IRS Answers Many Questions on New 21% Executive Compensation Tax

By Norma Sharara, JD and Joan Vines, CPA

On Dec. 31, 2018, the IRS released Notice 2019-09 (the Notice), providing interim guidance regarding Section 4960 of the Internal Revenue Code (the Code) that was enacted on Dec. 22, 2017, by the Tax Cuts and Jobs Act (the Act).

The Notice provides the first guidance on new excise taxes that tax-exempt and governmental entities (and their related for-profit entities) may need to pay on the amount of remuneration in excess of $1 million in compensation and any excess parachute payments paid to a covered employee as early as May 15, 2019 (for calendar year entities). Affected organizations must report and pay the tax on recently updated IRS Form 4720.

The 2017 Tax Reform and Jobs Act established new Code Section 4960, effective Jan. 1, 2018, which imposes an excise tax on "excess" executive compensation paid by tax-exempt and certain governmental entities. The excise tax rate is established in Section 11 of the Code and is currently 21 percent. For-profit employers related to such entities may also need to pay their pro rata share of the tax (such as for-profit entities within a tax-exempt hospital or university's controlled group).

Employers Pay the Tax

The excise tax is the employer's responsibility — it is not withheld from employee compensation. The 21 percent excise tax applies to employers who pay, after taking into account payments by members of its controlled group:

- **More than $1 million in annual "remuneration"—** wages subject to withholding, including 457(f) income but excluding Roth contributions, certain retirement plan contributions and payments, and wages for certain medical services paid to any "covered employee" (five highest compensated employees for the current or any prior year starting with 2017)
- **"Excess parachute payments"—**amounts over three times the employee's five-year average wages that are contingent on an involuntary termination (including a "good reason" termination or non-renewal of an employment agreement), but only if the employee makes over the IRS' qualified retirement plan limit for "highly compensated employees" during the year (currently $125,000).

Even Small Employers Are Affected

Notice 2019-09 clarifies that even if an employer never pays anyone more than $1 million per year, it could still owe the tax on excess parachute payments. But employers who do not pay anyone over $125,000 for a year may never have a 4960 tax liability. Nevertheless, employers of all sizes must track "covered employees."

Covered Employees

Since there is no minimum dollar test to be a "covered employee," tax-exempt employers who do not have a 4960 tax liability for a year would still need to make a list of covered employees each year. Per the Notice, once someone is a covered employee, he or she is a covered employee forever under 4960, even after termination of employment. Since the definition of "covered employee" is cumulative, the list will likely include more than five individuals over time.

Note that each applicable tax-exempt employer within a controlled group must make a cumulative list of its covered employees for 2017, 2018 and all subsequent years (there isn't one list for the whole controlled group). The Notice confirms that even though 4960 took effect Jan. 1, 2018, employers need to make a covered employees list starting in 2017, because remuneration paid to those individuals in 2018 or later could trigger the 4960 tax.

Remuneration Is a New Concept

Section 4960 created its own concept of "remuneration" that is different from any other way that employers calculate annual compensation. To determine 4960 tax liability, employers need to look to when amounts are vested under 457(f)'s special timing rule (not when the amounts are paid). The Notice confirms that this analysis is required even if the amount is not technically subject to 457(f). For example, certain bona fide disability plans are exempt from 457(f)'s special timing rules because they are not treated as deferred compensation. But such amounts would be counted for 4960 tax liability purposes when they are vested (not when they are paid).

The Notice confirms that for 4960 purposes, amounts provided after an involuntary separation are excluded if all of the benefits vested before the separation (since the separation affected only the timing of the payments, not the employee's right to the payments). But any new increase in value (such as earnings) that accumulate after the vesting would be treated as remuneration subject to 4960 testing. Also, if the termination of employment accelerates vesting, then the value of the acceleration is treated as remuneration for 4960 purposes.

The Notice also clarifies that certain amounts are excluded from "remuneration" entirely, such as wages paid for medical services (which are discussed in detail in the Notice) and amounts paid to independent contractors (such as director's fees). The Notice also says that certain other amounts are included in "remuneration"—such as payments conditioned on a release of claims, damages for employment agreement breaches, payments under early retirement or other "window" programs, payments for non-compete and non-disclosure or similar agreements.

Who's the Employer

This Notice makes it clear that "common law" employers of the covered employee owe the 4960 tax. Employers with related entities will need to determine which entity is the common law employer under applicable IRS tests. Employers cannot avoid liability by using payroll agents, common paymasters, professional employer organizations (PEOs), etc.

