OVERVIEW OF SECTION 512(a)(7): UNRELATED BUSINESS TAXABLE INCOME INCREASED BY DISALLOWED FRINGE BENEFITS

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 19, 2019

Prepared by the Staff
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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing for June 19, 2019, relating to section 512(a)(7),[1] which generally requires a tax-exempt organization to increase its unrelated business taxable income by reason of providing certain transportation-related fringe benefits to its employees. This document,[2] prepared by the staff of the Joint Committee on Taxation, provides an overview of this provision.

On December 22, 2017, the President signed into law Public Law 115-97, sometimes referred to as the Tax Cuts and Jobs Act. The law includes two provisions that, taken together, modify the tax treatment of tax-exempt employers that provide qualified transportation fringes, such as parking and certain transit benefits, to their employees.

Public Law 115-97 first amends section 274 generally to disallow a deduction to taxable employers[3] for the provision of a qualified transportation fringe. As a companion provision, the law adds new section 512(a)(7), which generally requires a tax-exempt organization to pay corporate tax on amounts relating to the provision of qualified transportation fringes, provided that a deduction would be disallowed under section 274 (as amended). The mechanism by which this corporate tax is imposed is an increase in the organization's unrelated business taxable income, or UBTI. The two provisions of Public Law 115-97 are thus designed to apply to the same fringe benefits in the same amounts, in one instance by disallowing a deduction and thus increasing taxable income (to a taxable employer) and in the other instance by increasing UBTI (of a tax-exempt employer).

Part I of this document includes a summary of relevant law in effect prior to the enactment of Public Law 115-97. Part II describes the changes made by Public Law 115-97 to the tax treatment of qualified transportation fringes, including the enactment of section 512(a)(7). Part III describes IRS guidance relating to section 512(a)(7), including interim guidance concerning the determination of the deduction disallowance or UBTI increase when an employer provides parking to its employees. Finally, Part IV describes recent legislative activity at the Federal and State levels in response to the enactment of section 512(a)(7).

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[1] Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[2] This document may be cited as follows: Joint Committee on Taxation, *Overview of Section 512(a)(7): Unrelated Business Taxable Income Increased by Disallowed Fringe Benefits* (JCX-25-19), June 14, 2019. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[3] Throughout this document, references to taxable employers also include unrelated trades or businesses of a tax-exempt organization that give rise to unrelated business taxable income. Such income generally is taxed at corporate rates and is computed by allowing deductions that are directly connected with the unrelated trade or business. In determining allowable deductions for this purpose, the deduction disallowance rules of section 274 (as modified) apply.

I. BACKGROUND

This Part describes background law in effect before the enactment of Public Law 115-97. Section A provides an overview of the unrelated business income tax ("UBIT"), which applies to certain income of a tax-exempt organization that is derived from a trade or business unrelated to the organization's tax-exempt purpose. Section B briefly describes the tax treatment to employers and to employees of the provision of certain fringe benefits.

A. Unrelated Business Income Tax

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including section 501(c)(3) charitable organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Unrelated business income tax, in general

UBIT generally applies to income derived from a trade or business regularly carried on by a tax-exempt organization that is not substantially related to the performance of the organization's tax-exempt purpose or functions.[4] An organization determines its unrelated business taxable income ("UBTI") by subtracting from its gross unrelated business income the deductions directly connected with the unrelated trade or business.[5] UBTI is taxed at the income tax rates that apply to corporations.[6] For tax years beginning after December 31, 2017, corporations pay tax at a flat rate of 21 percent.[7]

The UBIT rules apply to most tax-exempt organizations, including: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);[8] (2) qualified pension, profit-

[4] Secs. 511-514.

[5] Sec. 512(a).

[6] Secs. 11 and 511(a)(1).

[7] Sec. 11(b). A tax-exempt organization that is a fiscal year taxpayer, rather than a calendar year taxpayer, must compute tax on its UBTI using a blended tax rate for a fiscal year that begins in 2017 and ends in 2018. Tax liability using a blended rate generally is determined by computing tax liability using the pre-2018 tax rate and the post-2017 tax rate for the entire year, then prorating those amounts based on the number of days in each period relative to the total days in the tax year. On June 5, 2019, the IRS issued a news release that indicates that the blended rate applies to UBTI arising from section 512(a)(7). The news release is available at: https://content.govdelivery.com/accounts/USIRS/bulletins/2493a03?reqfrom=share.

