Department of Health and Human Services
DEPARTMENTAL APPEALS BOARD
Appellate Division

University of California
Docket No. A-15-30
Decision No. 2662
October 14, 2015

DECISION

The University of California (University) seeks to charge the cost of employee fringe benefits to its federal financial assistance awards using fringe benefit rates (FBRs). The University's FBRs must be negotiated with, and approved by, Cost Allocation Services (CAS), an office within the United State Department of Health & Human Services (HHS) that serves as the cognizant agency for the University's federal awards.

In essence, an FBR is calculated by dividing the fringe benefit costs of a group of employees by the salaries and wages of those employees. The University has proposed that the denominator of that formula exclude the portion of any salary or wages above a specified limit, which is referred to here as a salary cap.

In 2014, after many months of negotiations in which CAS rejected this proposal, the University asked CAS to formalize its position. In response, CAS provided a written decision that it would not approve an FBR that is calculated using a salary cap, stating that its "normal long-standing practice is to include all salaries and wages in the fringe benefit rate calculation base." HHS Ex. 7, at 1. CAS's decision was reviewed and upheld by HHS's Office of Grants Policy Oversight & Evaluation (OGPOE),[1] prompting the University to file this appeal.

The University's chief contention in this appeal is that FBRs calculated on the basis of a salary cap are necessary to ensure that employee fringe benefit costs are equitably distributed between federal and non-federal funding sources. The University further

[1] According to HHS counsel, OGPOE "provides coordinated leadership in cost policy management and Department-wide cost policies and procedures affecting assistance awards." Agency's Brief (HHS Br.) at 5 (internal quotation marks omitted). OGPOE also "leads the preparation of . . . Government-wide policies affecting grants and represents the Department regarding internal and external grants management activities." *Id.* (internal quotation marks omitted). We will at times refer to CAS and OGPOE collectively as HHS.

alleges that it will be substantially harmed if it is not permitted to use the methodology it has proposed. We find these contentions unsubstantiated. Furthermore, HHS articulated legally valid and sufficient reasons for not departing from its practice of requiring that FBRs be calculated on the basis of total salaries and wages. Accordingly, we affirm HHS's decision to reject the University's salary-cap proposal.

Legal Background

The University consists of ten campuses, five medical schools, scientific research laboratories, and other facilities. University of California Appellate Brief (UC Br.) at 4. University employees perform scientific and medical research and other activities funded in part by "Federal awards" (a term that is defined to include grants, cooperative agreements, and cost-reimbursement contracts). 2 C.F.R. § 200.38. Federal award funds are used by the University to cover personnel and other costs of performing the sponsored activities. In state fiscal year (SFY) 2013, the University received more than $2 billion in federal award funds for health, science, and technology research.[2] In that year "[a]bout three-quarters of [the University's] federal research funds came from just two agencies: the National Institutes of Health and the National Science Foundation."[3]

"Cost principles" formulated by the Office of Management and Budget (OMB) and adopted by HHS (and other federal departments and agencies) govern the extent to which an organization's costs are allowable under – that is, may be charged to – a federal award.[4] *See* 2 C.F.R. §§ 200.100(c), 200.101; 45 C.F.R. §§ 75.100(c), 75.101. In order to be allowable under the cost principles, a cost must meet certain general criteria. 2 C.F.R. § 200.403; 45 C.F.R. § 75.403. One of those criteria is that the cost be "allocable" to the award. 2 C.F.R. § 200.403(a); 45 C.F.R. § 75.403(a). The organization must allocate costs to its federal awards (and other cost objectives) "in accordance with relative benefits received" – that is, in proportions that fairly reflect the

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[2] *See* Annual Accountability Report (2014), University of California, at viii (cited in HHS's brief and available at http://accountability.universityofcalifornia.edu/documents/accountabilityreport14.pdf (last visited Sept. 30, 2015)).

[3] *Id.* at 117.

[4] Prior to 2014, these cost principles were contained in various OMB "circulars," including OMB Circular A-21, which was specifically applicable to educational institutions. *See* 2 C.F.R. Part 220 (Jan. 1, 2013). In late 2013, OMB consolidated the content of OMB Circular A-21 and eight other OMB circulars into a single set of uniform cost principles. 78 Fed. Reg. 78,590 (Dec. 26, 2013). HHS and other federal departments and agencies adopted (in whole or part) the uniform cost principles in late 2014. 79 Fed. Reg. 75,872 (Dec. 19, 2014). HHS's adoption of the uniform cost principles is codified in 45 C.F.R. Part 75 and became effective on December 26, 2014. *See* 2 C.F.R. § 300.1; 45 C.F.R. §§ 75.106, 75.110(a).

extent of the benefits received by the cost objectives as a result of the costs having been incurred. 2 C.F.R. § 200.405(a); 45 C.F.R. § 75.405(a). (The term "cost objective" includes a federal award or a particular internal project or direct activity of the non-federal entity. 2 C.F.R. §§ 200.28, 200.44.) Overall, the cost principles "are designed to provide that Federal awards bear their fair share of cost . . . except where restricted or prohibited by statute." *Id.* § 200.100(c); 45 C.F.R. § 75.101(c).

As noted in the introduction, the costs at issue in this case are fringe benefits paid to University employees whose work is funded in part by federal awards. "Fringe benefits are allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages." 2 C.F.R. § 200.431(a); 45 C.F.R. § 75.431(a). Fringe benefits may include, but are not limited to, various types of leave, pension plan contributions, contributions to Social Security and Medicare, and employer-paid health, unemployment, and worker's compensation insurance. 2 C.F.R. § 200.431(a)-(c); 45 C.F.R. § 75.431(a)-(c).

The cost principles indicate that fringe benefit costs may be "assigned to cost objectives" – such as a federal award, a state appropriation, or private sector grant – using one of two methods. 2 C.F.R. § 200.431(d); 45 C.F.R. § 75.431(d). First, an organization may assign fringe benefits "by identifying specific benefits to specific individual employees." *Id.* Under this method, the value of each fringe benefit paid to an employee is identified and charged to the appropriate funding source(s). UC Br. at 5; Agency's Brief (HHS Br.) at 3. This method, which essentially involves the charging of the employer's actual costs, is highly accurate but administratively burdensome. *See* UC Br. at 5 ("Specific identification system essentially charges thousands of fringe benefit rates to employees throughout the system, one for each benefit for each employee").

Alternatively, the organization may assign fringe benefit costs by allocation "on the basis of entity-wide salaries and wages of the employees receiving the benefits." 2 C.F.R. § 200.431(d); 45 C.F.R. § 75.431(d). Under this method, fringe benefit costs incurred by the organization for its employees are pooled. The pooled costs are then divided by the employees' salaries and wages to yield a fringe benefit rate (FBR). (We sometimes refer to this formula's divisor as the "salary-and-wage base.") For each employee, the amount of fringe benefits charged to a federal award or other funding source is calculated by multiplying the applicable FBR by the amount of the employee's salary or wages allocated to the funding source. *See* HHS Br. at 3. A simple example: for a given period, an organization incurs fringe benefit costs of $100,000 on behalf of its employees and pays those employees $1 million in salary and wages. The FBR for those employees is .10 or 10 percent – $100,000 (pooled fringe benefit costs) divided by $1 million (the salary-and-wage base). If $200,000 of the organization's salaries and wages are allocated to a federal award, then the amount of corresponding fringe benefits charged to that

award will be $20,000 – a result obtained by multiplying allocated salaries and wages ($200,000) by the FBR (.10 or 10 percent). The so-called "allocation" method of charging fringe benefit costs simplifies accounting and reduces administrative burden by allowing fringe benefits to be assigned on the basis of a single, rate-based charge, rather than on the basis of multiple charges for each type of benefit earned by an employee. *See* UC Br. at 5-6 (discussing benefits of an FBR methodology).

