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Section 4960 Excise Tax Guidance

IRC Sec. 4960(a), added to the Code by the 2017 Tax Cuts and Jobs Act, generally provides that an *applicable tax-exempt organization* paying a *covered employee remuneration* in excess of (1) $1 million during a tax year, or (2) any excess parachute payment is subject to an excise tax. The $1 million limit also includes compensation paid by related organizations. Because of this, an organization paying less than $1 million directly can be subject to the excise tax (21% for 2020). As with all tax law, the details matter. Recently issued proposed regulations provide guidance on some critical details in determining the liability for this excise tax.

Previously, the IRS issued initial guidance in Notice 2019-9 (2019-04 IRB 403) and requested comments. The IRS has recently released proposed regulations (REG-122345-18) providing additional guidance and considered the prior comments requested for Notice 2019-9. Additionally, written comments on the current proposed regulations are requested and must be submitted (preferably electronically) by August 10, 2020.

Effective Date

The regulations are proposed to apply to tax years beginning on or after the date the final regulations are published in the Federal Register. Until then, taxpayers may rely on the guidance provided in Notice 2019-9 or, alternatively, on the guidance provided in these proposed regulations, including for periods prior to June 11, 2020. Taxpayers may also base their position on a reasonable, good faith interpretation of the statute.

To Whom Does IRC Sec. 4960 Apply?

The proposed regulations restate certain statutory definitions and define various terms in IRC Sec. 4960. One clarification is for an *applicable tax-exempt organization (ATEO)*. IRC Sec. 4960 provides that an ATEO can include an organization exempt from tax under IRC Secs. 501(a), 521(b)(1), 115(1), and 527. The treatment of

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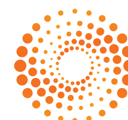

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governmental entities has been clarified in the proposed regulations to provide the following:

- A governmental unit (including a state university) that does not have an IRS determination letter recognizing its tax exemption is not considered an ATEO. **Note:** The entity may be liable for the Section 4960 excise tax if it is a related organization of an ATEO.
- A governmental unit with an IRS determination letter recognizing its tax-exempt status is considered an ATEO. However, the organization may choose to relinquish the Section 501(c)(3) status.
- A government entity that excludes all or part of its gross income under IRC Sec. 115(1) is an ATEO regardless of whether it has a private letter ruling to that effect.

Related organization. The proposed regulations generally adopt the definition of related organization used in the annual reporting requirements for Form 990, which include the greater than 50% standard in IRC Sec. 512(b)(13)(D). In addition, the Section 318 attribution rules apply.

Foreign organization. The proposed regulations also address when foreign organizations can be an ATEO. A foreign organization that otherwise qualifies as an ATEO will be treated as an ATEO unless it receives substantially all of its support (other than gross investment income) from sources outside the U.S.

Covered Employee and the Five Highest

The proposed regulations define *covered employee* as any individual who is one of the five highest-compensated employees (five highest) of the ATEO for the tax year or was a covered employee of the ATEO for any prior tax year beginning after 2016. The guidance clarifies that the five highest is determined separately for each ATEO and not for the entire group of related organizations. Therefore, a related group of ATEOs can have more than five highest for a tax year. An employee may be a covered employee of more than one ATEO in a related group of ATEOs in a tax year. In addition, once an employee is a covered employee of an ATEO, they continue to be a covered employee for all subsequent tax years of that ATEO.

Note: Board members, serving in their capacity as such, are not employees. However, officers are employees unless the minor services exception under Reg. 31.3401(c)-1 applies.

Corporate employers with executives providing volunteer services to a related exempt organization (i.e., the loaned executive) may be subject to the Section 4960 excise tax. The following are excluded from the definition of employee and covered employee, and for determining the five highest-compensated employees:

- An individual performing services for the ATEO solely as an independent contractor.
- An individual who is a bona fide employee of a related organization, including a related organization providing services to the ATEO.
- For determining the five highest, an employee is disregarded if neither the ATEO nor any related organization pays remuneration, or grants a legally binding right to nonvested remuneration for services performed as an employee of the ATEO or any related organization.

Note: In determining the five highest-compensated employees, the proposed regulations use the term *remuneration* (see later discussion), including that from related organizations, as compensation.

Exceptions. These additional exceptions apply for determining the ATEO's five highest for a tax year:

Limited hours. Neither the ATEO nor any related ATEO pays remuneration, or grants a legally binding right to nonvested remuneration, to the employee for services performed for the ATEO; and the employee performed services for the ATEO (and all related ATEOs) for no more than 10% of the employee's total hours of service for the ATEO (and all related ATEOs) during the tax year.

