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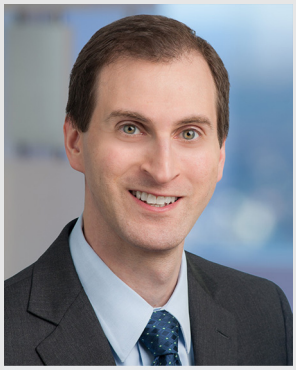

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In this article, Ghatan and Ozmon examine recent guidance on a new rule that requires tax-exempt employers to report unrelated business taxable income when they provide qualified transportation fringe benefits to their employees.

In Notice 2018-99, 2018-52 IRB 1067, issued December 10, 2018, Treasury and the IRS provided interim guidance on determining the amount of unrelated business taxable income attributable to qualified parking expenses and other qualified transportation fringes (QTFs). The notice addresses many key questions tax-exempt organizations have been wrestling with for nearly a year, since the enactment of new section 512(a)(7) as part of the Tax Cuts and Jobs Act (P.L. 115-97), while leaving other issues unresolved and potentially setting traps for the unwary. Taxpayers may rely on the notice immediately pending the issuance of proposed regulations. In a concurrent release, Notice 2018-100, 2018-52 IRB 1074, Treasury and the IRS provide relief for failure to pay estimated unrelated business income tax but only for tax-exempt organizations required to file a Form 990-T, "Exempt Organization Business Income Tax Return (and Proxy Tax Under Section 6033(e))" for the first time because of section 512(a)(7).[1]

I. UBTI Rule for Qualified Transportation Fringes

Section 512(a)(7) provides that, for a tax-exempt employer, UBTI is increased by any amounts for which a deduction would have been disallowed under section 274 if the employer were taxable and that are paid or incurred by the tax-exempt organization for any QTF,[2] any parking facility used in connection with qualified parking, or any on-premises athletic facility.

For taxable employers, section 274(a)(4) provides that no deduction is allowed for the expense of any QTF provided to an employee of the taxpayer. That section does not refer to parking facility expenses.

The asymmetry between these two sections created uncertainty regarding whether parking facility expenses in connection with the provision of qualified parking — specifically referenced in section 512(a)(7) but not in section 274(a)(4) — would nevertheless give rise to UBTI. Also unclear

[1] Attempts to repeal section 512(a)(7) gained momentum at the end of the 115th Congress through the introduction of a manager's amendment to other tax legislation by former House Ways and Means Committee Chair Kevin Brady. Whether such momentum will continue into the 116th Congress remains to be seen.

[2] QTFs include (1) transportation in a commuter highway vehicle between the employee's residence and place of employment, (2) any transit pass, and (3) qualified parking. Qualified parking is parking provided to an employee on or near the business premises of the employer or on or near a location from which the employee commutes to work. Qualified bicycle commuting reimbursements are also listed as a QTF, but under section 132(f)(1)(D), enacted as part of the TCJA, they are suspended as a QTF for 2018 through 2025.

was how to calculate parking facility expenses and whether the amount excluded from an employee's income as a QTF could serve as a substitute or even a cap for calculating the employer's expense (and, therefore, UBTI). Many tax-exempt employers, law firms, bar associations, and industry groups have submitted comments to Treasury and the IRS seeking clarification of these and other issues.

II. Questions Answered by Notice 2018-99

A. Parking-Related Questions

1. Do parking facility expenses give rise to UBTI?

Yes. Notice 2018-99 gives no weight to the fact that parking facility expenses, although specifically identified in section 512(a)(7), are not referenced in section 274(a)(4). Instead, it takes the position that because qualified parking is a QTF and section 274(a)(4) refers to QTFs generally, expenses from qualified parking at facilities owned or leased by the employer are covered and can therefore give rise to UBTI. This view is supported by the Joint Committee on Taxation "bluebook" on the TCJA.[3] However, while parking facility expenses may give rise to UBTI, the notice provides a safe harbor method, as well as an interpretation of parking facility expenses that address many of the concerns that tax-exempt organizations had regarding UBTI from qualified parking.

