# An Excess of Uncertainty: The New Tax on Tax-Exempt Compensation

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In this article, the authors examine the new excise tax imposed on remuneration exceeding $1 million paid by tax-exempt organizations to some employees, and they discuss technical issues arising from the statute's borrowing of several terms and concepts from section 162(m). The authors also explore numerous questions raised by other defined terms in the statute and offer possible interpretations for consideration.



## I. Introduction

On December 22, 2017, the president signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act (P.L. 115-97). The new law represents the largest change to U.S. tax policy in decades and includes several new provisions that specifically apply to tax-exempt organizations. Of those provisions, perhaps the most significant is a new excise tax on compensation exceeding $1 million paid by tax-exempt organizations.

Congress justified this excise tax — enacted as section 4960 — in part as a way to achieve parity between tax-exempt organizations and taxable publicly held corporations.[1] Publicly held corporations have long faced limitations on deductions for executive compensation exceeding $1 million under section 162(m) and now face significantly tightened limitations in the wake of the TCJA. Tax-exempt organizations generally have little need for deductions, and therefore would suffer minimally — if at all — from a disallowance regime like that found in section 162(m). Recognizing the futility of denying deductions to tax-exempt organizations, the new statute attempts to parallel section 162(m) by imposing an excise tax equal to the corporate tax rate on remuneration exceeding $1 million paid to specific employees.

Imposing an equivalent of section 162(m) on tax-exempt organizations raises the question of why Congress thought tax-exempt organizations should be on equal footing with publicly held companies, as opposed to privately held companies, which are not subject to section 162(m). The attempt to create a section 162(m) equivalent also results in numerous technical issues that arise from borrowing several terms and concepts from section 162(m) that do not translate well into section 4960 given the substantial organizational and operational differences between publicly held corporations and exempt organizations. The defined terms used in section 4960 to apply an excise tax on excess compensation — that is, "remuneration" paid by an "applicable tax-exempt organization" (ATEO) with respect to employment of any "covered

[1] House Ways and Means Committee's Section-by-Section Summary, at 61 (Nov. 2, 2017); Explanation of Senate Finance Committee Bill (posted by Senate Budget Committee), at 243 (Nov. 30, 2017).

employee" — are ambiguous and raise difficult questions and issues. This article discusses some of those questions and issues and suggests some possible answers for consideration.

Also, section 4960 imposes an excise tax on any "excess parachute payment" paid by an ATEO to any covered employee. The provisions in the statute relating to excess parachute payments also raise many difficult questions deserving of careful analysis, but those issues are beyond the scope of this article.

## II. Applicable Tax-Exempt Organization

Section 4960 applies if an ATEO pays remuneration exceeding $1 million to a covered employee. An ATEO is any one of the following four categories of organizations: (1) an organization exempt from tax under section 501(a); (2) an exempt farmers' cooperative (section 521(b)(1)); (3) a political organization (section 527); or (4) an organization that "has income excluded from taxation under section 115(1)."[2] The last category has been by far the most controversial, with practitioners and government officials debating the extent of its intended and actual scope.[3] The central question is whether ATEOs include state universities and other state and local governmental entities that do not have a section 501(c)(3) determination letter or that rely on section 115 to exclude their income from federal income tax.

Section 115(1) excludes from gross income any income derived from the exercise of any essential governmental function that accrues to a state or political subdivision. This exclusion applies only to an entity regarded as separate from a state or political subdivision for federal income tax purposes.[4] By contrast, state and local governments themselves as well as entities that are not regarded as separate from a state or local government for federal income tax purposes — called "integral parts" of state or local governments — are not subject to federal income tax under the doctrine of implied statutory immunity. Under that doctrine, the income of a state or local government (or an integral part thereof) is "generally not taxable in the absence of specific statutory authorization for taxing such income."[5]

Whether an entity is an integral part of a state or local government or excludes its income under section 115 (a section 115 entity) is not always clear. Before the TCJA, this was essentially a distinction without a difference. In both situations, an entity's income would not be subject to federal income tax, and the entity generally would not have a Form 990-series filing requirement.[6] Now, however, section 4960 has made this ill-defined distinction potentially significant.

It is unknown how many state colleges and universities would be considered by the IRS to be integral parts, as opposed to section 115 entities. However, numerous private letter rulings make clear that the IRS has already recognized at least some portion of those organizations as integral parts, and not section 115 entities.[7] Unfortunately, state colleges and universities that would like to know whether they are integral parts cannot turn to the IRS for a letter ruling or determination. That

[2] Section 4960(c)(1).

