

# Increases to unrelated business taxable income by amount of certain fringe benefit expenses for which deduction is disallowed

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Section 501(a) exempts certain organizations from federal income tax. Such organizations include:

- (1) Tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations)
- (2) Religious and apostolic organizations described in section 501(d)
- (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

The unrelated business income tax (UBIT) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance

of the organization's tax-exempt functions. The rules applicable to UBIT are housed in sections 511–514. An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990–T (Exempt Organization Business Income Tax Return).

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 engage in a substantial amount of unrelated business activity without jeopardizing its 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 and this is a regulatory and statutory requirement, see Treas. Reg. section 1.501(c)(3)–1(e). Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business pursuant to the rules as provided for in section 512(a).

## Organizations subject to tax on unrelated business income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to UBIT generally include: (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); (2) qualified pension, profit-sharing and stock bonus plans described in section 401(a); and (3) certain state colleges and universities, see section 511(a)(2).

## Exclusions from unrelated business taxable income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and state fairs, income from bingo games and income from the distribution of low-cost items incidental to the solicitation of charitable contributions.

## New law

Under the provision, unrelated business taxable income includes any expenses paid or incurred by a tax-exempt organization for qualified transportation fringe benefits (as defined in section 132(f)), a parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)) or any on-premises athletic facility (as defined in section 132(j)(4)(B)), provided such amounts are not deductible under section 274. The effective date of this provision is for amounts paid or incurred after Dec. 31, 2017 (rather than for the tax year beginning after Dec. 31, 2017). This provision will apply to calendar year organizations beginning with tax year 2018; however, organizations with a fiscal year-end will need to consider the impact of this provision for a portion of the period included within their tax year 2017 Form 990–T filing (e.g., for a fiscal year-end June 30, for the period Jan. 1, 2018 through June 30, 2018, reported on a 2017 tax form).

**The changes detailed in the following discussion are applicable currently with respect to the specified fringe benefits and require immediate review by exempt organizations. These changes may result in an exempt organization taking immediate action to change, modify or suspend affected fringe benefits. Alternatively, some tax-exempt organizations may elect to continue providing these affected fringe benefits to employees and accept the resulting tax liability as an additional cost of providing the benefit.**

As background related to this new provision, new section 512(a)(7) was provided for in the House version of the Tax Cuts and Jobs Act (TCJA). The Senate had no such like provision. So as adopted, it was the version as provided for by the House. In addition, each chamber of Congress' version of the TCJA contained amendments to section 274 (discussed later), where the House version of those amendments seemingly more closely resembled the section 512(a)(7) provision's contents;

however, the Senate version, which was materially different than the House version, was adopted for purposes of section 274. As such, there is not only a disconnect between the two laws, but the result of their separate and combined interpretations yields (in some respects) a favorable outcome which will be discussed in the following analysis.

## New paragraph added to section 512(a)

As a result of this law change, a new paragraph has been added to subsection (a) of section 512 of the Internal Revenue Code, section 512(a)(7). Specifically, new section 512(a)(7) provides:

*"Increase in unrelated business taxable income by disallowed fringe.—Unrelated business taxable income of an organization shall be increased by any amount for which a deduction is not allowable under this chapter by reason of section 274 and which is paid or incurred by such organization for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)). The preceding sentence shall not apply to the extent the amount paid or incurred is directly connected with an unrelated trade or business which is regularly carried on by the organization. The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations or other guidance providing for the appropriate allocation of depreciation and other costs with respect to facilities used for parking or for on-premises athletic facilities."*

An examination of the statute's contents yields the following conclusions which appear clear:

- 1) The statute is clear in that the provision applies to employer provided and paid for benefits in the listed areas in section 512(a)(7):
  - a. "for any qualified transportation fringe (as defined in section 132(f)),
  - b. any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or
  - c. any on-premises athletic facility (as defined in section 132(j)(4)(B))."[Emphasis on the use of the word "any" in the above list.]
- 2) The unrelated business income of the exempt organization is increased "for **any amount** for which a deduction is not allowed under section 274."
- 3) The unrelated business income of the exempt organization is increased "... by *any* amount. . . and which is *paid* or *incurred* by such organization. . ." which seemingly applies to any expenditure, any expense, any amount paid or any amount incurred in providing the benefits listed in (1) above. In addition, such language appears to apply to both direct and indirect expenditures for providing the benefits listed in (1) above (for example, direct identifiable expenses such as an employer paying to rent a parking lot for employee use, or indirect identifiable expenses such as pre-tax parking arrangements used by employees for parking benefits and excluded from their income under section 132(f)).