If a covered employee is also employed by another entity related to the tax-exempt entity, each employer, including taxable entities, is separately liable for its pro rata share of the 4960 tax, regardless of any arrangement between them to bear the cost of the tax liability. So the amount of 4960 tax owed could change if the related entities restructure their employment relationships.

Related Organizations

The Notice says that for 4960 purposes, an entity is "related" to an employer if it:

- controls (or is controlled by) the employer
- is controlled by one or more persons which control the employer
- is a "supported" or "supporting" organization with respect to the employer
- establishes, maintains or contributes to a voluntary employees' beneficiary association

The Notice defines what "control" means for stock corporations, partnerships, trusts and non-stock organizations. The Notice also explains how to determine the 4960 tax if the entity becomes or ceases to be related to the employer during the calendar year.

In addition, the Notice adopts (for 4960 purposes) the broad definition of "related organization" for annual Form 990 reporting. While using the Form 990 definition reduces burdens when determining 4960 liability, it is likely to cause more tax to be paid than if a more narrow definition was selected.

Governmental Employers

Despite much publicity about highly paid public university sports team coaches being subject to the tax on annual remuneration over $1 million, some schools may avoid paying the 4960 tax unless Congress enacts a technical correction. Per the Notice, governmental entities that

rely on the doctrine of "implied sovereign immunity" for their tax-exempt status are not subject to 4960. The Notice also clarified that a governmental unit (including a state college or university) that received a favorable IRS determination letter confirming its 501(a) tax-exempt status may voluntarily relinquish that status (which may exempt it from 4960 tax).

How to Calculate the Excess Parachute Payment Tax

While calculating the 4960 tax on annual remuneration over $1 million may be fairly straightforward, calculating the tax on excess parachute payments is more complicated.

The Notice sets out six steps for determining the excess parachute tax (which is separate from the $1 million tax). Remember that the tax applies to the excess over one times the base amount (not the excess over three times the base amount).

Generally, a covered employee's base amount is the average of the employee's Box 1, Form W-2 annual taxable compensation for services performed as an employee of an applicable tax-exempt organization (ATEO) (and any predecessor entity of the ATEO) or a related entity for the five years prior to the termination year.

Compensation for short taxable years generally must be annualized before determining the five-year average (but a special rule applies to covered employees who have a separation from employment during their initial year of employment). If the covered employee was not employed by the employer for the entire five-year period, use the portion of the five-year period during which the employee performed services for the employer, a predecessor entity or a related entity.

Calendar Year Tax Liability

The Notice clarifies that 4960 tax will be based on the calendar year ending with or within the employer's taxable year. For example, assume an employer's taxable year began on July 1, 2018, and ends on June 30, 2019. The employer may owe 4960 tax on remuneration paid between July 1 and Dec. 31, 2018 (remuneration paid from January 1, 2018 to June 30, 2018 would not be subject to 4960 tax, which gives an initial, first-year advantage to entities that use non-calendar year fiscal years).

To avoid penalties and interest, the employer should remit any tax owed by filing IRS Form 4720 on or before Dec. 15, 2019 (5 1/2 months after its fiscal year end). This approach aligns with employers' Form W-2 and Form 990 disclosures.

No Transition Rules

Despite what many had hoped, the IRS declined to provide any 4960 transition rules. The Notice confirms that the Act clearly mandates the Jan. 1, 2018 effective date. So employers should already be complying.

Nevertheless, the Notice may help employers review and revise existing employment, deferred compensation, severance and other agreements or design and implement new arrangements. Employers may also want to consider whether changing existing management service arrangements among related entities may reduce 4960 liability exposure.

IRS intends to propose regulations under 4960, but until further guidance is issued, employers can apply a reasonable, good faith interpretation, which would include taking the Notice into account.

Accounting Considerations

Booking a contingent tax liability. Before reporting and paying the 4960 tax, employers may need to book a contingent tax liability if they are reasonably certain that they will incur a 4960 excise tax (for example, upon an employee's termination of employment based on existing employment agreements, deferred compensation agreements, etc.). Adjustments may need to be made ratably over the number of years between 2018 and when the tax is expected to be due. Many tax-exempt organizations may not be accustomed to booking contingent tax liabilities, so this may be uncharted territory for them.