[3] *See, e.g.*, comments of Veena Murthy, legislation counsel at the Joint Committee on Taxation, after a panel discussion at a conference on the TCJA sponsored by the District of Columbia Bar Taxation Community (Jan. 25, 2018); Elinor Ramey, attorney-adviser in the Treasury Office of Tax Legislative Counsel, at the American Bar Association Section of Taxation 2018 midyear meeting (Feb. 9, 2018) and Georgetown Law's 2018 Representing and Managing Tax-Exempt Organizations program (Apr. 26, 2018); Janine Cook, IRS deputy associate chief counsel (Tax-Exempt and Government Entities), at the 2018 TE/GE Joint Council Meeting (Feb. 23, 2018); Stephen Tackney, IRS deputy associate chief counsel (TEGE), on an American Law Institute webinar: "Executive Compensation Issues for Tax-Exempts: The New Rules Under Tax Reform" (Mar. 27, 2018); and Gordon Clay, senior legislation counsel at the JCT, at Georgetown Law's 2018 Representing and Managing Tax-Exempt Organizations program (Apr. 26, 2018). *See also* Ellen P. Aprill, "Response to Professor Kahn: Tax Status of Public Universities," *Tax Notes*, Feb. 8, 2018, p. 539.

[4] Rev. Rul. 77-261, 1977-2 C.B. 45; GCM 39601 (Jan. 25, 1985); LTR 201736015. Under section 6110(k)(3), written determinations such as general counsel memoranda, private letter rulings, and technical advice memoranda are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations do, however, offer an indication of the IRS's position on the issues addressed.

[5] Rev. Rul. 87-2, 1987-1 C.B. 18 (noting that an example of a statutory exception to this general rule is found in section 511(a)(2)(B), under which the unrelated business taxable income of colleges and universities that are state agencies or instrumentalities is taxable, even though those organizations may also qualify as section 115 entities or integral parts); *see also* TAM 7904006, GCM 37657 (Aug. 31, 1978) (discussing the scope of the doctrine of intergovernmental tax immunity and the constitutionality of imposing federal income tax on income of states and political subdivisions).

[6] Reg. section 1.6033-2(g)(v); Rev. Proc. 95-48, 1995-2 C.B. 418; Rev. Rul. 78-316, 1978-2 C.B. 304.

[7] *See, e.g.*, TAM 200126032; LTR 9143048; LTR 8849023; TAM 7904006; *cf.* LTR 201703005 (accepting the taxpayer's representation that a state university is an integral part of a state).

is because since 2007 Treasury and the IRS have included "criteria for treating an entity as an integral part" on the Priority Guidance Plan, and the IRS ordinarily will not issue letter rulings on "an issue that cannot be readily resolved before a regulation or any other published guidance is issued."[8]

It is the IRS's position that integral part status and section 115 entities are mutually exclusive — that is, it is not possible for an entity to have "dual status" as both.[9] Moreover, the IRS has made clear that an entity may not be both an integral part and exempt under section 501(a) by reason of being described in section 501(c)(3) — in contrast to section 115 entities, which may have dual status as organizations described in section 501(c)(3).[10]

Despite the latter principle, it appears that the IRS has erroneously issued section 501(c)(3) determination letters to some state colleges and universities that are integral parts.[11] Thus, state colleges and universities that have obtained a section 501(c)(3) determination letter from the IRS may still conclude that they are integral parts and that their section 501(c)(3) determination letter was issued in error. If they reach this conclusion, and determine that significant disadvantages would not result from their voluntarily relinquishing section 501(c)(3) status, those colleges and universities may relinquish that status by submitting a letter to the IRS.[12]

An attorney with the Joint Committee on Taxation has acknowledged that although Congress intended to subject all state colleges and universities to section 4960, extending the definition of an ATEO to include state universities that are integral parts will most likely require a technical correction.[13] Until a technical correction is enacted, however, governmental entities that do not exclude income by reason of section 115 presumably may take the position that they are not subject to section 4960 as ATEOs.

## III. Remuneration

Of the various terms in section 4960, "remuneration" is perhaps the best defined.[14] Nonetheless, pending further guidance from Treasury and the IRS, tax-exempt employers face several difficult questions in determining the remuneration of their covered employees.

### A. Tax Year or Calendar Year?

On Form 990, tax-exempt employers report compensation based on amounts reported on Forms W-2 filed for the calendar year ending with or within the organization's tax year. Although Treasury and the IRS could issue guidance following this convention for section 4960 purposes, the statute itself refers to remuneration paid "for the taxable year."[15] Thus, pending further guidance, fiscal-year employers presumably should determine remuneration based on wages paid during their tax year, not the calendar year ending with or within their tax year. This would essentially correspond to how remuneration is determined for purposes of section 162(m), which focuses on remuneration allowable as a deduction (without regard to section 162(m)) in the tax year.[16]

If fiscal-year employers adopt this interpretation, the fact that section 4960 is effective for "taxable years beginning after December 31, 2017"[17] means that the employer will not include in remuneration any wages paid in 2018 before the beginning of their tax year that ends in 2019. Thus, many fiscal-year ATEOs are looking to accelerate bonuses or the vesting of benefits under nonqualified deferred compensation plans into their tax year ending in 2018, to prevent that remuneration from potentially being subject to the tax.[18]

[8] Rev. Proc. 2018-1, 2018-1 IRB 1, section 6.09.

