Section 4960 -- Excise tax on “covered employee” compensation

ABA Tax Section Meeting
Executive Compensation Subcommittee, January 18, 2019
Excise tax on “covered employee” compensation

► **Provision summary**: section 4960 provides that, effective for taxable years beginning after December 31, 2017, an “applicable tax-exempt organization” is subject to a 21% excise tax on:

► Remuneration over $1 million paid to a covered employee (other than an excess parachute payment)
► Excess parachute payments paid to a covered employee

► **Notice 2019-09** provides details on how this tax is calculated.

► Until further guidance is issued, tax-exempt organizations and related organizations may apply a reasonable, good faith interpretation of the statute.
► Notice sets forth positions that are considered reasonable and other positions are deemed not to be a reasonable or good faith interpretation of the statute.
► Treasury and the IRS intend that future guidance will not apply to taxable years beginning before the issuance of that guidance.
What is an applicable tax-exempt organization?

► Applicable tax-exempt organization (ATEO) is an organization that:
  ► Is exempt from tax under section 501(a)
  ► Is a farmers’ cooperative described in section 521(b)
  ► Has income excluded from tax under section 115(1)
  ► Is a political organization described in section 527

► Governmental entities
  ► Governmental unit (including a state college or university) that do not have an IRS determination letter on their tax-exempt status is NOT considered an ATEO
  ► Governmental unit with an IRS determination letter is considered an ATEO, but it may choose to relinquish its section 501(c)(3) status
  ► Governmental entity that is separately organized from a state may meet the requirements of section 115(1) and would be considered ATEOs

► Takeaway – The JCT Bluebook states that state colleges and universities were intended to be subject to the Section 4960 excise tax, but acknowledges that a technical correction amendment to the statute would be needed to reflect this intent. However, even if the governmental unit is not considered an ATEO, it may be liable for the excise tax if it employs a covered employee and is “related organization”
Which entities are liable for the excise tax?

*The common-law employer is the entity liable for the excise tax*

- Common-law employer is determined based on federal tax rules
  - Note: A common-law employer does not avoid liability if a third party [e.g., payroll agent, common paymaster, statutory employer or certified professional employer organization (PEO)] pays its employees
- Only an ATEO has “covered employees” for purposes of calculating the excise tax; however, a covered employee of an ATEO may also be an employee of a “related organization,” which may cause the related organization to be subject to the excise tax
- *Takeaway* – multiple entities in a large affiliated group that are treated as common-law employers may be liable for the excise tax

*“Related organizations”*

- A person or governmental entity is considered a related organization to the ATEO if it controls or is controlled by the ATEO, as defined by section 512(b)(13) (and as applied for purposes of the Form 990 annual reporting requirements), which applies a more than 50% control test
- A taxable entity or governmental entity may be considered a related organization to the ATEO
- *Takeaway* -- A taxable or governmental entity that is a related organization may be liable for the excise tax if it employs one of the ATEO’s covered employees

*Calculation and allocation of the excise tax*

- Excise tax calculated based on excess remuneration and excess parachute payment made in calendar year ending with or within ATEO’s or related organization’s tax year
- The Notice provides guidance regarding the allocation of the excise tax among the entities
Who are considered covered employees?

- **Covered employee**
  - Any employee who is one of an ATEO's five highest-compensated employees in the current taxable year or a covered employee in any preceding tax year beginning after December 31, 2016
  - Limited service exception excludes employees if the ATEO paid less than 10% of the employee's total remuneration for services to the ATEO and all related organizations; anti-abuse rule applies
  - **Takeaway** -- once a covered employee, always a covered employee, even if no longer one of the five highest-compensated employees

- **Determination of “remuneration” to identify covered employees**
  - Means wages within the meaning of section 3401(a) (Form W-2 box 1 wages, with some significant and potentially consequential exceptions and modifications) paid in the calendar year ending with or within the employer’s taxable year
  - Does not include amounts paid to licensed medical professional for medical services
    - Teaching or research services are not medical services, unless they “relate directly to the diagnosis, cure, mitigation, treatment, or prevention of disease or affect a structure or function of the body”
  - Includes amounts paid by a related organization that is the employer of the covered employee
  - **Takeaway** – Significant tracking and administration will be required to determine employees’ annual remuneration; employers cannot refer exclusively to Form W-2 box 1 wages
Who are considered covered employees? Cont’d

