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2017 Tax Reform Legislation: Impact on Tax-Exempt Organizations, including Educational and Health Care Institutions

SUMMARY

The 2017 tax reform legislation colloquially referred to as the Tax Cut and Jobs Act (the Act) includes a number of provisions that will affect tax-exempt organizations of all types, as well as provisions that will affect educational institutions and health care organizations, both directly and indirectly. Provisions affecting all tax-exempt organizations include expansion of the unrelated business income tax (UBIT) regime and a new excise tax on high compensation. For educational institutions that satisfy certain thresholds, the Act introduces a new 1.4% excise tax on endowment earnings. In potentially the most significant change for health-care institutions, the Act essentially repealed the Affordable Care Act's (ACA's) requirement that all individuals be covered by health insurance (known as the "individual mandate") by eliminating the tax on individuals for failing to obtain minimum essential health care insurance coverage. This Alert discusses these law changes, as well as other significant proposals affecting tax-exempt organizations that were included in the House and Senate bills but that ultimately were not included in the Act.

PROVISIONS AFFECTING ALL EXEMPT ORGANIZATIONS

Excise Tax on Exempt Organization Employee Compensation

Tax-exempt organizations often use competitive compensation as a tool to attract and retain top talent. In structuring these compensation packages, however, tax-exempt organizations face limitations imposed by the Internal Revenue Code of 1986, as amended (the Code). The limitations seek to dissuade tax-exempt organizations from providing excessive compensation for certain high-level employees. For example:

- Under the "intermediate sanctions" provisions of the Code, certain individuals who exercise control or influence over organizations exempt from tax under Code Sections 501(c)(3) (except private foundations), 501(c)(4), and 501(c)(29) are subject to an excise tax on any excess compensation received from such organizations.
- Deferred compensation for employees of tax-exempt organizations must satisfy various technical provisions to avoid adverse tax consequences to the employee.

- To maintain its tax-exempt status under Code Sections 501(c)(3) or (4), no part of a tax-exempt organization's net earnings can inure for the benefit of any private shareholder or individual.

To add to the complexity, the Act created a new 21% excise tax on compensation that exceeds $1 million and on any excess payment contingent on a separation from service, also known as an "excess parachute payment," for any Covered Employee (as defined below). This provision is broadly intended as a tax-exempt analog to sections 162(m), which limits public companies' tax deduction for compensation in excess of $1 million paid to highly-compensated executives, and 280G, which limits taxable corporations' deductions for "excess parachute payments" (generally speaking, change in control payments that exceed three times the employee's five-year average compensation).

This new tax would apply to any organization tax-exempt under 501(a) of the Code, as well as certain other tax-exempt institutions. An organization's Covered Employees include each of the 5 highest compensated current or former employees (such as a former employee continuing to receive large payments under the terms of an employment contract) in the organization for the tax year and any current or former employee who previously qualified as a Covered Employee. This means that the group of employees subject to the tax may expand after 2018. Unlike with current Code section 162(m), the employee does not have to be an officer. For example, a college or university coach may qualify as a Covered Employee. The tax is imposed on compensation paid both by the tax-exempt organization and by any other related organization, such as a booster organization that is treated as a supporting organization of a university. The organization itself is liable for the tax.

A special exclusion applies to compensation paid to licensed medical professionals (including veterinarians). To the extent the compensation is attributable to the performance of medical or veterinary services, it is not taken into account. Such professionals can still qualify as Covered Employees, however, if they receive compensation in any other capacity.

Unrelated Business Income Tax Revisions

<u>Separation of Business Activities</u>

Most organizations otherwise tax-exempt under section 501 of the Code are taxable on their "unrelated business taxable income" (UBTI). This includes both any income arising from any trade or business unrelated to the exempt purpose of the organization and any "unrelated debt-financed income": generally, income that otherwise would not be UBTI, such as dividends or rents from real estate, to the extent that the income-producing asset is encumbered by acquisition indebtedness.