[9] GCM 37657 (Aug. 31, 1978).

[10] Rev. Rul. 60-384, 1960-2 C.B. 172.

[11] *See, e.g.*, TAM 200126032.

[12] *See* Rev. Proc. 2018-5, 2018-1 IRB 233, section 3.01(12).

[13] Comments of Murthy, *supra* note 3.

[14] Section 4960(c)(3).

[15] Section 4960(a)(1).

[16] Section 162(m)(1).

[17] TCJA section 13602(c).

[18] Acceleration of section 457(f) compensation must be considered carefully to ensure the tax-exempt employer does not have a history of not enforcing the substantial risk of forfeiture, which is required to allow a deferral under section 457(f).

## B. Is an Employment Relationship Necessary?

Section 4960 defines remuneration as wages within the meaning of section 3401(a), which in turn defines compensation that is subject to federal income tax withholding. In general, this definition means remuneration will correspond to amounts reported in box 1 of the Form W-2, although the overlap is not exact (and wages are reported on Form W-2 on a calendar-year basis, not based on the employer's tax year).

The regulations under section 3401 define wages as "all remuneration for services performed by an employee for his employer."[19] For these purposes, an employee is an "individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee,"[20] which is "defined under the usual common law rules."[21]

Thus, the definition of remuneration itself indicates that only amounts paid by an ATEO for a covered employee's services performed under a common law employment relationship are potentially subject to the section 4960 excise tax. To the degree there was any ambiguity on this point, section 4960(a) clarifies that the tax is only imposed on remuneration paid "with respect to employment of" a covered employee. Therefore, remuneration does not appear to include — and the statute does not appear to impose a tax on — any payments for the performance of services other than as an employee. For example, remuneration would not include payments for the performance of services as an independent contractor that are reported on Form 1099-MISC (and which include services as a member of a board of directors).[22]

That said, the statute directs Treasury and the IRS to promulgate regulations to prevent avoidance of the excise tax "through the performance of services other than as an employee."[23] Until Treasury and the IRS release guidance, one cannot be certain whether any payments for the performance of services other than as an employee might result in remuneration. Given the scrutiny that has been applied over the years to tax-exempt organizations' use of professional management companies for the provision of executive services, these companies may be one place Treasury and the IRS focus in exercising their discretion to take into account payments other than wages.[24]

## C. Deferred Compensation

Section 4960 also specifies that remuneration includes "amounts required to be included in gross income under section 457(f)" and is "treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such remuneration."[25] In general, section 457(f) provides that if a plan of a public or tax-exempt employer for a deferral of compensation does not meet the requirements of section 457(b), the deferred compensation is included in the gross income of the participant or beneficiary in the first tax year in which there is no substantial risk of forfeiture to the rights of such compensation.

Some practitioners have claimed that there is a potential conflict in that remuneration is defined by reference to section 3401(a) on one hand, but includes amounts included in gross income under section 457(f) on the other hand. This presumed conflict apparently arises because, even though deferred compensation is included in income when no longer subject to a substantial risk of forfeiture, that compensation is not necessarily subject to federal income tax withholding until actually or constructively paid.[26]

However, the fact that the definition of remuneration expressly includes "amounts required to be included in gross income under section 457(f)" in addition to a general cross-reference to section 3401(a) means that those

[19] Reg. section 31.3401(a)-1(a).

[20] Reg. section 31.3401(c)-1(a).

[21] Reg. section 31.3401(a)-1(b)(14)(iv).

[22] Reg. section 31.3121(d)-1(b). Note that in general, there are few situations in which a person is both an employee and a contractor.

[23] Section 4960(d).

[24] *See, e.g.*, Form 990 instructions, at 27 (generally providing that a filing organization should not report a payment to a management company as a payment directly to an officer, director, trustee, or key employee, unless that individual is a common law employee of the filing organization under state law); *see also* Announcement 2011-36, 2011-26 IRB 933; Announcement 2001-33, 2001-1 C.B. 1137.

[25] Section 4960(a), (c)(3)(A).

[26] *See, e.g.*, TAM 199903032 (citing reg. section 31.3401(a)-1(b)).

amounts are remuneration regardless of whether they are also considered wages within the meaning of section 3401(a). Accordingly, while the cross-references to section 457(f) in section 4960 might not correspond precisely to the withholding principles of section 3401(a), the cross-references do not appear to create any conflict or inconsistency and generally alleviate rather than create any potential confusion. Nevertheless, ATEOs should be aware that — in addition to other variances between section 3401(a) and Form W-2 reporting — compensation includable in gross income under section 457(f) is "remuneration" even though a given employer might not subject the amount to withholding.[27]