- Date when remuneration is treated as paid
  - Remuneration is treated as paid on the date amounts are no longer subject to substantial risk of forfeiture (vested), in accordance with section 457(f). This is true for compensation paid by tax-exempt employers and for-profit, taxable related organizations who employ a covered employee.
  - The amount of the remuneration is the present value of future payments as of the vesting date. (Notice sets forth present value rules consistent with the rules in the section 457(f) proposed regulations.)
  - Remuneration is treated as “previously paid remuneration” for taxable year to the extent treated as paid for purposes of section 4960, but amounts were not actually or constructively paid until a future date (i.e., future payment date of deferred compensation).
  - Net earnings on previously paid remuneration are treated as paid as of the close of the calendar year of accrual. (Differs from section 457(f) rules under which earnings are included in income when actually or constructively received in accordance with the section 72 rules.)

- Takeaway -- Quasi-grandfather for previously paid remuneration paid prior to effective date or prior to date employee becomes a covered employee. For example, in the case of an employer with a calendar year tax year, the present value of remuneration that was vested as of December 31, 2017 is treated as paid for taxable year 2017; thereafter, only earning on this amount are treated as remuneration for purposes of the section 4960 excise tax.
Applying the rules to identify covered employee

► **Example 1** (Aggregation of remuneration) – Hospital A is an ATEO and supporting organization B is a related organization to A. Both A and B have calendar year tax years and both employee E during calendar year 2020. E receives 50% of her compensation for services performed for A and 50% for services performed for B. E’s compensation from A and B must be aggregated for purposes of determining whether E is a covered employee of A or B.

► **Example 2** (Aggregation of remuneration and limited service exception) – Same facts as Example 1, except that E performs 95% of her services for A and only 5% for B and is compensated by A and B accordingly. Based on aggregated compensation, E could be considered a covered employee of A, but would not be a covered employee of B because B did not pay E at least 10% of total compensation.

► **Example 3** (Fiscal year tax year) – University C has a tax year ending 6/30 and is subject to the section 4960 for its tax year beginning 7/1/2018 (the initial tax year). C’s CFO is a covered employee based on compensation paid for the 2017 calendar year ending within C’s tax year ending 6/30/2018. CFO’s SERP (deferred compensation) award vested on June 15, 2018 and was included in income on that date. For the initial tax year, C considers the compensation paid to the CFO only from the 7/1/2018 (the section 4960 effective date for C) through 12/31/2018. Hence, the CFO’s SERP payment would not be included in the calculation of the excise tax.
Applying the rules

► Example 1 – Hospital A is an ATEO and supporting organization B is a related organization to A. Both A and B have calendar year tax years and both employed employee E during calendar year 2020. E receives 50% of her compensation for services performed for A and 50% for services performed for B. E’s compensation from A and B must be aggregated for purposes of determining whether E is a covered employee of A or B.

► Example 2 – Same facts as Example 1, except that E performs 95% of her services for A and only 5% for B and is compensated by A and B accordingly. Based on aggregated compensation, E could be considered a covered employee of A, but would not be a covered employee of B because B did not pay E at least 10% of total compensation.

► Example 3 – University C has a tax year ending 6/30. C is subject to the section 4960 excise tax for its taxable year beginning 7/1/2018 (the initial tax year). C’s CFO is considered a covered employee based on compensation paid for the 2017 calendar year ending within C’s tax year ending 6/30/2018. The CFO’s SERP deferred compensation award vested on June 15, 2018 and was included in income on that date. For the initial tax year, C would consider the only compensation paid to the CFO and its other covered employees from 7/1/2018 (the section 4960 effective date for C) through 12/31/2018. Hence, the C’s SERP payment would not be included in the calculation of the excise tax.
Applying the rules

► **Example 4** – Hospital A, a tax-exempt ATEO, owns 60% of the stock of a for-profit, taxable laboratory services corporation B that is treated as a related organization. Corporation B employs E, one of the Hospital A’s covered employees. In this case, Hospital A and Corporation B would both be liable for the Section 4860 excise tax if E receives remuneration in excess of $1 million.

