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Guidance on Parking Expenses Included in UBI

Background

The 2017 Tax Cuts and Jobs Act (TCJA) disallows an income tax deduction for any qualified transportation fringe (QTF) benefit provided to employees [IRC Sec. 274(a)(4)]. Additionally, the unrelated business income (UBI) of a tax-exempt organization is increased by these amounts of QTF benefit expense that are not directly connected with an unrelated trade or business [IRC Sec. 512(a)(7)]. [QTF benefit expenses directly connected to an unrelated business are disallowed under IRC Sec. 274(a)(4).]

TCJA did not address how to determine the amount of QTF benefit that is included in UBI. Notice 2018-99 (2018-52 IRB 1067) provides interim guidance for this calculation that may be relied on until proposed regulations are issued.

QTF Benefits Defined

QTF benefits 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 employer's business premises or on or near a location from which the employee commutes to work [IRC Sec. 132(f)(5)(C)].

Exceptions to Disallowance

IRC Sec. 274(e) lists nine specific exceptions to disallowance under IRC Sec. 274(a). Notice 2018-99 discusses two of these exceptions—

1. goods, services, and facilities treated as compensation to the employees, or
2. goods, services, and facilities made available to the general public.

Nondeductible Parking

Notice 2018-99 further explains the method of determining the nondeductible amount of parking expenses.

Taxpayer Pays a Third Party. If a taxpayer pays a third party so its employees can park at a parking lot or garage, the disallowance is generally the taxpayer's total annual cost of employee parking. However, if the total amount paid for an employee's parking exceeds the limitation on exclusion under IRC Sec. 132(f)(2)

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($265 for 2019 and $260 for 2018), the excess amount is compensation to the employee and not subject to disallowance under IRC Sec. 274(a).

Taxpayer Owns or Leases Parking Facility. Until further guidance is issued, a taxpayer that owns or leases parking facilities where its employees park can calculate the Section 274(a)(4) disallowance using any reasonable method. A four-step process explained in the notice is deemed to be a reasonable method. (Note using the *value* of employee parking to determine expenses allocable to employee parking is not a reasonable method.)

The four-step process described in the notice includes a provision allowing taxpayers with reserved employee parking spots to decrease or eliminate reserved employee parking by March 31, 2019. If this is done, the spots will not be considered reserved employee spots retroactively to January 1, 2018. For taxpayers that own or lease parking facilities, additional guidance is provided:

1. *Multiple Locations.* If a taxpayer owns or leases more than one parking facility in a single geographic location, the number of parking spots can be aggregated when making expense calculations. However, the taxpayer cannot aggregate the spots in parking facilities that are in different geographic locations.
2. *Total Parking Expenses.* 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. However, an allowance for depreciation is not a parking expense. Additionally, items related to property next to the facility (such as lighting or landscaping) are not included.

Practical Consideration:

Practitioners and their clients should monitor the release of proposed regulations. Organizations with reserved employee parking spots should consider revising their current parking designation by March 31, 2019.

Tax on Excessive Compensation

Background

The 2017 Tax Cuts and Jobs Act imposes an excise tax on applicable tax-exempt organizations (ATEO) and related organizations that pay excessive compensation or parachute payments to a covered employee during a tax year beginning after December 31, 2017 (IRC Sec. 4960). An ATEO is any organization that for the tax year is tax-exempt under IRC Sec. 501(a) or certain other exempt entities.

Notice 2019-9 (2019- IRB) provides interim guidance [some of which is provided in question and answer (Q&A) format] on the provisions of IRC Sec. 4960. This article summarizes the main aspects of Notice 2019-9.

Related Organization

A related organization is an entity that (1) controls, or is controlled by, the ATEO; (2) is controlled by one or more persons who control the ATEO; (3) is a supported organization by the ATEO under IRC Sec. 509(f)(3); (4) is a supporting organization of the ATEO under IRC Sec. 509(a)(3); or (5) the ATEO is a voluntary employees' beneficiary association (VEBA), or establishes, maintains, or makes contributions to such VEBA (Q&A-7). Control is further defined in Q&A-8.

