February 19, 2020

Mr. William McNally
Associate Chief Counsel
Office of Chief Counsel
Employee Benefits, Exempt Organizations,
and Employment Taxes
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Re: Notice 2019-09 – Interim Guidance on Excise Tax Imposed under Section 4960, Excess Remuneration

Dear Mr. McNally:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to address the need for guidance related to the changes on new section 4960[1] which was added to the Internal Revenue Code (IRC) by Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), related to the excise tax on executive compensation paid by tax-exempt organizations.

On December 31, 2018, Treasury and the IRS issued Notice 2019-09 – Interim Guidance on Excise Tax Imposed under Section 4960, Excess Remuneration (the "Notice"). This letter is in response to the request by the IRS and Treasury for comments on the rules described in the Notice.

Specifically, the AICPA recommends that Treasury and the IRS provide guidance on the following issues related to the new section 4960:

I. Allocation of Remuneration

II. Allocation of Excise Tax

III. Definition of the term "Employee"

IV. Equity Compensation

V. Duplication of the Excise Tax and a Disallowed Deduction under Section 162(m)

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.

VI. Definition of the term "Predecessor" for Purposes of Defining Covered Employees

VII. Vacation Pay, Sick Pay, Disability Pay, Paid Time Off and Payroll Practices

VIII. Short term Deferral Exception

IX. Application of the Limited Services Exception

X. Cut-off Date on Covered Employee Status

XI. Death Benefits

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Jeffrey Martin, Chair, AICPA Employee Benefits Taxation Technical Resource Panel at (202) 521-1526, or jeffrey.martin@us.gt.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Retting, Commissioner, Internal Revenue Service
Mr. Michael J. Desmond, Chief Counsel, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Mr. Thomas West, Tax Legislative Counsel, Department of the Treasury
Ms. Amber Soletto, Attorney Advisor, Department of the Treasury
Ms. Tamera Ripperda, Commissioner, Tax Exempt & Government Entities, Internal Revenue Service
Mr. Robert Choi, Acting Deputy Commissioner, Tax Exempt & Government Entities, Internal Revenue Service

Ms. Margaret Von Lienen, Director, Exempt Organizations, Tax Exempt & Government Entities, Internal Revenue Service
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AMERICAN INSTITUTE OF CPAs

Notice 2019-09 – Interim Guidance on Excise Tax Imposed under Section 4960, Excess Remuneration

February 19, 2020

BACKGROUND

Section 4960 imposes a 21-percent excise tax on the sum of:

1. Any remuneration paid (other than an excess parachute payment) by an applicable tax-exempt organization (ATEO) for a taxable year with respect to employment of any covered employee in excess of $1 million; plus
2. Any excess parachute payment paid by such organization to any covered employee.

The excise tax is imposed on ATEOs and related entities for remuneration in excess of certain amounts received by a covered employee. In general, a covered employee is an employee or former employee who is one of the 5 highest compensated employees. Once an individual is a covered employee for any taxable year beginning after December 31, 2016, that person remains a covered employee for all future taxable years. This new tax is effective for all taxable years beginning after December 31, 2017.

The guidance in the Notice provides rules regarding the entity liable for the excise tax under section 4960, how the excise tax is calculated, and how taxpayers should report and pay the tax. Until further guidance is issued, taxpayers may comply with the statute by using a good faith, reasonable interpretation of section 4960. The Notice provides such an interpretation.

SPECIFIC COMMENTS

I. Allocation of Remuneration

Overview

In certain situations, ATEOs will be required to allocate remuneration earned by a covered employee between services that are subject to section 4960 and services that are exempt from section 4960. For example, a teaching hospital, which is an ATEO, may employ a physician who provides medical services to patients of the hospital and teaches classes to students. The compensation for the medical services provided by the employee is not remuneration for purposes of section 4960, but the compensation for services as a teacher is remuneration for purposes of section 4960. The value to the ATEO of the medical services provided by the employee may be in excess of the value of the teaching services, even if the employee spends the same amount of time providing each service.

Recommendations

The AICPA recommends that the IRS and Treasury issue proposed regulations permitting ATEOs to allocate remuneration between an employee's medical and other services provided using a reasonable allocation method based on Treas. Reg. § 1.861-4(b). A reasonable method not strictly based on the time spent by the employee providing services in each function. The method may take into account other factors, including the value of each service function, in addition to the time spent providing the services. We suggest that any such method should be in writing and used consistently for the employee.

