TAX CUTS AND JOBS ACT COULD HAVE FAR-REACHING EFFECTS ON HIGHER EDUCATION

Date: 14 November 2017

U.S. Employee Benefits & Compensation and Tax-Exempt Organizations Alert

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The House of Representatives and the Senate are on a fast track to pass sweeping tax reform legislation that would have widespread implications for colleges and universities, their employees, and their donors.

As part of a plan to reform the Internal Revenue Code ("IRC"), the Tax Cuts and Jobs Act was introduced by the U.S. House of Representatives in the form of H.R. 1 (the "House Bill") on November 2, 2017 and was approved by the House Ways and Means Committee on November 9, as amended. On November 9, 2017, the U.S. Senate released a detailed summary of its bill (the "Senate Bill"). The actual legislative text will be produced after the Senate Finance Committee completes its mark-up of the bill this week. The full House is expected to approve H.R. 1 on November 16. The Senate plans to consider its tax reform proposal the week of November 26, amending H.R. 1 with the Senate language. If all goes as planned, a comprehensive tax reform bill could be on the President's desk in early December.

This summary focuses on the provisions of the House and Senate bills impacting the taxation of educational institutions and executive compensation, retirement plans, and benefits at educational institutions. At this stage, there are significant differences between the House and Senate measures, which are noted below. These differences will need to be reconciled prior to passage of the Senate bill or in conference. The two chambers are expected to coordinate efforts to minimize differences in the bills in order to facilitate and expedite passage of the most significant tax reform since 1986.

EXCISE TAX ON ENDOWMENTS

Under both the House Bill and Senate Bill, like private foundations, an educational institution would be subject to the private foundation 1.4% excise tax on net investment income if it (1) has at least 500 students, (2) is private (state institutions are exempted), and (3) has assets with a fair market value (other than assets that are used directly in carrying out the institution's exempt purpose) of at least $250,000 per student (based on the daily average number of full-time students, accounting for part-time students on a full-time student equivalent basis).

According to the Senate summary, assets "used directly in carrying out the institution's exempt purpose" would include "classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets."

This tax would represent a diversion from the existing rules for private foundations, which exclude from the excise tax "private operating foundations"—private foundations that function like public charities, such as educational institutions.

UNRELATED BUSINESS INCOME TAX ("UBIT")

Activity by Activity UBIT Computation

The Senate Bill (but not the House Bill) would require UBIT computations to be made on a business-line basis. This separate computation would restrict net operating losses ("NOLs") to be used only to offset income in the same unrelated business activity. There are no transition rules for existing NOLs.

Licensing Revenue from Use of Name or Logo

The Senate Bill (but not the House Bill) would treat revenue from an organization's licensing of its name or logo as subject to UBIT and treat such licensing activity as unrelated. There are no exceptions based on the nature of the license. Thus, for example, license fees for university branded clothing and other items sold in the campus bookstore would be taxable.

UBIT Paid on Certain Employee Fringe Benefits

The House Bill (but not the Senate Bill) would increase an organization's UBIT (so as to impose tax) by the amount of the organization's expenditures for employee transportation fringe benefits and on-premise gyms, and other athletic facilities.

EXECUTIVE COMPENSATION

A 20% Excise Tax on Compensation Above $1 Million for "Covered Employees"

Intended to align the treatment of compensation at tax-exempt entities with that of public companies, both the House Bill and Senate Bill would impose a 20% excise tax on taxable wages paid to a "covered employee" (defined below) that exceed $1 million in a taxable year. This would apply to IRC §501 tax-exempt entities as well as state and local governments, and the excise tax would be payable by the organization.

"Covered employee" means any current or former employee that was one of the five highest-paid employees of the organization for the tax year or any preceding tax year beginning with 2017. In other words, once an employee is among the five highest-paid employees, he or she will always be subject to the excise tax if taxable wages exceed $1 million in a taxable year.

A 20% Excise Tax on Large Severance Payments to "Covered Employees"

Under both the House Bill and Senate Bill, for the same group of "covered employees" discussed above, payments triggered upon a termination of employment that exceed 300% of the employee's "base amount" would also be subject to a 20% excise tax. The "base amount" is equal to the employee's taxable wages (Box 1 of Form W-2) averaged over the last five tax years. While IRC §401(a), §403(b), and §457(b) retirement benefits would not be included in the calculation, this could apply to any other payments triggered or accelerated by a termination of employment, including severance and retirement benefits under nonqualified plans.

Like the excise tax on compensation above $1 million, the severance payment excise tax would apply to nonprofits as well as state and local governments, and the excise tax would be payable by the organization. The same compensation could not be subject to both excise taxes, so if a termination of employment triggers severance subject to excise tax that also exceeds $1 million, only the excise tax on severance would apply.

