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BLOG

No Good Deed Goes Unpunished: Public and Other For-Profit Employers May Be Subject to New Section 4960 21% Excise Tax Originally Aimed at Non-Profits

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Now that Notice 2019-09 has been out for several months, the Notice's very serious implications are becoming clearer for taxable entities, in addition to the non-profits that were the primary aim of the new statutory provisions. Specifically, employers or employees of taxable entities who work for little or no pay at a related non-profit may be subject to significant excise taxes as well as overwhelming administrative burdens. Notice 2019-09 addresses new section 4960 of the Internal Revenue Code as amended by the TCJA, which provides a current 21% excise tax on total wages over $1 million paid to the five highest-paid "covered employees" of non-profit entities, plus monetary sanctions related to parachute payments made upon involuntary severance of employment.

Unfortunately, *all of the wages* of the covered employees of the non-profit over $1 million from *all related entities*, including taxable entities, will now be subject to the excise tax, which must be paid by the related entities in proportion to the allocable remuneration on Form 4720. In addition, Section 4960 imposes a separate excise tax for parachute payments made upon severance of a *highly compensated* covered employee upon involuntary separation from service, which can also result in a liability for the related taxable entities as well.

All employers should immediately determine whether there is a tax-exempt entity related to the employer, even with respect to unpaid or low-paid employees, which could cause the application of these excise taxes for years beginning in 2018.

Applicable Tax-Exempt Organization and Related Organizations

Section 4960 was intended to put tax-exempt organizations on par with public company employers subject to the Section 162(m) denial of deduction for compensation paid to covered employees over $1 million and liability for section 280G parachute payments upon a change in control. The applicable tax-exempt organizations (ATEOs) covered generally include those which are:

- Exempt from tax under Section 501(a) (including organizations exempt from tax under Section 501(c)(3), religious or apostolic organizations exempt from tax under Section 501(d), or a trust forming part of a stock bonus, pension, or profit sharing plan under Section 401(a))

- A political organization described in Section 527(e)(1) or a farmers' cooperative organization described in Section 521(b)(1)
- Excluding income from tax under Section 115(1) (generally excluding public utility or essential governmental function and accruing to a state, any political subdivision of a state, or the District of Columbia)

Section 4960 provides that the following persons and governmental entities are generally treated as organizations related to ATEOs based on control at *more* than 50% ownership, or more than 50% directors or trustees being represented or controlled by the other entity:

- Organizations that control or are controlled by the ATEO
- Organizations that are controlled by one or more persons which control the ATEO
- Organizations that are a "supported organization" as defined in Section 509(f)(3) or organizations that are a "supporting organization" as described in Section 509(a)(3) with respect to the organization
- If the ATEO is a voluntary employees' beneficiary association, organizations established, maintained, or that make contributions to such voluntary employees' beneficiary association

The definition of related organization is problematic from several perspectives, but the most important is that the requisite level for control is 50% or greater. For the vast majority of employee tax issues, control is determined instead by reference to Code Sections 414(b) and (c), which define control at 80%. Therefore, taxable entities must perform an analysis which has not been done previously, and the result can be penalty taxes which had not been previously contemplated.

Employer

The excise tax is paid only by the employer, which is defined as the *common-law* employer for purposes of Federal income tax regardless of whether the wages are paid by an agent, PEO, or other third party such as one member of a related corporate group pursuant to the agent or statutory employer rules. Accordingly, an employer may not simply look at the information as illustrated on Form W-2. This definition is similar to that used for ACA purposes. Furthermore, a disregarded entity's employees are treated as employees of its single member owner.

Covered Employee

Section 4960(c)(2) defines a "covered employee" as any current or former employee (not independent contractor such as a director) of an ATEO who is one of the five highest-compensated employees of the ATEO for the taxable year, or as a covered employee for any taxable year beginning after December 31, 2016. Accordingly, the rule for section 4960 is similar to the new rules for Section 162(m)—once an individual becomes a covered employee of an ATEO, the individual will always remain a covered employee. Furthermore, that covered employee status begins in 2017, rather than in 2018 when the excise tax is first applicable. Note that there is no minimum dollar threshold for an employee to be determined to be a covered employee.

EXAMPLE: A non-public taxable controlled group of companies has a related non-profit foundation which is an ATEO. The CEO of the taxable company, receiving $5 million in wages, acts as the unpaid CEO of the foundation providing significant services to the foundation. The foundation has employees whose total pay from all related entities is less than the CEO's total remuneration. Result: All of the CEO's remuneration over $1 million is subject to the excise tax under Section 4960 as a covered employee.

According to the Notice, if the CEO was employed by a public company, the result would be the same, but amounts subject to the Section 162(m) excess compensation provisions would not be relevant to the Section 4960 calculation of the excise taxes.

Determining the highest-paid employees is key to the analysis of the new excise taxes. Each ATEO will have its own five highest-paid employees each year, separately determined, although there could be overlap between any related

ATEOs. The remuneration which is relevant for this purpose is all remuneration from all related ATEOs, public and private taxable entities, and governmental entities during the calendar year ending within the subject ATEO's taxable year. Compensation which has been disallowed as a deduction pursuant to Section 162(m) applies to employees of public companies does not factor in for this purpose.

Notice 2019-09 gives a glimmer of hope for related employers with shared employees to avoid application of the excise tax, but this rule has very limited applicability. Specifically, if an ATEO pays less than 10% of an employee's total remuneration, the employee is not considered to be one of the five highest-paid employees of the ATEO. Unfortunately, there is a significant exception to this 10% rule, so that it will often not provide an exemption from application of the excise tax. If neither the ATEO at issue nor any related ATEOs pays at least 10% of an employee's total remuneration, then the ATEO paying the highest percentage of total remuneration must treat the employee as a potential covered employee.