## Section 132(f) benefits

For the purposes of the application of new section 512(a)(7), one affected fringe benefit is the qualified transportation fringe. These benefits mean any of the following fringe benefits provided by an employer to an employee:

- (a) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment
- (b) Any transit pass
- (c) Qualified parking
- (d) Any qualified bicycle commuting reimbursement (this benefit has been suspended for amounts paid after Dec. 31, 2017, and until the 2026 tax year (section 132(f)(8) suspends the exclusion from gross income and wages)

A transit pass means any pass, token, fare-card, voucher or similar item entitling a person to transportation (or transportation at a reduced price) if such transportation is on mass transit facilities (whether or not publicly owned), or provided by any person in the business of transporting persons for compensation or hire if such transportation is provided in a vehicle meeting the requirements of a commuter highway vehicle as defined below.

A commuter highway vehicle means any highway vehicle the seating capacity of which is at least six adults (not including the driver), and at least 80 percent of the mileage use of which can reasonably be expected to be for purposes of transporting employees in connection with travel between their residences and their place of employment and on trips during which the number of employees transported for such purposes is at least half of the adult seating capacity of such vehicle (not including the driver).

Qualified parking means 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 by transportation in a commuter highway vehicle, or by carpool. Such term shall not include any parking on or near property used by the employee for residential purposes.

Lastly, transportation provided by employer is considered to be provided by an employer if such transportation is furnished in a commuter highway vehicle operated by or for the employer.

For nonprofit employers under new section 512(a)(7), by continuing to treat the benefit as something other than taxable compensation to the employee (see section 274 analysis later), the organization must now pay tax on such amounts by treating such amounts as unrelated business income. For an exempt organization organized as a corporation, the organization would be taxed at a rate of 21 percent beginning with tax year 2018. For tax year 2018, an exempt organization operating as a trust may be taxed at a rate as high as 37 percent (if the organization is taxed at the top rate for a trust).

Based on the new section 512(a)(7), an employer has two options: 1) Continue to provide the fringe benefit tax-free to its employees and pay the associated tax liability; or 2) Treat the benefit to employees as taxable compensation, subjecting the employees to income tax and half of employment taxes on such amounts, with the tax-exempt organization matching its half of payroll taxes.

Additionally, another important point to highlight related to new section 512(a)(7), is that any expense paid or incurred for any qualified transportation fringe (as defined above) and disallowed under section 274 will be includable as unrelated business income to the tax-exempt organization (e.g., paying for a parking facility for its employees, in which employees use such space to park, notwithstanding that the parking may be "given free of charge" for the employee to use).

### **Section 132(j)(4)(B) benefits**

On-premises gyms and other athletic facilities which are offered by an employer to his/her employees generally does not result in gross income for the benefit. On-premises athletic facility means any gym or other athletic facility which is located on the premises of the employer, which is operated by the employer, and substantially all the use is by employees of the employer, their spouses and their dependent children.

For this purpose, employees include retired and disabled employees and surviving spouses of employees treated as employees. In addition, any use by the spouse or a dependent child of the employee shall be treated as use by the employee. For purposes of the definition of dependent child, the term dependent child means any child (as defined in section 152(f)(1)) of the employee who is a dependent of the employee, or both of whose parents are deceased and who has not attained age 25.

### **Changes made to section 274 disallowance of certain entertainment, etc. expenses**

The provision provides that no deduction is allowed with respect to (1) an activity generally

considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the present-law exception to the deduction disallowance for entertainment, amusement or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions).

