employee of both the ATEO and the related organization.

**Excess parachute payment.** An excess parachute payment is defined in the statute as the amount of any “parachute payment” that exceeds the portion of a covered employee’s “base amount” that is allocated to the payment. A parachute payment is any “payment in the nature of compensation” that (i) is contingent on the employee’s separation from employment, and (ii) together with all other such payments, equals or exceeds three times the employee’s base amount. An employee’s base amount is generally the employee’s average compensation.
over the five full calendar years preceding the employee’s separation from employment. An amount can be a parachute payment (or an excess parachute payment) only if it is paid to a highly compensated employee, as defined under qualified retirement plan rules (for 2019, someone who earns more than $125,000).

**Liability for tax.** Section 4960 provides that the employer is liable for the excise tax. When remuneration or parachute payments that trigger the tax are paid by more than one employer, each employer is liable for a portion of the excise tax, based on the proportion of the remuneration or parachute payments that it paid to the covered employee.

**The interim guidance**

The Notice defines, and clarifies the meaning of, key terms and concepts in the statute, and it highlights certain provisions that taxpayers might otherwise overlook. The most significant issues addressed by the Notice are discussed below.

**Eversheds Sutherland Observation:** Interestingly, the Notice also includes an extensive preamble that discusses the various alternatives that the Treasury Department and the IRS considered when developing their positions on certain issues. It is likely that this discussion was included to provide the agencies with a basis for applying certain positions in the Notice retroactively to the date of the interim guidance (which was December 31, 2018) when they propose and finalize regulations. This may allow the IRS to assert that some of its positions apply for all tax years for which section 4960 is effective.

**Related organizations**

The Notice provides helpful guidance on one of the most pressing issues raised by the statute – when a person or government entity is sufficiently related to an ATEO that it can be liable for the excise tax.

As explained above, section 4960 provides that a related organization can be liable for the excise tax under section 4960 if it makes some or all of the payments that trigger the tax. Under the statute, an organization is related to an ATEO if it is a supporting or supported organization (which are both well-established concepts under the Code) or if the organization “controls” or is “controlled by” the ATEO or is “controlled by” one or more persons that control the ATEO. The statute does not define the term “control,” and the Code includes several different definitions of “control.” One of those definitions is generally applicable to many of the employee benefits provisions of the Code; a different definition is generally applicable to many of the Code provisions governing tax-exempt organizations. The lack of a clear definition in section 4960 had left many organizations uncertain about whether they are sufficiently related to an
ATEO to be liable for the excise tax.

The Notice adopts a relatively broad definition of control that closely tracks the definition that is used for tax-exempt organizations generally and for the Form 990 filing requirements that apply to tax-exempt organizations. In the case of a stock corporation, partnership or trust, one organization controls another organization if it owns more than 50% of the stock, partnership interests or beneficial interests, respectively, of the other organization. In the case of a non-stock organization without owners or persons having a beneficial interest, control means:

- more than 50% of the directors or trustees of the ATEO or non-stock organization are “representatives of,” or directly or indirectly controlled by, the other entity; or

- more than 50% of the directors or trustees of the non-stock organization are “representatives of,” or directly or indirectly controlled by, one or more persons that control the ATEO.

For this purpose, a “representative” is a trustee, director, agent or employee, and “control” of a director or trustee includes the power to remove the director or trustee and designate a new one.

**Eversheds Sutherland Observation:** The Notice highlights that related organizations include not only related organizations that are ATEOs, but also other related taxable organizations and related governmental organizations that are not ATEOs. Thus, the Notice confirms that for-profit companies, and governmental organizations that are not ATEOs, can also be liable for the section 4960 excise tax.