Analysis

It is not clear in the Notice how to allocate remuneration among medical and other services when a portion of the employee's remuneration is exempt from section 4960. The Notice states that "the employer must make a reasonable, good faith allocation between remuneration for medical services and other services." According to the Notice, if an employment agreement states the remuneration is to be paid for particular services, the allocation in the employment agreement generally must be applied for purposes of section 4960. It is unlikely that many physician employment agreements will include this allocation. In those instances, the Notice states that any reasonable allocation method may be used. As an example, the Notice provides that an employer can use billing or patient records and other indications of the actual time spent by an employee providing medical services in determining the remuneration allocable to medical services. In many instances, a time-based allocation may be the appropriate method. However, strict time-based determinations are not always the most appropriate method for allocation of remuneration among service functions. It is likely that an employer will pay a different hourly amount for medical services compared to other services.

Treasury Reg. § 1. 1.861-4(b) provides sourcing rules that allow for the allocation of compensation on the basis of time, with the sourcing of certain fringe benefits allocated geographically. Pursuant to Treas. Reg. § 1.861-4(b)(iii)(C), an individual can also utilize another method for sourcing compensation if the alternative method more accurately provides a determination of the source of income versus a time or geographic basis.

A rule for allocating remuneration among service functions consistent with Treas. Reg. § 1.861-4(b) would provide ease of administrability. There are often reasons for allocating remuneration based on the value of services provided rather than the time spent in providing the services. The example above concerning a physician at a teaching hospital is only one situation in which this is applicable.

Example

Doctor A provides both medical and administrative services to an ATEO that is a medical facility. Doctor A is a covered employee of the ATEO. Approximately 50 percent of Doctor A's time is spent on administrative duties and the remaining 50 percent of Doctor A's time is spent providing medical services to patients. The administrative duties are time consuming, however, they are not as valuable to the

ATEO as the medical services provided by Doctor A. Thus, allowing the ATEO to allocate remuneration to Doctor A's medical services based on the value of Doctor A's time spent providing medical services to the ATEO is a reasonable approach.

II. Allocation of Excise Tax

Overview

In some situations, an ATEO's covered employee will provide services to a related organization. The ATEO and related organization may be so closely related that compensation paid by one party is effectively for services provided to both the ATEO and related organization. The remuneration paid to the covered employee by the ATEO and related organizations are generally aggregated for purposes of determining whether the covered employee receives excess remuneration. According to the Notice, to the extent the covered employee receives excess remuneration or excess parachute payments, the common law employer is liable for the excise tax. As a result, the ATEO and related organization must allocate the excise tax among themselves.

Many ATEOs provide long-term compensation to their employees that is earned over several years pursuant to a vesting schedule. The long-term compensation paid by the ATEO may be for services provided to both the ATEO and related organization. While the excise tax must be allocated among the ATEO and related organizations, the allocation of the excise tax related to compensation subject to a vesting schedule presents special challenges.

Recommendations

The AICPA recommends that the IRS and Treasury issue proposed regulations permitting ATEOs to use a reasonable method, similar to the allocation method recommended in section I. Allocation of Remuneration above, to allocate the excise tax among an ATEO and related organizations when employment agreements and similar contracts do not specify, in a reasonable manner, which common law employer pays the applicable remuneration.

Analysis

According to the Notice, in any case in which an ATEO includes remuneration from one or more other related organizations in determining the excise tax imposed by section 4960(a)(1), each employer is liable for the excise tax in an amount that bears the same ratio to the total excise tax determined with respect to the remuneration as: (1) the amount of remuneration paid by the employer with respect to that employee, bears to (2) the amount of remuneration paid by all the employers to that employee. It is not clear in the Notice how an ATEO and related organizations should allocate the excise tax when the compensation paid by one employer may be for services provided by the covered employee to another employer.

Treasury Reg. § 1. 1.861-4(b) provides sourcing rules that allow for the allocation of compensation on the basis of time, with the sourcing of certain fringe benefits allocated geographically. As discussed above, an individual can also utilize another method for sourcing compensation if the

alternative method more accurately provides a determination of the source of income versus a time or geographic basis.

In *Young & Rubicam v. the United States*[2] the Tax Court discusses the treatment of bonuses paid by a parent company to individual employees working for subsidiary companies. This case was decided before the section 861 regulations were issued; however, the thought process is similar. For most of the employees, the Tax Court found that the individuals' services were provided only to the subsidiary company and thus only the subsidiary company was entitled to the tax deduction. However, in some instances the Tax Court found that the individuals provided services to the subsidiary and provided separate services to the upper-tier parent. The Tax Court took into account the type of service and the company that most directly benefited from that service and, in some cases, held that the services more directly benefited the parent, making the deduction allocable to the parent company.

For section 4960, the ATEO and related employers will first aggregate all compensation to determine whether the compensation for the covered employee exceeds the allowable limits. Once it is determined that the employee's total compensation is in excess of the allowable limits, the ATEO and related organizations should use a reasonable method, similar to Treasury Reg. § 1. 1.861-4(b) to allocate the excise tax among the ATEO and related organizations.

