Let's BOND over the Tax Act[1]
Part II - The Higher Education Edition

In the spirit of accentuating the positive, there are a few bits of good news for colleges and universities in the Tax Act…as Mary Poppins might say, a spoonful (or three) of sugar to help the medicine go down. Unfortunately, after those very small doses of sugar go down, what follows is more like a 50 gallon drum of cod liver oil for many colleges and universities (and their respective donors).

One very welcome point to highlight at the outset, is that several of the more unpopular provisions in the House and Senate versions failed to make the final cut. For example, the Tax Act does not change the (i) exclusion for qualified tuition reductions, (ii) exclusion for employer-provided housing, (iii) American Opportunity tax credit or Lifetime Learning credit, (iv) deduction for student loan interest, (v) deduction for qualified tuition and related expenses, (vi) exclusion for educational assistance programs, or (vii) exclusion for interest on United States savings bonds used for higher education expenses.

Below is a general overview of the major provisions of the Tax Act (and Internal Revenue Code (the "**Code**")) that colleges and universities should be aware of, and that are effective (or revised), as of January 1, 2018.

- <u>Increase in AGI Limit on Charitable Contributions aka Spoonful of Sugar #1:</u>
  - The 50% adjusted gross income limit on a donor's contributions to certain charities (including colleges and universities) is increased to 60%; thus potential donors may be inclined to give more (at least those donors who will still itemize charitable contributions after December 31, 2017).
- <u>Lower UBI Rates aka Spoonful of Sugar #2:</u>
  - Notwithstanding some of the other changes to unrelated business income or "UBI" discussed below, the tax on unrelated business taxable income ("**UBTI**") is calculated using the corporate tax rates (reduced to 21% under the Tax Act); thus, colleges and universities will be subject to a lower tax rate with respect to their unrelated businesses.
- <u>Continued Ability to Utilize the Exclusion from Income for Working Condition Fringe Benefits and Certain Expenses Reimbursed Under the "Accountable Plan" Rules aka Spoonful of Sugar #3:</u>
  - Despite the fact that individuals may no longer deduct miscellaneous itemized expenses under Code Section 67 (at least until December 31, 2025), including "unreimbursed expenses attributable to the trade or business of being an employee," like work-related education, colleges and universities may continue to reimburse expenses that otherwise qualify as "working condition fringe benefits" under Code Section 132 and/or that satisfy the "accountable plan" rules under Code Section 62.[2]
    - An employee's inability to take a deduction following the effective date of the Tax Act is not determinative with respect to whether an amount is excludable from income as a "working condition fringe benefit;" rather the test is whether the expense "could" have qualified for a deduction.
    - Similarly, under Code Section 62, reimbursements for expenses paid or incurred by an employee in connection with his or her performance of services as an employee are generally excludable from income if all of the "accountable plan" rules set forth in Treas. Reg. Section 1.62-2 are followed. The Tax Act did not amend the "accountable plan" rules.

[1] The official name of the new law is the "*Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for the fiscal year 2018*." Instead of that tongue-twister, we will refer to the new law by the catchier unofficial name *i.e.*, the Tax Cuts and Jobs Act of 2017 (the "**Tax Act**"). Our dedicated tax team is hard at work to bring you an easy to follow series of informational memos explaining how the Tax Act will affect our clients. See Part I in our series: ***<u>The Times They Are A-Changin': Estate and Gift Tax Exemption Amount Doubles</u>***

[2] Property or services provided to an employee by an employer generally will qualify as a "working condition fringe benefit" if, among other things, the cost of the property or the service is a cost that would have been deductible under Code Sections 162 or 167 if incurred by the employee.