Note: A safe harbor treats an employee performing fewer than 100 hours of service as an employee of an ATEO (and all related ATEOs) during a tax year as having worked less than the 10% threshold.

Nonexempt funds. Neither the ATEO, any related ATEO, nor any taxable related organization controlled by the ATEO pays the employee of the ATEO any remuneration for services performed as an employee of the ATEO. In addition, the related taxable organization paying the employee remuneration must not provide services for a fee to the ATEO, related ATEOs, or their controlled taxable organizations. Finally, the employee must have primarily performed services to the related taxable organization during the applicable year. The *primarily* criterion is met if the employee provided services to the related non-ATEO for more than 50% of the employee's total hours worked for the ATEO (and all related organizations) during the applicable year.

Limited services exception. The ATEO pays less than 10% of the employee's total remuneration during the applicable year for services performed as an employee of the ATEO (and all related organizations). However, if a related ATEO paid at least 10% of the total renumeration paid for services to the ATEO (and all related organizations), then this exception does not apply to the ATEO

that paid the employee the most during the applicable year.

Predecessor organization. A covered employee must be (or have been) an employee of an ATEO. Likewise, a predecessor organization must also have been an ATEO. The proposed regulations define a predecessor ATEO as an ATEO that has transferred, by any of several legal means, its assets and operations to another pre-existing or newly created ATEO (the successor of the predecessor ATEO).

What's Considered Remuneration?

For an ATEO to be liable for the Section 4960 excise tax, the organization (or a related one) must pay a covered employee excess remuneration. Excess remuneration is that which exceeds $1 million per covered employee in a tax year. The $1 million limit also includes compensation paid by related organizations. The tax also applies if an ATEO (or related entity) pays any excess parachute payments.

Remuneration is defined as wages for federal income tax purposes under IRC Sec. 3401(a) [excluding Roth contributions and certain retirement benefits and including amounts required to be included in gross income under IRC Sec. 457(f)]. Remuneration also does not include an *excess parachute payment* (discussed later) but does include a parachute payment that is not an excess parachute payment. In addition, certain items includible in gross income under IRC Sec. 7878 and the related regulations are considered remuneration.

Note: Remuneration paid to a licensed medical or veterinary professional for medical or veterinary services is excluded for Section 4960 purposes. These services include the diagnosis, cure, mitigation, treatment, or prevention of disease in humans or animals, including services provided to affect any structure or function of the human or animal body.

Excess Parachute Payments

IRC Sec. 4960(a)(2) imposes an excise tax on any excess parachute payment. An *excess parachute payment* is an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. The Section 4960 definition of parachute payment refers to payments contingent on an employee's separation from employment.

Who Is Liable for the Excise Tax?

IRC Sec. 4960(b) provides that the employer is liable for the tax imposed under IRC Sec. 4960(a). The employer is defined consistently with the definition under IRC Sec. 3401(d) used to determine federal income tax withholding. The proposed regulations provide that status as an employer of an employee is not avoided by using a third-party payor to pay remuneration to that employee. Therefore, remuneration paid by a separate organization to an individual for services the individual performed as an employee of the ATEO, whether related to the ATEO or not, is deemed remuneration paid by the ATEO for Section 4960 purposes.

Practical Consideration:

While only an ATEO has covered employees, a covered employee of an ATEO may also be an employee of a related organization, which may cause the related organization to be subject to the excise tax. Multiple entities in an affiliated group treated as common law employers may be liable for the excise tax.

Net Operating Loss (NOL) Carryback FAQs

In the June edition of this newsletter, the CARES Act changes to the NOL rules were covered. The IRS has now posted FAQs (**www.irs.gov/newsroom/faqs-carryback-of-nols-by-certain-exempt-organizations**) clarifying the effect of NOLs on calculating a tax-exempt organization's unrelated business taxable income (UBTI).

First, NOLs are treated differently for tax years beginning in 2018–2020 (CARES Act NOLs). They may be carried back five years and are required to be treated separately for each trade or business (silo).

Second, organizations can deduct CARES Act NOLs against aggregate UBTI in a tax year beginning before January 1, 2018, because the siloing rules didn't apply to those years. Additionally, the organization may carryback to a pre-2018 year a separate CARES Act NOL attributable to an unrelated trade or business, even if the organization would not have an aggregate CARES Act NOL.

