IRS clarifies nondeductible employee parking expensing

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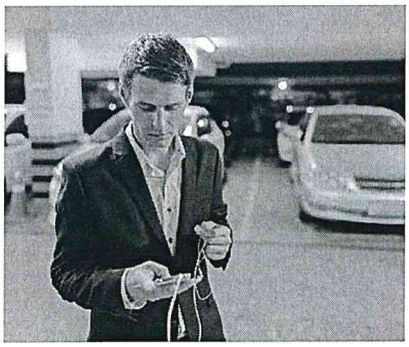

The IRS released Notice 2018-99 on Dec. 10 providing interim guidance on how to determine employee parking expenses that are no longer deductible for businesses or may increase the unrelated business taxable income (UBTI) for tax-exempt organizations.

Under the new Section 274(a)(4), enacted by the Tax Cuts and Jobs Act (TCJA), expenses paid or incurred by employers after Dec. 31, 2017, to provide employee parking are generally no longer deductible. To create parity between taxable and tax-exempt organizations, the TCJA also created the new Section 512(a)(7), which requires tax-exempt organizations to increase their UBTI by the amount of employee parking expenses that would be nondeductible if they were subject to the same deduction disallowance rules as taxable entities.

The TCJA did not change the rules that exclude the value of employer-provided parking (and other qualified transportation fringes) from the employees' taxable income. Section 132 continues to exclude the value of these benefits from an employee's income to the extent the value does not exceed a monthly threshold ($260 for 2018 and $265 for 2019, as indexed for inflation).

The notice provides complex and potentially onerous methods for determining nondeductible parking expenses as well as specific guidance and transition relief for tax-exempt organizations, but certain questions remain unanswered. Employers should begin considering ways to minimize the deduction disallowance and overall parking expenses. They should also consider other reasonable methods for determining the nondeductible portion of parking expenses, which may reduce their exposure to the new rules.

The interim guidance is discussed in more detail below.

Background

For purposes of these new rules, employee parking includes 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. There are a variety of methods employers use to provide tax-free parking benefits to employees. Employers may allow employees to park for free or at a reduced rate in an employer-owned or leased parking facility (for example, a parking lot or garage). Employers may pay a third party so the employer's employees can park at the third party's garage or lot. Alternatively, employers may reimburse employees for the cost of parking or allow employees to pay for parking on a pre-tax basis through a salary reduction arrangement. The new rules disallow an employer's deduction for expenses paid or incurred regardless of the method used by

the employer to provide parking benefits.

Qualified parking costs

Notice 2018-99 requires employers to determine the "total parking expenses" paid or incurred to provide the parking benefits. The notice explicitly states that the deduction disallowed under Section 274(a)(4) relates to the expense of providing parking benefits, and not to the value of the parking provided to employees (which is the amount used to determine the amount excluded from the employees' taxable income under Section 132). The expenses paid or incurred to provide parking benefits to employees include, but are not limited to, repairs, maintenance, utilities, insurance, property tax, interest, snow removal, leaf or trash removal, cleaning, landscaping, parking attendant expenses, security, and rent or lease payments or a portion of rent and lease payments (if not separately broken out).

The notice appears to reference a single lease agreement that covers both office space and parking, but does not separately break out the portion of the lease payments attributable to the parking facilities. However, it does not provide guidance as to how employers should determine the portion of the lease payments that are treated as parking expenses. Presumably, until further guidance is issued, it would appear that "any reasonable method" could be used to make that determination.

In addition, certain expenses are not subject to the disallowance rules under Section 274(a)(4), and are otherwise deductible:

- **Expenses paid or incurred to provide parking to partners of a partnership, 2% shareholders of S corporations, sole proprietors and independent contractors.** These expenses are generally deductible because such individuals are not permitted to exclude the value of parking benefits from income under Section 132.
- **Expenses paid or incurred to provide parking to employees who are required to include some or all of the value of the parking benefits in their taxable income under Section 132.** This generally occurs to the extent the fair market value of the parking benefits exceeds the monthly limits ($260 for 2018 and $265 for 2019). Unfortunately, the notice does not address how this special rule applies when the fair market value of the benefits exceeds the monthly limit, but the expenses paid or incurred to provide the benefits are less than the fair market value of the benefits.
- **Expenses paid or incurred for parking made available to the general public.** The notice provides guidance for situations where parking is made available to the public but is primarily used by employees.
- **Depreciation on a parking structure owned by a taxpayer and used by employees.** The depreciation is deductible in accordance with the general deduction rules. In contrast, lease payments paid or incurred for a parking structure owned by a third-party are subject to the deduction disallowance rules.
- **Expenses paid or incurred for items not located on or in the parking facility.** This may include landscaping and lighting adjacent to the parking structure and walkways between the parking structure and office building.