In Notice 2009-8 – Interim Guidance under Section 457A, the IRS points to Treas. Reg. § 1.861-8, which provides allocation rules for classes of income (including compensation) across related entities. Under these rules, many types of income can be apportioned to a specific activity, however, some deductions relate more broadly and are ratably apportioned to all gross income.

> *Example*
>
> An ATEO and related organizations have a shared-services agreement with an officer who is a covered employee for purposes of section 4960 with the ATEO and each of the related organizations. The agreement states that the officer will provide services to each of the organizations, and the officer's work supports all of the organizations. The aggregate remuneration paid to the covered employees by the ATEO and related organizations results in excess remuneration subject to the excise tax. According to the AICPA's recommendation, allocating the excise tax among the ATEO and related organizations may be based on the complexity of the work needed by each organization, the overall value of the covered employee's services to each organization, or some other reasonable method.

III. Definition of the term "Employee"

Overview

The Notice includes section 3401(c) statutory employees (i.e., officers) who are not common law employees receiving wages for performing meaningful work as covered employees. Those officers are charged with governance of a nonprofit organization under state law, are held to

[2] 410 F.2d 1233 (Ct. Cl. 1969).

fiduciary standards for the financial and governance of the organization and can be held personally liable for breach of those fiduciary duties.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations providing that an ATEO's officers (statutory employees) and directors are not automatically considered common law employees for purposes of section 4960 merely by virtue of the fact they receive reasonable directors' fees from the ATEO for fulfilling the proper fiduciary duties as an officer or director of an ATEO.

Analysis

Common law employees should not automatically include officers of an ATEO absent other facts for purposes of section 4960. These individuals have fiduciary responsibility to the ATEO and may meet periodically to carry out those duties, such as setting the mission/vision for the ATEO, approving the budget, and hiring leadership staff. The total hours spent by the officers and directors are often insubstantial in relation to the time these individuals spend providing services to the related for-profit entity and the services provided to the ATEO are often provided on a volunteer basis. These are not the duties and responsibilities of an employee.

In addition, the remuneration directors receive does not make them a common law employee as evidenced by the fact that they receive compensation on a Form 1099 rather than a Form W-2.

Services provided to a corporate foundation

Generally, a corporate foundation does not have separately employed individuals. Administrative duties (e.g., accounting, finance, investment, legal, human resources, information technology, etc.,) are performed by the individuals who provide these services to the for-profit corporation. Often the expenses for providing administrative services are absorbed into the corporate expense structure and treated as a marketing or community involvement expense of the corporation. The for-profit corporation may treat the expenses of the corporate foundation as a charitable out-of-pocket expense paid on behalf of or for the benefit of a related charitable organization. The for-profit corporation may separately deduct the out-of-pocket expense as a charitable deduction under section 170. Another option is to seek reimbursement from the corporate foundation for the services provided.

Individuals providing the day-to-day services are generally part-time employees of the corporate foundation, which is particularly true for finance, legal and accounting services. Generally, the individuals providing these shared services report to a supervisor who ultimately reports to the chief financial officer (CFO), head of human resources, or chief legal counsel for the entire for-profit corporate structure and are common law employees of the for-profit corporation. The for-profit corporation would generally meet the definition of the common law employer under the Social Security Administration's test. The employee is under the direction of the for-profit employer and is directed to perform services for the corporate foundation on behalf of the for-profit corporation with an agreement with the corporation foundation (actual or implied).

Excluding these individuals who are bona fide volunteer fiduciaries would benefit the sector and is in alignment with Congressional intent of the statute. An individual of a for-profit corporation who charges no time to a shared services agreement because they are salaried employees often serve as bona fide volunteer officers and directors of the foundation. Subjecting these individuals' corporate compensation to taxation was not contemplated in the drafting of section 4960.

Example

A for-profit corporation maintains a foundation which is an ATEO for section 4960 purposes. The foundation president is an officer of the foundation under applicable state law and is also a full-time employee of the corporation. The foundation pays no remuneration to the president. The ATEO should not automatically characterize the president as a common law employee of the ATEO solely because they are an officer of the ATEO.

IV. Equity Compensation

Overview

It is unclear, for purposes of section 4960, how to treat the appreciation and depreciation of the fair market value of compensatory stock and stock derivatives that are used by employers as part of the total compensation package of certain employees.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations providing for the inclusion of the appreciation and depreciation of compensatory stock and stock derivatives in the amount of remuneration for purposes of the calculation of section 4960.

The AICPA also recommends that the IRS and Treasury issue proposed regulations stating that the equity compensation, including stock, stock options, stock appreciation rights (SARs) and restricted stock units (RSUs), are valued using the rules of Treas. Reg. § 1.409A-1(b)(5)(iv) for valuing stock and Prop. Treas. Reg. § 1.409A-4(b)(6) for valuing options and SARs.