[8] Sec. 511(a)(2)(A).

sharing, and stock bonus plans described in section 401(a);[9] and (3) certain State colleges and universities.[10]

Exclusions from unrelated business taxable income

Certain types of income are specifically excluded from UBTI, such as dividends, interest, royalties, and certain rents,[11] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[12] Certain types of activities are not considered unrelated trade or business activities, such as activities in which substantially all the work is performed by volunteers, which involve the sale of donated goods, or which are carried on for the convenience of members, students, patients, officers, or employees of a charitable organization.[13] Additional exempt activities include certain activities of trade shows and State fairs,[14] conducting bingo games,[15] and the distribution of low-cost items incidental to the solicitation of charitable contributions.[16]

Specific deduction against unrelated business taxable income

In computing UBTI, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried to another year.[17]

In the case of a diocese, province of a religious order, or a convention or association of churches, there is also allowed a specific deduction with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the

[9] *Ibid.*

[10] Sec. 511(a)(2)(B). Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may generally engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities. Treas. Reg. sec. 1.501(c)(3)-1(e). Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

[11] Sec. 512(b).

[12] Sec. 512(b)(13).

[13] Sec. 513(a).

[14] Sec. 513(d).

[15] Sec. 513(f).

[16] Sec. 513(h).

[17] Sec. 512(b)(12).

gross income derived from any unrelated trade or business regularly carried on by the local unit.[18]

Annual reporting and reporting of UBIT liability

Exempt organizations are required to file an annual information return, Form 990 (Return of Organization Exempt From Income Tax), stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.[19] Exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.[20]

An organization that is subject to the UBIT rules and that has $1,000 or more of gross UBTI must report that income on Form 990-T (Exempt Organization Business Income Tax Return). The above-described Form 990 filing exceptions do not apply to the Form 990-T. Thus, for example, a church generally does not have to file Form 990, but it must nevertheless file Form 990-T if it has $1,000 or more of gross UBTI.

B. Tax Treatment to Employers and to Employees of the Provision of Fringe Benefits Prior to Public Law 115-97

Limitations on employer deductions

Under the law in effect before the enactment of Public Law 115-97, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation ("entertainment"), unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (*e.g.*, an airplane) used in connection with such activity.[21] If the taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount

[18] *Ibid*.

[19] Sec. 6033(a). An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination. An organization that is required to file an information return, but that has gross receipts of less than $200,000 during its taxable year, and total assets of less than $500,000 at the end of its taxable year, may file Form 990-EZ. If an organization normally has gross receipts of $50,000 or less, it must file Form 990-N ("e-postcard"), if it chooses not to file Form 990 or Form 990-EZ. Private foundations are required to file Form 990-PF rather than Form 990.

[20] Sec. 6033(a)(3); Treas. Reg. secs. 1.6033-2(a)(2)(i) and (g)(1).

[21] Sec. 274(a)(1).

otherwise deductible.[22] Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible.[23] In addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose.[24]

There are a number of exceptions to the general rule disallowing the deduction of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. One such exception applies to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and as wages to an employee.[25] Another exception applies to expenses for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (*e.g.*, a nonemployee director) as compensation for services rendered or as a prize or award.[26] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the taxpayer's actual cost, even if a greater amount (*i.e.*, fair market value) is includible in income.[27]

Other exceptions to the deduction disallowance rules include the following: expenses paid or incurred by the taxpayer, in connection with the performance of services for another person (other than an employer), under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person;[28] expenses for recreational, social, or similar activities primarily for the benefit of employees other than certain owners and highly compensated employees;[29] expenses directly related to business meetings of a taxpayer's employees, stockholders, agents or directors,[30] or directly related and necessary to attendance at business meetings or conventions of organizations described in section 501(c)(6) and exempt from taxation under section 501(a);[31] expenses for goods, services, and facilities made available

[22] Sec. 274(n)(1)(B).

[23] Sec. 274(n)(1)(A).

[24] Sec. 274(a)(3).

[25] Sec. 274(e)(2)(A).

[26] Sec. 274(e)(9).

[27] Treas. Reg. sec. 1.162-25T(a).

[28] Sec. 274(e)(3).

[29] Sec. 274(e)(4).

[30] Sec. 274(e)(5).

[31] Sec. 274(e)(6).

by the taxpayer to the general public;[32] and expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a *bona fide* transaction for an adequate and full consideration in money or money's worth.[33]

Employee compensation

Expenses treated as compensation

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.[34] In general, an employee (or other service provider) must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount (if any) paid by the individual and the amount (if any) specifically excluded from gross income.[35] Treasury regulations provide detailed rules regarding the valuation of certain fringe benefits, such as flights on an employer-provided aircraft.

Excludable fringe benefits

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, *de minimis* fringes, qualified transportation fringes, on-premises athletic facilities, and meals provided for the "convenience of the employer."[36]

Qualified transportation fringes provided by an employer include qualified parking (parking on or near the employer's business premises or parking on or near a location from which the employee commutes to work by transit pass, vanpool, or carpool), transit passes, vanpool benefits (commuter highway vehicles for travel between the employee's residence and place of employment), and qualified bicycle commuting reimbursements.[37] The qualified

[32] Sec. 274(e)(7).

