2019 Higher Education

Tax Reporting Trends Project

CAPINCROUSE LLP

Introduction

Welcome to the tenth edition of CapinCrouse's annual *Higher Education Tax Reporting Trends Project*. This unique statistical review includes financial and tax data compiled from the January 2019 eQueries, our weekly email mini-surveys. We had an average of 149 responses a week, and each week one respondent received a $25 gift card.

Our goal is for this report to be a useful reference guide and information tool. While we recognize that no two higher education institutions are exactly alike, the editorial and statistical information contained here should assist your accounting team in gaining a better understanding of potential tax reporting issues that you and your peer institutions face.

With the Tax Cut and Jobs Act, questions about the "parking tax," the new financial reporting standards in FASB ASU 2016-14 and more, there were many changes in 2018 that could continue to impact your institution throughout 2019 and beyond. We've distilled the key higher education tax updates down to the pertinent points and considerations so you can make informed decisions for your institution.

The theme of the 2019 *Higher Education Tax Reporting Trends Project* report is school mascots. We hope you enjoy the various pictures from participating colleges and universities.

As you may note, we have changed the format of this year's report. In response to a changing environment, we've streamlined the narrative and data-gathering process. Additionally, to provide a quick-read format we've foregone the geographical data and sorting by institution size (Categories A, B, and C).

We would love your feedback on the new format as compared to prior editions. Please let us know what you think! Send us an email at collegetax@capincrouse.com.

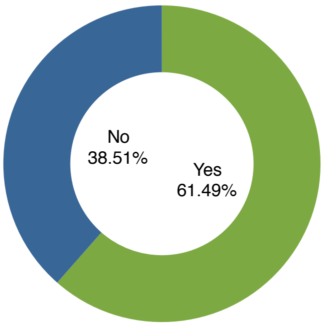
Enjoy!

Cover image: Wesley the Wildcat. Courtesy of Indiana Wesleyan University.

Colleges, Seminaries, and Universities – eQueries 2019

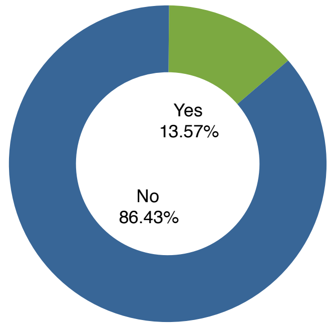
In January 2019, we conducted our annual eQuery surveys on each Tuesday of the month and asked various tax-related questions that institutions informed us that they were interested in. The questions, number of respondents, and percentages of "Yes" answers are as follows:

Does your institution currently have any designated "employee only" parking spaces? ("Staff only," "Faculty only," "President," "Dean of Music," "Employee of the Month," etc.)



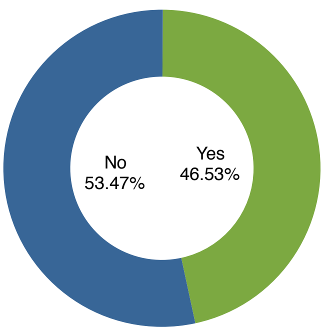
174
Respondents

Have you checked out the census mapping to see if your campus is in or near a "Qualified Opportunity Zone"?



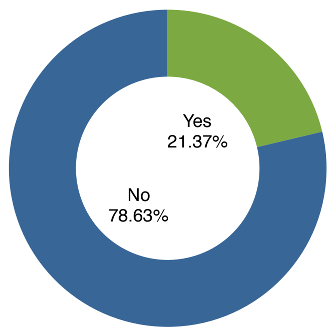
140
Respondents

Does your institution receive any Schedule K-1s annually from investments in partnerships, S Corporations, hedge funds, etc.?



144
Respondents

Has your team already written the functional expense narrative that is required to be a part of your financial statements this year?



137
Respondents

Buzzsaw the Yellow Jacket. Courtesy of Howard Payne University.

The "Parking Tax"

Internal Revenue Code (IRC) section 512(a)(7) was added by the 2017 Tax Cuts and Jobs Act. It's often called the "parking tax" or the "church tax," but those are misnomers. At its core, it is a tax on "disallowed fringe benefits." And the benefits targeted are some transportation fringes in section 132 of the Code.

