JUST-PASSED TAX CUTS AND JOBS ACT WILL SIGNIFICANTLY IMPACT HIGHER EDUCATION

Date: 20 December 2017

Public Policy, Tax, and Tax-Exempt Organizations/Nonprofit Institutions Alert

By: J. Barclay Collins, Mary Burke Baker, Barry J. Hart, William N. Myhre, Charles H. Purcell

House and Senate Republicans passed a comprehensive tax reform bill on December 20, 2017 that makes sweeping changes throughout the Internal Revenue Code affecting many educational institutions, as well as most individuals and businesses. The president has not announced when he intends to sign the bill, which will automatically become law if he does not sign it within 10 days of congressional approval, excluding Sundays (January 1, 2018). The "Tax Cuts and Jobs Act" (H.R. 1) worked its way through the tax committees and a conference committee quickly, over the course of just eight weeks, using a budget process known as reconciliation that required only 51 votes in the Senate. There were several fits and starts during the process, including a last-minute procedural glitch in the Senate that required the House to vote on the bill twice. House Ways and Means Committee Chairman Kevin Brady (R-TX) said that he "couldn't be more excited to deliver the Tax Cuts and Jobs Act to the American people."

HIGHER EDUCATION EFFECTS FAR-REACHING

As stated, a broad range of provisions in the legislation affects higher education, including private university endowments, the treatment of both undergraduate and graduate students, and more. The following are the key changes the bill brings about for higher education:

Excise Tax on Endowments. The bill imposes a 1.4 percent excise tax on the net investment income of colleges and universities with at least 500 students, with more than 50 percent of their student body in the United States, and whose assets not used to carry out the educational mission are at least $500,000 per student. The tax does not apply to state colleges and universities. Based on current estimates, the provision impacts approximately 25 universities.

Trade and Business Segregation for UBIT Computations. The provision requires Unrelated Business Income Tax ("UBIT") computations, including the use of Net Operating Losses ("NOLs"), to be made on a line-of-business basis. Pre-2018 NOL carryovers may be used to offset income from any unrelated activity. There is no definition of what constitutes a separate business activity. UBIT is taxable at the new 21 percent corporate tax rate.

Advance Refunding and Tax Credit Bonds. While the benefits for many tax-exempt bonds survive, the interest exclusion for advance refunding bonds is repealed. The bill also repeals the authority to issue tax-credit and direct pay bonds after 2017.

Institution Tax on Compensation over $1 Million. Public and private institutions will pay a 21 percent excise tax on any amount above $1 million in compensation paid to the five highest-paid employees ("Covered Employees").

Once an employee becomes a Covered Employee, their compensation will continue to be subject to the excise tax in future years even if they are no longer one of the five highest-paid employees. In an update to the Senate-passed provision, the final bill excludes compensation paid to medical professionals related to providing medical (but not to other) services. Medical professionals include doctors, nurses, and veterinarians. The provision also contains related organization and antiabuse rules.

Severance. Severance payments to Covered Employees that exceed three times base compensation (using Code § 280G principles) are subject to a 21 percent excise tax paid by the institution. Similar to the compensation provisions that will affect the five highest-paid employees, severance to medical professionals related to medical services will not be considered in the computation.

Tax Paid on Certain Employee Fringe Benefits. Institutions will pay taxes (as UBIT at the new 21 percent corporate tax rate) on the value of providing specified nontaxable fringe benefits to employees for certain transportation fringe benefits and on-premises gyms and other athletic facilities.

Moving Expenses. Employer paid or reimbursed moving expenses are taxable to the employee and employees may no longer deduct moving expenses. Neither provision applies to military personnel or their families. This provision sunsets after 2025.

Work Related Education. Employees may not deduct work related education expenses. This provision is part of the larger removal of deductions subject to the 2 percent floor. There is no protection for currently enrolled education programs. This provision sunsets after 2025.

Charitable Contribution Limit. The charitable contribution limit increases to 60 percent of adjusted gross income for the amount of cash that can be deducted annually as charitable contributions to public charities, including colleges and universities. This provision sunsets after 2025.

Charitable Deduction for Seating Rights. Donors may no longer deduct 80 percent of the amount paid for the right to purchase tickets for college athletic events.

SOME HIGHER EDUCATION PROVISIONS DROPPED

Despite the number of provisions in the legislation that will impact higher education, the final version eliminates several items that appeared in the previous House- and Senate passed versions. Chairman Kevin Brady (R-TX), Chairman of the House Ways and Means Committee, has reportedly stated that he plans to seek further tax reforms in 2018, and we expect many of the following provisions may come back into play.