[33] Sec. 274(e)(8).

[34] Sec. 61(a)(1).

[35] Treas. Reg. sec. 1.61-21(b)(1).

[36] Secs. 132(a), 119(a), 3121(a)(19) and (20), 3231(e)(5) and (9), 3306(b)(14) and (16), and 3401(a)(19).

[37] Secs. 132(f)(1) and (5). For this purpose, "employee" is defined as any individual who is currently employed by the employer, including common law employees and other statutory employees such as officers of corporations. Treas. Reg. secs. 1.132-1(b)(2)(i) and -9(b) Q/A-5. Partners, two-percent shareholders of S corporations, sole proprietors, and independent contractors are not employees for purposes of section 132(f). Treas. Reg. sec. 1.132-9(b) Q/A-24. While many volunteers are not treated as employees for this purpose, some volunteers may be treated as employees, depending on the particular circumstances.

transportation fringe exclusions are subject to monthly limits.[38] The adjusted maximum monthly excludable amount for 2019 is $265.

On-premises athletic facilities are gyms or other athletic facilities located on the employer's premises, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.[39]

[38] Sec. 132(f)(2).

[39] Sec. 132(j)(4).

II. CHANGES MADE TO THE TREATMENT OF CERTAIN TRANSPORTATION FRINGE BENEFITS BY PUBLIC LAW 115-97

Public Law 115-97 changed the tax treatment to both taxable employers and tax-exempt employers of providing certain transportation fringe benefits to employees. To understand the changes that apply to a tax-exempt employer, it is necessary first to understand the changes that disallow certain deductions to a taxable employer. Section A therefore describes the changes made by Public Law 115-97 to the deductibility of qualified transportation fringes. Section B then describes new section 512(a)(7), which increases the UBTI of a tax-exempt employer by qualified transportation fringes.

A. Changes to the Deductibility of Qualified Transportation Fringes

Public Law 115-97 amends section 274 to disallow a deduction for items with respect to providing any qualified transportation fringe to employees of the taxpayer. Such items include amounts elected by an employee to be used on a pretax salary basis towards any qualified transportation fringe. The term "qualified transportation fringe"[40] includes qualified parking, and therefore encompasses costs associated with providing qualified parking, including any parking facility maintained by the employer or parking on any portion of the employer's business premises used in connection with qualified parking. This is intended to include appropriate allocations of depreciation[41] and other costs with respect to facilities used for parking (*e.g.*, allocable salaries for security and maintenance personnel, property taxes, repairs and maintenance, etc.). The term also includes transportation in a commuter highway vehicle between the employee's residence and place of employment and any transit pass.

The amount of the deduction disallowance is equal to the amount of direct and other properly allocable costs of the taxpayer to provide the qualified transportation fringe. Accordingly, the deduction disallowance is not determined by reference to the value of the transportation fringe benefit calculated for purposes of applying section 132(f).

The provision also disallows a deduction for any expense incurred for providing any transportation, or any payment or reimbursement, for commuting between the employee's residence and place of employment, except as necessary for ensuring the safety of an employee.

Generally, the deduction disallowance does not apply to qualified transportation fringe expenses that are treated by the taxpayer as compensation to its employees.[42]

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[40] Sec. 132(f).

[41] A technical correction may be necessary to reflect this intent. In interim guidance, the IRS takes the position that a deduction for an allowance for depreciation is not a parking expense for this purpose. See Notice 2018-99, December 10, 2018. See also footnote 52 and accompanying text, *infra*.

[42] See section 274(e)(2). See also IRS Notice 2018-99, described below. A technical correction may be necessary to reflect this intent. Note that this would apply to qualified bicycle commuting reimbursements during

B. Increase in Unrelated Business Taxable Income of a Tax-Exempt Employer That Provides Qualified Transportation Fringes

Under section 512(a)(7), added to the Code by Public Law 115-97, UBTI of a tax-exempt organization is increased to the extent that a deduction is not allowable by reason of section 274 for any item with respect to qualified transportation fringe benefits[43] or any parking facility used in connection with qualified parking.[44] The determination of UBTI associated with providing qualified transportation fringes, including parking facilities used in connection with qualified parking, is intended to be consistent with the determination of the deduction disallowance under section 274.

On its face, new section 512(a)(7) also provides that UBTI is increased by any amount paid or incurred by an organization for any on-premises athletic facility (as defined in section 132(j)(4)(B)) for which a deduction is not allowable by reason of section 274. The enacted amendments to section 274, however, do not result in a deduction disallowance for items with respect to on-premises athletic facilities if the facility is primarily for the benefit of the organization's employees and does not discriminate in favor of highly compensated employees;[45] therefore, such items are not included in UBTI.