Also, by providing that "remuneration shall be treated as paid when there is no substantial risk of forfeiture," the flush language in section 4960(a) can be interpreted as including some items in remuneration that might not otherwise be categorized as either section 3401(a) wages or amounts included in gross income under section 457(f). For example, an amount earned in one year and paid in the first two and a half months of the following year can either be under a method treating that payment as taxable in the year vested (that is, when there is no substantial risk of forfeiture) or as a short-term deferral taxed in the following year.[28] If paid and taxed in the following year, those amounts are not section 3401(a) wages or included in gross income under section 457(f) in the year vested. Nonetheless, if the earnings are "treated as paid when there is no substantial risk of forfeiture," they appear to be included in remuneration in the vesting year for purposes of section 4960. Treasury and the IRS will hopefully clarify whether those and similar items are brought into section 4960's ambit by the flush language in section 4960(a).[29]

### D. Remuneration for Medical Services

The definition of remuneration includes several exceptions,[30] the most important of which may be remuneration paid to licensed medical professionals for the performance of medical services.[31] At many hospitals some medical specialists, such as surgeons, routinely earn more than $1 million, and the medical services exception ensures that amounts paid to those specialists for the performance of medical services will not be subject to the excise tax.

The statute does not define medical services. While it is clear that the direct delivery of healthcare services to a patient (such as the performance of surgery) constitutes the performance of a medical service, it is less clear whether the exception would cover supervising the delivery of those services (for example, in the case of a chief medical officer), teaching medical students, or conducting medical research. The conference report's explanatory statement refers to remuneration that is "directly related" to the performance of medical services, implying some distinction between directly and indirectly related services, but neither the statute nor the conference report provides insight into which side of the line supervisory, teaching, or research activities may fall.[32]

The conference report also suggests that if a licensed medical professional receives remuneration both for medical services and for other kinds of services, the latter is taken into account while the former is not.[33] However, the conference report does not shed light on how a tax-exempt employer should allocate a licensed medical professional's remuneration between medical and "other" services. For guidance, one could look to the existing deduction allocation rules for dual-use facilities under the unrelated

[27] Quite a few tax-exempt organizations report and withhold on section 457(f) vesting amounts to make sure the employee has sufficient income tax withheld for the year.

[28] Prop. reg. section 1.457-12(d)(2).

[29] As another example, when deferred compensation is included in gross income under section 457(f), subsequent earnings on that deferred compensation are not treated as section 3401(a) wages until they are distributed (or otherwise made available to the employee) and are not included in income under section 457(f). Nevertheless, if those nontaxable, undistributed earnings are "treated as paid when there is no substantial risk of forfeiture," they could have to be included in remuneration for purposes of section 4960.

[30] Other exceptions include designated Roth contributions (as defined in section 402A(c)), "excess parachute payments," and remuneration for which a deduction is not allowed by reason of section 162(m). *See* section 4960(c)(3)(A), (c)(5), and (c)(6).

[31] Section 4960(c)(3)(B).

[32] Conference Committee's Explanatory Statement for H.R. 1, at 494 (Dec. 15, 2017).

[33] *Id.* ("Remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account, whereas remuneration paid to such a professional in any other capacity is taken into account.").

business income tax regulations, which require that deductions attributable to facilities or personnel used in both an unrelated trade or business and exempt activities be allocated on a "reasonable basis" between the two functions.[34]

### E. Remuneration Paid by Related Organizations

The statute provides that "remuneration of a covered employee by an applicable tax-exempt organization shall include any remuneration paid with respect to employment of such employee by any related person or governmental entity."[35] This language is difficult to parse and could be subject to differing interpretations. The most natural reading likely is that any remuneration paid to a covered employee of an ATEO for services performed under that employee's common law employment relationship with an organization related to the ATEO will be taken into account in determining whether and by how much remuneration exceeds $1 million and is subject to excise tax. Presumably, absent further guidance, any amount paid to a covered employee of an ATEO by a related organization would not be taken into account if it were paid for the compensation of services performed for the related organization in a capacity other than as an employee — for example, as an independent contractor, board member, or partner.

For partners, if a covered employee of an ATEO were provided a profits interest in a related organization of an ATEO treated as a partnership for federal income tax purposes, the partnership income the covered employee would derive from the partnership (and upon redemption of the profits interest) would not generally constitute section 3401(a) wages. Also, the granting of the profits interest itself generally would not result in taxable income if the profits interest were compensation for services provided to or for the benefit of the partnership, rather than the ATEO, and certain other requirements were met.[36] Similarly, if a covered employee of an ATEO were provided stock in a related corporation, dividends therefrom (and gain upon disposition of the stock) would not constitute section 3401(a) wages once the stock was fully vested and included in compensation.[37] Thus, section 4960 might increase the use of equity interests in related organizations of an ATEO to compensate the ATEO's covered employees. That said, section 4960 does instruct Treasury and the IRS to issue regulations as may be necessary to prevent avoidance of the tax by "providing compensation through a pass-through or other entity to avoid such tax."[38]

