TAX REFORM UPDATE

UNDERSTANDING INTERIM GUIDANCE

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Agenda

- Parking Expense Calculations
- Excess Compensation Issues
- Multiple Unrelated Business Income Activities

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PARKING EXPENSE COMPENSATION

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Parking Expense Compensation

- Final Regulations are still outstanding, rely on Notice 2018-99

- In General:
  - Employees can exclude up to $265 (2019) per month from their wages.
  - Employers that pay (directly or indirectly) up to $265 per month per employee must now recognize this as an unrelated business taxable income.

Parking Expense Compensation

- Qualified parking is defined as parking provided to employees on or near the business work premises, or parking on or near a location from which employees commute to work by commuted highway vehicle, mass transit or van pool.
- In its initial guidance, the IRS permitted employers to use “any reasonable method” to calculate taxable parking expenses and established a process to determine safe harbor.

Parking Expense Compensation

- If the organization pays a third party for employee parking spots only, the UBTI is limited to the lesser of the total cost or the monthly exclusion limit of $265 (2019) per employee per month.
- If the organization leases an entire parking lot, or portion of a parking lot, the following analysis is required:
  - Reserved employee parking as a percentage of total parking expense is subject to UBTI.
  - If the general public use the remainder of a nonprofit's parking, then the remaining expense for parking is not subject to UBIT.
  - The portion of expenses related to parking spots that are reserved non-employee spots are not subject to UBIT.

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Parking Expense Calculation

- The AICPA has requested clarification on the following:
  - More specific methods to determine parking expense when not allocated in lease agreement (like comparative lease analysis, value of leased building with and without parking, and use of market rate for parking)
  - General public use threshold should be determined by dividing only the spots used by employees by the total parking spots available to all tenants
  - Use of a snapshot method with a weighted average to determine parking usage in a multi-use facility
  - Ability to aggregate all employee spots if multiple facilities fall within a single geographic location

Parking Expense Calculation

- Filing Requirements:
  - Form 990-T – annually
  - Form 990-W – quarterly estimates
- Payments should be made via EFTPS – if you don't have an account set up, don't wait until the tax is due!

EXCESSIVE COMPENSATION

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Excessive Compensation

- In general, a 21% excise tax is imposed on:
  - Annual compensation exceeding $1 million paid during a given tax year to covered employees of the organization
  - Separation payments <u>over</u> 3 times base salary (golden parachutes)
- Industries most impacted:
  - Credit Unions – both federally and state chartered
  - Financial services
  - Healthcare
  - Higher education

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Excessive Compensation

- Covered employees are current and former employees who are among the top five highest compensated employees for the year since 2016
- Common exclusions:
  - Roth contributions to 401(k) plan
  - Compensation paid to licensed medical professionals for medical services

Excessive Compensation

- **Shifting income:** Nonprofits may consider moving the portion of a covered employee’s bonus that exceeds the $1 million annual threshold to involuntary separation pay.
- If both the wage category and separation pay category are already at or very near the $1 million threshold, organizations should reevaluate pay models to reduce the potential excise tax impact.
- These tactics must be conducted in compliance with Sections 457(f) and 409A regulations for nonqualified deferred compensation for employees of tax-exempt entities.

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Excessive Compensation

- **Phased approach to retirement:** Replacing parachute payments with a phased retirement program eliminates the separation pay and benefits that trigger the excise tax.
- This model could avoid the excise tax on a parachute payment by distributing the amount of separation pay over the step-down years.
- This could have an impact on the service provided by the employee as well as eligibility for medical benefits, so vet thoroughly before implementing.

Excessive Compensation

- **Longer vesting period:** Nonprofits may also want to consider extending vesting schedules for employee compensation. This approach would spread payments over several years to prevent any single year from exceeding the $1 million threshold.

Excessive Compensation

- Where to report:
  - Schedule N of Form 4720
  - Due same day as annual return (if no annual return is filed, it is due 15th day of 5th month after year end.)

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MULTIPLE UBI ACTIVITIES

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Multiple UBI Activities

- In general: Unrelated Business Income is now calculated on each trade or business individually rather than aggregated
    - Trade or business definition is unclear –
        - Example: Do investments in multiple real estate partnerships count as one trade/business or is each partnership a separate trade/business?
    - NOLs from prior years will be able to offset all UBTI until used in their entirety

Multiple UBI Activities

- Under §512(a)6 any organization with more than one unrelated trade or business, unrelated business taxable income shall be computed separately with respect to each such trade or business.
- In interim guidance, IRS Notice 2018-67, issued August 21, 2018, the Notice indicates that a "reasonable, good-faith interpretation" includes the use of the North American Industry Classification System (NAICS) 6-digit codes. Meaning that if the organization has more than one activity under the same NAICS code, it would qualify as one trade or business.

Multiple UBI Activities

- Items needing clarification from Notice 2018-67:
  - Sections 512(b)(4), (13), and (17) treat unrelated debt financed income, specified payments received from controlled entities, and certain insurance income (as defined in § 953) as items of gross income derived from an unrelated trade or business and therefore includable in the calculation of UBTI under § 512(a) even though such amounts ordinarily would be excluded from the calculation of UBTI under §512(b)(1), (2), (3), or (5).
    - Is each debt-financed property a separate trade or business?
    - Is income of the same type from multiple controlled entities separate trade or business?

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UBI: Partnership Interests

- Interim & Transition Rules for Partnership Investments:
  - “exempt organizations with partnership investments should use a reasonable, good-faith interpretation of §§511 and 514, considering all the facts and circumstances, when identifying separate trades or businesses for purposes of §512(a)(6)(A) until the issuance of proposed regulations”
  - De Minimis Test
  - Control Test

UBI: Partnership Interests

- Pending publication of proposed regulations, an exempt organization may aggregate its UBTI from its interest in a single partnership with multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships, as long as the directly-held interest in the partnership meets the requirements of either the de minimis test or the control test.
- Additionally, under this interim rule, an exempt organization may aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as comprising a single trade or business for purposes of § 512(a)(6)(A).

UBI: Partnership Interests

- De Minimis Test:
  - In general - A partnership interest is a qualifying partnership interest that meets the requirements of the de minimis test if the exempt organization holds directly no more than two percent of the profits interest and no more than two percent of the capital interest.
  - Percentage interests – you may rely on the Schedule K-1.
  - Combining Related Interests - must include interest of disqualified persons, supporting organizations and/or controlled entities in the same partnership.

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UBI: Partnership Interests

- Control Test:
  - In General - A partnership interest is a qualifying partnership interest that meets the requirements of the control test if the exempt organization (i) directly holds no more than 20 percent of the capital interest; and (ii) does not have control or influence over the partnership.
  - Percentage interest: you may rely on the Schedule K-1.
  - Combining related interests: same rules as de minimis test.

UBI: Partnership Interests

- Control Test:
  - Control or Influence:
    - if the exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership.
    - if any of the exempt organization’s officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership’s business at any time, or if the exempt organization has the power to appoint or remove any of the partnership’s officers, directors, trustees, or employees.

UBI: Partnership Interests

- Unrelated Debt-Financed Income - The income from qualifying partnership interests permitted to be aggregated under the interim rule includes any unrelated debt-financed income (within the meaning of § 514) that arises in connection with the qualifying partnership interest that meets the requirements of either the de minimis test or the control test.

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