While it is helpful that the Treasury Department and the IRS adopted a definition that is familiar to tax-exempt organizations, this relatively broad definition is likely to result in the imposition of the excise tax more often and in greater amounts than would have been the case if they had adopted the narrower definition that applies for most employee benefit plan purposes. The employee benefits definition is similar to the definition adopted by the agencies, but it uses an 80% threshold for control, rather than a 50% threshold. In support of their decision to reject the employee benefits definition, the Treasury Department and the IRS assert that the standard adopted will be more familiar to tax-exempt organizations and will prevent potential abuse.

**ATEOs**

To trigger the excise tax, payments of remuneration in excess of $1 million or excess parachute payments must be made to a covered employee of an ATEO. While the statutory definition of an ATEO is generally clear, there was some
uncertainty about how the definition would apply to governmental organizations that are exempt from tax for reasons other than the Code sections identified in the statute, and how it would apply to governmental organizations that are exempt from tax for more than one reason when one of the reasons is a Code section identified in the statute but the other reason is not.

As mentioned above, ATEOs include organizations that are exempt from tax under section 501(a) (such as 501(c)(3) organizations) and organizations that have income excluded from tax under section 115(1). However, states, political subdivisions of states (such as cities and counties), and integral parts of states and political subdivisions of states (together referred to as “governmental units”) are largely exempt from federal tax under the doctrine of implied statutory immunity, which is derived from the basic principles of federalism. For example, some state colleges and universities are considered integral parts of a state or political subdivision of a state and are exempt from tax under this doctrine.

Nonetheless, some governmental units that are exempt from tax under the doctrine of implied statutory immunity have obtained determination letters from the IRS confirming that they are also exempt from tax under section 501(c)(3). Some colleges and universities have done this to help with fundraising because many donors seeking a charitable deduction for their contributions are more familiar with the tax exemption under section 501(c)(3) than the implied statutory immunity doctrine.

The Notice helpfully acknowledges that governmental units exempt from tax under the doctrine of implied statutory immunity, rather than section 115(1), are not ATEOs. The Notice further confirms that a governmental unit that is exempt from tax under the doctrine, but that also has a determination letter recognizing its exempt status under section 501(c)(3), can relinquish its section 501(c)(3) status to avoid being an ATEO.

**Eversheds Sutherland Observation:** One of the reasons that Congress enacted section 4960 was concern over the significant amounts paid to some coaches of college and university sports teams. According to the legislative history, Congress believed that tax-exempt organizations enjoy a tax subsidy from the government and that, in exchange for that tax subsidy, these organizations are required to use their resources for specific purposes; excessive compensation paid to some employees “diverts resources from those particular purposes.” The General Explanation of Public Law 115-97 prepared by the Congressional Joint Committee on Taxation (the “Blue Book”) plainly states that ATEOs “are intended to include State colleges and universities.”

The Notice, however, confirms that the statute, as enacted, does not reach many of the college and university coaches that Congress intended to tax. To the extent that those colleges and universities are integral parts of a state or subdivision of a state, and not organized as separate entities, they
are exempt from tax under the doctrine of statutory immunity, not sections 501(a) or 115(1). The Blue Book acknowledges that a technical correction to section 4960 may be needed to achieve its full intended purpose.

 Covered employees

Under section 4960, a covered employee is any employee of an ATEO who (i) is one of the highest compensated employees of the ATEO for the taxable year, or (ii) was a covered employee of the ATEO for any prior taxable year beginning on or after January 1, 2017. The Notice clarifies that each ATEO (that is, each separate entity that is an ATEO) must identify its own highest compensated employees for each taxable year, even if the ATEOs are related to each other. Under the Notice, covered employees cannot be determined on a controlled group or consolidated group basis.

The Notice also provides that the compensation used to determine whether an employee is among the five highest compensated employees of an ATEO is the “remuneration” paid for services that the employee provides both to the ATEO and to any related organization. In other words, an ATEO determines its covered employees by aggregating the remuneration paid to each of its employees for services provided to the ATEO and the remuneration paid to that employee for services provided to all of the ATEO’s related organizations. The relevant remuneration for this purpose is the remuneration paid for the calendar year ending with or within the ATEO’s taxable year.

