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Taxes on Executive Compensation for Tax-Exempt Employers

by **Farah N. Ansari**

The 2017 Tax Cuts and Jobs Act enacted new Section 4960 of the Internal Revenue Code, which imposes an excise tax on certain executive compensation.¹ On Dec. 31, 2018, the Department of the Treasury and Internal Revenue Service released Notice 2019-09, which provides interim guidance pending the issuance of proposed regulations. *At the time this article was submitted for publication, proposed regulations had not yet been issued.*

Code Section 4960 imposes an excise tax on applicable tax-exempt organizations (ATEOs) and “related entities” at the corporate tax rate, currently 21 percent, that pay “excess remuneration” and “excess parachute payments” to “covered employees.” The law provides an important exception from the excise tax for amounts paid to licensed medical professionals and veterinarians.

The following brief discussion is meant to highlight certain aspects of the law, including the medical services exception.

Background

In general, organizations exempt from taxation under code Section 501(a) are subject to numerous rules, including a prohibition on private inurement. If an “insider” of a tax-exempt organization receives any portion of the income or assets of such an organization in an amount greater than the value of consideration or services he or she provides to the organization, there may be prohibited “private inurement.”² Additionally, there are potential excise taxes on “disqualified persons” for excess benefit transactions under code Section 4958 for public charities. There are also potential excise taxes on self-dealing transactions under code Section 4941 with respect to private foundations.³ These rules often focus on whether compensation is “reasonable.”

Code Section 4960 imposes an excise tax on ATEOs similar to the manner in which the golden parachute rules under code Section 280G and Section 4999 operate and the rules disallowing deductions for “excess compensation over \$1 million” under code Section 162(m) apply to for-profit organizations. Effectively, code Section 4960 implements a tax on the employer (or related employers) based on certain bright-line criteria, and is in addition to the above-mentioned more general rules applicable to certain tax-exempt organizations and their insiders.

Mechanics of the Operation of Section 4960

The code Section 4960 excise tax is on the sum of: 1) remuneration paid (other than “excess parachute payments”) by an ATEO for the taxable year “with respect to employment of any covered employee” that exceeds \$1 million, and 2) any excess parachute payment paid by such organization to a covered employee.⁴

An ATEO is an organization that: 1) is exempt from taxation under code Sec-

tion 501(a); 2) has income excluded under code Section 115(1); 3) is a political organization under code Section 527(e)(1); or 4) is a farmers’ cooperative organization as set forth in code Section 521(b)(1).⁵ Code Section 4960 is effective for taxable years beginning after Dec. 31, 2017.

A covered employee is a current or former employee of an ATEO who is among the five highest compensated of the ATEO for the taxable year, or was a covered employee of the ATEO for any prior taxable year beginning after Dec. 31, 2016.⁶

Remuneration of a covered employee by an ATEO includes “remuneration paid with respect to employment of such employee by any related person or governmental entity.”⁷ Code Section 4960 deems a person or governmental entity “related” to the ATEO if the person or governmental entity “(1) controls or is controlled by the organization; (2) is controlled by one or more persons which control the organization; (3) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the organization; or (4) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the organization.”⁸ Control is based on greater than 50 percent ownership for stock corporations or, with respect to nonstock organizations, when greater than 50 percent of the directors or trustees are representatives of or controlled by the other entity.⁹ If more than one entity is liable for the tax, then the tax is imposed on the group of related entities on a *pro rata* basis, based on the remuneration paid by each entity.¹⁰

Remuneration generally includes wages and amounts required to be included in gross income under code Section 457(f).¹¹ As discussed below, remuneration does not include amounts paid for “medical services.”¹²

Excess Parachute Payments

The rules governing excess parachute payments are modeled after the code Section 280G rules. For purposes of code Section 4960, excess parachute payment is defined as “an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.”¹³

Parachute payment is defined as a payment “in the nature of compensation to (or for the benefit of) a covered employee if (1) such payment is contingent on such 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) such individual which are contingent on such separation equals or exceeds an amount equal to 3 times the base amount.”¹⁴ The base amount is determined under rules “similar to the rules of 280G(b)(3).”¹⁵ There are a number of exceptions to parachute payments, including, critically, amounts for medical services, as discussed in the following section.¹⁶

The Medical Services Exception

Code Section 4960 includes an exception from the definitions of both remuneration and parachute payments for certain medical services. In other words, if amounts are paid for certain qualifying medical services, then such amounts are excepted from the potential code Section 4960 excise tax.