In many organizations, different classes of employees earn substantially different types or amounts of fringe benefits. For example, a part-time worker may be ineligible for certain fringe benefits – pension contributions, for example – available to a full-time worker. In that and comparable situations, an FBR that is calculated on the basis of total, organization-wide salaries and wages may substantially or systematically overstate or understate the fringe benefit costs actually incurred for certain employee classes. The cost principles take this common situation into account. They state that "[w]hen the allocation method [that is, an FBR methodology] is used, separate allocations must be made to selective groupings of employees, unless the non-Federal entity demonstrates that costs in relationship to salaries and wages do not differ significantly for different groups of employees." 2 C.F.R. § 200.431(d); 45 C.F.R. § 75.431(d); *see also* HHS Ex. 1 (excerpts from the "DCA Best Practices Manual for Reviewing College and University Long-Form Facilities & Administrative Cost Rate Proposals") at 20 ("If the organization provides a substantially different level of fringe benefits to different classes of employees and the cost of those benefits in relation to the salaries of the employees differs significantly, a separate rate for each class must be considered."). When an organization calculates FBRs for "selective groupings" of employees (rather than calculating a single, organization-wide rate), then the amount of fringe benefit costs charged to an award for a given employee is based on the FBR applicable to the group of which the employee is a member. HHS Br. at 4.

Before an organization's FBR methodology can be used to charge a federal award, it must be submitted for review, and approved in advance, by the appropriate federal "cognizant agency." 2 C.F.R. § 200.19; 45 C.F.R. § 75.2. For most institutions of higher education, CAS is the cognizant agency responsible for reviewing and approving – on behalf of all federal agencies – indirect cost rates, cost allocation plans, and similar methods by which certain types of costs are charged to federal awards. 45 C.F.R. Part 75, App. III, *Indirect (F&A) Costs Identification and Assignment, and Rate Determination for Institutions of Higher Education*, ¶ C.11.a., C.11.f. CAS negotiates FBR agreements with more than 200 colleges and universities nationwide. HHS Ex. 14, ¶¶ 3-5.

Case Background

The University reports that it is in the process unifying and updating its payroll and other personnel systems in order reduce duplication and costs (and meet other internal goals). UC Br. at 4. That initiative is called UCPath. *Id.* As part of UCPath, the University has discontinued (or is in the process of discontinuing) its longstanding use of specific identification to charge fringe benefit costs in favor of using FBRs – what the University sometimes calls "composite benefit rates." *Id.* at 6; HHS Ex. 4, at 1. The University indicates that it has proposed various employee groups – including a group of medical school employees called Health Science Compensation Plan (HSCP) faculty – for whom FBRs will be calculated and submitted for approval.[5] UC Br. at 6-7. The group rates will be applicable system-wide. *Id.* at 6, 15 (indicating that FBR charging "was created and approved by all of the campuses" and will "treat all entity-wide salaries the same").

The University states that each proposed employee group was "created to help provide a better distribution of fringe benefit costs" but that "[d]ue to an uneven distribution of employee compensation across departments, the fringe benefit rates [calculated for the groups] still created large variances with some departments being charged a much lower cost for fringe benefit cost and other departments being charged a much higher cost." *Id.* at 7. In order to "resolve this discrepancy," says the University, it proposed to use a salary cap in its FBR formula. *Id.* at 7-8. The salary cap in this context is the limitation in section 401(a)(17) of the Internal Revenue Code (IRC), 26 U.S.C. § 401(a)(17). *Id.* at 11-12. Section 401(a)(17) essentially limits the annual compensation that an employer may take into account in calculating pension benefits due to an employee under a qualified pension plan. *See* 26 C.F.R. § 1.401(a)(17)-1; *Aramony v. United Way of America*, 254 F.3d 403, 407 (2nd Cir. 2001). For 2014, the section 401(a)(17) compensation limitation, which is subject to cost-of-living adjustments, was $260,000; the limit increased to $265,000 in 2015.[6] (We use the 2014 limit in our discussion.)

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[5] The proposed rate groups identified by the University include: (1) HSCP faculty with full benefits; (2) Non-HSCP faculty with full benefits during the academic year; (3) Non-HSCP faculty with full benefits during summer months; (4) Other Academic faculty with full benefits; (5) Staff Exempt with full benefits; (6) Staff Non-Exempt with full benefits; (7) Post Docs; (8) Students; (9) Faculty and staff with partial benefits; and (10) Faculty and staff with no benefits. UC Br. at 6-7.

[6] *See* Internal Revenue Service News Release IR-2014-99, *IRS Announces 2015 Pension Plan Limitations* (Oct. 23, 2014), available at http://www.irs.gov/uac/Newsroom/IRS-Announces-2015-Pension-Plan-Limitations-1 (last visited Sept. 30, 2015).

In general, the salary cap would operate to exclude from the salary-and-wage base of the FBR formula the portion of an employee's salary above the cap.[7] The University provides an example involving HSCP faculty at the University of California, Los Angeles (UCLA) who, according to the University, earned $79,444,309 in fringe benefits and $338,349,998 in salaries and wages during SFY 2014. UC Br. at 25 (table). If a salary cap is not used in the rate formula, according to the University, then the FBR for this employee group for SFY 2014 would be 23.5 percent – or ($79,444,309 ÷ $338,349,998) × 100. *Id.* Under the salary-cap methodology proposed by the University, only the portion of employee salaries and wages up to the IRC § 401(a)(17) limit would be counted in determining the group's salary-and-wage base. *Id.* Applying that limit, the HSCP faculty's salary-and-wage base would be $303,012,834, rather than $338,349,998. *Id.* Plugging the lower figure into the rate formula yields an FBR of 26.2 percent – or ($79,444,309 ÷ $303,012,834) × 100. *Id.*

The University argues that its salary cap proposal should be understood in light of the relationship between the fringe benefits earned by its employees and their salaries and wages. UC Br. at 8. According to the University, the fringe benefits costs it incurs on behalf of its employees can be grouped into the following categories (in order, from highest to lowest, of their share of total fringe benefit costs (shown in parentheses))[8]:

- Health insurance premiums (45.5 percent)
- Retirement plan contributions (30.7 percent)
- Payment of the employer share of Social Security tax (13.6 percent)
- Payment of the employer share of Medicare tax (4.6 percent);
- Workers compensation insurance and related costs (3.5 percent)
- Other benefits such unemployment, disability, and life insurance premiums (2.1 percent)

See id. at 8. Some of these costs vary according to an employee's salary or wages. For example:

- Contributions to the University's defined benefit pension plan equal a fixed percentage (12.7 percent in 2014) of an employee's earnings up to the compensation limit established pursuant to IRC § 401(a)(17);

[7] The University also indicates that the salary cap would be used to limit the amount of allocated salary to which the FBR would be applied to calculate a fringe benefit charge. UC Br. at 11. In addition, the University states that the "salary cap as proposed would be applied on a pay period basis, dividing the total IRC limit by the number of pay periods within a calendar year." *Id.* at 12.

[8] The University asserts that although the percentage figures are based on fringe benefit data from just one of its 10 campuses, they are "representative of the fringe benefits offered to employees for the entire system as all comparable employees across all UC campuses are provided the same fringe benefits." UC Br. at 8.

- Payment of the employer's share of Social Security taxes equals 6.2 percent of earnings up to a limit that is currently $118,500; and
- Payment of the employer's share of Medicare taxes equals 1.45 percent of covered earnings with no cap on the amount of covered earnings subject to the Medicare tax.

See id. at 8-10. Other fringe benefit costs – most notably, health insurance premiums – do not vary with the amount of an employee's earnings. *Id.*

According to the University, "greater than 95% of [a representative campus's] fringe benefit expenses in FY2014 were either capped at a defined salary limit [retirement plan contributions and payment of Social Security taxes, for example] or not based on salary at all." *Id.* at 11. Emphasizing that one its goals is to "align fringe benefit costs with the salaries that generate the benefit," *id.* at 23, the University asserts that the salary cap represents a "reasonable and logical breaking point" because "[e]arnings above th[e] limit are not eligible for retirement benefits or social security benefits" and because "[h]ealth insurance and other benefit costs are completely unaffected by salaries that exceed these limits because they are based on an individual's status or selected benefit program," *id.* at 11-12.

Although the salary cap, as proposed, would be used to calculate the FBRs of all employee groups, the University indicates that the salary cap would primarily affect the allocation of fringe benefit costs associated with a single group – namely, HSCP faculty, many of whom receive salaries above the salary cap. *See* UC Br. at 25 (stating that "most [University] employees over the proposed fringe benefit cap are HSCP Faculty" and "the primary group impacted by the fringe benefit rate salary cap"). HSCP faculty are medical school faculty who participate in teaching, research, and clinical activities. *Id.* at 19-20. Their clinical activities are performed as part of the medical schools' "medical practice plans." *Id.* The salaries of HSCP faculty are funded by multiple sources, including research grants issued by the National Institutes of Health (NIH), revenue generated by the medical practice plans, and state and private sources. *Id.* at 20, 26.