Analysis

The calculation of section 4960 remuneration should include the appreciation and depreciation of the fair market value of compensatory stock and stock derivatives as an accretion or decline in an employee's wealth. It is necessary to value the stock and stock derivatives each year in order to include equity appreciation or depreciation in remuneration annually. The section 409A guidance contains detailed rules for valuing equity, stock options and SARs. Valuing equity amounts for purposes of section 4960 should use these same rules.

V. Duplication of the Excise Tax and a Disallowed Deduction under Section 162(m)

Overview

Section 4960(c)(6) provides that if remuneration is subject to a section 162(m) loss of deduction, the nondeductible amount under section 162(m) is not section 4960 remuneration. The section 162(m) loss of deduction takes precedence over the section 4960 excise tax. Occasionally, compensation is includable in section 4960 remuneration in a tax year prior to the tax year the same remuneration is subject to a section 162(m) loss of deduction. It is unclear how this mismatch of tax years is reconciled when the section 4960 excise tax is paid prior to the tax year of a section 162(m) deduction limitation.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations coordinating the section 4960 excise tax with a section 162(m) deduction limitation when the excise tax is paid prior to the taxable year in which the employer's section 162(m) deduction is limited. We recommend that the proposed regulations allow taxpayers to claim a refundable tax credit equal to the section 4960 excise tax paid on the nondeductible remuneration in the tax year the deduction is not allowed under section 162(m) and not require taxpayers to amend their excise tax return to claim this refund.

Analysis

Section 4960(a)(1) remuneration includes wages as defined in section 3401(a) (excluding Roth IRA contributions) and required inclusion amounts under section 457(f), whether or not the employer is a tax-exempt entity. The Notice specifies that wages are deemed paid when no longer subject to a substantial risk of forfeiture under section 457(f), even if the amounts are not subject to section 457(f).

Public companies receive a tax deduction for compensation in accordance with their methods of accounting under section 461, which is generally the accrual method of accounting. In the case of deferred compensation, the public company is allowed a deduction under section 404(a)(5) only in the tax year of the employer in which or with which ends the taxable year of an employee in which the amounts were included in gross income. The section 162(m) deduction limitation applies in the public company's taxable year that the compensation is otherwise deductible. As a result of the deduction and timing rules under sections 461 and 404(a)(5), the loss of deduction under section 162(m) can occur in a tax year that is later than the taxable year that the amount is treated as remuneration for purposes of section 4960. Section 4960(c)(6) provides that if remuneration is subject to a section 162(m) loss of deduction, the remuneration is not taken into account for purposes of section 4960. The loss of deduction takes priority over the excise tax. However, the section 4960 excise tax could apply to some amounts of compensation paid in a year prior to the year in which there is a deduction disallowance under section 162(m).

The section 4960 statutory language should not require a taxpayer to amend a tax return. Instead, taxpayers should claim a refundable income tax credit equal to the section 4960 excise tax paid on

the nondeductible amount of compensation in the tax year of the loss of deduction. Filing an amended return is an administrative and financial burden for the taxpayer and the IRS. Additionally, the proper correction involving an amended return could require multiple amended returns. Allowing a refundable income tax credit is analogous to the relief provided in the case of a claim of right under section 1341. Under these rules, a correction can be made in the form of a credit. The correction does not involve amending a tax return.

Example

A group of calendar-year related entities include ATEOs and a public company. Employee A is a covered employee of one of the ATEOs for purposes of section 4960 and the public company for purposes of section 162(m). The public company sponsors an annual bonus plan in which Employee A participates. Employee A provides all of the services to earn a bonus of $200,000 in 2020 and vests in the bonus on December 31, 2020. The bonus is paid to Employee A on April 1, 2021. For purposes of section 4960, the $200,000 bonus is remuneration in the 2020 tax year because it is vested in 2020. For 2020, Employee A has other remuneration of $1 million and the $200,000 bonus resulting in an allocation of the excise tax under section 4960 among the related entities. While the $200,000 bonus is included in section 4960 remuneration in 2020, it is not otherwise deductible by the public company until the 2021 taxable year in accordance with section 404(a)(5). In 2021, the public company is not allowed a deduction for the entire $200,000 bonus pursuant to section 162(m). The $200,000 bonus would have been excluded from section 4960 remuneration in 2020 if the loss of deduction under section 162(m) had occurred in the same or an earlier tax year. Under these facts the public company loses a tax deduction in a taxable year after the taxable year in which the entities paid the section 4960 excise tax. As a result, the related entities that paid the section 4960 excise tax should be allowed a refundable tax credit equal to the amount of the excise tax paid on the nondeductible bonus.