### F. Definition of a Related Organization

The statute provides that a person or governmental entity shall be treated as related to an ATEO if that person or governmental entity: (1) controls or is controlled by the ATEO; (2) is controlled by one or more persons that control the ATEO; (3) is a supporting or supported organization during the tax year with respect to the ATEO; or (4) in the case of an ATEO that is a voluntary employees' beneficiary association (VEBA), establishes, maintains, or makes contributions to the VEBA. This definition mirrors the definition of related organization used for Form 990.[39]

The statute also provides that in any case in which remuneration from more than one employer is taken into account in determining the excise tax, each employer is liable for an amount of tax proportionate to the relative amount of remuneration the employer pays.[40]

The definition of related organization, and the accompanying imposition of tax on related organizations, raises several questions. First, how will control be defined? Only one code provision defines control by a tax-exempt organization: section 512(b)(13), which subjects certain payments from controlled entities to the

[34] Reg. section 1.512(a)-1(c).

[35] Section 4960(c)(4)(A).

[36] *See* Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343.

[37] The IRS has blessed a tax-exempt organization's granting of stock in a corporate subsidiary as compensation for the tax-exempt organization's employees in several private letter rulings. *See, e.g.*, LTR 201125043; LTR 200602041; LTR 200225046.

[38] Section 4960(d).

[39] *See* 2017 Form 990 instructions, at 70.

[40] Section 4960(c)(4)(C). This ratable allocation of tax among concurrent employers is consistent with section 4960(b), which states that "the employer shall be liable for the tax" without specifying the ATEO.

unrelated business income tax. Treasury and the IRS could also draw upon regulations governing supporting organizations, which contain definitions of the terms "controlled by" and "controlled in connection with."[41] Also, section 414 and the regulations thereunder define when common control exists between an exempt organization and another organization,[42] and section 414 is itself cross-referenced in section 162(m).[43] Finally, the Form 990 instructions contain a detailed definition of control, which Treasury and the IRS might use given how closely the definition of related organization in those instructions tracks the definition used in section 4960.[44]

Second, unlike the definition of an ATEO, which captures governmental entities only by reference to section 115, the definition of a related organization includes a "governmental entity." It seems uncontroversial that the term governmental entity captures state or local governmental units — as well as integral parts thereof — that rely on the doctrine of implied statutory immunity rather than section 115 as their basis for not paying federal income tax.[45]

Thus, even if a state university is not itself an ATEO, if an ATEO is related to that state university and concurrently employs, for example, the coach of the university's football team, and that coach is a covered employee of the ATEO, any remuneration paid by the state university could presumably be taken into account in determining whether the $1 million threshold is crossed. The state university would be liable for its proportionate share of any excise tax. In other words, while the state university could not be subject to tax as an ATEO, it could be subject to tax as an organization related to an ATEO.

Third, nothing in the relevant definition excludes a taxable entity from being categorized as a related organization. Therefore, a taxable entity could be subject to section 4960 as a result of having to pay its pro rata share of the tax as a person related to an ATEO. While a somewhat odd result, it would be consistent with section 4960(c)(6), which provides that "remuneration the deduction for which is not allowed by reason of section 162(m) will not be taken into account for purposes of" the excise tax. Only a taxable entity (and, more specifically, a publicly held corporation) may have a deduction disallowed by reason of section 162(m), so apparently Congress contemplated that remuneration from taxable entities could, absent the applicability of section 4960(c)(6), be subject to the excise tax.

By not including any exception for taxable entities, Congress has effectively imposed the equivalent of section 162(m) on some privately held companies merely because of their relationships with ATEOs, putting them at an economic disadvantage vis-à-vis other privately held taxable entities that do not have such relationships.

Finally, the reference to organizations related to VEBAs apparently contemplates a situation in which the VEBA itself employs individuals. Most VEBAs do not have employees (though some of the larger ones may), and thus cannot have covered employees to whom remuneration is paid with respect to employment by the VEBA.

## G. Contracts That Predate Section 4960

The significant changes to section 162(m) that were made by the TCJA do not apply to remuneration provided under a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after that date.[46] A similar grandfather rule

[41] Reg. section 1.509(a)-4(g), (h). These regulations also contain a separate definition of control for purposes of determining whether the supporting organization is controlled by disqualified persons. *See* reg. section 1.509(a)-4(j). Also, the regulations under sections 4941 and 4958 contain definitions of control for purposes of determining, respectively, whether indirect self-dealing and excess benefit transactions have occurred. *See* reg. section 53.4941(d)-1(b)(5); reg. section 53.4958-4(a)(2)(ii)(B). Finally, the regulations under section 4942 contain a definition of control for purposes of determining whether a private foundation has made a contribution to an organization it controls. *See* reg. section 53.4942(a)-3(a)(3).

[42] *See*, *e.g.*, reg. section 1.414(c)-5(b).

[43] Section 162(m)(5)(B)(iii), (6)(C)(ii).

[44] *See* 2017 Form 990 instructions, at 57.