2. How is UBTI determined for qualified parking at a non-employer facility?

UBTI is increased by the total annual cost of employee parking paid by a tax-exempt employer to a third party. That amount, however, is capped at the section 132(f) monthly exclusion limit for employees for QTFs ($260 per month in 2018 and $265 per month in 2019). Notice 2018-99 indicates that Treasury and the IRS read section 274(e)(2) — an exception to the general deduction disallowance rule of section 274(a) — as permitting a deduction for amounts in excess of the section 132(f) exclusion limit, meaning that if a taxable employer provides QTFs in excess of the amount that may be provided tax free to employees, the excess is includable as gross income for employees and may be deducted by taxable employers. For tax-exempt employers, amounts exceeding the section 132(f) exclusion limit are treated as additional employee compensation, as was already the case before the TCJA, and do not give rise to UBTI.

3. How is UBTI determined for qualified parking at employer-owned or leased facilities?

Until further guidance is issued, the notice provides that tax-exempt employers may use any reasonable method for determining expenses in connection with providing qualified parking at facilities they own or lease. The notice provides a safe harbor method, described below, that may be used to calculate such expenses. Notably, using the value excluded by employees as QTFs under section 132 is not considered a reasonable method.

a. What expenses are included in total parking expenses?

Total parking expenses include, but are not limited to, repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments.

b. What about depreciation?

Notice 2018-99 is clear that Treasury and the IRS do not consider depreciation a parking expense, instead viewing it as an allowance for the exhaustion, wear and tear, and obsolescence of property. Thus, according to the notice, depreciation would not give rise to UBTI. The JCT bluebook, released shortly after the notice, takes a notably different view, stating that the expense of providing qualified parking "includes appropriate allocations of depreciation and other costs with respect to facilities used for parking (for example, allocable salaries for security and maintenance personnel, property taxes, repairs and maintenance, etc.)." Clearly, including depreciation as a parking facility expense would be significantly less favorable to tax-exempt organizations, potentially resulting in substantially higher UBTI liability from the provision of qualified parking. At least until

[3] JCT, "General Explanation of Public Law 115-97," JCS-1-18 (Dec. 20, 2018).

proposed regulations are released, tax-exempt organizations may rely on the notice and not treat any depreciation associated with their parking facilities as giving rise to UBTI.

c. What is the safe harbor method?

The safe harbor, which Treasury and the IRS consider to be a reasonable method of calculating expenses in connection with providing qualified parking, involves a four-step process:

- Step 1: Reserved employee spots.
  - First, identify all spots in the parking facility exclusively reserved for the organization's employees.
  - Next, determine the percentage of these reserved employee spots in relation to all spots and multiply that by the total parking expenses. This amount is included as UBTI.
  - Transition relief: The notice also provides transition relief, allowing employers until March 31, 2019, to change their parking arrangements to decrease or eliminate reserved employee spots, with the change given retroactive recognition as of January 1, 2018.
- Step 2: Primary use of remaining spots.
  - Determine whether the primary use of the remaining parking spots is to provide parking to the general public. "Primary use" means greater than 50 percent of actual or estimated usage of the spots, tested during normal hours on a typical day. Notably, non-reserved spots available to the general public but typically empty during normal hours are nonetheless treated as provided to the general public. "General public" includes customers, clients, visitors, individuals delivering goods or services to the organization, patients of a health care facility, students of an educational institution, and congregants of a religious organization.
  - If the primary use of the remaining spots is to provide parking to the general public, the remaining total parking facility expenses are not included in UBTI.
- Step 3: Reserved non-employee spots.
  - If the primary use of the spots considered in Step 2 is not to provide parking to the general public, identify any of those spots specifically reserved for non-employee use. Then determine the percentage of those reserved non-employee spots in relation to all remaining spots and multiply that by the total remaining parking expenses. This amount is not included as UBTI.
- Step 4: Remaining spots.
  - If there are any remaining spots not addressed in Steps 1-3, reasonably determine the employee use of the remaining spots during normal hours and the allocable expenses. Acceptable methods for making this determination may include specifically identifying the number of employee spots based on actual or estimated usage, such as through number of spots, number of employees, hours of use, or other measures.