Who's Liable

An ATEO, or related organization, is taxable at the corporate tax rate (currently 21%) on the sum of (1) remuneration in excess of $1 million paid to a *covered employee* and (2) any *excess parachute payment* paid to a covered employee, made in the calendar year ending with or within the tax year of the employer.

The common-law employer is the entity liable for the tax. The employer can't circumvent IRC Sec. 4960 by using a third-party payor arrangement. Consequently, a payment to an employer's employee from a third-party payor (e.g., common paymaster) or from an unrelated management company is considered a payment to the employee from the common-law employer. Similarly, a payment to the employee from a related entity, including a related entity that is an ATEO, for services to the common-law employer is considered a payment from the common-law employer.

When an employer that is an ATEO and a related organization pay a covered employee either excessive remuneration or an excess parachute payment, each employer is liable for a portion of the Section 4960 excise tax (Q&A-3). The liability is an amount that bears the same ratio to the total tax as the amount of remuneration paid by the employer bears to the amount of remuneration paid by all employers.

Covered Employee Defined

A *covered employee* is any employee who is one of an ATEO's five highest-compensated employees for the current tax year or who was a covered employee of the ATEO (or any predecessor) for a prior year beginning after December 31, 2016 [IRC Sec. 4960(c)(2)]. Once an employee is a *covered employee*, he or she is a covered employee for all subsequent tax years. There is no minimum dollar threshold for an employee to be a covered employee. Consequently, an employee can be a covered employee even though not paid excess remuneration or an excess parachute payment or not be a highly compensated employee under IRC Sec. 414(q).

Notice 2019-9 (Q&A-10) provides that the determination of an ATEO's five highest-compensated employees is based on remuneration paid in the calendar year ending with or within the employer's tax year. However, remuneration paid to a licensed medical professional that is directly related to performing medical or veterinary services by that professional is not counted. Amounts paid to that professional in any other capacity is counted.

Only an ATEO's common-law employees (including officers) can be one of its five highest-compensated employees. To identify the five, the ATEO must include remuneration paid for the tax year by any related organization, including that paid by a related for-profit organization or governmental entity for services performed as an employee of such related organization. In addition, remuneration paid by a separate organization on behalf of the ATEO, whether or not related, for services performed as an employee of the ATEO is treated as remuneration paid by the ATEO [Q&A-12(c)].

Special rules apply if a related organization or ATEO did not pay at least 10% of the employee's remuneration during the calendar year. Also, an ATEO and related organizations are not combined for determining if an employee is one of the five highest-compensated employees.

Remuneration Defined

Remuneration includes wages subject to withholding and amounts required to be included in gross income under IRC Sec. 457(f), but excluding designated Roth contributions under IRC Sec. 402A(c) [IRC Sec. 4960(c)(3)(A)]. Remuneration also includes a parachute payment that is not an excess parachute payment (Q&A-12).

Excess Parachute Payment Defined

The Basics. Determining whether there is an excess parachute payment is complicated. A parachute payment is any payment in the nature of compensation to (or for the benefit of) a covered employee if (1) such payment is contingent on such employee's separation from employment with the employer, and (2) the aggregate present value of the payments equals or exceeds an amount equal to three times the base amount (defined later). There are exceptions for certain retirement plans, certain payments to licensed medical professionals, and payments to individuals who are not highly compensated employees (HCEs) as defined in IRC Sec. 414(q).

A parachute payment is an excess parachute payment to the extent it exceeds the base amount allocated to the payment. **Caution:** this is the excess over one times the base amount, not the excess over three times the base amount.

Base Amount. The term *base amount* means an individual's annualized includible compensation for a base period [IRC Secs. 4960(c)(5)(D) and 280G(b)(3)]. Base period means the five most recent tax years of the employee during which he or she performed personal services for the ATEO.

Separation from Employment. A payment is contingent on a separation from employment if it would not have been made in the absence of an involuntary separation from employment. If the right to a payment vests as the result of an involuntary separation, the payment is treated as a payment that is contingent on a separation from employment (Q&A-20).

However, some payments made after an involuntary separation from employment are not contingent on a separation from employment. For example, vested deferred compensation paid after an involuntary separation from employment generally is not deemed a parachute payment. Separation from employment may impact the time of, but not the right to, the payment.