Book/tax difference. The employer may also need to track a book/tax difference due to the timing of when the liability is accrued for financial statement purposes and when the amounts are subject to 4960 excise taxes (i.e., when the amounts are vested).

For further information access the Notice. The Notice has a detailed frequently asked questions section and examples that clarify certain scenarios.

The Uniform Guidance – Five Years and Counting

By Matt Cromwell, CPA

It has been over six years since Title 2 U.S. Code of Federal Regulations (CFR) Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, more commonly known as the Uniform Guidance (UG) was released. The date of Dec. 26, 2013, will forever be seen as the day compliance took on a new meaning for recipients of federal funding.

During this time, entities have worked to establish, update and critically review internal policies and procedures to ensure compliance with the Uniform Guidance. From my clients' perspective, the amount of resources, both time and money, spent on meeting the new requirements has been staggering. Much progress has been made, but there continue to be key areas where we find that entities encounter issues. A few areas in which we continue to see issues and findings are discussed below:

Performance Reporting (UG §200.38) – Although an audit under the Uniform Guidance does not include programmatic data testing, it does focus on the performance reporting process. Entities must maintain adequate systems and controls over the programmatic reporting process. Entities must ensure that program teams: have a full and complete understanding of the reports required, have complied with submission requirements, perform programmatic reviews and present the data on the reports accurately and in compliance with the requirements of the award.

Equipment / Real Property (UG §200.13) – The Uniform Guidance requires that entities comply with requirements related to equipment and real property purchased with federal funds. The UG established specific requirements nonprofits must follow related to equipment additions (utilizing the definition of equipment in UG §200.33) and equipment disposals. In addition, if the entity has purchased equipment with federal funds, it must perform an inventory of federally purchased equipment no less than once every two years. Even if an entity has no federal equipment purchases in the past two years, but still holds material amounts of equipment purchased in the past with federal funds that have not been disposed, the nonprofit must still comply with equipment disposal requirements and perform the required inventory.

Procurement (UG §200.317-§200.326) – An inordinate amount of time has been spent in the area of procurement, including multiple revisions, delays and

then additional revisions of the UG during 2018. However, the requirements to clearly and accurately document the rationale for a vendor selection remain and must include: systematic rationale for selection of the vendor; basis for selection of contract type; basis for contractor selection, including rejection reasoning; and finally the basis for price. Each procurement must have each of these four required components clearly documented to substantiate compliance. Another area that continues to pose challenges is the sole sourcing of procurements. UG §200.320 establishes a point of emphasis that has drastically reduced the ability to sole source procurements in all but the following circumstances:

- the item is only available from one source
- the public exigency or emergency is such that the delay of competition is deemed reasonable (extremely rare instances and in this case it is strongly encouraged to obtain approval from your oversight agency)
- express authorization from an agency after a written request from the federal recipient
- after solicitation of a number of sources, competition is ultimately deemed inadequate

Subrecipient monitoring (UG §200.330 – §200.331) – A few key areas continue to cause overall challenges for entities. The primary areas of emphasis continue to focus on enhanced documentation around monitoring of the subrecipients and related follow-up on any findings or issues. Often times when performing testing, we will see the entity has vast amounts of documents from the subrecipient which address a portion of the monitoring requirement; however, the documentation will often include the latest audit report of the subrecipient which details compliance findings. However, there is no documented evidence of how the entity has increased its scrutiny and monitoring around the compliance findings reported. Additionally, we continue to see that entities are not performing the pre-award assessment as required. There are multiple proscribed steps in the Uniform Guidance on the pre-award assessment that are required to be performed at the time of each award, regardless of how many times you use a subrecipient on other awards.

Mandatory Disclosures (UG §200.113) – This section states "The Non-Federal entity or applicant for a Federal award must disclose, in a timely manner, in writing to the Federal awarding agency or pass-through entity, all violations of Federal criminal law involving fraud, bribery, or gratuity violations potentially affecting the Federal award. Non-Federal entities that have received a Federal award including the term and condition outlined in Appendix XII - Award Term and Condition for Recipient Integrity and Performance Matters are required to report certain civil, criminal, or administrative proceedings to SAM. Failure to make required disclosures can result in any of the remedies described in §200.338 Remedies for noncompliance, including suspension or debarment." We continue to encounter instances where entities have a multitude of reasons not to disclose this within their own reporting. Unlike OMB Circular A-133, where there were thresholds of reporting such matters, under the Uniform Guidance, that de minimis reporting threshold no longer exists. Oftentimes, entities had historically considered the Form 990 fraud disclosure thresholds as a compass in this area, but clearly the two concepts have diverged with the explicit nature of UG §200.113. Secondarily, the "timely manner" concept is also widely debated. In this case, we strongly encourage timely reporting with clear guidelines from the client's general counsel.

