

## IRS Proposes Compensation Tax Relief for Company Foundations

by Shane Hamilton and Tony Provenzano



Shane T. Hamilton



Anthony G. Provenzano

Shane Hamilton is special counsel and Tony Provenzano is a member with Miller & Chevalier Chtd.

In this article, Hamilton and Provenzano discuss specific exceptions in the proposed regulations under section 4960 that may apply to relieve a for-profit company of liability for the tax on excess remuneration.

Treasury and the IRS recently promulgated proposed regulations under section 4960<sup>1</sup> that impose an excise tax on most tax-exempt organizations, including company-sponsored private foundations, which pay some employees compensation over \$1 million annually. Given that many if not most company-sponsored private foundations do not compensate their directors, officers, or other employees, it might be reasonable to assume these rules do not apply when a company-sponsored private foundation pays no compensation. However, remuneration received from a related for-profit company generally is included when determining whether

the section 4960 tax applies, and for purposes of calculating the amount of the tax, even when the private foundation itself pays no compensation to the employee. This article discusses specific exceptions in the proposed regulations that may apply to relieve a for-profit company of liability for the section 4960 tax on excess remuneration paid to a company employee who also provides uncompensated services to a related private foundation.

### I. Overview of Section 4960

Section 4960(a) imposes a tax at the rate imposed by section 11 (21 percent for corporations) on “so much of the remuneration paid . . . by an applicable tax-exempt organization [ATEO] for the taxable year with respect to employment of any covered employee in excess of \$1,000,000.” An ATEO includes a private foundation<sup>2</sup> exempt from federal income tax as an organization described in section 501(c)(3).<sup>3</sup>

A covered employee includes “any employee (including any former employee) of an applicable tax-exempt organization if the employee . . . (A) is one of the 5 highest compensated employees [HCEs] of the organization for the taxable year, or . . . (B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.”<sup>4</sup>

Remuneration for purposes of section 4960 includes “wages (as defined in section 3401(a)),” and deferred compensation “required to be

<sup>1</sup>REG-122345-18, 85 F.R. 35746 (June 11, 2020).

<sup>2</sup>All references to a private foundation herein assume the foundation is a non-stock, nonprofit corporation recognized as exempt from federal income tax as an organization described in section 501(c)(3), and therefore is also an ATEO within the meaning of section 4960.

<sup>3</sup>Section 4960(c)(1)(A).

<sup>4</sup>Section 4960(c)(2).

included in gross income under section 457(f).<sup>5</sup> Remuneration includes any remuneration paid regarding the employment of a covered employee “by any related person.”<sup>6</sup> A person is treated as related to an ATEO if that person “(i) controls, or is controlled by, the organization, . . . [or] (ii) is controlled by one or more persons which control the organization.”<sup>7</sup> Under the statute, remuneration, a deduction for which is not allowed by reason of section 162(m) is excluded for purposes of section 4960.<sup>8</sup>

The employer who pays the excess remuneration is liable for the tax,<sup>9</sup> and allocation rules apply when more than one employer contributes to the excess remuneration giving rise to the tax.<sup>10</sup>

## II. For-Profit Company Compensation

The proposed regulations expressly rejected a suggestion that remuneration exclude any amounts paid by a related person regarding the employment of the employee by the related person. Instead, the proposed regulations provide that, in general, remuneration paid (or a grant of a legally binding right to non-vested remuneration)<sup>11</sup>:

- by a third-party payer (whether a related organization, payroll agent, or other entity) during an applicable year for services performed as an employee of an employer is

deemed paid (or payable) by the employer; and

- by a related organization to an ATEO’s employee during an applicable year for services performed as an employee of the related organization is treated as paid (or payable) by the ATEO.<sup>12</sup>

Therefore, absent an exception, a payment made to a private foundation employee during an applicable year by a related for-profit company is treated as remuneration paid by the private foundation, even when the payment is not for services provided to the private foundation.

The proposed regulations likewise provide that, in general, for purposes of determining whether an employee is one of an ATEO’s HCEs for a tax year, remuneration paid by the ATEO during the applicable year is aggregated with remuneration paid by any related for-profit company for services performed as an employee of the related for-profit company.<sup>13</sup> Therefore, absent an exception, an employee of a private foundation who is compensated by a related for-profit company may be one of the private foundation’s HCEs even if the private foundation itself pays no compensation to the covered employee.

The proposed regulations provide two exceptions to these general rules that apply in situations in which an employee of a related for-profit company performs only limited services for a related ATEO. These exceptions are discussed later, after a discussion of the definition of control for purposes of determining whether a for-profit company is related to an ATEO in the first instance, and a discussion of the circumstances under which uncompensated directors and officers of an ATEO may be considered covered employees of the ATEO.