In addition, the provision disallows a deduction for expenses associated with providing any qualified transportation fringe benefit to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment. It is important to note the magnitude of this addition to section 274, as it applies to "any qualified transportation fringe benefit" provided to employees by the employer.

Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). For amounts incurred and paid after Dec. 31, 2017, and until Dec. 31, 2025, the provision expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that qualifies as a de minimis fringe benefit. Such amounts incurred and paid after Dec. 31, 2025, are not deductible.

Examining the statute post TCJA changes yield the following changes made to section 274(a) and an addition to section 274 of new subsection (l)[changes are highlighted]:

**"Section 274. Disallowance of certain entertainment, etc., expenses**

**(a) Entertainment, amusement, recreation, or qualified transportation fringes**

- (1) *In general. No deduction otherwise allowable under this chapter shall be allowed for any item—*
  - (A) *Activity. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or*
  - (B) *Facility. With respect to a facility used in connection with an activity referred to in subparagraph (A).*
- (2) *Special rules. For purposes of applying paragraph (1)—*
  - (A) *Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.*
  - (B) *An activity described in section 212 shall be treated as a trade or business.*
- (3) *Denial of deduction for club dues. Notwithstanding the preceding provisions of this subsection, no deduction shall be allowed under this chapter for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.*
- (4) Qualified transportation fringes—No deduction shall be allowed under this chapter for the expense of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer.**

And the addition of new subsection (l):

**(l) Transportation and commuting benefits.—**

- (1) In general—No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.**
- (2) Exception—In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after Dec. 31, 2017, and before Jan. 1, 2026."**

The focus of new section 512(a)(7) is not only on specifically identified section 132(f) fringe benefits provided by tax-exempt organizations to its employees, but also on providing employees use of a facility that may be considered used for recreational purposes.

Some distinctions must be pointed out related to the above changes to section 274. One, the changes make transportation fringe benefits provided to employees by an employer nondeductible for tax purposes. And it appears to be an absolute prohibition to deductibility for "the expense of *any* qualified transportation fringe, (as defined in section 132(f))" and this may be notwithstanding whether or not the expense is incurred by the employer in the form of a direct expense, or in the form of an indirect expense, (e.g., the employer provides compensation to the employee and part of that compensation is used by the employee to pay for qualified transportation fringes (e.g., pre-tax)).

In association with the provision in section 512(a)(7), section 512(a)(7) specifically lists out "any on-premises athletic facilities," however, section 274 does not highlight specifically this benefit, but retains facility use as a deductible expense for employers providing such a benefit. During the legislative process, as stated above, the House and Senate amendments to section 274 were substantially dissimilar. One large distinction was the House version of the amendments to section 274 not only specifically added as a disallowed expense "qualified transportation fringes" but also specifically listed as an addition to disallowed expenses "on-premise use by employees of an athletic facility." The Senate version, which was the version adopted, specifically added as a disallowed expense "qualified transportation fringes" and was silent altogether regarding "on-premise use of an athletic facility." So since this specific reference was not included in the final amendments to section 274, other applicable provisions in it will control in the area of facility usage.

As such, a few paragraphs as set forth in section 274(e) should apply, namely, if a benefit disallowed by reason of section 274(a) is included in the taxable compensation of the employee's W-2, subject to income tax withholding, such amount included in the taxable compensation of that employee will be deductible by the employer for income tax purposes. See section 274(e)(2). Also, expenses for recreational, social or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are highly compensated employees (within the meaning of section 414(q))), are deductible as provided in section 274(e)(4). Section 414(q) provides for the definition of highly compensated employee. Therefore, the facility usage of an "on-premise athletic facility" will be tax deductible by employers (and any disallowance under section 274 will not apply) unless such use is by highest compensated employees, and such use is *not* included in the taxable compensation of those highest compensated employees.