Additionally, an amount that was included in gross income in a previous year and excess remuneration that was treated as paid (under Q&A-13) before the separation from employment are not deemed contingent on such separation (Q&A-20). Therefore, while these amounts may be included in the employee's base amount, they are not parachute payments.

Practical Consideration:

There can be no excess remuneration if an ATEO, together with any related organization, pays remuneration of less than $1 million to each of its employees for a tax year, and there can be no excess parachute payment if the employer does not have any highly compensated employees for the tax year.

Implementation Tip #4—Underwater Endowments

Here's an additional tip in our series of implementation tips for ASU 2016-14, *Not-for-Profit Entities (Topic 958), Presentation of Financial Statements of Not-for Profit Entities*. The amendments from the ASU are effective for annual financial statements issued for fiscal year beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. The ASU permits, but doesn't require, nonprofit organizations to apply the changes to interim financial statements in the initial year of adoption.

What are the changes for underwater endowments?

ASU 2016-14 reduces the net asset classes from three (unrestricted, temporarily restricted, and permanently restricted) to two (without donor restrictions and with donor restrictions). Intuitively, it seems like one would just combine the temporarily restricted and permanently restricted net assets classes and arrive at the amount of net assets with donor restrictions. However, that isn't the case if the nonprofit organization has underwater endowments.

Previously, nonprofit organizations reported amounts by which an endowment fund was underwater in unrestricted net assets. After the adoption of ASU 2016-14, organizations report those amounts as a decrease in net assets with donor restrictions. If the organization has done a good job of tracking endowment funds, the reclassification of net assets shouldn't be difficult to calculate.

Practical Consideration:

An underwater endowment is a donor-restricted endowment fund which has a fair value that is less than the original amount of the gift (or other amount the nonprofit organization is required to maintain by either donor restriction or applicable law).

ASU 2016-14 also includes additional financial statement disclosures related to underwater endowments. Those disclosures include:

- in the aggregate, for all underwater endowment funds, the fair value of the underwater endowments;
- the original amount of the endowments (or the level required to be maintained by donor stipulations or by law that extends donor restrictions);
- the deficiency (the amount by which the original gifts exceed the fair value of the endowments); and
- the organization's policy for appropriation from underwater endowment funds and any actions taken during the period.

Practical Consideration:

Use a financial statement disclosure checklist such as the one included in *PPC's Guide to Preparing Nonprofit Financial Statements* or *PPC's Guide to Audits of Nonprofit Organizations* to ensure you are aware of all the required financial statement disclosures related to ASU 2016-14.

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Implementation Tip #5—Comparative Financial Statements

ASU 2016-14, *Not-for-Profit Entities (Topic 958), Presentation of Financial Statements of Not-for Profit Entities,* makes significant changes to financial statement presentation for nonprofit organizations. These changes, which should be applied retrospectively, may present many challenges for organizations that prepare comparative financial statements. Here are some tips on considering financial statement presentation options.

Practical Consideration:

PPC's Guide to Nonprofit GAAP and *PPC's Guide to Preparing Nonprofit Financial Statements* provide detailed coverage, implementation guidance, and example financial statement illustrations and disclosures for the new requirements of ASU 2016-14.

Should your nonprofit organization present comparative financial statements?

The guidance in FASB ASC 205 encourages, but does not require, the presentation of comparative financial statements. In the first year that ASU 2016-14 is adopted, to help ease the transition to the new standards and reduce the costs of adopting the new guidance, organizations may consider whether presenting only a single year (period) in the financial statements versus presenting comparative financial statements is a better option. The authors have heard from several practitioners that they are suggesting that their clients carefully consider just presenting single year financial statements in the year an organization adopts ASU 2016-14. Some practitioners are also urging organizations to consider that option for additional years as organizations face implementation challenges associated with the lease and revenue recognition standards. Organizations that consider this option need to ensure that they are not required to present comparative financial statements (for example, to comply with financing or funding requirements, or grant provisions). Organizations may be able to obtain a waiver from those requirements, or obtain approval from the appropriate entity to just submit two single year financial statements.

Practical Consideration:

The amendments are effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Application to interim financial statements is permitted but not required in the initial year of adoption.