## III. Control and Related Persons

The statute does not define control for purposes of determining whether a for-profit company is a related person to an ATEO. The proposed regulations provide that a person

<sup>5</sup>Section 4960(c)(3)(A); and prop. reg. section 53.4960-2(a). In general, remuneration that is a regular wage within the meaning of reg. section 31.3402(g)-1(a)(1)(ii) is treated as paid on the date it is actually or constructively paid, and all other remuneration is treated as paid on the first date on which the remuneration is vested. Prop. reg. section 53.4960-2(c).

<sup>6</sup>Section 4960(c)(4)(A).

<sup>7</sup>Section 4960(c)(4)(B).

<sup>8</sup>Section 4960(c)(6). Despite the plain language of this section, the proposed regulations provide that “remuneration . . . the deduction for which is disallowed by reason of section 162(m), is taken into account for purposes of determining an ATEO’s five highest-compensated employees.” Prop. reg. section 53.4960-1(d)(2)(i); *see also* prop. reg. section 53.4960-2(f)(2). According to the preamble, “This rule is needed to ensure proper coordination between the rules under section 162(m) and the rules under section 4960.” Preamble to REG-122345-18, 85 F.R. at 35750.

<sup>9</sup>Section 4960(b).

<sup>10</sup>Section 4960(c)(4)(C); and prop. reg. section 53.4960-4(c).

<sup>11</sup>As a general matter, throughout the proposed regulations the grant of a legally binding right to non-vested remuneration is treated as remuneration. Therefore, references herein to remuneration paid include grants of legally binding rights to non-vested remuneration.

<sup>12</sup>Prop. reg. section 53.4960-2(b).

<sup>13</sup>Prop. reg. section 53.4960-1(d)(2)(i).

controls a non-stock organization under either a removal power test or a representative test. Under the removal power test, a person controls a non-stock organization if the person has the power, directly or indirectly, to remove more than 50 percent of the trustees or directors of the non-stock organization and designate new trustees or directors. Under the representative test, a person generally controls a non-stock organization if more than 50 percent of the non-stock organization's directors or trustees are also trustees, directors, officers, agents, or employees of the person.<sup>14</sup> Therefore, if more than 50 percent of a private foundation's directors are also directors, officers, agents, or employees of a company, or the company has the power to remove more than 50 percent of the private foundation's directors, the company controls the private foundation and the company will be a related person to the private foundation for purposes of section 4960.

#### IV. Covered Employees

For purposes of determining who is among a tax-exempt private foundation's HCEs, the proposed regulations define employee consistently with the definition of employee for purposes of federal income tax withholding in section 3401(c) and the regulations thereunder. Specifically, the proposed regulations cross-reference the definition of employee in reg. section 31.3401(c)-1, which includes common law employees and some officers of corporations.<sup>15</sup>

Consistent with reg. section 31.3401(c)-1(f), the proposed regulations confirm that a member of a private foundation's board of directors, acting solely in his capacity as a director, is not an

employee of the private foundation.<sup>16</sup> Treasury and the IRS, however, expressly rejected a suggestion that the proposed regulations provide categorically that officers are not employees for purposes of section 4960. Therefore, under the proposed regulations, and consistent with reg. section 31.3401(c)-1(f), an officer of a private foundation generally is considered an employee of the private foundation unless the officer performs no services or only minor services and neither receives, nor is entitled to receive, directly or indirectly, any remuneration for those services.<sup>17</sup>

Treasury and the IRS also rejected the suggestion that the proposed regulations include an exception that would more generally exclude volunteers from the definition of employee for purposes of section 4960, on the ground that doing so would modify the common law standard for determining employee status solely for purposes of section 4960. The preamble to the proposed regulations notes that the limited-hours and nonexempt funds exceptions, discussed next, as well as the general exclusion of officers providing no or only minor services from the definition of employee, should operate to exclude from covered employee status many common law employees who some might consider to be volunteers.<sup>18</sup>

#### V. Exceptions

The proposed regulations provide two exceptions that could address the problem created when a private foundation officer or other private foundation employee is treated as an employee for purposes of section 4960, even if he is not compensated by the private foundation: a limited-hours exception and a nonexempt funds exception. If either of these exceptions applies, an individual is disregarded for purposes of determining the private foundation's HCEs for a

<sup>14</sup> Prop. reg. section 53.4960-1(i)(2)(v) (specified attribution and indirect control rules apply). The proposed regulations provide that an employee of a related for-profit company — other than a trustee, director, or officer, or an employee who possesses at least the authority commonly exercised by an officer — who is a director of a private foundation will not be treated as a representative of the company if the employee does not act as a representative of the company in his service with the private foundation. A private foundation that is relying on this exception must report that it is relying on the exception on its Form 990-PF and provide details supporting the application of the exception. Prop. reg. section 53.4960-1(i)(2)(v)(C). The preamble to the proposed regulations makes it clear that this exception is intended to apply only to lower-level employees of the company. Preamble to REG-122345-18, 85 F.R. at 35755.