Example

ATEO and Public Company are related entities. Employee B is a covered employee of the ATEO for purposes of section 4960 and of Public Company for purposes of section 162(m). Both ATEO and Public Company are calendar year taxpayers. Employee B participates in a supplemental executive retirement plan (SERP) sponsored by Public Company. One half of the balance in the SERP is paid upon termination of employment and the remaining one half of the balance is paid on the first anniversary of the termination date. Employee B vests in $500,000 of the SERP balance on December 31, 2020 and separates from service on June 1, 2021. No earnings accrue on the SERP balance between December 31, 2020 and June 1, 2021. $250,000 of the SERP balance is paid to Employee B on July 1, 2021 and the remaining $250,000 is paid to Employee B on June 1, 2022. The SERP payments are otherwise deductible by Public Company under section 404(a)(5) in the taxable years the payments are received by Employee B (2021 and 2022) and are subject to section 162(m) in the years paid. The $500,000 SERP balance is

included as remuneration in 2020 for purposes of section 4960. The section 162(m) loss of deduction is calculated separately in 2020 and 2021 based on all compensation payments paid by Public Company to Employee B. A loss of deduction in 2021 and 2022 could occur for amounts previously subject to the section 4960 excise tax. These amounts should result in a refundable tax credit for the entity paying the excise tax in the year that the deduction is disallowed under section 162(m).

Example

ATEO and Public Company are related entities. Employee C is a covered employee of the ATEO for purposes of section 4960 and Public Company for purposes of section 162(m). Public Company maintains a deferred compensation arrangement for its covered employees for services at Public Company. The deferred compensation arrangement includes both employee deferrals and employer contributions. Employee C vests in employer contributions in 2020. However, payments are made upon termination of employment, which occurs in 2031. For purpose of the section 4960 excise tax, remuneration for 2020 includes elective deferrals for 2020 and all employer contributions that vested in 2020. These amounts are taken into income by the employees and subject to the section 162(m) loss of deduction in 2031. In 2031, the entity paying the excise tax should be eligible for a refundable tax credit in the amount of the loss of the deduction under section 162(m).

Example

Employee D is a covered employee of both ATEO and Public Company, which are related entities. Employee D participates in the Public Company's deferred compensation arrangement for tax years 2020 through 2030, vesting annually in both the employee elective deferral and employer contribution. The section 4960 excise tax is paid annually for the vested deferred compensation amounts. Employee D separates from service at the end of 2030 from ATEO and Public Company. Employee D receives substantially equal installments from the deferred compensation arrangement over 5 years from 2031 through 2035. Each annual payment is subject to a loss of deduction under section 162(m) for amounts on which a section 4960 excise tax has been paid. A refundable tax credit would allow a correction for applying the section 4960 rules for each year from 2031 through 2035.

VI. Definition of the Term "Predecessor" for Purposes of Defining Covered Employees

Overview

Section 4960(c)(2)(B) requires any covered employee of an ATEO or any predecessor of the ATEO for any taxable year beginning after December 31, 2016 to remain a covered employee in all future years. It is unclear which individuals are considered covered employees under this new

rule in the case of an asset acquisition or disposition by an ATEO or a restructuring of one or more ATEOs.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations defining the term predecessor employer for purposes of determining who is a covered employee under section 4960(c)(2)(B).

Specifically, we recommend that the proposed regulations provide that in the case of an ATEO (acquirer) that purchases or merges with a previously unrelated taxable entity or ATEO (target), the target is not considered a predecessor employer. Any employees of the target continuing in employment are not treated as covered employees based on their status with the employer prior to the acquisition as it was not a related entity prior to the acquisition.

We also recommend that the proposed regulations provide that in the case of an ATEO (acquirer) that purchases an insubstantial portion of the assets of another ATEO (target), the target's assets are not treated as assets of a predecessor employer. Any employees of the target hired by the acquirer as part of the asset acquisition are not treated as covered employees based on their status at the previous employer.

Analysis

ATEOs require a precise definition of predecessor employer to properly identify which employees are considered covered employees potentially subject to the section 4960 excise tax. It is unclear if the employees joining the acquirer as part of a purchase of assets are considered covered employees of the purchaser based on their status at the previous employer. The target of an acquisition of an insubstantial portion of its assets, whether or not the target is an ATEO, should not establish the target as a predecessor employer for purposes of section 4960. An employee could subsequently become a covered employee of the acquiring ATEO based on the compensation the employee earns for services to the acquirer subsequent to the asset purchase.

An unrelated taxable entity (or the assets of a taxable entity) that is purchased by an ATEO should not be considered a predecessor employer since it was not subject to section 4960 prior to the acquisition. However, an individual hired as part of the purchase of a taxable entity is not precluded from becoming a covered employee after the purchase, based on service to and compensation earned from the acquirer.