The Notice, however, also provides that an employee will not be treated as a covered employee of an ATEO for a taxable year if the ATEO pays less than 10% of the employee’s total remuneration for services provided by the employee to the ATEO and all related organizations. This exception does not apply if an employee who would otherwise be a covered employee of an ATEO would not be treated as a covered employee of any ATEO in the ATEO’s group of related organizations because no ATEO in the group pays at least 10% of the employee’s remuneration.

Remuneration

Types of remuneration.

Consistent with the treatment of remuneration for purposes of identifying an ATEO’s covered employees, the Notice provides that an employee’s remuneration for other purposes under section 4960 includes remuneration paid to the employee for services provided to the ATEO and any related organization of the ATEO. The Notice further clarifies that remuneration includes not only amounts paid by an ATEO or a related organization, but also amounts paid by any other person for the services provided to the ATEO or related organization. For example, if a university that is an ATEO employs a football coach, and an unrelated alumni booster club pays amounts to the football coach for the services provided by the coach to the university, the coach’s remuneration for...
purposes of section 4960 includes the remuneration paid by both the university and the booster club.

**Time when remuneration is paid.**

In addition to providing rules for determining the amounts that are treated as remuneration, the Notice provides detailed rules for determining when remuneration is treated as paid, which is important for determining how much remuneration an employee receives during a calendar year. Both the statute and the Notice clearly indicate that these special timing rules apply for purposes of determining whether a covered employee receives more than $1 million in a year. It is less clear whether they apply for purposes of the annual determination of covered employees.

Under the Notice, remuneration is treated as paid on the first date that is not subject to a substantial risk of forfeiture within the meaning of section 457(f) – that is, when the payment is not conditioned on the performance of substantial future services or the occurrence of an event that is related to the purpose of the remuneration. In other words, amounts are treated as paid when they are vested. If the remuneration is not actually paid until a later date, the amount that is recognized as remuneration on the vesting date is generally the present value of the amount to be paid in the future, determined using reasonable actuarial assumptions. If the amounts that become vested are not paid until a future year, any earnings on the previously vested amounts are treated as additional remuneration paid as of the end of the calendar year in which they accrue. Losses on previously vested amounts can be used to reduce earnings on previously vested amounts.

Interestingly, the Notice provides that these timing rules apply even if the arrangement under which the remuneration is provided is not subject to section 457(f). Presumably, this means that if a taxable entity (such as a for-profit company) employs a covered employee and pays some of the employee’s remuneration, these timing rules will apply to deferred compensation provided by the taxable organization, even though section 457(f) normally would not apply to these amounts. This is a significant departure from the normal accounting and income recognition rules that otherwise apply with respect to these amounts.

**Eversheds Sutherland Observation:** The treatment of deferred amounts as paid when vested and the treatment of earnings as paid annually generally will have the effect of spreading income over a longer period of time and, thus, reducing the likelihood that an employee with deferred compensation that accrues over many years will be treated as being paid more than $1 million in any one taxable year. However, for ATEOs and related organizations that provide deferred compensation benefits, this unique method for counting remuneration may require sophisticated new systems for tracking deferred compensation and determining the
remuneration for top paid employees.

If the Treasury Department and the IRS apply these special timing rules to the remuneration used to determine whether an individual is a covered employee, these rules could become a significant headache even for ATEOs and related organizations that rarely expect to make payments of more than $1 million or payments that could be excess parachute payments. This is the case because ATEOs will generally need to determine their covered employees each year if there is even the slightest chance that they will have employees who will receive payments that are subject to the excise tax in future years, because an ATEO’s covered employees for any future year will include employees who were among the five highest paid employees in all prior years going back to 2017.

Medical and veterinary services

The Notice provides considerable guidance on the statutory exclusion of remuneration paid to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services.