Remuneration that is paid to a licensed medical professional or veterinarian for the direct performance of medical services (including nursing services) or veterinary services, is not counted toward the excess remuneration amount or the excess parachute payment. Payments for administrative and management services performed by the professional, however, are not excluded and, therefore, count toward the code Section 4960 excise tax. Notice 2019-09 defines a licensed medical pro-

fessional as an “individual who is licensed under state or local law to perform medical services (including nursing services) or veterinary services.”¹⁷ Medical services must fall within the definition of medical care, as defined in code Section 213(d)(1)(A) and the corresponding Treasury Regulations.

Notice 2019-09 provides that “medical services are services for the diagnosis, cure, mitigation, treatment, or prevention of disease, including services for the purpose of affecting any structure or function of the body.” Teaching or research services are generally not considered medical services.¹⁸ Notice 2019-09 further explains that while documenting the care and condition of a patient is “the direct performance of medical services,” performance of administrative duties, such as managing the operations of an organization, including scheduling and staffing, are not the performance of medical services.¹⁹

A reasonable, good faith allocation must be made by the employer for those employees who perform both medical services and other services, such as administrative services. If an employment agreement or other agreement sets forth an allocation of remuneration for particular services, then that allocation must be respected, “unless the facts and circumstances demonstrate that the amount allocated for medical services is unreasonable for those services or that the allocation was established for purposes of avoiding application of the excise tax under section 4960.”²⁰

Notice 2019-09 provides examples to help illustrate these rules (assume there is no employment or other agreement setting forth an allocation of remuneration for services for the below example).

C is a medical doctor who is employed by a university hospital that is an ATEO. C’s duties include overseeing and teaching a group of resident physicians who have a restricted license to practice medicine. C’s

duties include supervising and instructing the resident physicians while they treat patients. C’s other duties include instructing the resident physicians in a classroom setting. To the extent that C, in conjunction with the resident physicians, performs services directly related to the diagnosis, cure, mitigation, treatment or prevention of a patient’s disease, or affecting a structure or function of the patient’s body, those services constitute “medical care” for purposes of section 213(d), and, thus, C directly performs medical services. Accordingly, any remuneration allocable to those medical services is not remuneration for purposes of the excise tax. However, because classroom instruction does not involve actual patient treatment, those activities are not medical care for purposes of section 213(d), and, thus, do not constitute the direct performance of medical services. Accordingly, any remuneration allocable to those services is remuneration for purposes of section 4960.²¹

Organizations potentially subject to the code Section 4960 tax employing professionals providing medical services must be mindful of the above rules and implement procedures to capture the necessary information needed to comply with these rules.

Reporting

An excise tax imposed pursuant to code Section 4960 is reported and paid using IRS Form 4720, titled “Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.” The tax must be paid by the 15th day of the fifth month after the end of the employer’s taxable year. An employer may file a Form 8868, titled “Application for Automatic Extension of Time to File an Exempt Organization Return,” to request an automatic extension to file Form 4720; however, the extension does not extend the time to pay the tax. If the tax is paid late, then interest and penalties will accrue.²²

Conclusion

Organizations subject to code Section 4960 must consider these rules when determining compensation for their employees and when filing returns. In addition, tax-exempt organizations must continue to comply with other existing rules, such as the prohibition against private inurement, the excess benefit rules and the self-dealing rules for private foundations. Notice 2019-09 specifically states that code Section 4960 and the excess benefit and self-dealing rules are not linked. For instance, if an excise tax is due pursuant to Section 4960, that does not necessarily mean an excise tax is due under the code Section 4958 excess benefit or the code Section 4941 self-dealing rules. Finally, although Notice 2019-09 does address certain questions, tax advisors still lack some guidance until proposed regulations are issued. ◊

Endnotes

1. Section 13602 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97.
2. “An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.” Treas. Reg. § 1.501(c)(3)-1(c)(2).
3. Code Sections 4958 and 4941 also provide for excise taxes on certain “managers.”
4. Code Section 4960(a).
5. Code Section 4960(c)(1).
6. Code Section 4960(c)(2). Notice 2019-09 Q&A 10 provides additional guidance on how the five highest-compensated employees are determined and includes a “limited services exception.”
7. Code Section 4960(c)(4)(A).
8. Code Section 4960(c)(4)(B). There is