Interest Exclusion for 501(c)(3) Bonds. The bill does not include the House provision to generally repeal the interest exclusion for 501(c)(3) bond provisions after 2017.

Intermediate Sanctions. The Senate-passed provision to expand the rules on excess benefit transactions and change the rebuttable presumption for unreasonable compensation was removed due to Senate procedural rules.

Deferred Compensation. Despite early proposed fundamental changes in the House and Senate bills, there are no fundamental changes to repeal the rules on deferred compensation.

Employer Provided Housing. The final bill follows the Senate's lead and drops the House-passed provision to place additional rules on the exclusion from income of the value of employer provided housing.

Tax on Name and Logo Royalties. An amendment to the final Senate bill dropped a proposal to subject royalty income from the sale of names and logos to UBIT.

Tuition Remission. There is no provision in the final bill to repeal the deduction for education benefits supplied under tuition remission programs to employees or graduate students.

Educational Assistance Programs. The proposed repeal of the $5,250 exclusion for annual education assistance provided by employers does not appear in the final bill.

UBIT Research Exception. The House-passed provision to change the research exemption was not carried over into the final bill.

Student Loan Interest Deduction. Students will continue to enjoy a deduction for their student loan interest, as repeal of this provision was not included in the final bill.

SWEEPING EFFECTS FOR ALL AMERICANS

Beyond the impact on higher education, the 500-plus page bill will have an effect on nearly all Americans. For individuals, the legislation lowers the income tax rate on the highest income bracket from 39.6 percent to 37 percent, doubles the standard deduction, limits the deduction taxpayers can take for state and local taxes, and lowers the mortgage interest deduction to a $750,000 cap on new mortgages. Further, the bill significantly increases the exemption from the alternative minimum tax ("AMT"), doubles the estate tax exemption, repeals the Affordable Care Act's individual mandate, increases the child tax credit, and temporarily lowers the adjusted gross income threshold necessary to qualify for the medical expense deduction. In general, adjustments to individual income taxes will sunset after 2025.

With regard to the taxation of corporations and other business entities, the legislation substantially lowers the corporate tax rate to 21 percent, repeals entirely the corporate AMT, and reduces the effective tax rate of certain pass-through entities via a 20 percent deduction on qualifying business income. The bill also switches from a worldwide system of international corporate taxation to a territorial system, imposes a three-year holding requirement for carried interest to qualify as a long-term capital gain, allows for full and immediate 100 percent capital expensing, and imposes a limitation on the deductibility of interest expense of the lessor of net interest expense or 30 percent of adjusted taxable income.

FURTHER ACTION EXPECTED IN 2018 - YOUR CHANCE TO ENGAGE

While extensive in its scope and effect, Republican leaders and tax writers say the Tax Cuts and Jobs Act should not be viewed as a stand-alone event but as the beginning of a process. This provides an opportunity for stakeholders affected by the legislation to participate in addressing the many unintended consequences, omissions, ambiguities, and drafting errors that are anticipated as a result of this extremely fast-moving legislation. Chairman Brady already has said he expects to work on a corrections bill in 2018, and leadership and tax staff are soliciting input from stakeholders to help them identify and remedy concerns. There also will be regulatory projects to interpret the legislation.

Please be in touch with questions, concerns, and suggestions as you study the legislation and determine its effects. Our subject matter and tax policy experts will be following these issues closely and stand ready to assist you in assessing policy impact and developing a strategy to address your concerns. Please contact any of the authors for further information.

KEY CONTACTS

J. BARCLAY COLLINS
PARTNER

WASHINGTON DC
+1.202.778.9244
BARCLAY.COLLINS@KLGATES.COM

MARY BURKE BAKER
GOVERNMENT AFFAIRS COUNSELOR

WASHINGTON DC
+1.202.778.9223
MARY.BAKER@KLGATES.COM

BARRY J. HART
OF COUNSEL

WASHINGTON DC
+1.202.778.9215
BARRY.HART@KLGATES.COM

WILLIAM N. MYHRE
PARTNER

WASHINGTON DC
+1.202.661.6222
WILLIAM.MYHRE@KLGATES.COM

CHARLES H. PURCELL
PARTNER

SEATTLE
+1.206.370.8369
CHARLES.PURCELL@KLGATES.COM