- **Excise Tax on Compensation in Excess of $1M AND Certain Severance and Similar Arrangements:**
    - o The Tax Act imposes a 21% excise tax on “compensation” in excess of $1M paid by colleges or universities to “covered employees.” [3]
        - A "covered employee" is defined as one of the organization’s five highest-paid employees for the tax year or any employee who was a "covered employee" for any tax year after December 31, 2016.
        - Compensation for this purpose includes wages paid and any vested non-qualified deferred compensation (within the meaning of Code Section 457(f)(3)(B)),[4] including any compensation paid by a person or entity related to the college or university (but not “excess parachute payments” described below).
            - By including the reference to Code Section 457(f)(3)(B), the Conference Committee threw in a major dose of MOVIPREP®,[5] now requiring compensation to be treated as being paid when it vests. As an example, if a coach who is a “covered employee” has a combined annual base salary and bonus of $500,000 and is granted a vested non-qualified deferred compensation benefit under a Code Section 457(f) plan with a present value of $800,000, the coach would be treated as having been paid $1,300,000, and as a result, the college or university would owe an excise tax of $63,000 (*i.e.*, 21% of $300,000).
        - It is not clear at this time whether compensation paid by certain unrelated entities in connection with a covered employee’s services for a college/university will be included as “related employers” in the implementing regulations (for example, suppose a coach has a salary of $1M, but also has a separate contract with Nike for $1M; it is unclear whether the amounts will need to be aggregated, even though Nike is not technically related to the college or university employer. This question has been posed to the Internal Revenue Service (“**IRS**”) for clarification).
    - o Also, the Tax Act imposes a 21% excise tax on severance and similar arrangements that provide for “excess parachute payments.”
        - A parachute payment is defined as compensation that (i) is contingent on the employee’s separation from employment, and (ii) exceeds three times the employee’s “base amount.”
            - The “base amount” is the average of the employee’s annualized compensation for the five most recent taxable years that end before the employee’s separation from employment.
        - The excise tax is imposed on the amount paid that exceeds the base amount.
        - Benefits payable from tax-qualified retirement plans such as a Code Section 401(k) plan, a Code Section 403(b) plan or a Code Section 457(b) eligible deferred compensation plan, are not parachute payments.
            - Curiously, although the statute itself refers to benefits payable from “457(b) plans” as being excluded from the definition of parachute payments, the Conference Committee specifically refers to a “457(b) eligible deferred compensation plan of a state or local government employer,” a more limited subset of Code Section 457(b) plans. This narrower definition could mean that benefits payable from Code Section 457(b) plans maintained by private colleges and universities would be treated as parachute payments subject to the excise tax. Although we believe (*i.e.*, we hope) this particular disconnect between the statute and the Conference Committee Report is unintentional, we await clarification by the IRS, either in the implementing regulations or other guidance.
        - Employees who are not “highly-compensated employees” within the meaning of Code Section 414(q) (*i.e.*, for 2018, those who earned $120,000 or less in the preceding calendar year) are exempt from this rule.
    - o There are special rules for compensation paid to certain qualified and licensed medical professionals (including doctors, nurses and veterinarians), if the compensation is directly related to the performance of medical or veterinary services.

[3] Generally, this will most likely impact coaches, athletic directors, and presidents/chancellors.

[4] In other words, vested non-qualified deferred compensation is included in this calculation regardless of whether it has been paid!

[5] For those of you who have not had the pleasure, MOVIPREP® is a common colonoscopy preparation medication.

- These new excise taxes are imposed on the college/university employers and not the affected employees.
- The Tax Act does not provide for the grandfathering of existing agreements.
- As an anti-abuse measure, the IRS is authorized to issue regulations necessary to prevent avoidance of the tax, including avoidance by performing services other than as an employee or by providing compensation through a pass-through entity.

- **Excise Tax on Investment Income:**
    - The Tax Act imposes a new 1.4 % excise tax on the investment income of certain "qualifying" private colleges and universities and their related organizations.
    - To be a "qualifying" private college or university, the institution must have (i) at least 500 tuition-paying students during the preceding taxable year, more than 50% of whom are located in the U.S., and (ii) investment assets with a fair market value of at least $500,000 per student as of the end of the preceding taxable year (*for example*: at least $250M in investment assets for a college or university with 500 students).
- **No Deduction for Donations for Seating:**
    - Effective for purchases made after December 31, 2017, no charitable contribution deduction will be allowed for any payment to a college or university, if, in exchange for that payment, the donor receives the right to purchase tickets or seating at an athletic event.[6]
- **Changes to UBIT/UBTI:**
    - The Tax Act imposes an unrelated business income tax ("**UBIT**") on transportation, parking, and athletic facility fringe benefits that a college or university provides to its employees.
    - Also, under the Tax Act, tax exempt organizations that have multiple sources of UBTI will no longer be able to net the gains and losses of these different sources to reduce UBIT liability.
        - We recommend colleges and universities consider consolidation of UBTI generating activities in a subsidiary in order to net these gains and losses going forward.
- **Elimination of "Advance Refundings":**
    - The Tax Act eliminates all "advance refundings" after December 31, 2017.
        - Advance refunding is where new tax-exempt bonds are issued to refinance existing tax exempt bonds more than 90 days in advance of the redemption date or maturity date of such existing tax exempt bonds.

As with most new legislation, each of these provisions will likely be fleshed-out in greater detail in the form of implementing regulations or other IRS guidance, which, with any luck, will come sooner rather than later.

If you have any questions about this memorandum, please contact Lisa Christensen, or any other member of our Tax Practice Group, or Higher Education Practice Group, or the attorney in our firm with whom you are regularly in contact.

[6] For purchases made on or before December 31, 2017, up to 80% of any such payment generally was allowed as a charitable deduction.

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