We have also seen instances where an international nonprofit has notified the local agency mission overseas; however that notification did not reach the appropriate officials at the offices in Washington, D.C. As a result, the entity has been deemed to be in violation of this notification requirement. Entities should inform all parties of any issues subject to UG §200.113 in writing in a timely manner to clearly document the actions they have taken.

One final consideration – We continue to find instances where entities establish internal policies and procedures that are more restrictive than the UG requirements. One example we have seen on many occasions is where an entity establishes a policy that all transactions with any vendor are required to have a suspension and debarment check performed and documented. Per the UG, this is a requirement for certain covered transactions and above certain dollar thresholds. If the entity complies with the UG requirements, it will still have a finding since it did not comply with its internal policy. This applies even if the transaction may not have exceeded the UG thresholds. We strongly encourage entities to review their policies and procedures and consider the UG requirements and determine what is best for them.

GASB Simplifies Accounting For Capitalized Interest

By Susan Friend, CPA

The Governmental Accounting Standards Board (GASB) Statement No. 89 (Statement), Accounting for Interest Cost Incurred before the End of a Construction Period, which is effective for reporting periods beginning after Dec. 15, 2019, brings a welcome relief to state and local governments by eliminating complex capitalized interest calculations.

Under this Statement, for financial statements prepared using the economic resources measurement focus, interest incurred during construction will be recognized as an expense of the period. This means that interest costs will no longer be included as part of the historical cost of a capital asset. Interest costs on ongoing construction in progress will be capitalized only through the implementation date. Furthermore, the provisions of this Statement are to be applied prospectively and therefore do not require restatement of any prior period balances.

This Statement does not change the treatment of accounting for interest costs incurred before the end of a construction period in financial statements prepared using the current financial resources measurement focus (modified accrual basis) where an expenditure is recorded, or for governmental activities which never required capitalizing interest. With the implementation of this new Statement, capital asset and cost of borrowing information for a reporting period for both governmental activities and business-type activities will be more comparable.

Prior to implementation, state and local governments should determine how additional interest expense that will be recorded will affect bond covenants and their budget. An additional item to note is that this new Statement is a departure from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) standards, both of which require the capitalization of interest. As a result, financial statements of public sector entities and similar privately run entities will not be comparable.

Although accounting is simplified for many organizations, there is an exception for regulated operations and some concerns for component units.

For governments that have regulated operations (as defined by paragraph 476 of GASB Statement No. 62), the requirements of paragraph 485 of GASB Statement No. 62 are not eliminated with this new Statement. What this means is that if a regulator requires your organization to calculate and capitalize construction period interest, you will still be required to capitalize qualifying interest costs as a regulatory asset.

As a best practice, most component units of a primary government adopt new standards in the same fiscal year as the primary government so that the financial statements are presented consistently. It is a good idea for representatives from each component of the reporting entity to meet and discuss planned implementation dates to ensure consistency.

Guidance Released on Taxable Income From Parking and Other Fringe Benefits

By Marc Berger, CPA, JD, LLM

The bill known as the Tax Cuts and Jobs Act, enacted in December 2017, added new Section 512(a)(7) to the Internal Revenue Code (IRC). This new section requires tax-exempt organizations to increase their unrelated business taxable income (UBTI) by the amount paid or incurred for qualified transportation fringe benefits (QTFs) provided to employees.

For this purpose, QTFs include the provision of parking and mass transit benefits, and taxable income is created whether the employer pays for the benefits directly or allows employees to pay for the benefits on a pretax basis. Made effective Jan. 1, 2018, mere days after the new law was enacted, many tax-exempt organizations were facing the daunting requirement to calculate, report and pay income tax for the first time.

In December 2018, the Treasury Department provided organizations and their tax advisors with some much-needed guidance on the new law in Notice 2018-99. As described below, some compliance questions have been answered, and underpayment of estimated tax penalties will be waived for certain organizations.