<sup>15</sup> Prop. reg. section 53.4960-1(e)(1).

<sup>16</sup> Prop. reg. section 53.4960-1(e)(2). Also, director's fees generally are not considered remuneration. Prop. reg. section 53.4960-2(a)(1).

<sup>17</sup> Prop. reg. section 53.4960-1(e)(1). There does not appear to be any uniform definition of what constitutes "minor services." Mere participation in board or executive committee meetings clearly qualifies as minor services, but representation of the corporation on outside business councils and appearances before legislative committees for the corporation do not. See Rev. Rul. 57-246, 1957-1 C.B. 338.

<sup>18</sup> Preamble to REG-122345-18, 85 F.R. at 35752.

tax year (and therefore will not meet the definition of a covered employee).<sup>19</sup>

### A. Limited-Hours Exception

Under the limited-hours exception, an employee of a company-sponsored private foundation will be disregarded for purposes of determining the private foundation's HCEs for a tax year if:

- the private foundation did not pay any remuneration to the employee for services performed for the private foundation; and
- the hours of service the employee performs as an employee of the private foundation comprise 10 percent or less of the employee's total hours of service for both the private foundation and the related for-profit company during the applicable year.<sup>20</sup>

If the private foundation reimburses a related for-profit company for compensation the company pays to the employee (presumably for personal services the company employee provides to the private foundation), the private foundation will be considered to have paid remuneration to the employee and the limited-hours exception will not apply.<sup>21</sup>

The proposed regulations include a safe harbor under which an employee who performs fewer than 100 hours of service as an employee of the private foundation during an applicable year is treated as having worked less than 10 percent of their total hours for the private foundation.<sup>22</sup>

<sup>19</sup>The proposed regulations also include a limited services exception that applies when an ATEO did not pay more than 10 percent of an employee's total remuneration for services performed for the ATEO and all related organizations. Prop. reg. section 53.4960-1(d)(2)(iv). For this exception to apply, however, the ATEO must have at least one related ATEO. References herein to a private foundation describe a private foundation (i) that is controlled by a for-profit corporation within the meaning of the proposed regulations, and (ii) that has no related ATEOs and no other related for-profit corporations. More complex corporate structures involving additional ATEOs and related for-profit companies may implicate other proposed rules, such as the limited services exception, which are not discussed herein.

<sup>20</sup>Prop. reg. section 53.4960-1(d)(2)(ii)(A). Rather than hours of service, a private foundation may instead use a percentage of total days worked by the employee, provided that any day that the employee works at least one hour for the private foundation is treated as a full day worked for the private foundation and not for the related for-profit company. Prop. reg. section 53.4960-1(d)(2)(ii)(A)(2).

<sup>21</sup>Prop. reg. section 53.4960-1(d)(2)(ii)(B).

<sup>22</sup>Prop. reg. section 53.4960-1(d)(2)(ii)(C).

**Example:** An employee of a related for-profit company serves as an officer of a private foundation. Only the company paid remuneration to the employee and the private foundation did not reimburse the company for any portion of the employee's remuneration in any manner. During 2021, the employee provided services as an employee for 2,000 hours to the company and 200 hours to the private foundation. The employee qualifies for the limited-hours exception because only the company paid the employee in 2021 and the employee provided services as an employee to the private foundation for 200 hours, which is not more than 10 percent of the total hours ( $2,000 + 200 = 2,200$ ) worked as an employee of the private foundation and all related organizations ( $200/2,200 = 9$  percent). Therefore, the employee is disregarded for purposes of determining the private foundation's HCEs for 2021.<sup>23</sup>

The conclusion in the previous example does not change if the private foundation, under an accountable plan described in reg. section 1.62-2, provides a reasonable allowance for expenses incurred by the employee in executing the employee's duties as an officer of the private foundation. For purposes of both the limited-hours exception and the nonexempt funds exception, remuneration does not include benefits excluded from the definition of wages. An expense allowance under an accountable plan is excluded from wages within the meaning of section 3401(a), as provided in reg. section 31.3401(a)-4, and therefore is not remuneration within the meaning of prop. reg. section 53.4960-2(a).<sup>24</sup> Similarly, premiums under a directors and officers liability insurance plan are not treated as remuneration paid to an employee for purposes of determining whether one of the exceptions applies, because section 3401(a)(1) excludes those premiums from the definition of wages as a working condition fringe benefit.<sup>25</sup>

<sup>23</sup>Prop. reg. section 53.4960-1(d)(3)(v) (Example 5).