The University asserts that the compensation structure for HSCP faculty is unique among public universities in part because the medical practice plans that contribute to HSCP faculty salaries are organs of the University, rather than separate business entities. *Id.* at 19-21. In part because of this "unique" structure, the University alleges that fringe benefit costs associated with HSCP faculty may be improperly allocated unless it is allowed to use a salary cap in the FBR formula:

> There is an adverse impact to the medical practice plan funds within some of the medical departments when fringe benefit rates without a salary cap are used. The compensation levels of the HSCP faculty have more variability than any other group. Without a salary cap, this leads to an uneven distribution of fringe benefit charges across departments. The salary cap was designed to minimize those impacts.

Id. at 20.

The University's discussions with CAS over the salary cap have spanned many months. *See* HHS Br. at 5-6. In a letter dated June 10, 2014, the University advised CAS that the salary cap was necessary to "address funding issues related to the conversion from a direct charge approach to [composite benefit rates]." HHS Ex. 4, at 1. The University stated that use of a salary cap would allow "for the more accurate distribution of fringe benefit costs to the appropriate salaries that generate the costs," reduce "large inequities between [fringe] benefits a person receives and the benefits charged for a person to funding sources" (such as federal awards), and minimize "shifts in funding" among funding sources that would otherwise result. *Id.* at 1-2.

A memorandum attached to the June 10, 2014 letter describes the salary cap as "necessary to ensure an equitable match of salary charges to actual costs of benefits." *Id.* at 3. The memorandum expresses concern that "[i]f salaries above the IRS limit are included in the [salary-and-wage] base" in calculating an FBR, then "benefit costs will be shifted to funding sources for higher paid employees (such as medical school faculty whose activities are funded by federal awards). *Id.* at 3. Without a salary cap, says the memorandum, "the more highly compensated employees and their funding [sources] would bear a disproportionate share of fringe costs[.]" *Id.* at 4. The memorandum states that the University's overall objective in using a salary cap was "to more closely align with the direct charging practice and minimize benefit cost-shifting under CBRs." *Id.* at 5.

In a letter dated July 24, 2014, CAS informed the University that it would not approve the University's salary cap proposal. HHS Ex. 7. CAS stated that its "normal long-standing practice" was to require organizations to calculate an FBR by including all salaries and wages in the FBR formula's denominator (the salary-and-wage base). *Id.* at 1. CAS gave five additional reasons for rejecting the University's proposal.

First, CAS stated that the salary cap "would inappropriately increase the fringe benefit rates that are charged to Federal awards" and violate federal cost principles. *Id.* at 1-2. Second, CAS stated that FBRs calculated on the basis of total salaries and wages "are an equitable method of assigning costs to various cost objectives." *Id.* at 2. Third, CAS

stated that while FBRs calculated on the basis of total salaries and wages may "cause some changes in charges to specific awards as compared to the specific identification method," those changes are "expected" and do not mean that FBRs calculated without a salary cap are an inequitable method of assigning fringe benefit costs to various cost objectives. *Id.* "By choosing to change [the University's] cost accounting methodology for Federal awards" from specific identification to FBRs, said CAS, the University "has to expect some changes in recoveries on individual awards." *Id.*

Fourth, CAS asserted that calculating FBRs based on total salaries and wages would "not cause significant inequities to Federal awards" that support high-salaried employees, most of whom, CAS noted, were HSCP faculty. *Id.* at 2. In support of that statement, CAS noted that federal appropriations law limits the amount of any employee salary that may be charged to HHS awards (including awards issued by NIH, the primary, if not exclusive, funding source for HSCP faculty), thereby limiting the amount of associated fringe benefits that may be charged to those awards. *Id.* (In 2014, the congressionally imposed salary limit applicable to HHS awards was $181,500, according to CAS.) Finally, CAS asserted that introducing a salary cap into the rate formula would unnecessarily complicate its oversight of federal awards:

> Rate agreements are made available to Federal grants and contracts officials across the Federal government. Application of published fringe benefit rates is a simple calculation that applies the applicable fringe benefit rate to the applicable salaries. UC is planning to use a complicated formula to charge the fringe benefit rates to awards, in order to ensure that the rates are not applied to salaries above the IRC limitation. It would not be appropriate to include a multi-part formula in the Federal rate agreement, because Federal officials would have to spend additional time familiarizing themselves with the formula and obtaining additional data from UC to complete the calculation. The more complex the rate application process is, the more likely that errors will occur. In recent years, the Federal government has sought to streamline and simplify grants administration procedures. The proposed deviation has the opposite effect of needlessly complicating a simple process.

Id. at 2.

In a September 10, 2014 letter, the University asked CAS to reconsider its decision. HHS Ex. 8. It stated that "[u]nder the University's policies, no incremental benefits accrue to . . . individuals [with salaries or wages] over the salary cap and therefore, capping rates is a reasonable matching of the costs to the salary." *Id.* at 2. The University further stated that the salary cap would reduce what it called "large inequities" between fringe benefit

charges associated with an employee and the actual costs incurred by the University for that employee's fringe benefits. *Id.* In addition, the University stated that it had "not identified any requirements in federal policy or practice that would specifically exclude a salary cap when developing composite fringe benefit rates since the charges would be allowable, allocable, reasonable and consistently applied to both direct and indirect activities." *Id.*

On October 15, 2014, OGPOE denied the University's request for reconsideration, stating that CAS policy regarding FBRs "does not result in significant inequities to federal awards" because federal law already caps the amount of a salary (and by extension the amount of any associated fringe benefits) that may be charged to all HHS awards. HHS Exs. 9 and 12 (citing Pub. L. 113-76, Div. H, Title II, § 203). "Due to the existence of this [federal] salary cap," said OGPOE, "the fringe benefit rate process employed by CAS does not result in significant inequities to federal awards." HHS Ex. 9.

<u>Discussion</u>

In its briefs, the University asks us to decide (1) that its proposed FBR methodology complies with federal cost principles and is "fair, reasonable, and equitable" and (2) "that the method mandated by the CAS decision meets none of those requirements." UC Reply Br. at 2-3. The University also asks us to decide that "[w]hen a fringe benefit rate is used, a salary cap is the most accurate way to calculate that rate – i.e., the method that will result in the greatest equity and the least amount of disparity between the sources of salary that actually generate those costs." UC Br. at 3.

This framing of the issues misperceives the Board's role. The Board does not make de novo decisions about the merits of award recipients' cost rate proposals. *Univ. of Ca. Indirect Cost Rate*, DAB No. 40, at 6 (1977). Nor does the Board make policy judgments on the relative merits of competing cost accounting methodologies. *Id.* (stating that "[t]he Board . . . must implement such Federal law and policy as may have been definitively promulgated by the Congress and the cognizant Federal agencies").

Rather, the Board's essential function, as established by the regulations that define the scope of its jurisdiction, is to resolve disputes about the merits of an adverse federal agency determination. *See* 45 C.F.R. § 16.8(a) (2) (requiring an appellant to provide a written statement "concerning why the respondent's final decision is wrong"); *id.*, Part 16, App. A, ¶ D (stating that the Board "reviews final written decisions" in cost allocation and rate disputes). In general, the Board (1) resolves factual disputes that are relevant to the grounds upon which the adverse determination is based and (2) decides whether the determination is supported by legally valid and sufficient grounds and otherwise complies with applicable statutes and regulations. *See* 45 C.F.R. §§ 16.11(a) (discussing the procedures available when there are "material facts in dispute") and § 16.14 (stating that "[t]he Board shall be bound by all applicable laws and regulations").

To the extent that an adverse determination reflects a reasonable exercise of programmatic discretion or expert judgment, the Board will ordinarily not interfere. *See, e.g., Okla. Dept. of Human Servs.*, DAB No. 963, at 6-7 (1988) (holding, in a dispute involving a cost allocation plan approved by the cognizant agency, that the Board would defer to agency expertise "absent a compelling reason for concluding that the approved plan was improper"); *S.D. Dept. of Social Servs.*, DAB No. 465, at 4 (1983) ("This Board has often held that it will not substitute its discretion for that of the Agency where the Agency's decision is in accordance with the rules and the Agency's exercise of its discretion is reasonable."); *Ca. Dept. of Health Servs.*, DAB No. 170, at 10 (1981) ("Where a matter involves an exercise of programmatic judgment, the Board will not normally interfere."). The Board has long recognized that CAS (formerly known as the Division of Cost Allocation), acting in its capacity as a federal cognizant agency, has expertise in cost accounting and in evaluating the adequacy and fairness of an organization's methods of cost allocation. *See, e.g., Neb. Health & Human Servs. Sys.*, DAB No. 2110, at 18 (2007).