[45] One can expect that Treasury and the IRS will define governmental entity to include not only state and local governments (and their integral parts) but also agencies or instrumentalities of governmental units, which should encompass most section 115 entities. *See*, *e.g.*, reg. section 1.6050S-1(d)(3) (referring to each of "a governmental unit, or an agency or instrumentality of a governmental unit" as a governmental entity); reg. section 54.4980H-1(a)(23) (defining government entity to include states, political subdivisions, and "any agency or instrumentality of any of the foregoing.").

[46] TCJA section 13601(e)(2).

was included in section 162(m) when it was first enacted in 1993, providing that the term "applicable employee remuneration" did not include any remuneration payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before the remuneration was paid.[47] These grandfather rules make policy sense, given that the remuneration memorialized by the grandfathered contracts was negotiated by employers based on the assumption that a deduction would be available for payments made thereunder. Presumably, employers would have negotiated lower remuneration had they expected a deduction would not be available.

In contrast to section 162(m), section 4960 contains no such grandfather rule. Thus, tax-exempt employers that negotiated remuneration before any knowledge that they might have to pay tax on remuneration exceeding $1 million are not accorded any relief by the statute itself. It is open to question whether Treasury and the IRS may decide to grant transition relief to these employers for employment contracts entered into before November 2, 2017 (that is, when ATEOs were first put on notice that section 4960 could become part of tax reform legislation).

## IV. Covered Employee

While the statute's definition of remuneration raises many questions, the meaning of that term is certainly clearer than the definition of covered employee. The statute defines a covered employee as "any employee (including any former employee) of an applicable tax-exempt organization" if the employee "is one of the 5 highest compensated employees of the organization for the taxable year" or "was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016."[48] However, the statute does not provide definitions or guidelines regarding how to determine who are the five highest compensated employees.

The concept of a covered employee is borrowed from section 162(m), which, as amended by the TCJA, defines a covered employee as including a publicly held corporation's principal executive officer, principal financial officer, and employees for whom compensation is required to be reported to shareholders under SEC disclosure rules by reason of being among the three highest compensated officers.[49] By referring to the SEC disclosure rules, section 162(m) uses a defined and known standard for determining the three highest compensated officers. Of course, the SEC disclosure rules have no applicability to tax-exempt organizations, and Congress would not have wanted to limit section 4960's applicability to executive officers if it intended to tax the "excess" compensation of highly paid employees like college football and basketball coaches. Unfortunately, Congress provided no replacement for the SEC disclosure rules and thus no guidelines whatsoever for determining an ATEO's five highest compensated employees. This gap leads to a host of difficult questions and issues.

### A. How Is Employee Defined?

The term "covered employee," and the definition of this term as an employee who is or was one of the five highest compensated employees, suggests that an individual must be an employee of the ATEO to be a covered employee. Pending further guidance, it seems reasonable to assume that an employee is defined under the usual common law rules.[50]

If common law employment standards govern, an ATEO cannot necessarily argue that an individual is not one of its covered employees simply because another entity issues the individual a Form W-2 or a paycheck. Thus, if one entity in a system of related organizations issues a Form W-2 and acts as a payroll agent for all the related organizations, it will not automatically be considered the employer for purposes of determining the five highest compensated employees. Rather, as discussed below, one might need to look independently at each ATEO in the

[47] Section 162(m)(4)(B).

[48] Section 4960(c)(2).

[49] Section 162(m)(3).

[50] *See, e.g.*, reg. section 31.3401(c)-1(a); reg. section 31.3401(a)-1(b)(14)(iv).

system with which each individual has a common law employment relationship to identify the five highest compensated employees for each ATEO.

## B. How Is Compensation Defined?

In contrast to remuneration (which is defined by reference to section 3401(a) wages), the statute does not define compensation for purposes of determining the five highest compensated employees. In the absence of any statutory definition, one option would be to assume that compensation for these purposes is limited to wages as defined in section 3401(a) (perhaps along with amounts required to be included in gross income under section 457(f)). Supporting this approach is the fact that the legislative history — and even the title of section 4960 itself — appears to use the terms "compensation" and "remuneration" interchangeably.[51] Another option would be to use the more expansive definition of compensation used for the Form 990, which includes not only wages reported on Form W-2 but also amounts reported on Form 1099-MISC and deferred compensation not taxable in the current year. A third option might be to (to the extent possible) try to draw from the definition of compensation used in the SEC disclosure requirements.

## C. Payments for Medical Services

Related to how compensation should be defined for purposes of identifying covered employees is whether remuneration paid to a licensed medical professional for the performance of medical services should be disregarded. On the one hand, the fact that the statute only carves those payments out of "remuneration" might suggest that one should not disregard the payments in determining the five highest compensated employees. On the other hand, the conference report's explanatory statement provides that "*for purposes of determining a covered employee*, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services . . . is not taken into account."[52] Moreover, as a policy matter, it is difficult to imagine that Congress would want some highly paid licensed medical professionals to reduce the number of employees subject to the excise tax by including them in an ATEO's five highest compensated employees based on remuneration that could never be subject to the excise tax.