Section 512(a)(7) does not apply to any item directly connected with an unrelated trade or business that is regularly carried on by the organization.[46] The $1,000 specific deduction available to organizations under section 512(b)(12) may be used to offset UBTI resulting from the provision of qualified transportation fringes.[47]

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the suspension period (taxable years beginning after December 31, 2017, and ending before January 1, 2026) of the exclusion from gross income for such benefits.

[43] See sec. 132(f).

[44] See sec. 132(f)(5)(C).

[45] Secs. 132(j)(4) and 274(e)(4).

[46] These amounts are excluded from section 512(a)(7), because income from an unrelated trade or business of a tax-exempt organization that is regularly carried on generally is subject to corporate tax under the UBIT rules, described above. An organization determines its UBTI by subtracting from its gross unrelated business income the deductions directly connected with the unrelated trade or business. In determining allowable deductions for this purpose, the deduction disallowance rules of section 274 (as modified) apply.

[47] A separate provision of Public Law 115-97 created new section 512(a)(6), which relates to the computation of UBTI by an organization with more than one unrelated trade or business. For such an organization, section 512(a)(6) requires that UBTI first be computed separately with respect to each trade or business and without regard to the $1,000 specific deduction generally allowed under section 512(b)(12). The organization's UBTI for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a separate unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction

III. ADMINISTRATIVE GUIDANCE

On December 10, 2018, the IRS issued two notices concerning the changes made by Public Law 115-97 to the tax treatment of transportation fringe benefits. Notice 2018-99, described in section A below, provides interim guidance to employers to determine the nondeductible amount (in the case of a taxable employer) or increase in UBTI (in the case of a tax-exempt employer) attributable to the provision of parking to employees. Notice 2018-100, described in section B below, provides relief to a tax-exempt employer from penalties for underpayment of estimated taxes that relate to the provision of qualified transportation fringes.

Section C, below, describes modifications to IRS Form 990-T (Exempt Organization Business Income Tax Return) for the reporting of a tax-exempt employer's increase in UBTI under section 512(a)(7).

A. Interim Guidance Relating to Parking

Overview

IRS Notice 2018-99 provides interim guidance to assist taxpayers in determining the amount of a qualified transportation fringe for qualified parking that is nondeductible under section 274 or for which an amount is includible in UBTI under section 512(a)(7). The Notice indicates that the Treasury Department and IRS intend to issue proposed regulations on this matter. Until such time, however, taxpayers and tax-exempt organizations that own or lease parking facilities where their employees park may use any reasonable method (including the method set forth in the Notice) to determine the nondeductible or includible amount.

Consistent with the Joint Committee staff's *General Explanation of Public Law 115-97*,[48] Notice 2018-99 clarifies that section 274 denies a deduction for qualified transportation fringes, such as employer-provided parking, whether the fringe benefit is provided in-kind, through a bona fide cash reimbursement arrangement, or through a compensation reduction agreement.[49]

Exceptions to deduction disallowance or UBTI inclusion

The Notice describes two exceptions to the deduction disallowance rule under section 274 that are particularly relevant in determining the nondeductible amount (or, in the case of a tax-exempt employer, the amount of the increase in UBTI) with respect to qualified transportation fringes: (1) expenses treated by the taxpayer as compensation to its employees;

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from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.

[48] JCS-1-18, December 2018, p. 189.

[49] See also IRS Publication 15-B, "*Employer's Tax Guide to Fringe Benefits (For Use in 2019)*" (revised December 18, 2018), p. 21 (providing that, by reason of the Public Law 115-97 amendments to section 274, no deduction is allowed for qualified transportation fringes whether provided directly by the employer, through a bona fide reimbursement arrangement, or through a compensation reduction arrangement).

and (2) expenses for goods, services, or facilities made available by the taxpayer to the general public.

Expenses treated as compensation to the taxpayer's employees

Although section 274(a)(2) generally denies a deduction for qualified transportation fringes (including qualified parking), section 274(e)(2) provides an exception for amounts that are treated as compensation and wages to the employee. As is discussed above, qualified transportation fringes generally are excluded from an employee's gross income and from wages for employment tax purposes, but only up to a monthly limit that is annually adjusted.[50] The monthly limit for 2019 is $265.

Notice 2018-99 provides that expenses for a qualified transportation fringe qualify for the section 274(e)(2) exception to the extent that the fair market value of the fringe benefit exceeds the monthly limit on the amount of the employee's exclusion, and such excess amount is included in the employee's compensation and wages. In other words, to the extent the value of the qualified transportation fringe provided to an employee exceeds $265 per month (for 2019) and the value in excess of $265 per month is treated as compensation, the employer's expenses with respect to such fringe benefit remain deductible. In the case of a tax-exempt employer, such excess expenses do not increase the employer's UBTI under new section 512(a)(7).