First, the Notice clarifies that amounts paid for the performance of medical services are excluded for all purposes under section 4960, including the determination of who is a covered employee, whether payments of remuneration exceed $1 million, and whether excess parachute payments have been made.

Second, it provides a definition of medical services. For these purposes, medical services are services that constitute medical services under section 213(d)(1)(A) and the corresponding regulations. Under section 213(d)(1)(A), services for medical care are services for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body. In the case of veterinary services, this definition applies with respect to animals by analogy.

Third, the Notice provides that only remuneration for the “direct” performance of medical services qualifies for the exception and that remuneration paid for “other services” does not qualify. The distinction between “direct” medical services and “other services” is drawn largely by example. The Notice provides that documenting the condition and care of a patient is a direct medical service, and so is supervising another licensed professional while that other licensed professional performs direct medical services. Teaching and doing research, however, generally are not direct medical services, nor are management and administrative services, such as scheduling, staffing, providing appraisals and similar actions. Although these examples will certainly be helpful in determining whether most services constitute “direct medical services” or “other services,” there will be many instances in which it is unclear.

Fourth, the Notice explains how to allocate remuneration between that provided
for direct medical services and that provided for other services. Recognizing that most medical professionals are paid both for performing direct medical services and other services, the Notice requires employers to make a reasonable, good faith allocation of remuneration between the two. If an employment agreement designates the remuneration that will be paid for various types of services, that allocation must be followed for purposes of section 4960, unless the allocation is unreasonable or was established to avoid the excise tax. If an employment agreement does not allocate the remuneration, an employer may use any reasonable allocation method. The Notice sets out several examples of reasonable methods, including the use of a representative sample of records, such as patient, insurance and Medicare/Medicaid billing records.

Payments in excess of $1 million

Consistent with the statute, the Notice explains that if an ATEO and one or more employers that are related organizations pay more than $1 million of remuneration to a covered employee in a calendar year, the excise tax applies, and each employer is liable for its proportional share of the tax. The percentage of the excise tax that each employer owes is equal to the percentage of the total remuneration paid by that employer. For example, if an individual is a covered employee of an ATEO and is also an employee of a related organization, and each organization pays the employee $1.25 million in a calendar year (for a total of $2.5 million), the excise tax under section 4960 with respect to that remuneration is $315,000 (21% x $1.5 million, which is the amount of remuneration in excess of $1 million); the ATEO would be liable for 50% of the excise tax ($1.25 million / $2.5 million), and the related organization would be liable for the remaining 50%.

The Notice also includes rules to avoid double taxing remuneration in excess of $1 million if an individual is a covered employee with respect to multiple ATEOs that are related to each other or if the remuneration in excess of $1 million includes excess parachute payments. It also provides rules to address organizations that become, or cease to be, related organizations with respect to an ATEO.

Excess parachute payments

Under section 4960, an excess parachute payment is the amount by which a "parachute payment" exceeds the portion of the "base amount" allocated to the payment. The Notice explains that a parachute payment is any payment in the nature of compensation made by an ATEO (or a predecessor of the ATEO) or a related organization to (or for the benefit of) a covered employee if:

- the payment is contingent on the employee’s separation from employment; and

- the aggregate present value of all such payments equals or exceeds three
times the employee’s base amount.

The Notice highlights that a parachute payment does not include payments from most types of tax-favored retirement plans, payments for the performance of medical or veterinary services, or payments to individuals who are not highly compensated employees (HCEs). An employee is an HCE for this purpose if the employee is an HCE under the applicable qualified plan rules at the time of separation from employment, even if the employee is not an HCE at the time a payment is made.

The Notice defines a “payment in the nature of compensation” expansively as any payment arising from the employment relationship. As one would expect, this includes wages, salaries, deferred compensation and similar payments, but the Notice clarifies that it also includes less obvious amounts, such as payments under a non-competition agreement, transfers of property (like options, whether or not they have a readily ascertainable fair market value), the value of non-taxable benefits (like medical benefits), and the value of accelerated vesting and payment.