## D. Compensation by Related Organizations

The statute is equally silent regarding whether and to what extent compensation paid to an ATEO's employee by a related organization should be taken into account in determining that ATEO's five highest compensated employees. At a minimum, one might consider including compensation paid by a related organization to the extent such compensation relates to services provided to the ATEO. Much less certain is whether one must apply a rule similar to that used for remuneration, which appears to include amounts paid to a covered employee of an ATEO for services provided to a related organization as an employee of that related organization.

Taking compensation paid by related organizations into account in determining covered employees could create significant issues. Consider, for example, a situation in which a highly paid executive of a taxable company also receives de minimis compensation for serving as an officer of a company-sponsored foundation that is an ATEO. If all compensation paid by related organizations is taken into account in determining covered employees, that executive could be considered a covered employee of the foundation, even though her compensation for services to the foundation is minimal. Indeed, unless guidance provides otherwise, even if the foundation paid no compensation to the officer, she could be considered an employee of the foundation — and a covered employee if

[51] Explanatory Statement, *supra* note 32; Ways and Means Section-by-Section Summary, *supra* note 1.

[52] Explanatory Statement, *supra* note 32 (emphasis added).

compensation from the taxable company were included — if it is determined that she provides more than "minor services" to the foundation.[53]

If each ATEO in a system of related ATEOs must determine its covered employees separately (an issue discussed separately below) and if an individual is employed by more than one ATEO in the system, including the compensation of related organizations could also increase the number of ATEOs for which that individual will be considered a covered employee. Whether that result will increase the total amount of excise tax owed will depend on the circumstances.[54] On the one hand, this result could increase the chances of the individual showing up on the list of the five highest compensated employees of at least one ATEO. On the other hand, the same individual could end up taking up a "slot" on the list of five highest compensated employees for multiple ATEOs, bumping off the list other individuals whose remuneration might otherwise be taxed.

It is worth noting that compensation paid by related organizations generally is included when determining the five highest compensated employees for purposes of the Form 990. Moreover, the SEC disclosure requirements generally look to compensation paid within the entire affiliated group in determining the three highest compensated employees.

### E. Covered Employees of Related ATEOs

The statute appears to contemplate that each ATEO will determine its covered employees separately, regardless of whether it is related to other ATEOs. That interpretation would mean that one system of related ATEOs may have many more than five covered employees. Treating a group of related ATEOs as one employer, with only five covered employees across the entire group (based on compensation paid by all organizations in the group) would be an alternative, perhaps more administrable approach, but is less obviously supported by the statutory language.

If covered employees are determined separately for each related ATEO, an individual employed by more than one related ATEO could be a covered employee of multiple related ATEOs. If that happens, an ATEO could theoretically be taxed on its portion of a covered employee's remuneration exceeding $1 million more than once — once as an ATEO and then again as a related organization — based on a literal application of the statute. For example, suppose a covered employee of both ATEO A and ATEO B received salaries of $1 million from A and $2 million from B (meaning total remuneration of $3 million and "excess compensation" of $2 million). Would A have to pay one-third of the excise tax owed on the $2 million excess once as an ATEO and then again as an organization related to B? That result seems exceptionally harsh and likely unintended, but nevertheless appears to require clarification from Treasury and the IRS.

### F. Disregarded Entities

A disregarded entity is disregarded for most federal tax purposes except for employment tax purposes.[55] In other words, a disregarded entity that is a common law employer of an employee is responsible for the employment taxes for that employee. However, the default rule to disregard the entity for other tax purposes should prevail for section 4960, allowing an ATEO to ignore its disregarded entities when determining its five highest compensated employees. Clarification from Treasury and the IRS on this point would be helpful.

### G. Is Compensation Determined on a Tax Year?

Because the statute refers to the "5 highest compensated employees of the organization for the taxable year," and in the absence of further guidance, it appears that the tax year of the ATEO (and not the calendar year ending with or within

[53] Reg. section 31.3401(c)-1(f). Treasury and the IRS could provide relief (assuming they have the statutory authority to do so) by issuing guidance that excepts some volunteer executives of related for-profit organizations from the definition of covered employee, similar to the "volunteer exception" to reporting compensation of volunteer officers and directors on Form 990. Under the Form 990 volunteer exception, a tax-exempt organization need not report compensation paid by a related organization to a volunteer officer, director, or trustee of the tax-exempt organization if the related organization is a for-profit organization, is not owned or controlled directly or indirectly by the filing organization or one or more related tax-exempt organizations, and does not provide management services for a fee to the filing organization. *See* 2017 Form 990 instructions, at 29.

[54] This assumes, of course, that remuneration of a covered employee of multiple related ATEOs would be taxed only once.

[55] Reg. section 301.7701-2(c)(2)(iv).

that tax year) should be used to identify covered employees. That approach would be consistent with how the three highest compensated officers are determined under the SEC disclosure requirements.