This new law was widely misinterpreted and speculated on throughout 2018. Then on December 10, 2018, the IRS issued Notice 2018-99 with guidance on this new tax. In some ways the notice helped and in others it simply muddied the waters. Ultimately, the "tax" is an addition to an organization's unrelated business income based on "total parking expenses" paid or incurred for employee parking.

Section 512(a)(7) is concerned with amounts paid or incurred after December 31, 2017. Here's an example to illustrate:

Denali Christian College (DCC) has a parking lot with 400 spaces. Of these, 40 spaces are labeled "Faculty Only" and 25 are labeled "Visitors Only." DCC has 100 employees who drive to work and park in the lot.

The cost to build this parking lot eight years ago was $600,000. It is being depreciated over 15 years. DCC leases a surveillance system for $20,000 per year and estimates the compensation of various security personnel assigned to the parking lot to be $60,000 annually. In addition, the college pays $16,000 for sweeping the lot. Note that the new guidance specifically excludes depreciation.

DCC's annual parking expenses are as follows:

Security comp. =	$ 60,000
Surveillance =	$ 20,000
Utilities =	$ 4,000
Sweeping/cleaning =	$ 16,000
TOTAL =	$100,000

Using the prescribed four-step methodology, here's how DCC will fare under the new guidance:

Step 1: Calculate the disallowance for reserved employee spots

Forty of DCC's parking spaces are reserved for employees. So 10% (40 / 400) of the total parking expenses are includable as unrelated business taxable income (UBTI). Thus, DCC must increase its UBTI by $10,000 for this portion of the calculation.

Step 2: Determine the primary use of the remaining spots

This is the "50% general public parking rule." DCC has 360 parking spaces remaining after Step 1. Because DCC has 100 employees and 40 could park in reserved employee spots, that leaves 60 employees parking in the remaining spots. That means 300 of the 360 spots remaining after Step 1 may be used by the "general public" during "the normal hours of the exempt organization's activities on a typical day." DCC's Step 2 percentage is 83.33% — greater than the 50% required threshold. Thus, they are done — they've accounted for all 400 spaces in their parking universe.

Step 3: Calculate the allowance for reserved nonemployee spots

If DCC had not met the greater than 50% threshold in Step 2, they would have had the opportunity to decrease the employee allocation of remaining use by excluding the number of parking spots reserved for nonemployees from the calculation. In DCC's case, this would be the 25 "Visitors Only" spaces. This would mean that 25 / 360 (6.94%, or $6,940) would appear to be an "add back" against the employee use amount in Step 4. (Note that this interpretation is not held by all commentators.)

Step 4: Determine the remaining use and allocable expenses

If DCC had not met the 50% threshold in Step 2 — let's say they had 240 total employees parking in the lot on a typical day — they would have needed to "reasonably determine the employee use of the remaining parking spots during the normal hours of exempt organization activity on a typical day."

This is where things might get expensive. In DCC's case under the new supposition, they did not meet the 50% rule in Step 2 (because 200/360 = 55.55%, which leaves 44.45% as public parking). They would then have remaining employee use calculated at 200 / 360 (400 – Step 1 spots) multiplied by total parking expenses — which would have added an additional $55,555 to their imputed UBIT of $10,000 (Step 1). Note that Step 3 may affect this final amount.

Striker the Cobra. Courtesy of Coker College.

In our new example, if DCC did not have other unrelated business activities they would owe $12,099 in tax ($65,555 – $6,940 – $1,000 specific deduction = $57,615 x 21%). The "addition to unrelated business taxable income" would be reported at Form 990-T, Part III, Line 34. Now, there is some discussion regarding whether some expenses — maybe Form 990-T preparation fees, charitable contributions, etc. — could be deducted from the Line 34 amount. It would appear that a statement attached to Form 990-T that references Line 34 should accompany this tax position.

Under the original example, DCC could potentially eliminate their parking tax if they "undesignated" the faculty-only parking spots prior to March 31, 2019. The notice allows for this change in parking arrangements to be considered retroactive to January 1, 2018.

From Notice 2018-99:

> For purposes of this notice, "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). <u>A deduction for an allowance for depreciation on a parking structure owned by a taxpayer and used for parking by the taxpayer's employees is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not a parking expense for purposes of this notice.</u> [Emphasis added.]
>
> For purposes of § 274(a)(4) and this notice, the "general public" includes, but is not limited to, customers, clients, visitors, individuals delivering goods or services to the taxpayer, patients of a health care facility, students of an educational institution, and congregants of a religious organization. The general public does not include employees, partners or independent contractors of the taxpayer.