In Board proceedings, the non-federal party ordinarily bears the burden of proof with respect to the grounds on which it challenges the federal agency's determination. *See* Appellate Div. Practice Manual, "Who has the burden of proof in a case before the Board" (available at http://www.hhs.gov/dab/divisions/appellate/practicemanual/manual.html); *Vanderbilt Univ.*, DAB No. 903 (1987) (stating that the university "ha[d] a burden under [the applicable cost principles] to demonstrate that alternative bases [for allocating certain costs] result in a more equitable allocation . . . than the 'standard' methodology"); *Council for Econ. Opportunities in Greater Cleveland*, DAB No. 1980, at 9 n.11 (2005) ("In general, the burden is on a recipient of federal grant funds to justify both the allowability of its costs, and the methods used to allocate those costs to its federal awards.").

Applying the foregoing standards, we conclude, for the reasons explained below, that HHS's determination to disapprove the University's use of a salary cap is consistent with the applicable cost principles and reasonable in view of the record.

1. *HHS's longstanding practice of requiring FBRs to be calculated on the basis of total salaries and wages is consistent with the cost principles governing the assignment of fringe benefit costs.*

The University has decided – for reasons that include administrative efficiency – to abandon the specific identification method of assigning fringe benefit costs to its federal awards in favor of "allocating" fringe benefits based on one or more FBRs. When an institution of higher education opts to assign fringe benefit costs by the allocation method, the cost principles require the institution to do so "*on the basis of* entity-wide

salaries and wages of the employees receiving the benefits." 2 C.F.R. § 200.431(d); 45 C.F.R. § 75.431(d) (italics added). The University proposes to allocate fringe benefit costs on the basis of salaries and wages – but only on the basis of salaries and wages up to the limitation in IRC § 401(a)(17). The University asserts that the use of a salary cap "is not specifically prohibited under the federal regulations," UC Br. at 2, but this statement misses the point. The question is whether HHS's interpretation and application of the regulations (and the cost principles they contain) are reasonable. Nothing in the text of the applicable cost principles provides or even suggests that the distribution "basis" – that is the salary-and-wage base or denominator of the FBR formula – should or may be limited for any reason. Accordingly, it is reasonable for CAS to conclude that such a limitation is inconsistent with the regulations and therefore disapprove its use.

The University's salary cap appears to be based on a number of assumptions that are not adequately documented in the record before us and flawed conceptually. The idea behind the cap, for example, is that salaries above it do not generate additional actual fringe costs for the University. It is therefore appropriate, says the University, to exclude the portion of the salary above the cap in order to more closely "align fringe benefit costs with the salaries that generate the benefit." UC Br. at 23; *see also id.* at 8 (asserting that the salary cap "provides a means to equitably align fringe benefit costs to the associated salaries"). However, as the University admits, there is at least is one type of fringe benefit cost – the employer share of Medicare taxes – that is directly driven by salaries above the cap. The University does not contend that Medicare costs above the cap are insignificant, nor does it deny that the salary cap would effectively preclude a distribution of those costs to funding sources that benefit from them.

Indeed, the salary cap is basically unrelated to the degree to which individual fringe benefits vary except in regard to certain pension costs. The largest fringe benefit cost, health insurance, does not necessarily vary based on salary, as the University points out, but that does not demonstrate that excluding a portion of salary costs from the base is an equitable deviation from the normal rate development methodologies. On the contrary, the ability to use a rate is the regulatory solution to balancing the accuracy of tracking each fringe benefit component by employee against the efficiency of applying averaged rates across employee classes.

The University's general concern is that FBRs, as applied to the salaries of certain high-paid employees (especially medical school faculty with "unique" compensation structures), will cause funding sources (including federal awards) to be inequitably or "disproportionately" charged. UC Br. at 12, 19-21. As HHS correctly points out, the cost principles provide the approved mechanism to mitigate such potential inequity. When the relationship between fringe benefit costs and compensation for a particular

group of employees is substantially different from other employee groups – such that the use of an entity-wide rate would lead to inequitable fringe benefit charges – the cost principles permit, and in fact require, the institution to define and calculate a separate FBR for that "selective grouping." That is what the University appears ready to do: the University has proposed – and HHS says it will allow the University[9] – to calculate and apply an FBR for HSCP faculty, the employee class whose fringe benefit costs are primarily implicated by the parties' dispute over the salary cap.

2. *The University has not substantiated its claim that capping the salary-and-wage base is necessary to ensure that fringe benefit costs are allocated in accordance with relative benefits received and would not cause federal awards to be overcharged.*

The University implies that FBRs calculated without a salary cap, even those for "selective groupings" of employees, are insufficient to ensure fair allocation of its fringe benefit costs. The use of such rates, the University suggests, will result in "misallocations" or "uneven distributions" of those costs. UC Br. at 7, 20; UC Reply Br. at 10, 12-14. As noted, the University identifies HSCP faculty as the primary group of employees whose fringe benefit costs would allegedly be misallocated or unevenly distributed if a salary cap is not approved.[10] UC Br. at 25. The University submits that the salary cap "provides a means to equitably align fringe benefit costs to the associated salaries" and "ensure[s] that the relative fringe benefits charged are a fair representation of the fringe benefits costs incurred by a class of employees . . . ." *Id.* at 7-8, 11-12.

To illustrate these points, the University presents (in its reply brief) a table containing estimates of "actual" fringe benefit costs incurred by the University for each of two hypothetical HSCP employees, one earning $100,000 per year and the other earning $600,000 per year. UC Reply Br. at 7. For each employee, the table also compares the fringe benefit *charges* resulting from an FBR that is calculated on the basis of total salaries and wages, with the fringe benefit charges resulting from an FBR calculated on the basis of the University's proposed salary cap. *Id.* (It appears that each FBR is derived from salaries and wages of HSCP faculty only, although the University does not provide details or documentation sufficient for verification.)

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[9] HHS states that. although the University "has not formally submitted its FBR proposal, CAS has already informed [the University] that it would allow for [the "unique" situation of HSCP faculty] to be accounted for by having multiple distinct rate structures for faculty" and that "CAS has not objected" to an HSCP Faculty rate "which would be calculated and published separately from the FBR for all other Faculty." HHS Br. at 22-23.

[10] In its July 24, 2014 determination, HHS stated that highly paid *non*-Health Sciences faculty "most often do not" charge their salaries and fringe benefits to Federal awards." HHS Ex. 7, at 2. The University does not dispute that finding or allege that fringe benefit charges for this group will be problematic unless it is permitted to use a salary cap.

The University's table shows that for the employee making $600,000, both FBRs yield total fringe benefit charges that exceed actual fringe benefit costs incurred for the employee. *Id.* However, the disparity between charges and costs is greater when the FBR based on total salaries and wages is applied. *Id.* According to the table, the actual fringe benefit costs associated with the employee making $600,000 fall within the range of $48,974 to $68,146, with the range reflecting variable health insurance costs. The total fringe benefit charge for that employee under the University's salary-capped FBR is $64,305, while the total charge based on the rate derived from total salaries and wages is $133,104. The University observes that the "CAS-mandated [FBR] method allocates nearly twice as much in total fringe benefit costs to highly compensated employees compared to the maximum benefit cost paid by [the University]."[11] *Id.* at 10; *see also id.* at 11 (asserting that "[f]or every dollar in compensation over [the salary cap], the CAS-mandated method allocates about 10 percent in combined social security and pension costs to every dollar of compensation even though those employees do not actually earn any increased benefits on amounts in excess of the covered amounts").

In light of these circumstances, the University submits that an FBR calculated on the basis of total salaries and wages will cause funding sources that support high-salaried employees, particularly medical school faculty, to bear a disproportionate share of the University's actual fringe benefit costs.[12] *See* UC Br. at 12 (asserting that, if a salary cap

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[11] Despite the University's repeated references to CAS mandating an allocation method, we find no basis to conclude that CAS mandated a particular method for calculating FBRs. Instead, CAS simply declined to accept one aspect of the University's proposed method, *i.e.*, the use of a salary cap to limit the salary-and-wage bases in the development of FBRs for the selective groupings defined by the University.