It appears that because the House version of the amendments to section 274 were not adopted in the final TCJA, the exception under section 274(e) continues to apply to facilities used for recreation of the employees, to basically render as inapplicable, the requirement under section 512(a)(7) inapplicable for rank and file employee use of "on-premise athletic facilities." At this time we do not know if this was the true intention of Congress, but as time passes, and future guidance is provided, this "disconnect" between the two provisions as they now co-exist in the Internal Revenue Code should be clarified. We are not anticipating any kind of technical correction, however, in this particular area.

Finally, if an employee is reimbursed by an employer for parking, which was incurred while that employee was performing services for the employer, as described in section 274(e)(3), such expense paid for by the employer should not result in unrelated business income to the tax-exempt employer, even if not includible in the taxable compensation of the employee for such reimbursable employee business expense.

## Conclusion

As can be seen by the establishment of new code section 512(a)(7), tax-exempt employers that continue to offer certain qualified transportation fringe benefits to its employees and certain facility usage, on a tax-free basis will be required to include these benefit amounts in its unrelated business income subject to tax. The inclusion of these benefits as unrelated business income could result in a required Form 990-T filing and related tax liability for organizations that previously had no such filing requirement nor UBI tax liability.

Through an interpretative analysis, a few things may be concluded with reasonable certainty, while others appear to be applicable, as we wait for clarification. The following appears to be apply under section 512(a)(7) and section 274:

- 1) If section 274 applies to disallow an expense listed in section 512(a)(7), such amount may be considered unrelated business income to a tax-exempt taxpayer.
- 2) On-premise athletic facility usage may result in unrelated business income if such usage is by highest compensated employees and such amount is not included in their respective taxable income subject to income tax withholding.
- 3) If a tax-exempt employer is provided parking free of charge by its landlord, as a perk to sign a lease arrangement, and the employer allows its employees (other than highest compensated employees) to park in the spaces provided, and there are no other costs associated with such parking facility use, the fair market value of such parking will likely not be considered unrelated business income of the tax-exempt employer under such an arrangement.
- 4) If a tax-exempt employer pays for the use of a parking facility for its employees, such payments should be considered unrelated business income under section 512(a)(7).
- 5) All benefits highlighted in section 512(a)(7), if included in the taxable compensation of the employee's W-2, subject to income tax withholding, should not result in unrelated business income notwithstanding that the employer paid for directly such a benefit since section 274 will not apply to such provided benefit.
- 6) Reimbursements to employees for parking by a tax-exempt employer, under an accountable plan to reimburse employees for business related expenses incurred while performing services to the employer as an employee, should not result in unrelated business income to the tax-exempt employer.
- 7) Pre-tax employee payments for qualified parking benefits most likely will be includible as unrelated business income to the tax-exempt employer (for the portion of salary expense attributable to qualified parking benefits).

Below are a few examples to help clarify the above statements:

1. Organization rents office space with 10 parking spaces included as part of the rental (all rentals in building include parking spaces) appears to render section 512(a)(7) as inapplicable, as the employer does not pay or incur any expense related to the spaces given as a perk to sign the lease arrangement (and the spaces are not solely used by highly compensated employees).
2. Organization rents office space, is offered and agrees to pay additional charge to rent 10 parking spaces, as such employee use of such an employer provided benefit related to the parking facility should result in unrelated business income to the tax-exempt employer.
3. Organization rents office space, each month the organization provides a transportation fringe under section 132(f) directly which should result in unrelated business income to the tax-exempt employer.
4. Organization rents office space, allows pre-tax use of compensation for qualified parking benefits at the employees discretion appears to result in unrelated business income for the portion of employer compensation expense paid to the employee which that employee elects to use for such benefits under section 132(f).
5. Organization rents out a parking facility near the office premises for employee use, this should result in unrelated business income for the tax-exempt employer.
6. Organization employees, none of which are highest compensated under section 414(q) definitions, are provided full access and usage of an employer provided on-premise athletic facility should not result in UBIT for the tax-exempt employer.

There are many scenarios that exist in the market, many which have some variation of the above examples. There are still unanswered questions, therefore, it is expected that additional guidance needs to be issued by the IRS related to the application of the provision under section 512(a)(7) as it applies to tax-exempt employers.

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