Heads up:

- If your institution has reserved employee parking spots, you will likely be required to file Form 990-T and pay some tax.
- Under the new guidance, depreciation is not included in the "total parking expenses" used to impute UBTI for institutions subject to these rules.
- Using a "50% primary use rule" for general public parking, most colleges, universities, and seminaries should be able to minimize or eliminate the potential parking tax.
- If your institution "undesignates" reserved employee spots by March 31, 2019, the change is considered retroactive to January 1, 2018 — and can reduce or eliminate any taxes owed.
- Oh, and the whole thing could be repealed by Congress — as if it never happened.

"Qualified Opportunity Zones"

There is an interesting provision in the 2017 Tax Cuts and Jobs Act that could provide a funding source for institutions looking at revenue enhancement opportunities (alternative business income activities). New IRC sections 1400Z-1 and 1400Z-2 provide this opportunity (pun intended).

Example Situation

Troas Bible College (TBC) is a private college exempt under IRC section 501(c)(3) and 170(b)(1)(A)(ii). They are required to file Form 990 annually.

TBC has been approached by a local businesswoman about an alternative business income activity proposal. The idea would be to set up a qualified opportunity fund (QOF) that TBC would participate in by establishing a new course of study for students who would work in the endeavor. The QOF would then seek investors who are interested in investing capital gain amounts in a tax-advantaged investment.

Basically, "Qualified Opportunity Zones" (QOZ) have been mapped out throughout the U.S. based on census data. When investments are made in these designated zones, investors may defer recognition on invested capital gains. Investments would be made into a qualified opportunity fund that your school could set up or participate in. The three types of tax incentives are deferral of tax on capital gains, partial decreases of tax (5-year rule, 7-year rule), and "no additional tax" on capital gains (10-year rule).

Ultimately, the incentive for investors is that they may defer tax on capital gains by investing in funds that operate QOFs in QOZs. The amount of the tax deferral will depend on the holding period of the investment in the QOF. Currently, to maximize the tax benefit investors must invest in a QOF in 2019 as the program sunsets on December 31, 2026.

The Screaming Eagle. Courtesy of Toccoa Falls College.

In another example, if an investor owned publicly traded stock in MNO, Inc. with a basis of $100,000 and sold it for $1,100,000, she would normally pay taxes on a $1,000,000 capital gain. If she invested in a QOF in 2019 and held that investment until December 31, 2026, the investor would defer the taxes on the 2019 sale of MNO, Inc. stock until 2026 and — because it was held in a QOF for seven years — she would receive an "imputed" basis in the stock of 15% of the original QOF investment ($150,000 basis). (Note that because she is deferring the tax on the $1 million MNO capital gain, her basis in the QOF investment begins at zero.) With the 10-year rule, there are some post-acquisition gain calculations involved as the program technically expires on December 31, 2026.

This is a simplified summary. The information and guidance on QOZs are fairly technical, and there are many hoops to jump through and rules to navigate. Internal Revenue Bulletin (IRB) Notice 2018-48 provides a grid listing of the designated qualified opportunity zones by state, county, census tract number, tract type, and ACS data source. The notice is 518 pages long with 516.5 pages consisting of this line-by-line, detailed list. It's much easier to use the interactive map available at cims.cdfifund.gov/preparation/?config=config_nmtc.xml. (You'll need Adobe Flash Player.)

A few things to consider:

- The Tax Cuts and Jobs Act introduced IRC sections 1400Z-1 and 1400Z-2 – "Qualified Opportunity Zones."
- For QOF investments held for five years, the taxpayer's basis is increased by 10% of the amount of deferred gain.
- For QOF investments held for seven years, the taxpayer's basis is increased an additional 5% (to 15%) of the amount of deferred gain.
- For QOF investments held beyond the maximum deferral date (i.e., December 31, 2026) and for a minimum of 10 years, the taxpayer's basis in the investment shall be equal to the fair market value of the investment on the date it is sold or exchanged, resulting in no additional recognized gain.

Might You Have UBIT from "Alternative Investments"?

When we speak of "alternative investments," we are generally referring to investments in partnerships or Subchapter S corporations that produce Schedule K-1s annually. If your school receives Form 1065 or Form 1120-S Schedule K-1s, you should be aware that they are apt to produce reportable unrelated business income (UBI). For 1065 K-1s, we start with Line 20, Code V to investigate potential UBI. We then look to the statements accompanying the schedule. With regard to 1120 K-1s, virtually every item of income on the schedule is taxable. Remember, there are state tax issues that must be considered, too.