<sup>24</sup>Prop. reg. section 53.4960-1(d)(3)(vi) (Example 6).

<sup>25</sup>Prop. reg. section 53.4960-1(d)(3)(iv) (Example 4).

## B. Nonexempt Funds Exception

Under the nonexempt funds exception, an employee is disregarded for purposes of determining a private foundation's HCEs for a tax year if:

- the private foundation did not pay any remuneration to the employee for services performed for the private foundation;
- the private foundation does not control the related for-profit company from which the employee received compensation;<sup>26</sup>
- the individual performed services as an employee of the private foundation for less than 50 percent of the total hours worked as an employee of the private foundation and the related for-profit company;<sup>27</sup> and
- to prevent indirect payment of remuneration by the private foundation, the related for-profit company that paid the employee did not provide any services for a fee to the private foundation.<sup>28</sup>

As with the limited-hours exception, if the private foundation reimburses a related for-profit company for compensation the company pays to the employee (presumably for personal services the company employee renders to the private foundation), the private foundation will be considered to have paid remuneration to the employee and the nonexempt funds exception will not apply.<sup>29</sup>

**Example:** An employee of a related for-profit company serves as an officer of a private

foundation. The private foundation does not control the company. Only the company paid remuneration to the employee and the private foundation did not reimburse the company for any portion of the employee's remuneration in any manner. During 2021, the employee provided services as an employee for 1,000 hours to the company and 900 hours to the private foundation. The company provided no services to the private foundation for a fee. The employee qualifies for the nonexempt funds exception, and is disregarded for purposes of determining the private foundation's HCEs, because the employee worked less than 50 percent of the year providing services for the private foundation and only the company paid any remuneration to the employee during 2021.<sup>30</sup>

## VI. Reliance on Proposed Regulations

The guidance provided in the proposed regulations generally is consistent with the guidance previously provided in IRS Notice 2019-09, 2019-4 IRB 403 but modifies that guidance in some respects. Until the regulations are finalized, taxpayers may rely on the guidance provided in Notice 2019-09 or, alternatively, on the guidance provided in the proposed regulations, including for periods before June 11 (the date of publication of the proposed regulations in the *Federal Register*).

The preamble to the proposed regulations states that Treasury and the IRS "continue to invite comments on any modifications to these proposed regulations with respect to identifying an ATEO's five highest compensated employees that are consistent with the statutory provisions, treat similarly situated taxpayers consistently, do not permit improper avoidance of the provisions, and are administrable and not overly burdensome."<sup>31</sup> Evidently, many of the comments previously received were determined not to meet one or more of these standards. Therefore, it may be unlikely that the rules in the proposed regulations will change materially when the regulations are finalized.

<sup>26</sup> A person controls a stock corporation if it owns (by vote or value) more than 50 percent of the stock in the stock corporation. Prop. reg. section 53.4960-1(i)(2)(ii). Because ownership of more than 50 percent of a business enterprise would be an excess business holding under section 4943, it is unlikely that a private foundation, unless it has received a recent gift or bequest of stock, will control a stock corporation.

<sup>27</sup> Rather than hours of service, a private foundation may instead use a percentage of total days worked by the employee, provided that any day that the employee works at least one hour for the private foundation is treated as a full day worked for the private foundation and not for the related for-profit company. Prop. reg. section 53.4960-1(d)(2)(iii)(A)(2).

<sup>28</sup> Prop. reg. section 53.4960-1(d)(2)(iii)(A). The preamble explains that the nonexempt funds exception balances the concern (expressed in the legislative history to section 4960) that excessive compensation paid to senior executives of tax-exempt organizations diverts resources from supporting appropriate exempt purposes, against the reality that taxable companies commonly donate the services of their employees to a related ATEO without charge to assist the ATEO in furthering its exempt purposes without the ATEO inadvertently paying compensation that may be subject to excise tax under sections 4941, 4945, or 4958. Preamble to REG-122345-18, 85 F.R. at 35751.

<sup>29</sup> Prop. reg. section 53.4960-1(d)(2)(iii)(B).

<sup>30</sup> Prop. reg. section 53.4960-1(d)(3)(viii) (Example 8).

<sup>31</sup> Preamble to REG-122345-18, 85 F.R. at 35753.

Until then, companies with related private foundations should examine their employees' employment relationships with the private foundations and modify them when appropriate to ensure they do not give rise to an unexpected section 4960 liability. ■