In addition to employees that were among the five highest compensated employees in the tax year at issue, the definition of covered employee includes any employee who "was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016."[56] If covered employees are determined based on an ATEO's tax year, some fiscal year taxpayers have not yet fixed their five highest compensated employees. For example, an ATEO with a tax year that began October 1, 2017 (ending September 30, 2018), has not completed its tax year beginning after December 31, 2016, as of the publication of this article.

### H. Forever Covered?

The statute provides that a covered employee may include not only an employee but also a "former employee." Also, as noted above, the statute defines a covered employee as including an employee who "was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016." Thus, it appears that once an individual is classified as a covered employee of an ATEO, that individual's status as a covered employee exists in perpetuity, without regard to the receipt of payments arising from employment with that entity. If, for example, an individual is one of an ATEO's five highest compensated employees in 2018, and in 2019 ceases employment with the ATEO and becomes an employee of a related organization in which that individual is not one of the five highest compensated employees, that individual would presumably still be considered a covered employee of the ATEO in 2019. As a result, any remuneration paid to the individual by the related organization in 2019 would appear to be considered remuneration paid to a covered employee for purposes of the excise tax.

## V. Procedural Questions

### A. Estimated Payments

The TCJA did not amend the statutory provisions governing estimated taxes to include the section 4960 excise tax.[57] Thus, estimated tax payments are not required for section 4960 liabilities, and the earliest any ATEO (namely, those on a calendar year) will have to pay the excise tax will be May 15, 2019.

### B. How Will the Tax Be Reported and Paid?

Most excise taxes under chapter 42 are reported and paid on Form 4720, so it is likely the tax will be remitted with this form. In fact, the director of the IRS's Exempt Organizations Division recently suggested as much.[58]

Whichever form the IRS decides to use for reporting and payment of the Form 4960 excise tax, reg. section 53.6011-1 will most likely need to be amended to reflect section 4960 filing requirements.

### C. Section 4960 and Audit Risk

In explaining the rationale behind section 4960, the legislative history suggests that "some may question whether excessive executive compensation diverts resources from" the purposes that form the basis for exemption.[59] Moreover, the title of section 4960 refers to "excess" compensation, which would seem to imply that compensation exceeding $1 million is per se excessive. Nevertheless, there is no reason to think that the enactment of section 4960 has changed current standards applicable to determining whether remuneration might jeopardize exemption as a result of being

[56]Because the new statute does not define what a predecessor organization is, ATEOs involved in mergers or consolidations could find themselves in the difficult position of attempting to divine how broadly, or narrowly, Treasury and the IRS may construe that term until guidance is issued. Varying definitions of predecessor and successor organizations can be found in the code, regulations, and other forms and guidance, although neither section 4960 nor the legislative history provides insight into Congress's intent in making covered employees of a predecessor ATEO the covered employees of a successor ATEO as well. *See, e.g.*, section 3121(a)(1); reg. section 1.415(f)-1(c); PMTA 2011-11 (Feb. 10, 2011); and Form 1023, Schedule G, "Successors to Other Organizations."

[57]Sections 6654(l)(3) and 6655(g)(3).

[58]Comments of Margaret Von Lienen at the 2018 Washington Non-Profit Legal & Tax Conference (Mar. 23, 2018).

[59]Ways and Means Section-by-Section Summary, *supra* note 1.

excessive.[60] Nor is there any basis to suspect that tax under section 4960 results in remuneration constituting a "self-dealing" transaction under section 4941 (in the case of a private foundation), or an "excess benefit transaction" under section 4958 (in the case of public charities described in section 501(c)(3) or organizations described in section 501(c)(4) or (29)).[61]

## VI. Conclusion

Perhaps because of the many difficult questions raised above, Treasury and the IRS have prioritized "guidance on certain issues relating to the excise tax on excess remuneration paid by 'applicable tax-exempt organizations' under section 4960" in the 2018-2019 Priority Guidance Plan.[62] In preparing for the impact of section 4960, tax-exempt employers will need to, among other things, identify the individuals with whom they have a common law employment relationship (regardless of whether they issue Forms W-2 to those individuals); determine whether those individuals are covered employees (regardless of whether remuneration paid to the individuals exceeds $1 million); and consider whether and to what extent less obvious remuneration, such as payments from related organizations or nonqualified deferred compensation, must to be taken into account. Tax-exempt employers thinking through how section 4960 will apply to their facts are in the best position to flesh out the issues for which guidance is needed, to call Treasury and the IRS's attention to these issues, and to recommend administrable solutions. Hopefully, the outline of questions and issues above will assist tax-exempt employers in this endeavor when Treasury and the IRS inevitably request comments on how best to proceed with guidance. ■

[60] Under current law, payments for services that exceed reasonable compensation may result in private inurement or non-incidental private benefit, which may jeopardize exemption.

[61] A government official recently stated that section 4960 exposure should not affect the application of section 4958. *See* Clay comments, *supra* note 3.

[62] *See* Treasury, "2017-18 Priority Guidance Plan: Second Quarter Update," at 6 (Feb. 7, 2018).