Methodologies for determining nondeductible parking expenses

The notice provides two methods for calculating the disallowed deduction, and their applicability depends on how the parking benefits are provided to the employees. The first method applies to taxpayers who pay third parties for employee parking spots. The second method applies if the employer owns or leases all or a portion of the parking lot or garage.

First method – payment to a third party for parking spots

Under the first method, which applies to the extent an employer pays third parties for employee parking spots, the deduction disallowance is calculated as the taxpayer's total annual cost of employee parking paid to the third party. Any amount paid in excess of the monthly qualified parking exclusion under Section 132 ($260 in 2018 and $265 in 2019) is included in the employee's income as compensation, is subject to Form W-2 reporting and employment tax withholding and

is exempt from the disallowance rules under Section 274(a)(4).

Examples of the first method include the following:

- An employer pays a third party operating a parking garage $300 per month for an employee to park in the third-party garage in 2018. A total of $260 of the benefit is excluded from the employee's income, and the employee recognizes $40 ($300 - $260) of compensation income each month. The employer is not allowed a deduction for $260 of the monthly cost, but is allowed a deduction for the $40 included in the employee's income.
- An employee elects to pay for parking on a pre-tax basis through a salary deferral program sponsored by the employer. The cost of the employee's parking is $200 per month. The employer is not allowed a deduction for the full $200 per month that is used to pay for the parking, even though parking is paid with the employee's pre-tax salary.

Second method – employer-owned or leased facility

The second method applies to taxpayers who own or lease all or a portion of a parking facility. The notice states that the disallowed deduction may be calculated using any reasonable method and provides a four-step methodology that is deemed to be a reasonable method (essentially a safe harbor method). Although other methods may be used if they are reasonable, any methodology that uses the value of employee parking instead of the expenses paid or incurred will not be considered a reasonable method.

This four-step methodology is as follows:

Step 1: Calculate the disallowance for reserved employee spots

First, determine whether any parking spots in the lot or garage are specifically reserved for the employer's employees. For example, the parking may be designated by signage or through the use of a separate facility or portion of the facility segregated by a gate that limits access. The amount of the deduction disallowed under this step is determined by multiplying the total parking expenses for the facility by a percentage equal to the total number of reserved employee spots divided by the total number of parking spots in the parking facility.

For example, an employer owns a parking lot with 500 parking spots, and the total annual parking expense is $10,000. Fifty of those spots are specifically reserved for the employer's management team. The employer is not allowed a deduction under this Step 1 for $1,000 of the total annual parking expenses ($10,000 x [50 / 500]). In the notice, the IRS provides a grace period until March 31, 2019, for employers to modify their parking arrangements to reduce or eliminate reserved employee parking spots. Any such changes will be applied retroactively to Jan. 1, 2018, for purposes of the notice.

The remaining steps apply to any remaining parking that is not specifically reserved for the employer's employees.

Step 2: Determine the primary use of remaining spots (the "primary use test")

The remaining parking facility costs are fully deductible if the primary use of the remaining parking spots is to provide parking to the general public. This occurs if less than 50% of the actual or estimated usage of the remaining parking spots is by employees during normal business hours on a typical business day. Non-reserved parking spots that are available to the general public, but empty during normal business hours on a typical business day are treated as provided to the general public. The percentage is determined by dividing the number of parking spots actually or estimated to be used by employees (excluding reserved employee spots identified in Step 1) by the total number of remaining parking spots in the facility (excluding reserved employee spots identified in Step 1).

Consider the same facts as the example in Step 1. The parking lot is generally available to the public. Of the remaining 450 parking spots (excluding the 50 reserved employee spots), 300

spots are estimated to be used by employees during normal business hours on a typical business day. Thus, greater than 50% of the remaining spots are used by employees, so the primary use of the parking lot is not by the general public.