[12] It is not at all clear on the record before us that FBRs calculated without a salary cap will necessarily cause funding sources (be they federal or non-federal) supporting high-salaried employees to absorb disproportionate shares of actual costs. The University fails to mention that an FBR is an "average" fringe benefit cost per dollar of compensation. Thus, as applied to any particular employee, an FBR that is calculated on the basis of total salaries and wages will, depending on the level of an employee's salary, result in an aggregate fringe benefit charge that either overstates or understates the actual amount of fringe benefit costs incurred by the organization for that employee. And so while it is true that a fringe benefit charge for a high-salaried employee may (with respect to the portion of the employee's salary to which the rate is applied) exceed the amount of actual fringe benefit costs incurred by the University, that disparity may be offset (partially or fully) by fringe benefit charges with respect to lower-salaried employees for whom the charges understate actual costs. The table on page seven of the University's reply brief confirms the potential for offsetting charges: actual fringe benefit costs associated with the HSCP employee making $100,000 fall within the range of $20,350 to $42,048. The total fringe benefit charge for that employee using the FBR based on total salaries and wages is $22,184, meaning that the aggregate charge may, depending on the cost of the employee's health insurance, substantially understate actual fringe benefit costs incurred for the employee. Whether or not a funding source, or a group of funding sources, is bearing a disproportionate burden of fringe benefit costs depends on the overall profile of the employees who charge the funding source(s), the precision of the rates that are applied to the employees' allocable salaries, and perhaps other factors. Also, the larger base for a grouping without a salary cap necessarily means that the resulting FBR is lower on average.

is not used, "certain salaries and their funding sources would bear a disproportionate share of fringe benefit costs"); *id.* at 17 ("Without a salary cap, funding sources that support salaries above the IRC limit would be paying for the fringe benefits earned by other (lesser) salaries on other funding sources."). In particular, the University alleges that "an additional $5.5 million would be charged to the funding sources of approximately 150 HSCP faculty" if the salary-and-wage base is not capped. *Id.* at 32. The University further asserts that the absence of the salary cap will effectively "reduce[ ] the amount of allowable cost that [it] is entitled to recover on its Federal awards" (although precisely why that would occur is unexplained). UC Reply Br. at 13. In disapproving the University's salary cap, CAS recognized that the "averaging concept" embodied in an FBR methodology (*see supra* footnote 12) may result in some awards being charged more for fringe benefits than they would under a specific identification method. HHS Ex. 7, at 2. CAS noted that such changes are "expected" and do "not mean that rates are inequitable." *Id.* The University takes no issue with that proposition.[13] Indeed, the University properly acknowledges that the salient issue in this case is overall fairness – in particular, whether a given rate or rate methodology produces allocations that result in federal awards bearing their fair share of costs. *See* UC Reply Br. at 2-3 (indicating that the acceptability of its methodology depends on whether it "assign[s] a fair share of fringe benefit costs to Federal awards"). As noted in the case background, an allocation of costs among one or more cost objectives (such as funding sources or sponsored projects) is equitable if it reflects the "relative benefits received" by those objectives from the activities as a result as a result of the organization incurring the costs. 2 C.F.R. § 200.405(a); 45 C.F.R. § 75.405(a); *see also* 2 C.F.R. § 200.4 (defining allocation to mean the assigning of costs "in reasonable proportion to the benefit provided or other equitable relationship").

CAS expressly determined that FBRs calculated in the "normal" way – on the basis of total salaries and wages – will equitably allocate the University's fringe benefit costs. HHS Ex. 7, at 1, 2. The University has not persuaded us (for the reasons outlined below) that this determination is unreasonable or unfounded. At the outset, we note the absence of evidence clearly showing that the salary cap was designed specifically to further the cost principles' fundamental objective – namely, ensuring that federal awards absorb their fair share of costs. The record indicates that the cap was proposed, not to promote fair allocation of costs among federal and non-federal funding sources (in light of relative benefits provided to those sources), but to mitigate the "uneven distribution" of costs among University "departments" or to compensate for funding reductions or "shifts of

[13] "It is . . . obvious," says the University, "that any method that involves proportional allocation of costs rather than specific identification will produce a result that is different from the result that is produced by specific identification." Reply Br. at 4.

funding" resulting from the abandonment of the specific identification method of assigning fringe benefit costs.[14] The University's apparent concern was not that federal awards *per se* would be inequitably charged; it was that funding sources that support high-salaried employees – and those funding sources are both federal and non-federal[15] – would bear a disproportionate share of the University's actual fringe benefit costs relative to funding sources that support fewer (or proportionally fewer) high-salaried employees. UC Br. at 17 ("Without a salary cap, funding sources that support salaries above the IRC limit would be paying for the fringe benefits earned by other (lesser) salaries on other funding sources.").

Whatever concerns actually motivated the University to propose the salary cap, it now contends that capping the salary-and-wage base is "necessary" to prevent federal awards from being inequitably charged. "[W]hen the fringe benefits earned by [its] employees are examined," says the University, "it is shown that a reduction in the fringe benefit rate calculation base is not only appropriate, but necessary to ensure that cost objectives are charged in accordance with relative benefits received." UC Br. at 32. The University further contends that the salary cap "[p]rovides a *more equitable* allocation of fringe benefit costs at the grant/fund source level when compared to either the specific identification method or the use of rates without a cap." *Id.* (italics added).

These claims are simply unsupported. In a 2014 memorandum provided to CAS, the University offered sample calculations which purport to show the "large impact to individual federal awards" from using FBRs that are calculated on the basis of total salaries and wages. HHS Ex. 4, at 5. The sample calculations show that, for high-salaried UCLA employees from five employee groups, the fringe benefit charges generated by FBRs derived from an uncapped salary-and-wage base are higher than the charges generated by FBRs that are calculated on the basis of a capped salary-and-wage base. However, the mere fact of these discrepancies does not show that federal awards

[14] *See, e.g.*, UC Br. at 7-8 (stating that it introduced the salary cap to address a situation in which "some departments [were] being charged a much lower cost for fringe benefit costs and other departments being charged a much higher cost"); *id.* at 20 (stating that the salary cap was "designed to minimize" the "uneven distribution of fringe benefit charges across [medical] departments"); UC Reply Br. at 20 (noting that "[i]f the costs [of the hypothetical high-salaried employee] were allocated to [lower-earning] employees who actually earn the benefits, a substantial portion of the costs would be under the NIH compensation cap and recoverable as allowable costs on other grants"); HHS Ex. 4 (June 10, 2014 letter from the University to CAS), at 1-2 (noting that the salary cap was intended to minimize "shifts in funding" that would otherwise result).

[15] According to the table in the University's opening brief, the funding sources for HSCP faculty salaries include state appropriations, tuition and fees, federal grants and contracts, and medical practice plan revenue. UC Br. at 20.

would collectively absorb a disproportionate share of fringe benefit costs (relative to non-federal funding sources). Award-level cost data and analysis is needed to show that federal awards would be charged inequitably, and the University's 2014 presentation to CAS contained none. At most, what we can glean from that presentation is that some federal awards might be charged more for fringe benefits under the HHS-approved rate formula than under the University's salary-cap-based formula.

There are other problems with that presentation. First, it is unclear whether the subset of highly-paid employees from each employee grouping charges its salaries to federal awards, raising a question about the magnitude of the alleged "impact" on those awards. The largest subset consists of 313 "Health Sciences Faculty," who often do charge their salaries to federal awards (mostly NIH awards). HHS Ex. 5, at 4. The second largest subset consists of 149 "Academic-Faculty." *Id.* CAS noted in its determination, and the University does not dispute, that non-Health Sciences faculty "most often do not" charge their salaries and fringe benefits to federal awards. HHS Ex. 7, at 2. The record does not indicate the extent to which the highly-paid employees from the other three employee groups – one Academic-Other" employee, two "Partial-Ben[efits]" employees, and 11 "Staff Exempt" employees – charge their salaries to federal awards.

Another significant problem with the presentation is that it takes no account of regularly enacted appropriations laws which limit the amount of direct salary that may be charged to HHS awards, from which the University receives most of its federal funding. Under those laws, an institution may charge federal awards for fringe benefits only with respect to the allocable portion of an employee's salary up to a specified limit. That limit was $181,500 in 2014 and is currently $183,300, a level substantially lower than the IRC-derived salary cap.[16] Notably, by reducing the salary-and-wage base, the University's method would increase the FBR (since the numerator of benefit costs remains the same), which means that the rate applied to the direct salary under the appropriation limit charged to federal award would actually be higher.

