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## Nonprofit Tax on Excess Compensation Could Ensnare For-Profits as Well

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### ***Speed Read***

The IRS has released interim guidance interpreting portions of the 2017 Tax Cuts and Jobs Act (the Act) related to executive compensation for tax-exempt entities. This alert highlights a key provision of the Act that may unexpectedly ensnare many tax-exempt **and** for-profit entities. ***This provision could result in the imposition of tax on for-profit entities whose highly paid executives serve on a volunteer basis as officers or employees of related charitable organizations.***

## EXCISE TAX IMPOSED ON EXCESS EXECUTIVE COMPENSATION

The Act adds a new excise tax applicable to certain tax-exempt employers. Effective for taxable years beginning after December 31, 2017, an excise tax of 21% will be imposed on an applicable tax-exempt organization (ATEO) if it pays compensation in excess of \$1 million – not indexed for inflation – to its “covered employees.” The excise tax is applicable to any organization exempt under Code Sections 501(a) (including 501(c)(3) public charities, private foundations, and other 501(c) exempt organizations), 115(1), or 527, and exempt farmers’ cooperatives. The organization, and not the covered employee, is responsible for payment of the excise tax.

Subject to a very narrow exception, a covered employee is defined as (1) one of the five highest-compensated employees of the ATEO for the taxable year<sup>[1]</sup>, or (2) any employee who was a covered employee of the entity (or any predecessor) for a preceding taxable year beginning after December 31, 2016. Once an employee qualifies as a covered employee, the employee remains a covered employee permanently, even in subsequent taxable years when the employee is no longer one of the five highest-compensated employees of the ATEO.

The excise tax is applicable to remuneration paid in excess of \$1 million in a taxable year (excess remuneration). Whether compensation has exceeded \$1 million is generally calculated in accordance with Code Section 3401(a) **and includes any remuneration paid to the covered employee by a related organization**. Remuneration includes all amounts no longer subject to a substantial risk of forfeiture, even if such amounts have not yet been paid to the covered employee. It includes amounts that are vested but not yet paid under Code Section 457(f)(3)(B). There is a specific exclusion from the definition of remuneration for payments to qualified medical and veterinary service providers for the performance of medical or veterinary services.

## NOTICE 2019-09

The IRS has published Notice 2019-09, which aims to clarify the provisions relating to ATEO executive compensation under the Act, including the Code Section 4960 excise tax. Notice 2019-09 has garnered significant attention in recent months as its implications become apparent.

First, the IRS confirmed its position in Notice 2019-09 that both ATEOs **and** related organizations are liable for the excise tax on excess remuneration. For purposes of Code Section 4960, a related organization is defined as a person or governmental entity that: (i) controls, or is controlled by, the ATEO; (ii) is controlled by one or more persons which control the ATEO; (iii) is a supported organization under Code Section 509(f)(3) with respect to the ATEO; or (iv) is a supporting organization under Code Section 509(a)(3) with respect to the ATEO.<sup>[2]</sup>

The implication of this definition is that a for-profit entity or a governmental entity (including a state college or university) may be subject to the Code Section 4960 excise tax **if it is considered an employer**<sup>[3]</sup> of a covered employee of a related ATEO. The determination as to whether compensation has exceeded \$1 million (and thus is excess compensation) is made taking into account **any remuneration paid to the covered employee by a related organization**, including a for-profit entity. The IRS states explicitly in Notice 2019-09 that it is not consistent with a good faith, reasonable interpretation of Code Section 4960 to take a position that for-profit entities are not liable for the Code Section 4960 excise tax.

When remuneration is paid by an ATEO and one or more other employers of the covered employee that are related organizations, each employer is liable for the excise tax. The amount of the excise tax due by each employer is equal to the pro rata share of the remuneration each entity paid to the covered executive.

**Example 1:** An executive of a privately held corporation serves on a volunteer basis as the President of the corporation's related charitable foundation and qualifies as a covered employee. For purposes of this example, assume that the executive is treated as an employee of the charitable foundation. The executive receives \$1.5 million in compensation from the privately held corporation, \$0 from the related ATEO, and is treated as a common law employee of each entity. Since the executive (i) receives excess compensation (**even though it is paid by the for-profit entity**) and (ii) is a common law employee of each entity, the 21% excise tax on excess compensation is imposed **on the for-profit entity**.