EXAMPLE: Non-profit hospitals A, B, and C pay 90%, 9%, and 1%, respectively, of a shared employee's total pay from all related non-profit and taxable employers. Dependent upon the total pay of the hospital's employees, the shared employee is potentially a covered employee of hospital A but not of B and C. On the other hand, if hospital A was a taxable organization, then the shared employee would be a covered employee of non-profit hospital B and not of C.

The bottom line is that the 10% rule will not be of much use to taxable entities that pay significant remuneration to an employee who is also employed, perhaps even on a volunteer basis, at a related ATEO.

Excess Remuneration

In general, the excise tax imposed under section 4960(a)(1) is based on the remuneration paid (other than any excess parachute payment) by an ATEO for the taxable year with respect to employment of any covered employee in excess of $1 million. Remuneration specifically for the actual provision of medical or veterinary services is excluded (e.g., a doctor working all or partly in hospital administration would have remuneration subject to the penalty tax).

Section 4960(c)(3)(A) generally defines "remuneration" as wages under section 3401 (a) (wages subject to federal income tax withholding), but excluding designated Roth contributions under Section 402A(c) and including amounts required to be included in gross income under Section 457(f).

Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to the remuneration. The term "substantial risk of forfeiture" is defined by cross-reference to section 457(f)(3)(B). Unfortunately, what this means is that compensation paid by a for-profit organization which is subject to the over $1 million excise tax, must perform a complicated analysis of when compensation is vested.

EXAMPLE: S Corporation has 50% control of a tax-exempt organization. The executive has wages from both employer organizations and must determine whether the $1 million threshold is exceeded for 2018. A bonus of $2 million attributable to 2018 performance but paid in 2019 may be part of that calculation.

Parachute Payments

In addition to the payment of the 21% penalty tax on remuneration over $1 million, a penalty tax applies to an excess parachute payment. An "excess parachute payment" means an amount equal to the excess (if any) of the total amount of any parachute payment over the portion of the base amount, generally one year's compensation, allocated to such payment. A parachute payment is defined as any payment of compensation made by an ATEO (or a predecessor organization of the ATEO) or a related organization to (or for the benefit of) a covered employee if-

(1) the payment is contingent on the employee's separation from employment with the employer; and

(2) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) the individual that is contingent on the separation equals or exceeds an amount equal to three times the base amount,

generally one year's compensation.

The term "parachute payment" does not include any payment made from section 401(a) and other enumerated qualified plans including sections 403(b) and 457(b); made for medical or veterinary services performed; or ***made to an individual who is not a highly compensated employee as defined in section 414(q).***

The compensation threshold for status as a highly compensated employee for 2019 is $125,000.

The Notice refers "generally" to Treas. Reg. ection 1.414(q)-1T for purposes of the HCE definition for Section 4960. Unfortunately, the reference to the regulations defining a highly compensated employee picks up the aggregation rules applied to qualified plans, which would include all compensation from all related companies pursuant to sections 414(b), (c), (m), and (o).

Thus, for purposes of the parachute payment provisions, an individual would need to be analyzed: first, as being a control employee with respect to all remuneration from organizations exceeding the 50% control threshold, and second, as a highly compensated employee using a different threshold and aggregated group of employers.

Therefore, in a situation where a control employee works for a taxable organization under 80% common control with a related tax-exempt organization providing only $100,000 to the same employee, the employee would be a highly compensated employee of the related tax-exempt organization generally if an additional $150,000 was received from the related organization.

Due Date of Form 4720 and Effective Date

The payment of the 21% excise tax is made on Form 4920 and is due by the 15th day of the fifth month following the organization's taxable year—which, for calendar years, is a May 15 due date. This due date is coming up shortly for many employers.

The Notice provides that the Treasury Department and the IRS intend to issue proposed regulations that will incorporate the guidance provided in the Notice. Any future guidance under Section 4960 will be prospective and will not apply to taxable years beginning before the issuance of the additional guidance. Until further guidance is issued, to comply with the requirements of Section 4960, taxpayers may base their positions upon a good-faith, reasonable interpretation of the statute, including consideration of the legislative history, if appropriate. The Notice provides that the position reflected in the Notice constitutes a good-faith, reasonable interpretation of the statute.

Summary

Notice 2019-09 provides extensive rules regarding how to calculate the value of remuneration subject to the section 4960 excise tax, how governmental entities are treated, definitions of base amount, remuneration for medical and veterinary services, allocation and procedures for payment of the excise tax, and numerous other details on the issues presented by the new 21% excise tax. However, these rules do not apply to a taxable public or private company unless it determines whether any of its employees are also covered employees of a related ATEO.

Although taxpayers may rely on a good-faith interpretation of the new law until additional guidance is issued, this good-faith reliance is limited to the examples in the Notice. Taking a position that a taxable entity is not subject to the excise tax is not considered to be good-faith reliance.

In the interim, taxable entities should evaluate whether any of their highly compensated employees provide services to related tax-exempt entities and take the necessary steps to comply, bearing in mind that future guidance may resolve some scenarios before the due date for the payment of the excise tax. Executives may wish to exercise caution before starting to provide services to a tax-exempt entity, again watching for future guidance. In addition, payments upon an involuntary separation from service made to highly compensated employees of tax-exempt organizations should be limited to less than three times one year's compensation.

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