In rejecting the salary-cap proposal, CAS and OGPOE emphasized that the salary limitation applicable to HHS awards substantially mitigates any "inequities" that might result from applying an FBR calculated in the normal fashion to the salaries of highly paid Health Sciences faculty. HHS Ex. 7, at 2; HHS Ex. 9, at 1 (stating that the rate formula "employed by CAS does not result in significant inequities to federal awards" because the salary limitation on HHS awards "already significantly limits the amount of potential overcharges for fringe benefit costs for highly compensated employees"). The

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[16] *See* NIH, Notice on Salary Limitation on Grants, Cooperative Agreements, and Contracts, available at https://grants.nih.gov/grants/guide/notice-files/NOT-OD-15-049.html (last visited Sept. 30, 2015).

University concedes that point: it states that the "the direct impact on Federal awards from use of the CAS-mandated method is mitigated by the [appropriations law] cap on allowable compensation costs in National Institute of Health (NIH) grants" because "the *Government does not pay most of the [fringe benefit] cost that is over-allocated* using the allocation methodology mandated by CAS." UC Reply Br. at 11 (italics added). The University has provided no estimate of any residual inequity to federal awards after the salary limitation on HHS awards is taken into account.

In its opening brief , the University offers examples of how an FBR would be calculated and applied under both its proposed salary-cap methodology and what it terms the CAS-mandated method. The examples involve four hypothetical HSCP employees of UCLA who spend 10 percent of their time on activities funded by NIH awards. Two of the employees earn more than the proposed salary cap (which is $260,000 in the examples) and two earn less than the cap. The University compares the fringe benefit charges to federal and non-federal funding sources under its proposed methodology with the fringe benefit charges made using an FBR that is calculated on the basis of total salaries and wages.

According to the University, the four examples show that "at lower salary levels [$150,000 and $240,000] the uncapped rate charges less to [federal] grants than the capped rate" and that at "at higher levels the uncapped rate charges more [to federal grants] than the capped rate . . . ." UC Br. at 31. But the same is true for charges to non-federal funding sources: at lower salary levels, the uncapped rate charges less to non-federal funding sources than the capped rate, and at higher salary levels the uncapped rate charges more to non-federal funding sources than the capped rate does. Like the sample data provided to CAS in 2014, these employee-specific examples do not tell us – and the University does not claim that they tell us – that federal awards would be disproportionately charged relative to non-federal funding sources unless the salary-and-wage base of the rate formula is capped. Nor do the examples verify the University's assertions that the salary cap will produce more equitable allocations and "not unfairly increase the cost to the federal government." UC Br. at 16. At most, the examples tell us that, at the highest salary level, a salary-cap-based FBR will operate to reduce fringe benefit charges to both Federal and non-federal awards which support these particular employees.

The University states that, with respect to the highest-paid hypothetical HSCP employee (the one earning $600,000), an FBR calculated on the basis of total salaries and wages generates $72,000 more in fringe benefit charges than a salary-cap-based FBR. UC Br. at 31. The University says that "these additional charges are to salaries that do not generate this level of benefits." *Id.* at 31-32. But the University does not claim that these "additional" charges would otherwise be inequitably assigned to federal awards. Furthermore, such inequity is not apparent from the University's summary of the fringe benefit charges for the four hypothetical employees. That summary and the underlying

calculations show that the HHS salary limitation causes fringe benefit charges to level off as salaries increase: for the hypothetical employees making $240,000, $300,000, and $600,000, the monthly fringe benefit charge to federal awards – as determined using the FBR derived from total (uncapped) salaries and wages – is the same for each employee ($355).

The University asserts that it has "conducted extensive analysis to develop rate structures that minimize funding changes[,] and the salary cap has been part of the solution for funding source equalization." UC Br. at 6. The University did not submit this analysis (or, for that matter, any evidence), describe it in any further detail, or claim that it actually shows that federal awards will be charged more equitably in relation to non-federal sources if a salary cap is used. The University says that its analysis was part of its solution for "funding source equalization," but funding source equalization is obviously not the same as allocation on the basis of "relative benefits received."

In short, while a salary cap may (or may not) help achieve the University's objective of aligning fringe benefit charges and actual costs incurred for high-salaried employees, the University has not demonstrated that a salary cap (1) is necessary to ensure that federal awards are equitably charged, (2) will make cost allocations fairer than they otherwise would be, or (3) will not cause federal awards to be overcharged.

3. *Disapproval of the salary cap does not violate the requirement that separate allocations be made for "selective groupings" of employees.*

The University contends (UC Reply Br. at 12) that HHS's disapproval of the salary cap is "inconsistent with" the requirement that "separate allocations must be made to *selective groupings* of employees, unless the non-Federal entity demonstrates that costs in relationship to salaries and wages do not differ significantly for different groups of employees." 2 C.F.R. § 200.431(d); 45 C.F.R. § 75.431(d) (italics added). The University asserts that its proposed rate formula creates two "selective groupings" of employees: those earning less than the IRC § 401(a)(17) limitation and those earning more. UC Reply Br. at 12. The University submits that HHS has, in effect, unjustifiably rejected those groupings with the result being that fringe benefit costs will be "over-allocate[d]" to the group of employees with salaries exceeding the section 401(a)(17) limit. *Id.*

We see no merit in this argument. The applicable cost principles state that "*separate allocations* must be made to *selective groupings* of employees" in certain conditions. This quoted language is reasonably understood to mean that an institution may (and in some cases must) establish *separate rates* for each appropriate selective grouping. The proposed salary-cap methodology does not produce separate rates for employees making

above and below the IRC § 401(a)(17) limitation. Instead, according to the University own examples (*see* UC Br. at 25-31), the methodology operates to redistribute the fringe benefit cost burden among the members of a selective grouping (HSCP faculty, in particular).

The University, as mentioned earlier (*supra* footnote 5), defined nine selective groupings, and CAS has indicated that they are acceptable. The University did not subdivide these groupings by salary level or create additional selective groupings by salary, nor did the University propose separate FBRs for any such putative groupings. We conclude that the salary cap methodology proposed is not consistent with the selective groupings concept from the cost principles.

4. *The record demonstrates that HHS has a longstanding practice of requiring institutions of higher education to calculate FBRs on the basis of total salaries and wages.*

The University claims that there are relevant "precedents" for its salary-cap proposal – instances in which a cognizant agency has approved rates derived from formulas that "do not include all salaries and wages in the fringe benefit calculation base." UC Br. at 3, 21, 22-23, 33. According to the University, these include: (1) "[f]ringe benefit rates that exclude salaries related to perquisites or cash allowances"; (2) "[f]ringe benefit rates that exclude salaries related to vacation, sabbaticals, or sick leave"; (3) "[f]ringe benefit rates that exclude salaries that are not eligible for retirement benefits, i.e. particular bonuses related to medical practice plans"; and (4) "[f]ringe benefit rates that include a ladder approach where only a small fringe benefit rate is charged to salaries above a certain limit. . . ." *Id.*

The University does not identify actual examples of these allegedly approved rates. The University does say that it found one public university with an in-house medical practice plan (an institution it did not name) that "uses the IRC retirement limit as a salary cap" in order to address the "equity issue" that it faces with fringe benefit charges involving highly paid medical faculty. UC Br. at 21. In his declaration, CAS's director identifies that institution, Medical College of Wisconsin (MCW), and states that its FBR methodology, first introduced in fiscal year 1995, uses the "same Internal Revenue Code (IRC) salary cap that [the University] is proposing to use" but that MCW's methodology is "different from [the University's] proposed approach" because its salary cap applies to only one employee group (Faculty & Staff Labor). HHS Ex. 14, ¶ 4. CAS's director further states that "now that I am aware that MCW [has been] applying this [salary] cap to its fringe benefit base," the school "will no longer be allowed to use [the] salary cap in its fringe benefit rate calculation effective for FY 2016." *Id.* According to its director, "CAS has negotiated fringe benefit rates with 225 educational institutions," and "[n]one of these institutions [has] been allowed to use salary caps in the base of the fringe benefit rate calculation." *Id.*, ¶ 5.