Example

Organization X is an ATEO under section 4960(c)(1). In June 2019, Organization X acquires an insubstantial portion of Organization Y's total gross assets, resulting in some of Organization Y's employees joining Organization X. Organization Y is also an ATEO. Organizations X and Y were not related prior to the acquisition. Subsequent to the acquisition, Organization X employs individuals H, I and J who were previously employed by Organization Y. H, I and J were covered employees

of Organization Y before the transaction. Employees H, I and J should not be covered employees of Organization X based on their status as covered employees of Organization Y at the time of the acquisition because Organization X purchased an insubstantial portion of Organization Y's assets. However, one or more of these employees could become covered employees of Organization X after the transaction, based on compensation earned by the individuals for services to Organization X after the transaction.

VII. Vacation Pay, Sick Pay, Disability Pay, Paid Time Off and Payroll Practices

Overview

An employer pays numerous types of compensation annually to its employees that do not vary significantly from year-to-year. These include, but are not limited to, vacation pay, sick pay, disability pay, and paid time off (PTO). Many of these forms of compensation are paid infrequently. In addition, an employee's first paycheck in January often includes payment for services rendered in the prior calendar year. In determining an ATEO's remuneration for purposes of section 4960 during a taxable year, these types of compensation are most easily accounted for using a cash basis method. Using the cash method will not materially change the amount subject to tax annually and will simplify the tax computation for taxpayers.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations applying traditional payroll practices to determine the amount of remuneration subject to section 4960 with respect to end of the year payroll, accrued sick pay, accrued vacation pay, and accrued paid time off and disability pay. We also recommend inclusion of amounts in section 4960 remuneration only when paid (i.e., cash basis method of accounting for the compensation) instead of when it becomes vested under section 457(f).

Analysis

Certain types of compensation paid by a tax-exempt entity are not included in an employee's income until paid. For example, section 457(e)(11)(A)(i) excludes from the application of section 457(f), certain items such as vacation pay, sick pay, compensatory time and disability pay. As a result, these amounts are includable in an employee's gross income, subject to payroll tax withholding, when paid, rather than when the benefit vests.

These types of payments can be defined consistently with section 457 using rules similar to the rules of Prop. Reg. § 1.457-11(e)(2) and § 1.457-11(f). Treasury Reg. § 31.3121(v)(2)-1(a)(3)(ii) also excludes these amounts. Similarly, vacation pay is not taxed until the individual takes vacation, because the opportunity to receive payment without working is considered a substantial limitation on the amount until payment is made. By not requiring an adjustment to cash compensation for many immaterial amounts that are frequently paid each year, the calculation of section 4960 is simplified.

VIII. Short Term Deferral Exception

Overview

Section 4960(a) taxes remuneration when there is no substantial risk of forfeiture of the amounts. Under section 457(f)(3)(B), the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to the compensation are conditioned upon the future performance of substantial services by any individual.

Generally, this treatment would apply for income tax purposes because section 457(f)(1)(A) requires inclusion of compensation from ineligible deferred compensation plans of tax-exempt employers for the first taxable year in which there is no substantial risk of forfeiture. However, Prop. Reg. § 1.457-12(d)(2) provides an exception for short-term deferrals defined in Treas. Reg. § 1.409A-1(b)(4). Thus, payments that are actually or constructively received on or before the 15th day of the third month following the end of the year in which there was no longer a substantial risk of forfeiture are not included in gross income until they are actually or constructively received.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations providing that the short-term deferral exception to the definition of deferred compensation for section 457(f) applies to section 4960 such that the year of inclusion for income tax purposes matches the year of inclusion for section 4960 purposes.

In addition, since the definition of remuneration begins with the compensation subject to income tax withholding, elimination of short-term deferrals from compensation for purposes of section 4960 will eliminate an adjustment to compensation.

Analysis

The language in section 4960(a) that references the substantial risk of forfeiture provides a timing rule. Q–13 of the Notice provides that this timing rule will apply regardless of whether the compensation arrangement is subject to section 457(f). The timing of the application of section 4960(a) is only applicable, though, if an item first meets the definition of remuneration.

Section 4960(c)(3)(A) defines remuneration as wages (as defined in section 3401(a)), except that such term shall not include any designated Roth IRA contribution (as defined in section 402A(c)) and shall include amounts required to be included in gross income under section 457(f). Items that meet an exception to the definition of deferral of compensation for purposes of section 457(f) are not included in gross income under section 457(f) for a cash basis taxpayer, even though they are vested. If short-term deferrals were included in gross income under section 457(f), they would be included in the year of vesting rather than the year of payment. However, the IRS provided the short-term deferral exception under the proposed regulations to section 457(f) and allows taxpayers to rely on those proposed regulations until they are issued in final form. Since the definition of remuneration for purposes of section 4960 references items that are included in gross

income under section 457(f), inclusion of a short-term deferral exception to the vesting rules is warranted.