If the primary use of the remaining parking is not for the general public, proceed to Step 3.

Step 3: Calculate the allowance for reserved nonemployee spots

The parking facility, or the employer's portion of the facility, may reserve parking spots for the exclusive use of nonemployees, such as visitors, customers, independent contractors, partners, 2% or higher S corporation shareholders or sole proprietors. Employers may deduct the portion of total parking expenses associated with these reserved nonemployee spots. The deductible portion of the parking facility is determined by dividing the number of reserved nonemployee spots by the total remaining parking spots (excluding reserved employee spots identified in Step 1) and multiplying the percentage by the total annual cost of parking.

Consider the same facts in the Step 1 example. Forty-five of the remaining 450 spots (or 10%) are specifically reserved for nonemployees. Thus $1,000 of the $10,000 total annual parking expense is deductible and not subject to Section 274(a)(4) under this Step 3.

Step 4: Determine remaining use and allocable expenses

If any of the total annual parking expense amount remains after completing Steps 1-3, employers must use a reasonable method to determine the employee use of the remaining parking spots and the related expenses allocable to those parking spots. The notice details general guidelines to follow in determining a reasonable method. It states that this reasonable method may take into account the estimated or actual usage of spots by employees based on the number of spots, the number of employees, the hours of use or other measures.

Deduction disallowances for other qualified transportation fringes

Section 274(a)(4) applies to qualified transportation fringes other than employee parking expenses, but the notice does not provide guidance for purposes of determining the deduction disallowance for those other fringes. The notice does mention that the IRS intends to publish proposed regulations under Sections 274 and 512, and that those proposed regulations may provide guidance regarding the other qualified transportation fringes. The special UBTI rules for tax-exempt organizations also reference on-premises athletic facilities. Those are addressed in the notice and discussed further below.

Tax-exempt organizations

In general, the interim guidance applies to tax-exempt organizations that provide parking benefits to their employees for purposes of determining the increase to UBTI. Thus, the amounts identified as not deductible under the first or second method discussed above, as applicable, increases the tax-exempt organization's UBTI for the year. According to the notice, tax-exempt organizations with UBTI less than $1,000, after taking into account the increase to UBTI for parking expenses, are not required to file a Form 990-T. This may provide relief to some tax-exempt organizations with a small amount of parking expenses and little or no gross income from unrelated trades or businesses.

An exception applies to the extent any amount paid or incurred for parking expenses is directly connected with an unrelated trade or business regularly carried on by the organization. In such circumstances, there is no increase to UBTI. However, a deduction for the parking expenses directly connected with the unrelated trade or business is still disallowed under the rules of Section 274(a)(4).

Another exception applies to on-premises athletic facilities. Provided a tax-exempt organization's on-premises athletic facility is primarily for the benefit of the organization's employees and does not discriminate in favor of highly compensated employees, a deduction for expenses paid or incurred for the facility is not disallowed under Section 274(a)(4).

Transition relief for tax-exempt organizations

Because of the increase to UBTI from the disallowed deduction for parking expenses, many tax-exempt organizations that provide parking and other qualified transportation fringe benefits to their employees may owe unrelated business income tax and have to pay estimated income tax for the first time. The IRS issued Notice 2018-100 to provide tax-exempt entities transition relief for underpayment of estimated income tax. The addition to tax for failure to make estimated income tax payments required on or before Dec. 17, 2018, is waived for tax-exempt entities that owe unrelated business income tax due to the TCJA changes to parking benefits.

Transition relief is only available to tax-exempt organizations that were not required to file a Form 990-T for the taxable year immediately preceding the organization's first taxable year ending after Dec. 31, 2017. Relief is further limited to tax-exempt organizations that timely file Form 990-T and timely pay the amount reported for the taxable year for which relief is granted.

Next steps

Employers may rely on Notice 2018-99 to determine the amount of nondeductible parking expenses and increases to UBTI until further guidance is issued by the IRS. Companies should re-evaluate their parking arrangements or lease agreements related to parking facilities to avoid or reduce the deduction disallowance for reserved employee parking spots. Employers should also quantify their total parking expenses and consider opportunities to reduce those expenses. In addition, employers should consider whether there are any other reasonable methods for determining the nondeductible portion of parking expenses, which may reduce the employer's exposure to the new rules.

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