In response to the University's claim that some institutions use a "ladder approach," CAS's director asserts that over 20 years ago, the Office of Naval Research (ONR) – which serves as the cognizant agency for a small number of educational institutions but no longer negotiates FBRs – accepted the University of Rochester's "declining rate structure for annual salaries over $117,000," an allocation methodology under which salaries above the $117,000 threshold are charged a fringe benefit rate that is lower than the rate charged to salaries below the threshold. HHS Ex. 14, ¶ 3. This so-called "ladder approach," says the director, "only applies to the fringe benefit rate for the Faculty & Senior Administrators grouping of employees," and the impact of that approach is "small because it applies to only 4% of the salaries and wages" for that group. *Id.* Furthermore, says the director, the University of Rochester's ladder approach, initially approved by ONR, was "grandfathered" by CAS because its impact on the federal government "has been insignificant." *Id.*

Most notably, the University asserts that CAS approved the use of a salary cap at two of its campuses – the University of California, Berkeley (UCB), and the University of California, Davis (UCD). *See* UC Br. at 6. However, HHS proffered unrebutted statements and evidence that CAS's approval was explicitly given as temporary and not intended to set a "precedent." *See* HHS Br. at 18-21; HHS Ex. 5.

HHS explains in its appeal brief that, during the University's negotiations with CAS concerning "system-wide" FBRs, UCD and UCB asked CAS to enter into separate (campus-specific) FBR agreements because those campuses had recently installed new accounting systems that required the use of FBRs. HHS Br. at 18-21. CAS "reluctantly" agreed. *Id.* CAS's agreements with UCB and UCD, originally set to expire at the end of SFY 2014 but extended through June 30, 2015 (the end of SFY 2015), were intended to bridge the period of time needed for the University to complete its transition to a unified accounting system and system-wide FBRs. *Id.* at 18-19. In negotiating the temporary agreements, CAS communicated to UCB and UCD its position that "IRC salary caps for retirement plan contributions should not be used for Federal FBR base calculation purposes." *Id.* at 19 (*citing* HHS Ex. 5). "Both campuses acknowledged CAS's position, but requested that they be allowed to apply salary cap FBRs because the rate structures had already been programmed into their campus-specific accounting systems, and reprogramming the systems would be time consuming and expensive." *Id.* (*citing* HHS Ex. 5). CAS granted those requests, HHS says, "because [salary caps] were only going to be used temporarily and only involved two campuses, one of which (UCB) does not have

a medical school (and, therefore, any potentially negative impact to the Federal government would be small because UCB . . . charg[ed] fewer grants generally and has fewer higher paid employees)." [17] *Id.*

In July 2014 emails addressed to CAS, UCB and UCD both expressly acknowledged that the use of salary caps to calculate FBRs would not be permitted after SFY 2015. In particular, UCD acknowledged on July 15, 2014 that "CAS has issues with the assessment cap in regards to [FBRs] and that CAS has been in contact with UCOP [University of California Office of the President] regarding this issue." HHS Ex. 5, at 1. CAS responded two days later that the temporary, campus-specific "rates, rate structure, and items comprising the rates [were] *not intended to set a precedent* for future rate agreements or for the planned system-wide fringe benefit rates implementation . . . ." *Id.* at 3 (italics added). In addition, UCB confirmed on July 23, 2014 that it did "not consider any temporary approval of its [campus-specific FBR methodology] as precedent setting" and would "adopt whatever structure is approved for the UC system as soon as it is approved by all parties." *Id.* at 5.

In short, we find on this record that CAS has maintained a consistent practice of requiring FBRs for educational institutions to be calculated on the basis of total salaries and wages. The few exceptions we have just mentioned are limited in scope (*e.g.*, MCW's salary cap historically being applicable to only one selective grouping of employees but no longer being allowed by CAS), do not appear to involve capping the salary-and-wage base at all (*e.g.*, the University of Rochester's ladder approach), or were expressly acknowledged to be temporary and non-precedential. As such, the exceptions do not establish that HHS's refusal to depart from its longstanding practice in this case is arbitrary or unreasonable.

5. *The University's analogy to the modified total direct cost methodology is unpersuasive.*

The University asserts that capping the salary-and-wage base is analogous to the prescribed method of calculating a rate to distribute an institution's "facilities and administrative" (F&A) costs. F&A costs are synonymous with "indirect" costs. F&A costs are "costs incurred for a common or joint purpose benefitting more than one cost

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[17] HHS asserts, and the University does not dispute, that CAS's temporary FBR agreement with UCD, which has a medical school, allowed that campus to have two FBRs for Health Sciences faculty: one FBR for faculty paid more than $200,000 and another FBR for Health Sciences faculty paid less than $200,000. HHS Br. at 20. We agree with HHS that this dual-rate methodology is "different . . . from what [the University] is proposing for its system-wide methodology, which is to limit the salaries and wages that are included in the FBR calculation bases." *Id.*

objective" and which are "not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved." 2 C.F.R. § 200.56; *see also id.* § 200.414; *N.M. Children, Youth & Families Dept.*, DAB No. 2159, at 4 (2008).

The allocation of an educational institution's F&A costs is governed by cost principles separate from those which govern the assignment of fringe benefit costs. *See* 2 C.F.R. Part 200, App. III. An educational institution's F&A costs are typically allocated to cost objectives using a rate that is calculated by dividing the pool of indirect costs incurred for a particular organizational function (the numerator) by some distribution base consisting of the function's direct costs (the denominator). *Id.*, App. III, ¶¶ A.2.b, A.2.d., C.1.a. For many (or most) educational institutions, the appropriate (or required) distribution base is "modified total direct costs" (MTDC), which is defined to include "all salaries and wages," fringe benefits, materials and supplies, services, travel, and up to the first $25,000 of each subaward (regardless of the period covered by the subaward)." *Id.* § 200.68 & App. III, ¶ C.2. The cost principles expressly exclude from the MTDC base "equipment, capital expenditures, charges for patient care, rental costs, tuition remission, scholarships and fellowships, participant support costs and the portion of each subaward in excess of $25,000." *Id.* § 200.68.
The University's analogy is not persuasive. Modified total direct costs expressly exclude specific cost items (or categories of costs) from the distribution base. In this case, the University is not proposing to exclude specific cost items from the fringe benefit distribution base but seeking to cap the amount of all cost items properly included in that base.

6. *HHS's judgment that a salary cap would introduce substantial and unnecessary complexity is reasonable and supports its determination.*

In refusing to approve the University's salary cap methodology, HHS expressed concern that it would introduce needless complexity and increase the federal government's oversight burden, thereby increasing the likelihood of "errors." HHS Ex. 7, at 2. HHS elaborated on its concern in its appeal brief:

> Applying a salary cap to the denominator of the FBR calculation is not complicated in itself as demonstrated by the sample calculation provided at the bottom of page 25 and the top of page 26 of the [University's opening] Brief. However, as [the University] describes on the following pages of its brief, additional calculations would have to be applied for each employee earning above the salary cap amount to determine the fringe benefit costs to be charged to each award. In order to carry out those calculations, Federal officials and others involved in grant administration and auditing would need to know each employee's total salary for the year and the number of pay periods each employee is paid annually; they would have to determine

> whether each salary was above the IRC section 401(a)(17) limitation amount for the year; and then would have to carry out a calculation for each employee. Having a multi-part formula in the FBR agreement would require Federal officials to spend additional time familiarizing themselves with the formula and obtaining additional data from [the University] to complete the calculation. The proposed methodology would be very difficult to explain in a rate agreement and assumes access to information that grants and contracts officials would likely not readily have (such as the total salary for each employee and the number of pay periods per year). . . .

HHS Br. at 16-17.

Although it asserts that HHS has "exaggerated" the complexity of the proposed methodology, the University concedes that "ease of administration and audit" are factors that HHS may properly consider in deciding whether to approve an FBR rate methodology and that "CAS may be required to exert more effort in connection with the method proposed by [the University][.]"[18] UC Reply Br. at 15 n.6, 16. It is important to note that the University proposes to use the salary cap not only to calculate the FBR (by limiting the salary-and-wage base) but to limit the amount of allocable salary and wages against which that rate would be applied in order to determine the appropriate fringe benefit charge for each employee. *See supra* footnote 7. In addition, the University proposes to apply the salary cap on a "pay period basis, dividing the total IRC limit by the number of pay periods within a calendar year." UC Br. at 12. These features are clearly illustrated in the examples provided in the University's opening brief (*see* UC Br. at 26-30), and those examples corroborate HHS's assertion that CAS auditors would need to acquire information not otherwise needed (such as whether an individual's salary exceeded the IRC § 401(a)(17) limit, and the number of pay periods for each employee) and to review calculations that would otherwise not be performed (the calculation of pay-period-based charges). Furthermore, the University offers little more than a token and unsupported response (*e.g.,* auditing will be "good deal easier" because of "automation") to HHS's concern that the proposed methodology may increase the risk of "errors" and resulting misuse of federal funds. That concern is entirely reasonable given that the recent reform of federal cost principles was intended in part to "improve the integrity of the financial management and operation of Federal programs and strengthen accountability for Federal dollars . . . ." 78 Fed. Reg. at 78,590.

