IRS Proposal Clarifies Excise Tax But Leaves TCJA Questions

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On June 11, the U.S. Department of the Treasury and the Internal Revenue Service published proposed regulations under Internal Revenue Code Section 4960.[1]

Section 4960, enacted as part of the Tax Cuts and Jobs Act,[2] imposes an excise tax on remuneration in excess of $1 million and any excess parachute payment paid by an applicable tax-exempt organization, or ATEO, to any covered employee.

The proposed regulations provide comprehensive guidance under Section 4960 and address a number of concerns that commenters had with the scope of the excise tax in light of the interim guidance issued under Notice 2019-9.[3] However, the Treasury did not address all of these concerns, in large part because it believed that doing so would be inconsistent with the text and legislative history of the TCJA.

This article discusses three key areas where the Treasury addressed concerns of commenters but may not have been able to fully align the rules with taxpayer expectations.

Related Party Remuneration: Still Some Potential Traps for the Unwary

The excise tax under Section 4960 affects not only ATEOs but also certain entities that are treated as related to those organizations. Under Section 4960(c)(4)(A), remuneration of a covered employee by an ATEO "include[s] any remuneration paid with respect to employment of such employee by any related person or governmental entity."[4]

As a result, the excise tax may apply in situations where an ATEO provides much less than $1 million of compensation to an employee, or even no compensation, because such employee is highly compensated by a related organization.

Many commenters expressed concern that the definition of covered employee and the rules for identifying an ATEO's five highest-compensated employees provided in Notice 2019-9 would subject a non-ATEO to the excise tax on remuneration it pays to an employee who performs limited or temporary services for a related ATEO, and who typically receives remuneration only from the non-ATEO.

In particular, commenters noted that it is common for companies to ask or direct their employees to provide volunteer services to company foundations, for company executives to serve as officers of the related foundation, and for family offices and family-owned businesses to ask their employees to provide volunteer services to family foundations.[5]

This is particularly true due to the self-dealing rules that apply to foundations, where related entities may donate services to avoid the possibility of paying compensation subject to the excise taxes under Section 4941.

Some commenters suggested broad solutions to address these potential issues. For example, one commenter recommended that compensation paid by a related organization should not be taken into account for purposes of determining when an employee is among an ATEO's five highest-compensated employees — but should be treated as remuneration for purposes of the tax if an employee is one of the five highest-compensated employees.

Another commenter proposed that remuneration be read to include amounts paid by any related person or governmental entity only with respect to employment of the employee by the ATEO and not with respect to employment of the employee by the related person or government entity.

While these solutions may have aligned the rules more closely with taxpayer expectations, the Treasury did not adopt them. In the preamble to the proposed regulations, the Treasury explained that it believed these interpretations would be inconsistent with the statutory text and legislative history of the TCJA.

Instead, the Treasury adopted a patchwork of exceptions intended to avoid the most concerning situations in which the related-party rules could reach further than expected. These exceptions are based on the Treasury's authority and flexibility for determining which individuals are the five highest-compensated employees, and thus covered employees.

First, the excise tax may be avoided in situations where an individual is not an employee of an ATEO. The proposed regulations confirm that a director is not an employee in the capacity as a director, and an officer performing minor or no services and not receiving any remuneration for those services is not an employee. However, an officer that performs more than minor services or receives any remuneration from an ATEO will be considered an employee of the ATEO.

In addition, the preamble notes that a person who performs services for an ATEO as a bona fide independent contractor or solely as a bona fide employee of a related organization, including a related organization that provides services to the ATEO, is not an employee of the ATEO. While helpful, this rule may provide limited comfort to related organizations, because the common law tests for employee status typically depend on all relevant facts and circumstances, and do not provide bright-line rules.