Goods, services, or facilities made available to the general public

Although section 274(a)(2) generally denies a deduction for qualified transportation fringes (including qualified parking), section 274(e)(7) provides an exception for goods, services, or facilities made available by the taxpayer to the general public. Notice 2018-99 provides that expenses for parking made available to the general public qualify for this exception. In the case of a tax-exempt employer, such expenses do not increase the employer's UBTI under new section 512(a)(7).

Methods for determining the amount of the deduction disallowance or, for a tax-exempt employer, the UBTI inclusion

Notice 2018-99 includes guidance for determining the nondeductible amount or increase in UBTI where (1) the employer pays a third party for employee parking spots or (2) the employer owns or leases all or part of one or more parking facilities that are used by its employees. This guidance is based, in part, upon the two exceptions to the deduction disallowance under section 274 described immediately above.

Where the employer pays a third party for employee parking spots

Where a taxable or tax-exempt employer pays a third party an amount so that the employer's employees may park in the third party's parking facility, Notice 2018-99 provides that the amount that is nondeductible or that is includible in UBTI generally is the total annual cost of employee parking paid to the third party. If, however, the amount paid to the third party

[50] Sec. 132(f)(2).

exceeds the monthly limit on the amount of the exclusion from the employee's gross income and wages ($265 per employee for 2019), the excess amount is treated by the employer as compensation and wages to the employee. Such excess amount therefore remains deductible and, in the case of a tax-exempt employer, does not increase UBTI.

Where the employer owns or leases all or a portion of a parking facility

In general.–Determining the amount of the deduction disallowance or increase in UBTI may be more complex where the employer owns or leases all or a portion of one or more parking facilities that are used by its employees. Under Notice 2018-99, an employer may use any reasonable method to determine this amount until further guidance is issued. The Notice also sets forth a four-step method that is deemed to be a reasonable method.[51]

Total parking expenses.–To determine the amount of the disallowance or inclusion, Notice 2018-99 requires that the employer first determine the amount of "total parking expenses." The Notice provides that 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 or a portion of a rent or lease payment (if not broken out separately)." The Notice excludes expenses paid for items not located in or on the parking facility, including items related to property next to the parking facility such as landscaping or lighting.

The Notice further takes the position that a deduction for an allowance for depreciation is *not* a parking expense for this purpose. This position conflicts with the statement in the Joint Committee staff's *General Explanation of Public Law 115-97* that the term "qualified transportation fringe" includes "appropriate allocations of depreciation and other costs with respect to facilities used for parking."[52]

Four-step method for determining the amount of the deduction disallowance or increase in UBTI.–As stated above, Notice 2018-99 includes a four-step method that is deemed to be a reasonable method for determining the amount of the deduction disallowance or increase in

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[51] Using the *value* of employee parking to determining expenses allocable to employee parking is not a reasonable method, because section 274(a)(4) denies a deduction for the expense of providing a qualified transportation fringe regardless of its value. In addition, for tax years beginning on or after January 1, 2019, a method that fails to allocate expenses to reserved employee spots is not a reasonable method.

[52] JCS-1-18, December 2018, p. 190. The Notice compares the use of the term "item" in section 274(a)(1) (disallowing deductions relating to entertainment activities or facilities) with the term "expenses" as used in section 274(a)(4) (disallowing deductions for qualified transportation fringes), and concludes that the narrower term "expenses" does not include a deduction for an allowance for depreciation. As is discussed in Part IV, below, on January 2, 2019, Representative Kevin Brady, then-Chairman of the Ways and Means Committee, released as a discussion draft a bill that would make technical corrections to Public Law 115-97. Two of the proposed technical corrections would have the effect of denying a deduction (under section 274) or increasing UBTI (under section 512(a)(7)) for "items" with respect to qualified transportation fringes. The discussion draft is available at the following link: https://republicans-waysandmeansforms.house.gov/uploadedfiles/tax_technical_and_clerical_corrections_act_discussion_draft.pdf.

UBTI for a qualified transportation fringe where an employer owns or leases all or a portion of a parking facility.

1. Step 1: Calculate the disallowance for reserved employee spots. The employer must identify the number of spots in the facility (or the taxpayer's portion of the facility) exclusively reserved for the taxpayer's employees ("reserved employee spots"). The percentage of reserved employee spots in relation to total parking spots is multiplied by the employer's total parking expenses. The product is the amount of total parking expenses for which a deduction is disallowed, or for which an amount is included in UBTI, for reserved employee spots.

   Under a special safe harbor rule provided in the Notice, employers that had reserved employee spots were permitted to change their parking arrangements by March 31, 2019, to decrease or eliminate reserved employee spots (by changing signage, access, etc.). Employers are permitted to treat any such spots as *not* reserved employee spots under the Notice retroactively to January 1, 2018.