What is required if your nonprofit organization presents comparative financial statements?

According to FASB ASC 958, after the adoption of ASU 2016-14, a complete set of financial statements for a nonprofit organization includes:

- A statement of financial position.
- A statement of activities.
- A statement of cash flows.
- Notes to financial statements.

For organizations that choose to present comparative financial statements, in the initial year of adoption, the organization can elect to omit the following comparative prior period information:

- The analysis of expense by both functional expense classification and natural expense classification. However, nonprofit organizations, such as voluntary health and welfare organizations, that were previously required to present a statement of functional expense do not have the option to omit the analysis of expenses by functional and natural expense classifications.
- The qualitative and quantitative disclosures about liquidity and availability of resources.

Practical Consideration:

Organizations that choose to present comparative financial statements and were previously required to present a statement of functional expense may present the required comparative information in any of the permitted formats—on the face of the statement of activities, as a schedule in the notes to the financial statements, or in a separate financial statement—consistent with the presentation of in the period of adoption.

Definition of Materiality Revised

Recently, the FASB issued Amendments to Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information*, which as you would expect, amends Chapter 3 of Statement of Financial Accounting Concepts No. 8 (CON 8) with respect to the concept of materiality for financial reporting purposes.

Basically, the amended definition of materiality is the omission or misstatement of an item in the financial statements that is large enough or significant enough that it's probable a reasonable person relying on the information would change their judgment or would be influenced by the inclusion or correction of the item.

In addition to amending the definition of materiality for GAAP, there are other notable amendments:

1. While *materiality* and *relevance* are both dependent on what influences or makes a difference to an investor or other decision maker, relevance is a general notion, whereas materiality is entity-specific.
2. The nature of the item and the entity-specific circumstances should be considered when assessing the magnitude of materiality. That is, magnitude, alone, is generally not a sufficient basis for making a materiality decision.
3. There are no general guidelines that can encompass all considerations that influence judgments made by an experienced, reasonable provider of financial information.

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These amendments to CON 8 were effective immediately. CON 8 (as amended) is available at **www.fasb.org** and on Checkpoint at **checkpoint.riag.com**.

Website of Interest

The following website may be of interest to the nonprofit sector.

www.wanonprofitinstitute.org/

The Washington Nonprofits Institute resulted from a partnership between Washington Nonprofits and the Washington Office of the Secretary of State. In 2015, the Washington State Legislature increased the Secretary of State Office's funding for contracted training for charitable and nonprofit organizations. It has contracted with Washington Nonprofits to deliver these programs.

The Institute provides "anytime, anywhere" learning opportunities for nonprofit board members, management, and staff associated with nonprofit organizations of all sizes. The learning is delivered through various formats, including archived webinars and videos, discussion guides, and interactive learning and games. Most of the content is free; some low-cost on-demand courses are also available. Although certain aspects are directed to Washington State nonprofits, much of the content is applicable to all nonprofit organizations. Areas of study include collaboration, communication and marketing, evaluation, finance, fundraising, governance, human resources, information technology, leadership and management, legal and regulatory, planning and strategy, public policy and advocacy, and volunteer management.

The website also provides a checklist to ensure a successful training session for your organization. It is available at **www.wanonprofitinstitute.org/bring-learning-to-your-board**.

A subscription to the Institute's free email newsletter, *The Connector,* is also available.

Accounting Brief

CREDIT LOSSES STANDARDS IMPLEMENTATION DELAYED. In November 2018, the FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, to amend ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduced an expected credit loss methodology for the impairment of financial assets measured at amortized cost basis. ASU 2018-19 delays the implementation of the standard by one year, as discussed in the following paragraphs.

ASU 2018-19 revises the date of adoption for nonprofit organizations and entities other than public business entities. For these entities, the amendments are effective for fiscal years beginning after December 15, 2021, including interi periods within those fiscal years.

ASU 2018-19 also clarifies that receivables arising from operating leases are not in the scope of Subtopic 326-20, and the impairment of such receivables should be accounted for in accordance with Topic 842, *Leases*.

ASU 2018-19 is available at **www.fasb.org** and on Checkpoint at **checkpoint.riag.com**.