**Example 2:** Assume the same facts as Example 1, except that the covered executive receives 25% of his or her compensation from the ATEO and 75% from the privately held corporation. The two entities are liable for the excise tax in proportion to the amount of remuneration paid by each to the covered executive.

**Example 3:** Assume the same facts as Example 1, except that the executive is not a common law employee of the charitable foundation. Since the executive is not an employee of an ATEO, his excess remuneration earned and paid by the privately held corporation **is not subject to the Code Section 4960 excise tax**. The Code Section 4960 excise tax only applies if the executive is treated as a common law employee of the ATEO.

As incredible as the result in Example 1 may seem, it is possible that the IRS might seek to enforce this interpretation. In nonbinding remarks, IRS representatives have recently indicated that the IRS has received comments about situations in which individuals are employed by a private entity and also provide volunteer services as an officer of a related ATEO. Even if the officer receives no compensation directly from the ATEO, the IRS has not denied that this structure could result in an excise tax if the remuneration from the private entity exceeds \$1 million. One IRS representative expressed concern that an ATEO could avoid the excise tax

by simply having the compensation to individuals performing services for the ATEO paid by the private corporation. However, the IRS representatives acknowledged that they were not considering this scenario when they drafted Notice 2019-09, and they have requested comments on how the IRS should address this scenario in the forthcoming Treasury regulations.

Notice 2019-09 provides for small amounts of relief in certain scenarios. The excise tax generally does not apply to compensation an ATEO pays to a member of its board of directors, provided the director is not otherwise treated as an employee of the ATEO. For any entity that is publicly held, remuneration that is not deductible by virtue of Section 162(m) is excluded from the Section 4960 excise tax, although we caution that careful analysis will be needed in the event a public company executive performs services to multiple related entities. A “limited services exception” is also described in Notice 2019-09, but the IRS defined this exception so narrowly that it will be useful only to a very limited subset of ATEOs. Pursuant to this exception, an individual is not considered a covered employee if (i) the ATEO paid less than 10% of the employee’s total remuneration for services performed as an employee of the ATEO and all related organizations **and** (ii) the individual received remuneration from more than one related ATEO; this very limited carveout does not apply to the ATEO that pays more remuneration than the other ATEOs.

Additionally, as highlighted by Example 3, there may be instances where a private company executive that provides volunteer services to a related ATEO is not classified as a common law employee of the ATEO, potentially eliminating liability for the Code Section 4960 excise tax. Whether a volunteer executive of an ATEO is a common law employee is determined based on a facts-and-circumstances analysis.

### FINAL THOUGHTS

Employers (both for-profit and nonprofit) with related ATEOs should carefully consider the potential implications of Notice 2019-09, including whether executives who may receive excess remuneration should provide services to related ATEOs. Although on its surface Code Section 4960 seems to apply to only a small group of tax-exempt entities with rich payrolls, the IRS’s approach to remuneration paid by related organizations in Notice 2019-09 can also ensnare well-intentioned corporations that provide the services of their corporate executives to related ATEOs. If you have questions or are concerned that this tax may apply to your organization, please contact us to discuss possible approaches.

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<sup>[1]</sup> Whether an employee is one of the five highest-compensated employees is determined separately for each ATEO, and not for entire group of related organizations, meaning that each ATEO has five highest-compensated employees.

<sup>[2]</sup> “Control” is defined as follows for purposes of the Code Section 4960 excise tax: (i) ownership of more than 50% of (A) the stock of a corporation (either voting power or share value), (B) the profits interests or capital interests of a partnership, and (C) the beneficial interests in a trust; and (ii) for nonstock organization (e.g., nonprofit organization or other organizations without owners or persons with beneficial interests), more than 50% of the directors or trustees of the ATEO or nonstock organization are either representatives of or being controlled by the other entity, or more than 50% of the directors or trustees of the nonstock organization are either representatives of or being controlled by individuals that also control the ATEO.

<sup>[3]</sup> ATEOs and related entities are subject to Code Section 4960 only if they are treated as a common law employer of the executive. The IRS established a 20-factor, facts-and-circumstances test to determine if an employee/employer relationship exists. See, Revenue Ruling 87-41 and Treas. Reg. Section 31.3401(c)-1(b).

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