Third, any CARES Act NOLs remaining after being carried back to tax years beginning before January 1, 2018, must be siloed consistent with IRC Sec. 512(a)(6).

More on the 2020 Nonprofit Risk Alert

This year's AICPA Audit Risk Alert (Alert), *Not-for-Profit Entities Industry Developments—2020*, has been released, and much of the information is helpful to auditors and nonprofit organization managers alike. Last month's article summarized economic and industry developments discussed in the risk alert. This article summarizes key features of the 2020 edition relating to legislative and regulatory developments; audit and attestation issues and developments; accounting issues and developments; and other items.

Legislative and Regulatory Developments

This section of the Alert discusses the following topics in detail:

- Repeal of the "parking tax" and the IRS refund procedures.
- Changes to Form 990-T.
- Congressional mandating of electronic filing for Form 990 series returns.
- IRS examination of abusive syndicated conservation easement transactions.
- Deductibility of charitable contributions generating state income tax credits.
- Department of Labor overtime rule.
- Matters affecting higher education such as proposed "endowment tax" regulations, IRS guidance on publication of racial nondiscrimination policy, and use of professional employer organizations.
- Matters affecting religious organizations such as minister's housing allowance and the challenge to the Form 990 filing exemption available to churches.

Audit and Attestation Issues and Developments

Auditors are reminded to consider the impact of economic, legislative, and regulatory developments on each unique nonprofit organization engagement. The Alert covers the following areas to consider this year:

- Audit risks for nonprofit organizations.
- New auditing standards, including changes to the auditor's report and an omnibus statement that amends many auditing standard sections.
- New SAS improving transparency about other information in annual reports.
- New agreed-upon procedures standard that provides more flexibility to CPAs.
- New SAS revising the description of the concept of materiality.
- New SSARS providing guidance on materiality and adverse conclusions in review engagements.
- 2019 OMB Compliance Supplement. (Note: Be alert for the 2020 Compliance Supplement, which is expected to be available soon!)
- Enhanced IT controls testing in financial statement audits.

Accounting Issues and Developments

This section of the Alert discusses the following topics in detail:

- Clarification of the accounting for grants and similar contracts.
- Disclosure requirements for revenue from contracts with customers.
- Estimation risk in liquidity and availability disclosures.
- New FASB approach to effective dates.
- FASB delay of effective dates for credit losses, hedging, leases, and long-duration insurance standards.
- FASB's lease update.
- FASB Staff Q&A on credit losses standard implementation.
- Consolidation of related entities.
- FASB's reference rate reform.

Other Items

Other items discussed in the Alert include recent pronouncements; recent AICPA Technical Questions and Answers; recent AICPA independence and ethics developments; AICPA nonprofit initiatives; other projects on the horizon and in the pipeline; and other online or print and internet resources.

FASB's NAC Meets

The FASB's Not-for-Profit Advisory Committee (NAC) works with the FASB to provide input on how accounting standards impact the nonprofit sector. The NAC held its regular semiannual meeting on April 7, 2020. Due to the COVID-19 pandemic, the meeting was held via video conference.

Practical Consideration:

Information about the NAC and its activities is available on the FASB website at **www.fasb.org**.

Meeting Highlights

Here are the highlights on topics discussed at that meeting.

Reporting of Contributed Nonfinancial Assets (Gifts-in-kind) by Not-for-profit Entities (NFPs). NAC members are generally positive about the related proposed ASU, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, pointing to the flexibility in reporting that it is expected to provide, while acknowledging that valuation will be a challenge—but one that can be mitigated through examples in the FASB Codification or via Staff Q&A.

Practical Consideration:

On June 10, 2020, the FASB approved the issuance of a final ASU. It's expected to be issued in the third quarter of 2020, and we'll discuss it in a future issue.

Implementation of Major/Other Updates. NAC also discussed deferral of certain ASUs, which are discussed in the July 2020 issue of *The PPC Nonprofit Update*.

Other Projects in Progress. NAC received an update from FASB Staff on the Identifiable Intangible Assets and Subsequent Accounting for Goodwill project. The current status of that project is available at **http://fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176171566054&d=&pagename=FASB%2FFASBContent_C%2FProjectUpdateExpandPage**.