2. Step 2: Determine the primary use of the remaining spots. The employer must next identify the remaining parking spots in the facility and determine whether their primary use is to provide parking to the general public. If the primary use of the remaining spots is to provide parking to the general public, then the remaining total parking expenses (after completing Step 1) are excepted from the deduction disallowance (and, in the case of a tax-exempt employer, do not increase UBTI).

   "Primary use" means greater than 50 percent of actual or estimated usage of the parking spots in the parking facility. Primary use is tested during normal business hours on a typical business day, or in the case of an exempt organization during the normal hours of the exempt organization's activities on a typical day. Unreserved spots that are empty but available to the general public during normal business hours on a typical business day are treated as provided to the general public.

   For this purpose, the general public includes, but is not limited to: customers and potential customers, clients, visitors, individuals delivering goods or services to the taxpayer or organization, patients of a health care facility, students of an educational institution, and congregants of a religious organization.

3. Step 3: Calculate the allowance for reserved nonemployee spots. If, under Step 2, the primary use of the employer's remaining spots is not to provide parking to the general public, then the employer may identify the number of spots reserved exclusively for nonemployees (*e.g.*, spots reserved for visitors and customers). If the employer has reserved nonemployee spots, it may determine the percentage of its remaining total parking spots (after Step 1) that are reserved nonemployee spots and multiply this percentage by the remaining total parking expenses (after Step 1). The product is the amount of remaining total parking expenses for which a deduction is *not* disallowed or for which there is *not* an increase in UBTI.

4. Step 4: Determine remaining use and allocable expenses. If, after completing Steps 1-3, the employer has any remaining parking expenses that have not been classified as deductible or nondeductible (or for a tax-exempt employer includible or excludible from UBTI), then the taxpayer must reasonably determine the employee use of the remaining parking spots during normal business hours on a typical business day (or, in the case of an exempt organization, during the normal hours of the exempt organization's activities on a typical day), and the related expenses allocable to the employee parking spots.

Example.–The following example is reproduced from Notice 2018-99 (Example 9).

> Tax-Exempt Organization J, a religious organization that operates a church and a school, owns a surface parking lot adjacent to its buildings. J incurs $10,000 of total parking expenses. J's parking lot has 500 spots that are used by its congregants, students, visitors, and employees, and 10 spots that are reserved for certain employees. During the normal hours of J's activities on weekdays, J usually has approximately 50 employees parking in the lot in non-reserved spots and approximately 440 non-reserved parking spots that are empty. During the normal hours of J's activities on weekends, J usually has approximately 400 congregants parking in the lot in non-reserved spots and 20 employees parking in the lot in non-reserved sports.
>
> Step 1. Because J has 10 reserved spots for certain employees, $200 ((10/500) x $10,000 = $200) is the amount of total parking expenses that is nondeductible for reserved employee spots under § 274(a)(4). Thus, under § 512(a)(7), J must increase its UBTI by $200, the amount of the deduction disallowance under § 274(a)(4).
>
> Step 2. Because usage of the parking spots varies significantly between days of the week, J uses a reasonable method to determine that the primary use of the remainder of J's parking lot is to provide parking to the general public because 90% (440/490 = 90%) of the spots are used by the public during the weekdays and 95% (470/490) of the spots are used by the public on the weekends. The empty, non-reserved parking spots are treated as provided to the general public. Thus, expenses allocable to these spots are excepted from the § 274(a) disallowance by § 274(e)(7) under the primary use test, and only $200 of the expenses for the provision of the [qualified transportation fringe] will result in an increase in UBTI under § 512(a)(7).
>
> If J does not have gross income from any unrelated trades or businesses of $800 or more included in computing its UBTI (to reach the $1,000 filing threshold), J is not required to file a Form 990-T for that year.

Interaction between new sections 512(a)(6) and 512(a)(7).–As indicated above, new section 512(a)(6), which was also added to the Code by Public Law 115-97, requires that a tax-exempt organization that has more than one unrelated trade or business compute UBTI separately for each such trade or business (sometimes referred to as the "UBIT basketing" rule). The effect of the provision generally is to prevent the use of a deduction from one unrelated trade or business to offset income from another unrelated trade or business.

Notice 2018-99 clarifies that the provision of a qualified transportation fringe that results in an increase in UBTI under section 512(a)(7) is not an unrelated trade or business for purposes of determining whether an organization has more than one unrelated trade or business, thereby causing the organization to be subject to the UBIT basketing rule. As a result, an organization with an increase in UBTI under section 512(a)(7) and only one unrelated trade or business is not subject to the UBIT basketing rule of section 512(a)(6). Such an organization may use deductions from the unrelated trade or business to offset its increase in UBTI under section 512(a)(7).