► **Example 5** – Same facts as Example 4, Corporation B grants stock options to E. The Stock options must be included in income when they become vested. An open question exists how the stock options will be valued.
How are excess parachute payments determined?

- The excise tax may be imposed on an ATEO or related organization employer for any “excess parachute payment” made to a covered employee.
- An “excess parachute payment” is an amount in excess of a “parachute payment.”
- A “parachute payment” is a compensatory payment to a covered employee if:
  - (i) The payment is contingent on an employee separation from employment with the employer, and
  - (ii) The aggregate present value of the payment exceeds three times the base amount, which is the average annual compensation over the preceding 5-years.
- Notice 2019-09 provides that an amount is considered a parachute payment only if the payment is contingent on involuntary separation-from-service.
  - Vested deferred compensation amounts would not be considered parachute payment, even if paid after an involuntary separation from service.
  - Does not include (i) payments to licensed medical professional for medical services; or (ii) payments to an employee who is not a highly compensated employees, within the meaning of Section 414(q).
Example with parachute payment

Example – Covered employee experiences involuntary separation from employment

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base salary</td>
<td>$600,000</td>
</tr>
<tr>
<td>Other</td>
<td>$300,000</td>
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<tr>
<td>Deferred compensation vesting</td>
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</tr>
<tr>
<td>Accelerated vesting due to separation</td>
<td>$500,000</td>
</tr>
<tr>
<td>Severance payments</td>
<td>$2,000,000</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$3,450,000</strong></td>
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</tbody>
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Excise tax computation

<table>
<thead>
<tr>
<th>Description</th>
<th>Excess parachute payment</th>
<th>Excess remuneration</th>
</tr>
</thead>
<tbody>
<tr>
<td>4960 base amount</td>
<td>$750,000</td>
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<tr>
<td>3x base amount threshold</td>
<td>$2,249,999</td>
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</tr>
<tr>
<td>Amount over / (under) threshold</td>
<td>$250,001</td>
<td></td>
</tr>
<tr>
<td>“Excess parachute” amount</td>
<td><strong>$1,750,000</strong> (b)</td>
<td></td>
</tr>
<tr>
<td>Total remuneration less “excess parachute”</td>
<td></td>
<td><strong>$1,700,000</strong> (c)</td>
</tr>
<tr>
<td>Excess remuneration</td>
<td></td>
<td><strong>$700,000</strong></td>
</tr>
<tr>
<td>Excise tax amount</td>
<td><strong>$367,500</strong></td>
<td><strong>$147,000</strong></td>
</tr>
</tbody>
</table>

Total excise tax: **$514,500**
How does the Section 4960 excise tax coordinate with other excise taxes?

- Notice 2019-09 confirms no relationship between Section 4960
  - And the Section 4958 excise taxes for unreasonable and excessive compensation
  - And the Section 4941 excise tax imposed on disqualified person for personal services
- Remuneration for which deduction is disallowed under Sections 162(m) and 162(m)(6) is not taken into account for purposes of calculating the excise tax.
How will the excise tax be paid and reported?

► Draft 2018 Form 990 has a new question 15 in Part V:
  ► “Is the organization subject to the section 4960 tax on payment(s) of more than $1,000,000 in remuneration or excess parachute payment(s) during the year? If ‘Yes,’ see instructions and file Form 4720, Schedule N.”

► Proposed regulations under sections 6011 and 6071 have provisions regarding the section 4960 excise tax
  ► Reported on the Form 4720, Schedule N
  ► Each employer liable for the tax is responsible for separately reporting and paying its share of the tax
  ► Payment is due generally on the 15th day of the 5th month after the end of the taxpayer’s taxable year (May 15 for a calendar-year employer)
  ► No quarterly payments of estimated section 4960 tax are required
What can reduce the administrative and tax burdens?

► Avoid spikes in compensation
► Consider modifying deferred compensation vesting, severance, bonus provisions
► Assess viability of split-dollar arrangements, including section 4958 excise tax for loans from supporting organizations
► Consider modification of separation-from-service payments to avoid excess parachute payments
► Assess viability of equity interests in joint ventures, including assessment of private inurement issues
► Consider appropriate compensation allocation for shared employment