Furthermore, the proposed regulations provide a number of exceptions that generally permit an employee to be disregarded, for purposes of determining an ATEO's five highest-compensated employees for a taxable year, if:

- Neither the ATEO nor any related organization pays remuneration or grants a legally binding right to nonvested remuneration for services the individual performed as an employee of the ATEO or any related organization;[6]

- Neither the ATEO nor any related ATEO pays remuneration or grants a legally binding right to nonvested remuneration to the employee for services performed for the ATEO and the employee performs only limited services for the ATEO;[7] or

- The employee is compensated only through so-called nonexempt funds, i.e:

- Neither the ATEO, nor any related ATEO, nor any taxable related organization controlled by the ATEO pays the employee of the ATEO any remuneration for services performed for the ATEO or grants a legally binding right to nonvested remuneration to the employee;
- The employee performed services as an employee of the ATEO and all related ATEOs for less than 50% of the total hours worked; and
- The related organization paying the employee does not provide services for a fee to the ATEO, related ATEOs or taxable related organizations controlled by the ATEO.

These exceptions should help avoid the most common situations in which an individual whom many would consider a volunteer of the ATEO could be caught in Section 4960's related-party rules.

However, because the Treasury did not believe that it could adopt a comprehensive solution in light of the statutory text and legislative history of the TCJA, exempt organizations and related parties will need to carefully review compensation arrangements to ensure that they can meet one of the exceptions provided for by these regulations. Each of these exceptions includes detailed rules and definitions that must be considered.

Furthermore, traps for the unwary remain. For example, each of these exceptions requires that an employee receive no remuneration from various specified organizations. Fringe benefits that are excluded from income under Section 132[8] — such as most directors and officers liability insurance — are not considered remuneration for this purpose. However, certain minor benefits, such as providing an employee with a gift card as a show of appreciation, could cause an employee to fail to fall into an exception.

The consequences for minor mistakes can be dire. Once an employee becomes a covered employee of an ATEO they remain a covered employee, and subject to the tax, in perpetuity, even if they cease to be an employee of the ATEO and simply provide services for the related organization moving forward.

Limited Grandfathering Does Not Address Cliff Vesting

The definition of remuneration under Section 4960 presents problems for so-called cliff-vesting arrangements where amounts accrue based on services performed over a long period of time but the right to the entire amount vests only at the end of that period. These kinds of arrangements are commonly used by exempt organizations.

Section 4960(c)(3)(A) provides that remuneration "shall include amounts required to be included in gross income under Section 457(f)." Section 457(f),[9] in turn, generally provides that compensation that is provided under a nonqualified deferred compensation plan is included in income in the year that it vests.

As a result, cliff vesting arrangements can expose additional income to the excise tax by bunching it into a single year. Exempt organizations that pay an employee much less than $1 million per year may find that they are subject to the excise tax unexpectedly when compensation earned over a lengthy career vests all at once.

This issue unfortunately affects cliff-vesting arrangements put in place long before the

enactment of Section 4960 in the TCJA. Although changes to Section 162(m), which subjects publicly held corporations to a similar tax on excess compensation, made in the TCJA explicitly provided a grandfathering exception for remuneration payable under a written binding contract that was in effect prior to its enactment, the TCJA did not include such a grandfathering rule for tax-exempt organizations under Section 4960.

In order to address potential unfairness, including the unfairness of disturbing long-standing cliff-vesting arrangements, commenters requested the Treasury to adopt a similar grandfathering rule under its regulatory authority under Section 4960. However, the Treasury did not believe it had the authority to provide for such a rule in the absence of an express legislative provision, particularly when a provision had been expressly included under Section 162(m).

The proposed regulations do provide rules that have the effect of grandfathering compensation in limited circumstances. In particular, the proposed regulations provide that any nonqualified deferred compensation that vested prior to the first day of the first taxable year of the ATEO beginning after Dec. 31, 2017, is not considered remuneration for purposes of Section 4960.

However, this rule will not provide relief for any unvested compensation, such as that provided by a cliff-vesting arrangement.

Some Governmental Entities Left Out

When the TCJA was enacted, many assumed that highly-compensated employees of state colleges and universities, such as football coaches, would be subject to the excise tax. However, the definition of an ATEO under the statute does not reach as far as many expected.