Deferred Compensation, Including IRC §457(b) Plans

The Senate Bill (but not the House Bill) would dramatically change the tax treatment of deferred compensation for all taxpayers, including both nonprofit and for-profit entities. Under the Senate Bill, all deferred compensation would need to be paid by March 15 of the year following the lapse of the substantial risk of forfeiture ("SRF") tied to the compensation, and SRF would be narrowly defined to mean the requirement to provide substantial future services (i.e., time vesting).

Nonprofits are already subject to a similar rule under IRC §457(f), and, in that respect, the new rules on deferred compensation would replace IRC §457(f) for nonprofit and governmental entities. But more significantly, the new rules would also repeal IRC §457(b) for nonprofit entities (but not governmental entities). Additionally, the Senate Bill would require all amounts that are already subject to deferral to be includible in income no later than the end of 2026. As a result, the new deferred compensation rules would prohibit the use of IRC §457(b) plans beginning in 2018 and require all existing deferrals under IRC §457(b) to be brought into income no later than 2026 (except for governmental IRC §457(b) plans).

Intermediate Sanctions

The Senate Bill (but not the House Bill) would expand the intermediate sanctions rules to impose a 10% excise tax on the organization when the intermediate sanctions excise tax is imposed on a disqualified individual as a result of an excess benefit transaction. The tax would not apply if the organization's decision is not willful (made without knowing the transaction was an excess benefit transaction) and is due to reasonable cause.

The current rebuttable presumption standard would be available to demonstrate due diligence was used by the organization and, if satisfied, would protect the organization from the excise tax. However, the rebuttable presumption would no longer establish a presumption of reasonableness for the transaction generally, and organization managers (including trustees) would not be protected from the excise tax applicable to them by relying on professional advice. Such reliance would be a factor in demonstrating that a reasonable decision was made.

In addition, the Senate Bill would expand the list of disqualified persons subject to the intermediate sanctions rules to all coaches, regardless of compensation level, and certain investment advisors. This change would increase the administrative burden of the intermediate sanctions review.

RETIREMENT PLANS

As discussed above (under "*Deferred Compensation, Including IRC §457(b) Plans*"), the Senate Bill (but not the House Bill) would have a significant impact on IRC §457(b) deferred compensation plans for nonprofit entities. The Senate Bill would also limit governmental IRC §457(b) plans as well as IRC §403(b) plans for nonprofit and governmental entities in a number of additional ways, to treat those plans similar to IRC §401(k) plans.

First, a single deferral limit would apply for employee contributions ($18,000 for 2017) and for total combined employee and employer contributions ($54,000 for 2017) to a governmental IRC §457(b) plan and an IRC §401(k) or §403(b) plan of the same employer. Second, special rules regarding additional elective deferrals and catchup contributions under IRC §403(b) plans and governmental IRC §457(b) plans would be repealed, so that the same catchup contribution limits would apply as they do for IRC §401(k) plans. Third, the special rule allowing contributions to an IRC §403(b) plan for up to five years after termination of employment would be repealed. Fourth, early withdrawals before age 59 1/2 from a governmental IRC §457(b) would be subject to a 10% tax (similar to the tax that applies for early withdrawals from IRC §401(k) and §403(b) plans). Fifth, employees with wages of $500,000 or more for the preceding year would be prohibited from making catchup contributions to an IRC §403(b) or §457(b) plan.

BENEFITS

Various Tax-free Benefits Become Taxable

Under the House Bill (but not the Senate Bill) a variety of employer-provided, tax-free benefits would become taxable beginning in 2018, unless otherwise noted below. The Senate Bill would preserve these tax-free benefits (listed below), with the exclusion of employer-paid moving expenses.

- Tuition remission for employees and graduate students
- Employer-provided housing (tax exclusion limited to $50,000 per year and phased out for those with compensation above indexed threshold ($120,000 for 2017))
- Employer-provided educational assistance
- Moving expenses and relocation stipends
- Employee achievement awards
- Dependent care assistance (tax exclusion repealed beginning in 2023)
- Adoption assistance

Work-related Education Expenses

The Senate Bill would eliminate itemized deductions for work-related education expenses, which could impact the tax treatment of employer-paid, work-related education expenses, and would repeal the tax exclusion for qualified bicycle-commuting reimbursements

If any or all of these relatively common employer-provided tax-free benefits do indeed end up losing their tax-free status, employers will need to decide whether to continue to provide these benefits on a taxable basis. Employers will also need to revise the operation and administration of these benefits, as well as underlying plan documents, employee handbooks, and employee communications, to reflect both the change in tax treatment of these benefits and the employer's design decisions regarding whether and to what extent to continue to provide these benefits.

THIS IS A SERIOUS TAX REFORM EFFORT

These proposals should be taken seriously. After years of talking about tax reform, both chambers of Congress are moving quickly to put a tax reform bill on the President's desk in December. Despite a volatile political environment in Washington, Republicans are determined to enact a tax reform package before the 2018 campaign season begins. You should act promptly with questions or concerns. Our subject matter and tax policy experts will be following these issues closely and stand ready to assist you in assessing their potential impact and developing a strategy to address your concerns. Please contact any of the authors for further information.