With the introduction of IRC section 512(a)(6) and UBI "siloing," questions arise about how to "silo" revenues from the various activities reported on Schedule K-1. Notice 2018-67 provides initial guidance on this matter: investment partnerships in which the entity has a 2% or less profits interest and capital interest throughout the year are aggregated as one activity per the Schedule K-1. We await proposed regulations on this matter.

The New World of Functional Expenses

An interesting place where GAAP and Form 990 reporting might — but don't have to — deviate is in the new area of functional expense reporting and disclosure. For many years, institutions have been allocating "functional expenses" on Form 990, Part IX among Program service, Management and general, and Fundraising. Part IX has a stringent set of instructions regarding which line and column various expenses should be reported on. Now the FASB has published their own guidelines and examples under ASU 2016-14.

The two sets of rules are not necessarily mutually exclusive. Institutions should be careful in planning for the manner in which they will report functional expenses as a separate statement in their audited financials or in the notes to those financial statements. It is wise to consider Form 990, Part IX as you complete your financial statements.

The TU Trojan. Courtesy of Taylor University.

From ASU 2016-14 (page 2):

The main provisions of this Update, which amend the requirements for financial statements and notes in Topic 958, Not-for-Profit Entities, require an NFP to:

Provide the following enhanced disclosures about:

1. Amounts of expenses by both their natural classification and their functional classification. That analysis of expenses is to be provided in one location, which could be on the face of the statement of activities, as a separate statement, or in notes to financial statements.
2. Method(s) used to allocate costs among program and support functions.

From 2018 Form 990, Part IX instructions:

Use the organization's normal accounting method to complete this section. If the organization's accounting system does not allocate expenses, the organization can use any reasonable method of allocation. The organization must report amounts accurately and document the method of allocation in its records. Report any expense described in lines 1–23 in the appropriate line; don't report such expense in line 24. Don't report in Part IX expenses that must be reported on lines 6b, 7b, 8b, 9b, or 10b in Part VIII.

Bottom line:

- Have you looked at the new qualitative and quantitative disclosure rules for a Statement of Functional Expenses under ASU 2016-14?
- In a recent survey, almost 80% of schools stated that they had not already written the functional expense narrative that is required to be a part of their financial statements this year.
- Would this year be a good time to reconsider the manner in which you are reporting functional expenses — by column and line item — for Form 990, Part IX? Then, should you include a narrative explanation of any changes on Schedule O?
- It could be a big time saver to carefully plan how your school is going to accumulate, allocate, and present functional expenses on the two Statements of Functional Expenses you'll be preparing in 2019 — and beyond.

Support for Your Mission

Today's higher education leaders need to manage ever-increasing demands and challenges. To help achieve your mission, your institution needs a trusted business advisor to ensure you have the best financial, operational, and governance practices in place.

CapinCrouse is a national CPA and advisory services firm with one focus: serving higher education institutions and other nonprofit organizations whose **outcomes are measured in lives changed.** We don't just understand your mission — we support it.

CapinCrouse serves nearly 100 large and small private colleges, universities, and seminaries nationwide. We can support your institution with:

- More than 45 years of nonprofit and higher education experience
- A dedicated team of higher education specialists
- A full range of audit, accounting, tax, advisory, and cybersecurity services

We are dedicated to helping you operate with financial integrity and security.

Our higher education team welcomes the opportunity to talk with you about the issues outlined here or any other higher education tax issue. Please do not hesitate to contact us at collegetax@capincrouse.com.

About CapinCrouse

As a national full-service CPA and consulting firm devoted to serving nonprofit organizations, CapinCrouse provides professional solutions to organizations whose outcomes are measured in lives changed. Since 1972, the firm has served domestic and international outreach organizations, universities and seminaries, foundations, media ministries, rescue missions, relief and development organizations, churches and denominations, and many others by providing support in the key areas of financial integrity and security. With a network of offices across the nation, CapinCrouse has the resources of a large firm and the personal touch of a local firm. CapinCrouse is an independent member of the BDO Alliance USA.

Higher Education Team

CapinCrouse maintains a specialized team of people who focus on the higher education services provided by the firm.

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