Most taxpayers calculating remuneration will begin with the amount reported on Form W-2 and adjust for amounts included in income due to the vesting rule. Elimination of as many of these adjustments as reasonable while still properly considering the vesting rule simplifies the calculation of remuneration for taxpayers and, because many of these amounts are similar for each year, does not materially change the amount of remuneration reported.

IX. Application of the Limited Services Exception

Overview

The limited services exception applies to an individual who is often dual employed, but provides limited or *de minimis* services to one or more of the related exempt organizations.

Q–10(b) of the Notice provides the limited services exception under which certain employees are not considered one of an ATEO's 5 highest compensated employees for a taxable year. The limited services exception applies if the ATEO paid less than 10-percent of the employee's total remuneration for services performed as an employee of the ATEO and all related organizations. However, if no ATEO in the group of related organizations paid at least 10-percent of the total remuneration paid by the group during the calendar year, the limited services exception does not apply to the organization that paid the most remuneration to the employee during the calendar year.

Recommendations

The AICPA supports the limited services exception provided in the Notice. However, we recommend that the IRS and Treasury provide proposed regulations expanding the limited services exception to include the fact pattern where a multi-entity group has only a single nonprofit that is supported by one or more for-profit benefactors for the good of the community.

The AICPA further recommends that the IRS and Treasury issue proposed regulations that expand the limited services exception to exclude compensation paid by related for-profit employers from the section 4960 excise tax if conditions are met from the Form 990 instructions.

Analysis

The limited services exception in Q-10 is only useful to multi-entity groups with multiple nonprofit organizations. If the directors of a corporate foundation are employed full-time at a related for-profit organization(s), and strictly provide bona fide volunteer services, none of the fees paid to the for-profit corporation for investment management or routine bookkeeping services should be attributable to any corporate officer. In this case, none of the corporate officers' time should be charged directly or indirectly to the services contract. An employee's time could be related to direct time and indirect time. However, the officers and director are bona fide volunteers.

In addition, the instructions to the Form 990 allow compensation from a related for-profit organization paid to an officer, director or trustee is not disclosed on Form 990 if both of the following requirements are satisfied:

- The related for-profit organization is not owned or controlled directly or indirectly by the ATEO or one or more related ATEO(s); and

- The for-profit organization employing the volunteer does not provide [management] services for a fee to the ATEO.

Form 990 does not require disclosure of the compensation; the section 4960 excise tax should also not apply.

X. Cut-off Date on Covered Employee Status

Overview

Once an individual becomes a covered employee of an ATEO, that individual remains a covered employee of the ATEO, even if in a later year, that individual is not one of the 5 highest compensated employees of the organization. In addition, an individual who becomes a covered employee of the ATEO remains a covered employee of that ATEO even after leaving the ATEO.

Recommendations

The AICPA recommends that the IRS and Treasury issue proposed regulations that provide that an individual will no longer be considered a covered employee after a specified date or event.

Specifically, the AICPA recommends the IRS and Treasury issue proposed regulations providing the following:

- A former employee should no longer have covered employee status after the former employee has incurred a break in service equal to the period described in section 410(a)(5)(D)(i). Specifically, if a covered employee terminates service with an ATEO and does not perform service for that ATEO for a period equal to the greater of five years, or the individual's total period of service with the ATEO prior to the termination, the individual would no longer be a covered employee of that ATEO. Service for both the ATEO in which the individual was a covered employee, as well as organizations that were related to the ATEO with respect to which the individual had been a covered employee would be considered for this purpose.

- An individual ceases to be a covered employee of an ATEO upon the complete payment of all compensation (including regular salary, bonuses, and payments from all non-qualified deferred compensation plans, not limited to plans subject to sections 457(b) and 457(f)) earned while employed by the ATEO and/or any organizations related to the ATEO at the time the individual terminates employment). This rule would apply regardless of whether the individual has been a former employee for a period described in section

410(a)(5)(D)(i). As part of this rule, we recommend that payments received from a retirement plan meeting the requirements of section 401(a) or tax a deferred annuity meeting the requirements of section 403(b) do not provide the sole basis for continuing an individual's status as a covered employee.

- A limited exemption from taxation for remuneration paid to employees who are not covered employees of an organization, but whose remuneration is subject to taxation as remuneration paid by related organizations. This proposed exemption would apply in cases in which the following conditions are applicable:

  i. the individual is not a covered employee of their current employer;

  ii. the individual had qualified as a covered employee of a prior employer that was not related to their current employer at the time of employment; and

  iii. the individual's current employer becomes affiliated with the individual's former employer for which the individual is a covered employee and the affiliation occurs while the individual is employed with their current employer.

  As part of this rule, we recommend that the IRS and Treasury include a rule similar to the predecessor employer rule provided under the proposed regulations under section 162(m) that would make this exemption available if the individual has not been employed by their former employer for a period of three years.