Section 4960(c)(1) defines an ATEO as any organization which for the taxable year: (1) is exempt from tax under Section 501(a);[10] (2) is a farmers' cooperative organization described in Section 521(b)(1); (3) has income excluded under Section 115(1);[11] or (4) is a political organization described in Section 527(e)(1).

Many governmental entities rely on the doctrine of implied statutory immunity, rather than Section 115(1) or Section 501(a), to exempt their income from tax. But Section 4960(c)(1) does not list organizations exempt from tax under this doctrine as among the organizations treated as an ATEO.

The proposed regulations clarify the scope of this definition. In particular, under the proposed rules, a governmental entity that is separately organized from a state or political subdivision of a state and excludes income from gross income under Section 115(1) will be treated as an ATEO. In addition, a governmental entity that sought and received a determination letter recognizing its exemption from taxation under Section 501(a) will be treated as an ATEO.

However, a governmental entity, including a state college or university, that does not have a determination letter recognizing its exemption from taxation under Section 501(a) and that does not exclude income from gross income under Section 115(1) because it relies on the doctrine of implied statutory immunity is not an ATEO.

Furthermore, organizations that previously sought a determination letter may be able to avoid the Section 4960 excise tax by affirmatively relinquishing this status if they can rely

on the doctrine of implied statutory immunity, rather than Section 115(1), to exempt their income from tax. An entity that excludes all or part of its income from gross income under Section 115(1) is an ATEO regardless of whether it has a private letter ruling to that effect.

It is not clear what policy rationale would support excluding governmental entities that rely on implied statutory immunity from Section 4960 while including governmental entities that rely on Section 115(1) and Section 501(a). It also appears that Congress did not intend to make this distinction.

The general explanation of the TCJA, prepared by the staff of the Joint Committee on Taxation, states that ATEOs were intended to include state colleges and universities but that a "technical correction may be necessary to reflect this intent."[12] Nevertheless, the Treasury stuck closely to the statutory text on this issue, presenting a choice for certain entities, including many state colleges and universities.

Conclusion

ATEOs and related organizations will need to carefully consider how the proposed rules will apply to their existing compensation arrangements. As described above, a number of surprises may be in store for organizations who fail to do so.

In addition, exempt organizations should consider providing comments on the proposed regulations. Written or electronic comments are due by Aug. 10.

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Disclosure: While serving at the Office of Tax Policy, Ramey was involved in the development the proposed regulations discussed in this article.

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[1] Internal Revenue Code Section 4960.

[2] 115 P.L. 97.

[3] 2019–04 I.R.B. 403.

[4] For this purpose, a related person or government entity includes any person or government entity that: (1) controls, or is controlled by, the ATEO, (2) is controlled by one or more persons which control the ATEO, (3) is a supported organization (as defined in Section 509(f)(3)) during the taxable year with respect to the ATEO, (4) is a supporting organization described in Section 509(a)(3) during the taxable year with respect to the ATEO, or (5) in the case of an organization which is a voluntary employees' beneficiary association described in Section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.

[5] See generally American Bar Association Section of Taxation, Comments on Section 4960, Notice 2019-9 and Volunteers providing Services to Tax-Exempt Organizations (July 12, 2019).

[6] This exception is intended to clarify that if none of the ATEO's employees received remuneration from the ATEO or from a related organization, then the ATEO has no covered employees (instead of requiring that some employee be treated as a covered employee).

[7] Any employee provides "limited services" only if: (1) the hours of service the employee performs as an employee of the ATEO comprise 10 % or less of the employee's total hours of service for the ATEO and all related organizations during the applicable year; or (2) the employee performs fewer than 100 hours of services as an employee of an ATEO (and all related ATEOs) during an applicable year.

[8] Internal Revenue Code Section 132.

[9] Internal Revenue Code Section 457(f).

[10] Internal Revenue Code Section 501(a).

[11] Internal Revenue Section 115(1).

[12] Joint Committee on Tax, General Explanation of Public Law 115-97, at 264 & n.1251 (Dec. 2018).