Contingent on separation from employment

Although the statute provides that a payment is a parachute payment only if it is “contingent on a separation from employment,” that key phrase is undefined in the statutory text, and the legislative history sheds little light on its meaning. The Notice adopts a relatively narrow definition.

Under the Notice, a payment is treated as contingent on an employee’s separation from employment if the facts and circumstances indicate that the employer would not make the payment in the absence of an involuntary separation from employment. Thus, a payment that is vested before an employee’s involuntary separation from employment generally will not be a parachute payment because it is a payment that would have been made eventually, whether or not the employee had a separation from employment. Similarly, a payment that becomes vested early due to an involuntary separation from employment, but that would have become vested eventually if the employee had continued to perform services, generally will not be a parachute payment because it too is a payment that generally would have been made even if the employee had not separated from employment.

Consistent with the statute and existing guidance under section 280G, on which this part of section 4960 was based, the Notice provides that the value of accelerating the time when a payment is made can itself be a parachute payment if the acceleration is due to an involuntary separation from employment. For example, if an employee has a vested right to be paid $100,000 in January 2022, but the amount becomes payable in January 2020 because the employee has an involuntary separation from employment, the difference between $100,000 and the present value of a $100,000 payment in two years (based on reasonable actuarial assumptions) would be treated as a
payment that is contingent on a separation from employment. The Notice sets out a variety of rules for valuing accelerated payments based largely on the rules under section 280G.

For better or worse, the Notice adopts a familiar, but complicated, definition of separation from employment based on the definition of “separation from service” in the regulations under section 409A. Thus, an employee generally has a separation from employment if the level of services that the employee is expected to perform on and after a certain date is reduced to no more than 20% of the level of services that the employee provided during the immediately preceding 36-month period. Various other presumptions and rules apply in different circumstances. A separation from employment is generally involuntary if it is due to the independent exercise of the employer’s unilateral authority to terminate the employee’s services if the employee is willing and able to continue performing services, unless the separation is at the employee’s implicit or explicit request.

Applicable taxable year and grandfathered (or pre-effective date) remuneration

The Notice generally provides that remuneration paid, and excess parachute payments made, in the calendar year ending with or within an organization’s taxable year are treated as paid for that taxable year.

However, a different rule applies for the purpose of determining whether remuneration is paid and excess parachute payments are made before the effective date of section 4960, which is an organization’s first taxable year beginning on or after January 1, 2018. Payments made before the effective date are not subject to the excise tax. For this purpose, any amount that was vested as of the close of the employer’s taxable year preceding the taxable year for which section 4960 is effective for that employer will be treated as paid for that preceding taxable year and will not be subject to the excise tax – whether or not those amounts were actually or constructively paid at that time. Thus, if an employer has a taxable year that begins on October 1, remuneration and excess parachute payments that were vested before October 1, 2018, will not be subject to the excise tax.

Reporting

The excise tax imposed under section 4960 is reported and paid using Form 4720. If an ATEO and a related organization each make a portion of the payments giving rise to the tax, they each must file a separate Form 4720 to report the portion of the tax for which they are liable. The form is due by the 15th day of the 5th month after the end of the employer’s taxable year for which the tax is due, which is May 15 for calendar year employers, although employers may file a Form 8868 to request an automatic six-month extension to file the Form 4720.
Conclusion

The Notice generally provides welcome guidance for employers potentially subject to the excise tax under section 4960. For the most part, the positions taken in the Notice reflect a carefully considered interpretation of the statute and will have the effect of minimizing the tax imposed. However, some of the guidance could impose significant administrative burdens on ATEOs and their related organizations.

The Treasury Department and the IRS have asked interested stakeholders for comments on the Notice by April 2, 2019. These comments will be used to develop proposed, and then final, regulations. Employers that may be affected significantly by the positions taken in the guidance are encouraged to consider filing a comment with the agencies.

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.