Under prior law, exempt organizations were able to offset any unrelated business taxable losses against UBTI so that they only were taxed on their aggregate net UBTI.

The Act now requires exempt organizations to separate each unrelated trade or business. Losses from one unrelated trade or business cannot be offset against income from another unrelated trade or business. The Act does not specify when trades or businesses are "separate," referring simply to the definition of unrelated trade or business in section 513 of the Code. This segregation of trades or businesses means that an organization is more likely to pay tax on UBTI even if its unrelated activities are in an overall net zero or even loss position, particularly if the IRS takes a narrow view of what is a separate trade or business.

Although the potential amount of tax is increased under the Act, the rate of tax has decreased. UBTI is taxed at the corporate income tax rate, which now is only 21%, reduced from the prior maximum rate of 35%.

Possible planning response (with limitations): creation of corporate subsidiary

An exempt organization (other than a private foundation) could create a taxable corporate subsidiary and transfer its unrelated trade or business activities to that corporate subsidiary. Income and losses could be offset at the corporate subsidiary level, and the corporation would pay tax at 21% (plus state tax) on the corporate profits. Dividends to the exempt organization parent would not be subject to federal tax. However, any payment of rent, interest, or royalty by the controlled corporation to the exempt organization would constitute UBTI to the exempt organization.

This structure has several main limitations:

- Some states (such as Pennsylvania) do not separately impose tax on unrelated business income of exempt organizations. However, if an exempt organization moves unrelated trades or business into a taxable subsidiary, that income becomes subject to state tax.
- Many investments, particularly partnerships, generate some UBTI and some income that is not UBTI. If an exempt organization owned such an investment directly, it would only pay tax on a portion of its share of income from the investment. However, if it transferred the investment to a taxable subsidiary, the entire income would be taxable.

There also is a risk that Congress or Treasury could seek to "look through" corporations controlled by exempt organizations and apply this separation of business activities at the corporate level, effectively eliminating the benefit of the corporate structure.

Taxable Fringe Benefits

Beginning January 1, 2018, amounts paid by tax-exempt employers for certain employee benefits that are not deductible for taxable employers will now be subject to UBIT (at the new 21% corporate rate). This includes amounts paid for qualified transportation fringe benefits (defined in Code section 132(f)) and parking facilities used in connection with qualified parking benefits (defined in Code section 132(f)(5)(C)) that would not be deductible under section 274 if paid by a taxable employer. In addition, it appears that UBIT will also apply to the expenses of providing on-site athletic facilities unless they meet the requirements of section 274(e)(4), which generally allows taxable employers to deduct expenses for facilities that are available to all employees and not just to executives.

Charitable Giving Incentives Changed

The Act makes a number of changes affecting tax incentives for charitable giving, increasing the tax incentive for giving in some cases and decreasing the tax incentive in others.

Under prior law, current-year tax deductions for cash contributions to public charities by an individual were capped at 50% of that individual's adjusted gross income (without regard to any net operating loss carry-forwards). For tax years 2018 through 2025, the Act increases the contribution limit to 60% of adjusted gross income, increasing the incentive for charitable contributions for people who would have been near the 50% limit.

Other changes to individual tax, generally effective from 2018 through 2025, reduce the tax incentives for charitable contributions. The Act's significant increase to the standard deduction, coupled with the limit on state and local tax deductions, means that smaller donors to tax-exempt organizations will not have the same income tax incentive to give, because the contributions might not result in actual tax savings for them. In addition, the Act doubles the lifetime estate and gift tax exemption for that period, so fewer estates will receive a tax benefit for charitable contributions. Individuals with estates less than the exemption amount will not have the same income tax incentive to make charitable bequests.

The Act did not alter the rules regarding charitable contibutions from IRAs, so exempt organizations may wish to highlight those contributions to eligible donors.