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Endnotes

1. Pub. L. 115-97.
2. References to 'stock deals' or the like throughout this article, unless otherwise specified, are intended to apply to acquisitions of corporate stock, limited liability company membership interests, or other types of equity interests in business entities.
3. This is because the acquisition of 100 percent of an LLC's membership interests, where the LLC is not taxed as a corporation, is treated as an asset deal from the buyer's perspective for tax purposes. See Rev. Rul. 99-6. Even if the LLC will remain a partnership for tax purposes after the sale (*i.e.*, more than one member, and no election to be taxed as a corporation), stepped-up basis in the LLC's assets is possible if the LLC makes an election under code Section 754.
4. Code § 197.
5. Code § 168(k).
6. Code § 965.
7. See also Treas. Reg. § 301.7701-2(c)(2)(i) and Treas. Reg. § 301.7701-3(b)(1)(ii).
8. Code §§ 871(b), 882(a).
9. Code § 875(1).
10. *Grecian Magnesite Mining, Indus. & Shipping Co., SA v. Comm'r*, 149 T.C. 63 (2017).
11. IRS Notice 2018-29.
12. Prop. Treas. Reg. § 1.1446(f)-2(b).
13. See N.J.S.A. 54:50-38.
14. Code §338(d)(3).
15. Treas. Reg. § 1.338(h)(10)-1.
16. See Code § 453.
17. See Code § 1221.
18. See, *e.g.*, Code §§ 862(a)(5), 865(a).
19. See, *e.g.*, Code § 382.

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- one additional way to be a 'related organization' in the case of an ATEO that is a voluntary employees' beneficiary association as set forth in code Section 501(c)(9). Code Section 4960(c)(4)(B)(v).
9. Notice 2019-09, Q&A 8. For partnerships control means ownership of more than 50 percent of the capital or profits interest and for trusts ownership of more than 50 percent of the beneficial interests.
 10. Code Section 4960(c)(4)(C). The liability for the tax is on the employer. Code Section 4960(b). Notice 2019-09 Q&A 14 clarifies how the tax is imposed if remuneration is

- paid by an ATEO and other employers that are related entities.
11. Code Section 4960(c)(3)(A).
 12. Code Section 4960(c)(3)(B).
 13. Code Section 4960(c)(5)(A).
 14. Code Section 4960(c)(5)(B).
 15. Code Section 4960(c)(5)(D).
 16. The other exceptions are listed in code Section 4960(c)(5)(C). Note that the term 'parachute payment' also does not include payments made to an individual who is not a highly compensated employee under code Section 414(q). Code Section 4960(c)(5)(C)(iv).
 17. Notice 2019-09, Q&A 15.
 18. *Id.*
 19. *Id.*
 20. *Id.*
 21. Notice 2019-09, Q&A 15, Example 3.
 22. Notice 2019-09, Q&A 34.

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7. *VNO 1105 State Hwy 36, L.L.C. by Stop & Shop v. Twp. of Hazlet*, 31 N.J. Tax 112, 133 (Tax 2019), *reconsideration denied sub nom.*
8. *Id.*
9. N.J.A.C. 18:12A-1.9(l) states "no assessor shall appear before the board as an expert witness against another assessor or taxing district within the State except to defend the assessment of his or her taxing district."
10. Letter from Philip James Degnan to Hon. Sheila Y. Oliver, April 30, 2019, https://www.nj.gov/comptroller/news/docs/osc_letters_to_dca_taxation.pdf.
11. A-1169/S-3276, 2018 Leg., 218th Sess. (N.J. June 21, 2019).
12. *Handbook for New Jersey Assessors*, § 106.01, revised Oct. 2018.

13. *VNO*, 31 N.J. Tax at 124, fn 10.
14. N.J.S.A. 40A:9-22.1 to 22.25.
15. N.J.S.A. 40A:9-146 to 146.3.
16. N.J.S.A. 40A:9-22.5.
17. A-2004 3R/S-2673 2R, 2018 Leg., 218th Sess. (N.J. passed both Houses on June 20, 2019) amending N.J.S.A. 54:3-27.2.
18. N.J.S.A. 54:3-27.2.
19. S3631, 2018 Leg., 218th Sess. (N.J. May 13, 2019).