Notice 2018-99 (the Notice) indicates that the Treasury and the Internal Revenue Service intend to publish proposed regulations under Section 512 on the calculation of the increased UBTI attributable to QTFs, but until such guidance is issued, organizations may use any reasonable method to calculate the increase in UBTI under Section 512(a)(7). This includes being able to rely on the guidance provided in the Notice.

Guidance on how to determine the amount of parking expenses that should be treated as an increase in UBTI, indicates that the approach is dependent on how the organization provides the benefit. If the organization pays a third party so that its employees can park at the third party's garage, for example, then the amount of UBTI is the organization's total annual cost paid to the third party. However, to the extent that the amount paid for an employee exceeds the Section 132(a)(2) monthly limitation on exclusion ($260 for 2018), the excess amount must be treated as taxable wage compensation to the employee. In this situation, the excess over $260 per month will not be treated as additional UBTI under Section 512(a)(7).

If an organization owns or leases all or a portion of one or more parking facilities where its employees park,

the amount included as UBTI may be calculated using any reasonable method. For this purpose, "parking facility" includes indoor and outdoor garages and other structures, as well as parking lots and other areas where employees may park on or near the business premises of the employer, or on or near a location from which the employee commutes to work. "Parking expenses" include repairs, maintenance, utilities, insurance, taxes, security, snow removal and parking lot attendant expenses, but notably does not include depreciation expenses. The Notice provides a four-step method which is deemed to be a reasonable method. These steps are:

1. **Reserved Employee Spots**

   The organization must determine the percentage of reserved employee spots in relation to total parking spots and multiply that percentage by the organization's total parking expenses for the parking facility. The resulting amount is included in UBTI. In addition, the Notice gave organizations the ability, until March 31, 2019, to change their parking arrangements to reduce or eliminate their reserved employee spots and treat those parking spots as not reserved. Any change made under this provision will apply retroactively to Jan. 1, 2018.

2. **Determine Primary Use of Remaining Spots**

   If the primary use of the remaining parking spots in the parking facility is to provide parking to the general public, then the remaining parking expenses are not included in UBTI, and you can stop the calculation here. For this purpose, "primary use" means greater than 50 percent of actual or estimated usage, tested during the normal hours of the organization's activities on a typical day. The "general public" includes, but is not limited to, the organization's visitors, customers, clients, patients, students and congregants. The organization can use any reasonable method to determine the average actual or estimated use.

3. **Reserved Nonemployee Spots**

   If the primary use test in the previous step is not met, the organization should identify the number of spots reserved for nonemployees, if any (e.g., reserved for visitors and customers). Like the calculation in the first step, the organization should determine the percentage of reserved nonemployee spots in relation to the remaining total parking spots and multiply that percentage by the organization's total parking expenses for the parking facility. The resulting amount is not included in UBTI.

4. **Remaining Use and Allocable Expenses**

   If after the completion of steps 1-3 there remain parking expenses not specifically categorized as includible or excludable in UBTI, the organization must reasonably determine the employee use of the remaining parking spots during normal hours on a typical day.

The Notice provides 10 examples applying the methodologies described above to various factual situations, determining the amount of reportable UBTI in each situation. Tax-exempt organizations with UBTI in excess of $1,000 for the tax year are required to file Form 990-T and to pay federal income tax at the rate of 21 percent on their UBTI.

It should be noted that even though UBTI is increased under Section 512(a)(7), the provision of parking and mass transit benefits is not considered a separate unrelated trade or business for purposes of Section 512(a)(6). As a result, UBTI reportable under Section 512(a)(7) is calculated in the same "silo" as the income and deductions from an existing unrelated trade or business. Thus, organizations with a net loss from their one unrelated trade or business can offset their UBTI from Section 512(a)(7). However, the Notice does not specify whether or how organizations with multiple unrelated trades or businesses can offset their UBTI from Section 512(a)(7). We hope future guidance will address this issue.

Notice 2018-100, a companion notice, provides relief from estimated tax penalties for 2018 for those tax-exempt organizations that did not pay estimated income tax in connection with their UBTI reportable under Section 512(a)(7). This relief is available only to organizations that were not required to file Form 990-T for the previous tax year and requires timely compliance with their payment of the tax due for the current tax year.

Finally, the State of New York, which imposes a state unrelated business income tax of 9 percent on UBTI, enacted legislation exempting UBTI reportable under IRC Section 512(a)(7) from the state tax.

These actions by the IRS and the State of New York help tax-exempt organizations comply with the new law, but additional guidance could be forthcoming. We will continue to monitor the situation as it develops.