The mechanics of the safe harbor are demonstrated through eight examples, two of which are specifically for tax-exempt employers.

d. What about employers with multiple parking facilities?

Employers may aggregate, for purposes of using the safe harbor method, multiple parking facilities within the same geographic location, which, an example makes clear, includes all parking facilities within the same city.

e. Will tax-exempt organizations that make all their parking available to anyone have UBTI from parking facility expenses?

If the organization has no employee-only reserved spots and can demonstrate that the primary use of the spots is for the general public, the organization would have no UBTI. If, however, the primary use is not for the general public, the organization would need to determine actual or estimated usage by employees and include expenses allocable to such spots in UBTI.

B. Other QTF Questions

1. Do QTFs provided through a pretax election give rise to UBTI?

Yes. In March 2018, the IRS updated Publication 15-B, "Employer's Tax Guide to Fringe Benefits," to indicate that under section 274(a)(4) taxable employers are not permitted to deduct pretax employee contributions that are used to pay for QTFs. The notice reinforces this position. In the case of tax-exempt employers, this means employee pre-tax QTF elections would give rise to UBTI. This view is also shared by the JCT in its bluebook.

2. Do on-premises athletic facilities give rise to UBTI?

Generally, no. Section 274 was not amended to address on-premises athletic facilities, so the language in section 512(a)(7) that refers to on-premises athletic facilities is viewed as a drafting error. However, preexisting language in section 274(e) disallows a deduction for recreational expenses that discriminate in favor of highly compensated employees. The notice interprets this language as applying to on-premises athletic facilities. Therefore, to avoid UBTI in connection with any on-premises athletic facilities, tax-exempt organizations must ensure that the facilities do not favor highly compensated employees.

3. Can UBTI from QTFs be offset in any way?

Notice 2018-99 paves a narrow path for reducing UBTI that results from providing QTFs. Because section 512(a)(7) treats the expenses of providing QTFs as income, unlike all other types of UBTI, there are no expenses available from the activity generating the UBTI that could be used to offset the income. However, the notice reinforces a view articulated by Treasury and the IRS in Notice 2018-67, 2018 IRB 409, which provided interim guidance regarding the new UBTI silo rule of section 512(a)(6), namely that an increase to UBTI under section 512(a)(7) is not considered to result from an unrelated trade or business.[4] Consequently, until further guidance is issued, if a tax-exempt organization has only one unrelated trade or business, it would not be subject to the silo rule of section 512(a)(6), and, in the event that the unrelated trade or business has net losses for the year, such losses could be used to offset any UBTI from the provision of QTFs.

4. Must a tax-exempt organization file a Form 990-T if its only UBTI is from providing QTFs?

Yes, if the total UBTI resulting from the application of section 512(a)(7) is $1,000 or more. Draft instructions released by the IRS for the 2018 Form 990-T indicate an attempt to minimize the burden on tax-exempt organizations that are required to file a Form 990-T for the first time only because of section 512(a)(7). The draft instructions only require such filers to complete parts of the heading, relevant lines under Parts III and IV, and the signature line.

III. Questions Not Answered by Notice 2018-99

1. How much UBTI is includable when the expenses of providing qualified parking in an employer's facility exceed the section 132(f) limitation?

All the examples in the notice use relatively small amounts for parking facility expenses, resulting in fairly low UBTI totals. However, even with the exclusion of depreciation from the definition of parking facility expenses and the safe harbor method, employers with significant operating expenses for parking facilities (particularly those with significant interest expenses when most if not all the spots are not for the general public) could still face the risk of UBTI exceeding the value excluded by employees from income as a QTF.