Recent Trends, Concerns, and Observations of Not-for-Profit Advisory Committee. Not surprisingly, of interest to NAC are issues/solutions affected by the COVID-19 pandemic; for example, changes to grant agreements to increase flexibility in their use by recipients, accounting for forgivable loans provided by the CARES Act Paycheck Protection Program, and additional potential disclosures for subsequent events, going concern considerations, and other matters. NAC believes existing guidance in these areas is adequate.

Practical Consideration:

See the separate article in this issue discussing guidance released by the AICPA after the date of the NAC meeting on accounting for Payroll Protection Program (PPP) loans.

AICPA Q&A 3200.18 Issued on Forgivable PPP Loans

In June 2020, the AICPA issued Q&A Section 3200.18, *Long-Term Debt, Borrower Accounting for a Forgivable Loan Received Under the Small Business Administration Paycheck Protection Program*. The nonauthoritative guidance discusses how nongovernmental entities, which include nonprofit entities and business entities, may account for a forgivable loan received under the Small Business Administration Paycheck Protection Program (PPP). While the legal form of a PPP loan is debt, it may instead be considered, in substance, a government grant if certain conditions are met.

Accounting for PPP as a Loan

For nongovernmental entities, the entity may account for the PPP loan under FASB ASC 470, *Debt*, by initially recording the cash flow from the PPP loan as a financial liability and accruing interest in accordance with the interest method under FASB ASC 835-30, *Interest—Imputation of Interest*. Additional interest is not imputed to reach a market rate since the rate is prescribed by a government agency. The proceeds from the loan would continue to be recorded as a liability until either:

1. The loan is partly or wholly forgiven and the debtor has been legally released; or
2. The debtor pays off the loan.

If the loan is partially or wholly forgiven, the liability is reduced by the amount forgiven and a gain on extinguishment is recorded when the forgiveness occurs and legal release is received.

Accounting for PPP as a Government Grant

Not-for-profit Entities. If the PPP loan's eligibility and loan forgiveness criteria are expected to be met,

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a *not-for-profit entity* may account for PPP loans in accordance with FASB ASC 958-605, *Not-for-Profit Entities—Revenue Recognition*, as a conditional contribution. Under FASB ASC 958-605, the timing of recognition for a contribution received depends on whether the contribution is conditional or not. If the contribution is conditional, it is not recognized until the conditions are substantially met or explicitly waived. So, a not-for-profit entity would initially record the cash inflow from the PPP loan as a refundable advance. Then, the not-for-profit entity would reduce the refundable advance and recognize the contribution after the conditions of release have been substantially met or explicitly waived.

Business Entities. If a nongovernmental entity that is a *business entity* expects that it will meet the PPP's eligibility criteria and concludes that the PPP loan is, in substance, a grant that is expected to be forgiven, it can analogize to the forgivable loan model in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, to account for the PPP loan. In this case, the initial cash inflow is recorded as a deferred income liability and the government assistance would not be recognized until there is reasonable assurance that any conditions will be met and the assistance will be received. At that point, the earnings impact of the government grants should be recorded systematically over the periods that the entity recognizes as expenses the related costs for which the grants are intended to compensate. Alternatively, the AICPA Q&A states that for situations where the PPP's eligibility and loan forgiveness criteria are expected to be met, the business entity can also analogize to the guidance in FASB ASC 958-605 or FASB ASC 450-30, *Contingencies—Gain Contingencies*.

Practical Consideration:

AICPA Q&A 3200.18 is available on Checkpoint or **www.aicpa.org/content/dam/aicpa/interestareas/frc/downloadabledocuments/tqa-sections/tqa-section-3200-18.pdf**.

Auditing Brief

OMB COMPLIANCE SUPPLEMENT STATUS. With the COVID-19 pandemic and related federal funding issues, it is not surprising that we have yet to see the Office of Management and Budget's 2020 Compliance Supplement. OMB staff have indicated that the 2020 Compliance Supplement is in the clearance process at OMB, and they are hoping to release it by the end of July. However, an August release date may be a better bet! Expect the initial 2020 Compliance Supplement to include minimal information about the COVID-19-pandemic and related federal programs and look for an addendum in the fall addressing new federal programs and changes to existing programs. OMB has also confirmed that (1) the six-requirement mandate has been retained, and (2) Part 3.1 will be removed, and Part 3.2 will become Part 3. We'll update you on the Compliance Supplement's contents when it is released. In the meantime, you can check for the new Compliance Supplement at **www.whitehouse.gov/omb/management/office-federal-financial-management/**.