Lessons Learned From Implementing ASU 2016-14 – Functional Expenses

By Tammy Ricciardella, CPA

Nonprofit organizations with calendar year ends are working to implement the provisions of Accounting Standards Update (ASU) 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.

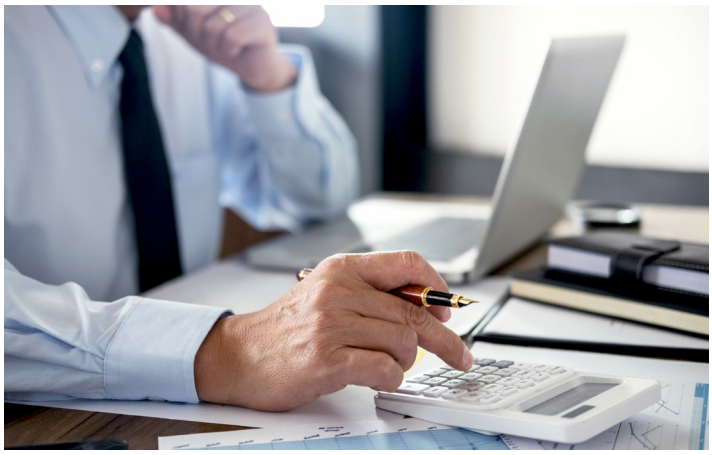
The ASU is effective for annual financial statements issued for fiscal years beginning after Dec. 15, 2017. Specifics of the requirements of the ASU have been highlighted in prior articles in the Nonprofit Standard and can be accessed in the Fall 2016, Winter 2016 and Spring 2017 issues. The ASU can be found here.

As implementation efforts have been undertaken, we have seen one area that is causing more issues than anticipated. This is the presentation of the statement of functional expenses that shows the analysis of expenses by function and natural classifications. As part of developing this information, entities are looking at their current cost allocation methodology as well as what components, both program and natural expense classifications, that they want to include.

Overall, the entity can decide whether to present this information in the statement of activities, as a separate statement of functional expenses that is part of the main financial statements, or as a footnote. The main issue is to determine the most efficient presentation and the one that will be the most beneficial to the readers of the entity's financial statements.

A word of advice on the presentation: Keep it simple. Yes, the statement of functional expenses should show the natural expenses of the entity by program and supporting activities, but this doesn't mean that every type of expense should be presented on its own line. A straightforward approach is needed to prevent the presentation from becoming overly complex and unwieldy. Focus on the information that will be useful to the reader of the financial statements in understanding the costs of the activities of the entity. Decide on which natural classification groupings are important and relevant. However, keep in mind that too much detail can overwhelm the reader of the financial statements.

Once the format is determined, entities should look at their allocation methods for their management and general costs (M&G) and determine if the items being



allocated are necessary for the direct conduct or direct supervision of programs and supporting activities, such as membership development or fundraising. If not they shouldn't be allocated. The costs that are allocated should be for the direct benefit of the activity they are being allocated to. For example, occupancy costs can be allocated to the programs if the programs utilize space to conduct their activities. The cost of the space is related to the direct conduct of the program and should be allocated to this functional classification to show the direct benefit the program receives from the use of the space.

An example provided in the ASU addresses the consideration of the CEO's costs. An organization may have all of the CEO's salary recorded as M&G. But upon further examination, they may determine that the CEO is directly involved in supervising one or more programs of the entity and that their time should be allocated to these programs. In addition, an entity may find that the CEO is directly involved in contacting donors and personally performing other activities to raise funds for the entity. If this is the case, these costs could be allocated to the fundraising function. The costs for the CEO's time to oversee the general operations of the entity would remain in M&G.

The ASU made a change to the examples of what constitute management and general activities. The following item was added to the list of what is included in M&G: Employee benefits management and oversight (human resources). Entities should look at their internal policies to determine how these costs have been traditionally treated and, if allocated, determine the effect on current and prior year numbers.

It is important to note that all expenses, with the exception of external and direct internal investment expenses, should be reported by their natural classification in the analysis of expenses by nature and function. An example of a scenario that is often excluded but shouldn't be are any salaries or other expenses included in cost of goods sold that are presented net of the related revenue in the statement of activities.

Once these allocations are reviewed by the entity, it should update its policies and develop the new required footnote disclosure that provides a description of the methods used to allocate costs among program and support functions.