2. Is the section 132(f) limitation available as a cap on UBTI in all cases?

The notice is clear that using the value excluded by employees as QTFs under section 132(f) ($260 per month in 2018 and $265 per month in 2019) is not considered a reasonable method for determining parking facility expenses, and none of the examples in the guidance involving employer-owned or leased parking facilities discuss applying the section 132(f) limitation. However, the notice does apply the limitation as a cap on UBTI resulting from qualified parking at third-party facilities and

[4] *See* Brittany G. Cvetanovich, Sarah Hall, and Franziska Hertel, "UBTI 'Silo' Notice: Interim Rules and Potential Future Guidance," *Tax Notes*, Oct. 15, 2018, p. 335, for a comprehensive summary of the new UBTI "silo" rule and Notice 2018-67.

implies that this cap may be available regarding other QTFs. Because section 274(a)(4) and section 512(a)(7) refer to the employer's expense of providing the QTF and not the value of the QTF excluded from the employee's income, it remains unclear whether the section 132(f) limitation is available as a cap on UBTI when the employer's expense of providing a QTF does not necessarily equal the value excluded from income by the employee. Additional guidance on the application of this cap is necessary.

3. Are parking facility expenses included as UBTI if a tax-exempt employer charges employees to park in an employer-owned or leased facility?

It remains unclear from the notice whether the provision of parking, even if not subsidized by the employer, constitutes a QTF simply by being made available by the employer to its employees. The definition of a QTF (including qualified parking) under the code does not depend on whether the benefit is includable or excludable by the employee; the term is defined as a transportation benefit provided by an employer to an employee. This interpretation is implied by Notice 94-3, 1994-1 C.B. 327, which provides rules for valuing QTFs. In discussing how to value free parking available to employees as well as the general public, that notice, rather than stating that no QTF has been provided, instead states that the parking has a value of $0. This could be read to suggest that a QTF arises simply by providing employees with parking, regardless of whether they pay fair value for that parking. It seems illogical to suggest that making parking available to employees at fair value could cause a tax-exempt employer's parking facility expenses to become includable as UBTI when no value has been excluded by employees from their income as a QTF. However, Treasury and the IRS have not specifically addressed this fact pattern.

4. If an employer permits its employees to make a pretax election to pay for parking in an employer-owned or leased facility, does the employer have to include parking facility expenses in UBTI?

It is clear from Notice 2018-99 that when a tax-exempt employer reduces an employee's salary to pay for parking, that salary reduction is treated as an employer expense includable as UBTI up to the section 132(f) limit ($260 per month in 2018 and $265 per month in 2019). It seems reasonable to conclude that this would be the case whether the compensation reduction is used to pay for parking at a third-party facility or at an employer-owned or leased facility.

However, does the mere fact that an employee uses pretax dollars to pay for parking at an employer-owned or leased facility mean that in addition to including in UBTI the amount of the salary reduction, the employer also has UBTI from its parking facility expenses by providing its employees qualified parking? Does the answer to this question depend on whether the employer charges fair value for the parking? The notice does not address these questions.

5. How is UBTI determined for provision of other QTFs, such as transportation in a commuter highway vehicle?

Notice 2018-99 generally focuses on parking facility expenses, which have been of greatest concern to tax-exempt employers. However, the notice is clear that looking at the value of the amount excluded by employees as QTFs is not a permissible way of determining the expense that gives rise to UBTI. In the case of non-parking QTFs, such as transportation in a commuter highway vehicle, the section 132 regulations provide several methods for calculating the exclusion amount (for example, for van pools, the value of the fringe benefit may be determined using the automobile lease valuation rule, the vehicle cents-per-mile rule, or the commuting valuation rule). It remains to be seen whether Treasury and the IRS will also adopt these methodologies for purposes of calculating UBTI under section 512(a)(7).

IV. Conclusion

Overall, the interim guidance in Notice 2018-99 provides much needed and welcome news for tax-exempt employers who have been struggling since December 2017 with how to account for their new UBTI liability. While the notice concludes that parking facility expenses in connection with providing qualified parking do give rise to UBTI despite the asymmetry between sections 512(a)(7) and 274(a)(4), the guidance provides a safe harbor

method for calculating those expenses and also makes clear that depreciation associated with parking facilities is not considered a parking expense, which together serve to limit the scope of UBTI includable under section 512(a)(7). Nonetheless, some key questions remain unanswered, to be addressed in the future proposed regulations.[5] ■

[5]Notice 2018-99 requests comments by February 22, 2019, on future guidance to clarify sections 512(a)(7) and 274, including on several interpretive decisions made by Treasury and the IRS in the notice.