B. Penalty Relief Relating to Qualified Transportation Fringes

In Notice 2018-100, the IRS indicates that, because of new section 512(a)(7), certain tax-exempt organizations that provide qualified transportation fringes will owe UBIT and be obligated to make quarterly estimated tax payments for the first time. As a result, an organization cannot qualify for penalty relief under an existing safe harbor for taxpayers that made estimated tax payments for the current year that are at least equal to 100 percent of the tax shown on the taxpayer's return for the preceding year.[53]

Accordingly, Notice 2018-100 provides that the penalty (addition to tax) under section 6655 for failure to make estimated income tax payments otherwise required to be made on or before December 17, 2018, is waived for certain tax-exempt organizations that provide qualified transportation fringes to an employee to the extent that the underpayment results from the enactment of section 512(a)(7). The relief applies only to a tax-exempt organization that (1) was not required to file a Form 990-T for the taxable year immediately preceding the first taxable year ending after December 31, 2017, and (2) timely files Form 990-T and timely pays the amount reported for the taxable year for which relief is granted.

C. Reporting By a Tax-Exempt Employer on Form 990-T

The IRS revised Form 990-T (Exempt Organization Business Income Tax Return) and the related instructions for 2018 to provide for reporting of an increase in UBTI by reason of the provision of qualified transportation fringes. An organization that has no UBTI other than an increase in UBTI attributable to transportation fringes must complete the introductory portions of Form 990-T that appear above Part I of the form, with the exception of blocks C (book value of all assets at end of year), E (unrelated business activity code), H (number of unrelated trades or businesses), and I (whether the organization was a subsidiary in an affiliated group or a parent-subsidiary controlled group). In addition, the organization must complete Parts III (total unrelated business taxable income), IV (tax computation), and V (tax and payments). Amounts that relate to the provision of qualified transportation fringes are reported on line 34 of Part III ("[a]mounts paid for disallowed fringes").

An organization is not required to file Form 990-T unless the sum of its gross income from a regularly conducted unrelated trade or business and any increase in UBTI under section 512(a)(7) is $1,000 or more.

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[53] Sec. 6655(d)(1)(B).

IV. LEGISLATIVE RESPONSE

A. Federal Legislation

This section describes legislation relating to the repeal or modification of new section 512(a)(7), which increases a tax-exempt organization's UBTI for the provision of qualified transportation fringes.

116th Congress

Introduced bills that would repeal section 512(a)(7)

- H.R. 513 (116th Congress), the "Nonprofits Support Act," was introduced January 11, 2019, by Representative Michael Conaway. The bill would repeal both section 512(a)(6) (requiring that UBTI be computed separately for each of an organization's unrelated trades or businesses) and 512(a)(7) (increasing UBTI for qualified transportation fringes). The repeal would be retroactive, as if originally included in Public Law 115-97.

- S. 501 (116th Congress), the "Stop the Tax Hike on Charities and Places of Worship Act," was introduced on February 14, 2019, by Senator Sherrod Brown. The bill would repeal section 512(a)(7). The repeal would be retroactive, as if originally included in Public Law 115-97. The bill would also increase the income tax rate on corporations from 21 percent to 22 percent, effective for taxable years beginning after the date of enactment.

- H.R. 1223 (116th Congress), the "Stop the Tax Hike on Charities and Places of Worship Act," was introduced on February 14, 2019, by Representative James Clyburn (for himself and other Representatives). The bill would repeal section 512(a)(7). The repeal would be retroactive, as if originally included in Public Law 115-97. The bill would also increase the income tax rate on corporations from 21 percent to 21.03 percent, effective for taxable years beginning after the date of enactment.

- S. 632 (116th Congress), the "Lessen Impediments From Taxes (LIFT) for Charities Act," was introduced on February 28, 2019, by Senators James Lankford and Christopher Coons. The bill would repeal section 512(a)(7). The repeal would be retroactive, as if originally included in Public Law 115-97.

- H.R. 1545 (116th Congress) was introduced on March 5, 2019, by Representative Mark Walker (for himself and other Representatives). The bill would repeal section 512(a)(7). The repeal would be retroactive, as if originally included in Public Law 115-97.

- S. 1282 (116th Congress), the "Preserve Charities and Houses of Worship Act," was introduced on May 2, 2019, by Senators Ted Cruz and Jeanne Shaheen. The bill would repeal both section 512(a)(6) (requiring that UBTI be computed separately for

each of an organization's unrelated trades or businesses) and 512(a)(7) (increasing UBTI for qualified transportation fringes). The repeal would be retroactive, as if originally included in Public Law 115-97.