Analysis

The Notice indicates that the IRS received comments advocating for a rule of administrative convenience under which a former employee should no longer be considered a covered employee after some defined period. The IRS did not indicate in the Notice what that period should be, and the Notice is otherwise silent on this point. Using a period described in section 410(a)(5)(D)(i) provides taxpayers and the IRS with an existing body of law for applying the rules.

In addition, including an additional exception applicable where the individual has received complete and final payouts of all items of compensation (except for qualified plan retirement benefits or benefits under a section 403(b) annuity) provides another measurable, objective standard for determining when an individual should no longer be a covered employee. The payments in question would be made pursuant to plans that were established while the individual had been employed with their former employer and cannot be readily modified to change benefits after a termination of employment.

The statute does not provide a limitation on the covered employee status of former employees of ATEOs. However, there is no indication that the statute intends that the tax should apply to remuneration paid to someone who is not a covered employee the current employer, but whose compensation would become subject to taxation to their current employer solely by reason of the employer's subsequent affiliation with the individual's former employer, for whom the individual

had been a covered employee. Unintended punitive results can occur in cases involving the combination of previously unrelated ATEOs.

One application of this rule can be illustrated by the following example:

> *Example*
>
> Individual A is a covered employee of ATEO X. Individual A terminates employment with ATEO X during 2019. Upon termination of employment, Individual A is hired by ATEO Y. ATEO Y is unrelated to ATEO X during 2019, the year that Individual A is hired by ATEO Y, and has never been related to ATEO X. Individual A is not one of the top 5 paid employees of ATEO Y, or any other organization related to ATEO Y in the year Individual A is hired or any subsequent year. Assume further, in 2023, ATEO X and ATEO Y become related organizations. In this case, solely by virtue of being a covered employee of their former employer, ATEO X, Individual A's remuneration from ATEO Y becomes subject to section 4960, even though Individual A is not one of the 5 highest paid employees of ATEO Y.

The section 4960 excise tax should not apply once the covered employee has received their final compensation from an ATEO. This treatment is consistent with the intent of section 4960 as follows: "once a covered employee; always a covered employee," as this ensures that all remuneration earned by a covered employee of a particular organization is subject to taxation under section 4960. We do not believe Congress intended covered employees' status to be of indefinite duration. Once all of the remuneration is paid, there is no purpose served in having an individual remain a covered employee of his or her former ATEO employer.

In addition, we do not believe that Congress intended the tax to follow the individual to unrelated organizations. Thus, the section 4960 excise tax should not apply when an individual obtains employment at an unrelated ATEO, even though the ATEOs subsequently becomes related in a transaction outside the control of the covered employee. There is no purpose served in having an individual's current employer subject to the tax solely as a result of the individuals' status with respect to a former employer, in the absence of the individual independently qualifying as a covered employee of the new, current employer.

XI. Death Benefits

Overview

Separation from employment is often used by an employer in compensation arrangements as the trigger to pay vested compensation amounts to employees. For example, it is typical for a nonqualified deferred compensation plan to provide that payments will be made or begin upon separation from employment, including separation resulting from death or disability, complying with section 409A(a)(2).

In addition to plans that vest as services are provided and that have payment triggered due to separation from service (including death), some plans or arrangements pay amounts only upon

death (and not upon any other type of separation from employment). These plans are not designed to benefit the service provider, but to benefit beneficiaries.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations stating that payments due to death that are not otherwise earned absent death are not considered parachute payments for purposes of section 4960(c)(5)(B)(i) or remuneration for determining who is a covered employee under section 4960(c)(2).

Analysis

The section 4960 definition of remuneration is based on section 3401(a). Section 3121(a)(13) excludes death benefits such as those described above from Federal Insurance Contributions Act (FICA) wages. While section 3401(a) does not have a similar exception for death benefits, Revenue Ruling 86-109 holds that employers can report such death benefits on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans*. As such, death benefits meeting the definition under section 3121(a)(13) are not reported through payroll with income tax withholding similar to other section 3401(a) wages. In addition, these amounts are reported to the beneficiary and not the decedent. The beneficiary was never a covered employee of the ATEO. Therefore, the amounts should not be considered remuneration for purposes of section 4960.

If these types of death benefits were subject to the section 4960 excise tax, it could cause a trap for unknowing organizations who are not otherwise required to include amounts not otherwise accounted for through payroll reporting in certain years.

Example

Employee A was a covered employee for purposes of section 4960 for any years prior to 2019. However, Employee A dies in 2019 and beneficiaries receive a death benefit of $200,000. Employee A never received or had a legally binding right to receive the $200,000 received by Employee A's beneficiaries. Employee A should not be considered a covered employee for 2019 or any future year as a result of the receipt of the $200,000 death benefit by beneficiaries.