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[18] The University asserts that "ease of administration and audit . . . cannot be used to justify the imposition of an allocation practice that produces grossly distorted and unfair results." UC Reply Br. at 16. As explained, however, the University has not substantiated its claim that FBRs calculated on the basis of total salaries and wages will inequitably burden its federal awards and other funding sources.

7. *The University's proposed FBR methodology is not entitled to deference.*

The University contends that its proposed FBR methodology is entitled to "deference" and should be approved because it is "not specifically prohibited" by the cost principles and because HHS has not demonstrated that the "prescribed method" of calculating FBRs would produce a "fair result." *See* UC Br. at 3; UC Reply Br. at 5-6, 14 (suggesting that it is "entitled" to use any method that produces fair results and that does not violate the cost principles). "There is nothing in the regulation[s]," says the University, "that permits [HHS] to impose a method of allocation that produces demonstrably unfair results for a specific institution, no matter how consistent or fair that practice may be at other institutions." UC Reply Br. at 14.

We are unaware of any legal requirement supporting the University's claim to "deference" in this appeal. Under the applicable cost principles, the University's proposed rate methodology must be approved by HHS, acting as the cognizant agency, before it can be used to charge federal awards. HHS has exercised that authority to disapprove the University's proposal. We are obliged to sustain that determination if it is consistent with the cost principles (and other applicable regulations and statutes), giving due deference to HHS's reasonable exercise of discretion or expert judgment.

As we have already explained, HHS's determination is consistent with the cost principles and neither arbitrary or unreasonable, and so we must sustain it. We see no basis upon which we could, in any event, defer to the University's proposal given (1) its failure to demonstrate that a salary cap will not result in federal awards being overcharged and (2) its parallel failure to show that the use of a total salary-and-wage base methodology is conceptually unsound, violates accepted cost accounting standards, or would "produce[ ] demonstrably unfair results."

8. *HHS's determination does not require the University to make significant changes in its internal accounting policies and practices.*

The University implies that that HHS's refusal to approve a salary cap violates 2 C.F.R. § 200.400(d), which states, in part, that application of the cost principles "should require no significant changes in the internal accounting policies and practices of the non-Federal entity." UC Reply Br. at 5-6. We see no evidence that HHS's application of the cost principles in this case has caused, or will cause, "significant changes in the [University's] internal accounting policies and practices." It is true that the University's decision to begin charging fringe benefit costs using the allocation method (in lieu of specific identification) is a significant change in accounting practice. The University made that decision for its own reasons, however, and not in response to any "application" of the cost principles. *See* UC Br. at 6 (stating that implementation of FBRs was a "necessary requirement to address a variety of management issues").

Furthermore, it is inappropriate to characterize the use of a salary cap as an accounting practice or policy that will be "changed" as a result of HHS's determination. The University describes its salary-cap methodology as a "proposal" and is well aware that the proposal must be negotiated with and approved by the cognizant agency; indeed, the proposal has been under discussion with CAS since 2012, when the University first presented its overall plan to use entity-wide FBRs. *See* HHS Br. at 5-6; UC Br. at 3. Nothing prevents an institution from adopting a new cost accounting practice, even one with potential ramifications for federal awards, prior to receiving an authoritative statement from the cognizant agency on the practice's acceptability. However, if the institution proceeds to implement the new practice before receiving the cognizant agency's determination, it may not invoke section 200.400(d) to claim that the cognizant agency's disapproval has improperly caused it to change or reverse course. Furthermore, while the regulation states an expectation that the cost principles can be complied with through normal internal accounting policies and practices, we do not read this provision as an assurance that a non-federal entity will never have to make accounting changes to ensure compliance. After stating that "application of [the] cost principles should require no significant changes" in an organization's internal accounting practices and policies, section 200.400(d) warns that "the accounting practices of the non-Federal entity must be consistent with these cost principles and support the accumulation of costs as required by the principles, and must provide for adequate documentation to support costs charged to the Federal award." The cost principles also require that an award recipient determine its costs in accordance with generally accepted accounting principles. 2 C.F.R. § 200.403(e). This requirement is another indication that the award recipient's choice of accounting practice is not unlimited.

9. *The University's allegations of harm are irrelevant and unsubstantiated.*

The University asserts that it will be harmed – "potentially in material amounts" – if its proposed methodology is not approved. UC Reply Br. at 12-13. The University further asserts that HHS's determination will "impact not just the amount of cost charged to Federal awards" but the "budgets and cost distribution of every element of the University's employment community." *Id.*

These allegations are irrelevant for two reasons. First, although the University implies that the alleged harm relates to "misallocations" that it says will result from using FBRs that are calculated on the basis of total salaries and wages, the University has not, for reasons already discussed, demonstrated that such FBRs will inequitably allocate its fringe benefit costs to federal and non-federal funding sources. Second, the University does not connect the alleged harm to any legal standard or principle that HHS improperly failed to consider or uphold when it rejected the salary-cap proposal.

Even if the allegations of harm were relevant, they are too opaque and thus entitled to little weight. The University asserts that calculating FBRs without a salary cap will lead to inequitable "shifts in funding" and "uneven distribution of fringe benefit charges across departments." HHS Ex. 8, at 2; UC Br. at 20. The University also claims that FBRs calculated on the basis of total salaries and wages will "reduce[ ] the amount of allowable cost that [it] is entitled to recover on its Federal awards." UC Reply Br. at 13. The University did not provide concrete examples of these potential outcomes or explain precisely how and why they would occur. Nor did the University proffer a monetary estimate of the alleged harm.

The University attempts to place the issue of harm in the context of a choice between the specific identification and allocation methods of assigning fringe benefit costs. The University asserts that "specific identification of fringe benefit costs is not a viable alternative with the implementation of the [University's] new . . . payroll and human resource system," and that "[t]o continue to use the specific identification method will require costly and unmanageable modifications." UC Br. at 3.

As both parties recognize, the choice between specific identification and using FBRs to charge fringe benefit costs involves a tradeoff between precision and administrative efficiency. Specific identification is a highly precise (or accurate) way to identify and assign fringe benefit costs to the cost objectives that benefit from them. That method can be administratively burdensome, however, especially for institutions as large and complex as the University. The allocation method is more efficient (less burdensome) but perhaps less accurate in aligning costs in accordance with "relative benefits received." The University understandably wants to minimize that tradeoff – that is, capitalize on the efficiency of FBRs while attempting to refine them to achieve more equitable allocations. However, there is insufficient evidence that the University's proposed methodology will achieve that objective and no persuasive reason to think that allocating fringe benefit costs on the basis of total salaries and wages will cause federal awards to bear an inequitable share of those costs.

Conclusion

In rejecting the University's salary-cap proposal, HHS determined that FBRs calculated on the basis of total salaries and wages will efficiently and equitably allocate the University's fringe benefit costs. HHS also determined that that any incidental inequity resulting from the University's adoption of such an FBR methodology (in lieu of the existing specific identification of fringe benefit costs) is likely to be insignificant, largely because of the salary limitation applicable to all HHS awards, the University's primary source of federal funding. Finally, HHS determined that the University's salary-cap

proposal would introduce unnecessary complexity and burden into oversight of Federal awards. The University has not demonstrated that these reasons are factually unfounded, arbitrary, or overlook relevant aspects of the University's compensation policies and funding mechanisms. We therefore conclude that HHS exercised reasonable judgment in rejecting the University's salary cap proposal. Accordingly, we affirm HHS's determination not to depart from its longstanding practice of requiring educational institutions to calculate FBRs on the basis of total salaries and wages.

/s/
Sheila Ann Hegy

/s/
Constance B. Tobias

/s/
Leslie A. Sussan
Presiding Board Member