115th Congress

Bills that passed the House

In December 2018, Representative Kevin Brady, then-Chairman of the House Committee on Ways and Means, introduced a manager's amendment to H.R. 88 (which included various retirement, savings, and other tax provisions). The manager's amendment included a provision to repeal section 512(a)(7). The repeal would be retroactive, as if originally included in Public Law 115-97. H.R. 88, as amended, passed the House on December 20, 2018.

Other introduced bills that would repeal section 512(a)(7)

- H.R. 6037 (115th Congress), the "Nonprofits Support Act," was introduced June 7, 2018, by Representative Michael Conaway. The bill is similar to H.R. 513 (116th Congress), described above.

- H.R. 6460 (115th Congress), the "Lessen Impediments From Taxes (LIFT) for Charities Act," was introduced on July 19, 2018, by Representative Mark Walker (for himself and other Representatives). The bill is similar to H.R. 1545 (116th Congress), described above.

- H.R. 6504 (115th Congress), the "Stop the Tax Hike on Charities and Places of Worship Act," was introduced July 25, 2018, by Representative James Clyburn (for himself and other Representatives). The bill is similar to H.R. 1223 (116th Congress), described above, except that H.R. 6504 would increase the corporate tax rate to 22 percent.

- S. 3317 (115th Congress), the "Protect Charities and Houses of Worship Act," was introduced August 1, 2018, by Senator Ted Cruz. The bill is similar to S. 1282 (116th Congress), described above.

- S. 3332 (115th Congress), the "Lessen Impediments From Taxes (LIFT) for Charities Act," was introduced on August 1, 2018, by Senator James Lankford. The bill is similar to S. 632 (116th Congress), described above.

Proposed technical corrections to section 512(a)(7)

On January 2, 2019, Representative Kevin Brady, then-Chairman of the House Committee on Ways and Means, released as a discussion draft a bill that would make technical corrections to Public Law 115-97.[54] The discussion draft would make several changes to the provisions of Public Law 115-97 relating to the tax treatment of qualified transportation fringes.

First, as noted above, subsection 274(e)(2) provides an exception to the deduction disallowance rule of section 274(a) for expenses properly treated as compensation to employees. This exception is intended to apply to qualified transportation fringes. Accordingly, the discussion draft amends the list of items eligible for the exception under subsection (e)(2) to include qualified transportation fringes.[55]

In addition, the discussion draft conforms the language relating to the deduction disallowance under section 274 with the language of section 512(a)(7). This includes conforming language relating to regulations or other guidance that the Secretary shall issue, as necessary or appropriate, to carry out the changes made by Public Law 115-97, including regulations or other guidance to provide for the appropriate allocation of depreciation and other costs with respect to facilities used for parking. More specifically, two of the proposed technical corrections would have the effect of denying a deduction (under section 274) or increasing UBTI (under section 512(a)(7)) for "items" with respect to qualified transportation fringes to clarify that the provisions can apply to a deduction for an allowance for depreciation.

B. State Legislation

Most States also impose tax on unrelated business income. The majority of States that tax unrelated business income conform to the Federal definition of UBTI, either as of a fixed date or on a rolling basis. States that conform to the Federal definition as of a fixed date must take affirmative action (generally by changing the date of conformity enacted into State law) to incorporate any subsequently enacted changes to the Federal UBTI definition. But in States that conform to the Federal definition on a rolling basis, any changes to the Federal definition generally are incorporated into the State computation automatically, unless the State decouples the State law in whole or in part from the Federal law.

Following the enactment of section 512(a)(7), some States have partially decoupled their computations of unrelated business income from Federal UBTI. For example, in 2018 New York enacted legislation that would subtract from Federal UBTI "any amount which is included therein solely by reason of the application of section . . . 512(a)(7)" in determining unrelated

[54] The text of the proposal is available at the following link: https://republicans-waysandmeansforms.house.gov/uploadedfiles/tax_technical_and_clerical_corrections_act_discussion_draft.pdf.

[55] As is discussed above, IRS Notice 2018-99 takes the position that the subsection 274(e)(2) exception applies to qualified transportation fringes.

business income for New York State law purposes.[56] North Carolina similarly has enacted legislation that would decouple from Federal UBTI for an increase in UBTI by reason of section 512(a)(7), but only for section 501(c)(3) organizations and only for parking facilities.[57]

[56] The change is effective for taxable years beginning on or after January 1, 2018. See https://assembly.state.ny.us/leg/?default_fld=&bn=A11051&term=2017&Summary=Y&Actions=Y&Text=Y&Committee%2526nbspVotes=Y&Floor%2526nbspVotes=Y.

[57] See North Carolina Department of Revenue, "2018 Tax Law Changes," available at https://files.nc.gov/ncdor/press-release/files/2018_law_change_book.pdf, p. 15. The North Carolina legislation is also effective for taxable years beginning on or after January 1, 2018.