Provisions Not Adopted

Numerous provisions that would have affected tax-exempt organizations were not adopted. These include:

- Elimination of "private activity" tax-exempt bonds, including all qualified 501(c)(3) bonds[1]
- Imposing excise taxes directly on exempt organizations for any "excess benefit transactions"

1 The Act did eliminate "advance refunding" bonds, which will affect when bonds can be refinanced efficiently. The provision ultimately enacted was described in the Firm's earlier Alert, reviewing all proposed changes to tax-exempt bonds in the original draft legislation, which may be found here: http://bit.ly/2m0xmjc

- Elimination of the "rebuttable presumption" protections against penalties relating to transactions with "disqualified persons" where the exempt organization governing body follows certain review and approval procedures
- Increased personal exposure for officers, directors, or compensation committee members who approve transactions found to be "excess benefit" transactions, including by removing the ability to rely on professional advice as an affirmative defense

PROVISION AFFECTING HEALTH CARE PROVIDERS: REPEAL OF INDIVIDUAL MANDATE

H.R. 1 essentially repealed the ACA's individual mandate. There is concern that by repealing the individual mandate healthier people will be less likely to voluntarily obtain insurance, thereby either increasing premiums for those who do elect coverage through the ACA marketplace and/or increasing the number of insured patients. At the same time, others argue that President's Trump's October 2017 Executive Order, which directed the Department of Labor ("DOL") to study how to make it easier for small businesses, and possibly individuals, to join together and buy health insurance through nationwide association health plans could counterbalance any such effects. On January 5, 2018, the DOL published proposed rules to try to implement this Executive Order's directive. The ultimate result of both the repeal and the proposed regulations is, as yet, unknown.

PROVISIONS AFFECTING EDUCATIONAL INSTITUTIONS

Excise Tax on Certain Educational Institution Endowments

The Act creates a new tax, imposed on any "applicable educational institution," equal to 1.4% of that institution's "net investment income" for the year. The tax applies with respect to income both of the educational institution and any "related organization."

An applicable educational institution is any institution described in section 481 of the Higher Education Act and that is eligible to participate in any Title IV programs thereunder, meeting all of the following criteria:

- It is neither an instrumentality of any government or political subdivision nor owned or operated by any government or political subdivision thereof, or any agency or instrumentality of one or more subdivisions.
- It had at least 500 students during the prior taxable year.
- More than 50% of its students are located inside the United States.
- The aggregate fair market value of its and any related organizations' assets (other than any assets used in carrying out its exempt purposes), as of the end of the preceding tax year is at least $500,000 per full-time student (taking part-time students into account on a full-time equivalent basis).

The Act provides that net investment income will be determined based on rules "similar to" those applicable to the private foundation excise tax. In general that means the sum of all capital gains, dividends, interest, rents, royalties, and payments with respect to securities loans, minus all ordinary and necessary expenses incurred for the production of that income (with some adjustments to depreciation and depletion allowances). Any income or gains that are subject to tax as UBTI are excluded from this computation.

A "related organization" is any organization that controls, or is controlled by, the educational institution or one or more persons that control that institution, or is a supported organization or supporting organization for the educational institution.

Limitation on Charitable Contribution Deductions for Seating Rights

Under prior law, a contributor to a college or university who received, directly or indirectly, the rights to buy tickets for seating at athletic events at one of the institution's athletic stadia could claim a deduction of 80% of the contributed amount, whether or not the tickets would have been available to a person who did not make the contribution. (The purchase of tickets was not tax deductible under prior law; this provision only applied to contributions that allowed a donor to get the right to purchase those tickets.)

The Act eliminated that charitable contribution deduction. This could affect charitable contributions by boosters.

Provisions Not Adopted

Numerous provisions that would have affected educational institutions were not adopted in the final version of the Act. These include:

- Taxing income from names and logos as UBTI
- Tax on tuition benefits granted to employees (such as graduate students who receive tuition waivers)
- Eliminating deductions for qualified tuition and related expenses and student loan interest

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