The New Tax Landscape

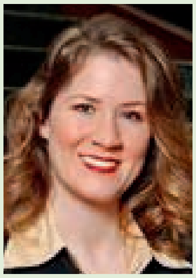
Understand the effect on tax-exempt organizations

By Mackenzie P. McNaughton, JD, LLM, and Justin J. Lowe, JD, LLM

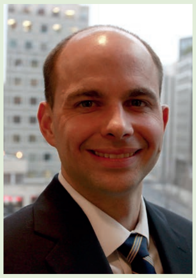
One of the primary aims of 2017 tax reform legislation was to "lower the rates and broaden the base." Tax-exempt organizations gain little from the former and the burden of the latter often falls squarely on their shoulders.

New taxes specific to exempt organizations are included, such as excise taxes on excess compensation and on investment income of educational organizations. Provisions that broaden the scope of the unrelated business income tax are also included. Tax-exempt healthcare organizations need to plan for added financial burdens, create new procedures for tracking activities, and consider significant operational changes.

Mackenzie P. McNaughton is a Senior Manager in Ernst & Young LLP's Exempt Organization Tax Services practice. She was a Senior Tax Law Specialist in the Tax Exempt/Government Entities (TE/GE) and Large Business and International (LB&I) divisions of the IRS. Mackenzie can be reached at Mackenzie.McNaughton@ey.com and (612) 371-6371.



Justin J. Lowe is a Senior Manager in Ernst & Young LLP's Exempt Organization Tax Services practice. He was a Technical Advisor to the IRS TE/GE Division Commissioner. Justin can be reached at Justin.Lowe@ey.com and (202) 327-7392.



The 2017 Tax Cuts and Jobs Act (TCJA),[1] includes some challenges for tax-exempt healthcare organizations, but not all is unwelcome news. Some ancillary benefits to the new law for taxable activities exist, such as repeal of the corporate alternative minimum tax and reduced income tax rates for taxable activity. However, tax-exempt organizations and their internal auditors should focus on the key changes to the Internal Revenue Code (IRC) that are likely to increase financial and operational burdens, and the actions needed to limit the adverse effect of those changes.

Unrelated business income tax

The unrelated business income tax (UBIT) requires an otherwise tax-exempt organization to pay income tax on the portion of income generated from any trade or business that is not substantially related to its tax-exempt purpose. This type of income will increase for many exempt organizations due to two changes to the rules.

The first change is for tax years beginning after December 31, 2017. New IRC Section 512(a)(6) requires tax-exempt organizations operating multiple unrelated businesses to compute income separately for each trade or business. Thus, an unrelated trade or business's income can only be offset using deductions directly connected with that particular trade or business. Losses from one trade or business can no longer be used to offset gains from another.

What constitutes a separate trade or business is undefined and remains a key question for regulatory guidance, including how income from investments regarded as partnerships (e.g., "alternative investments") will be treated. Absent guidance, organizations can take any reasonable approach to figuring out which of their activities constitutes a separate trade or business, which might include aggregating similar activities as a single trade or business.

In addition, organizations generating an overall operating loss for UBIT purposes may need to revise their approach to future valuation and recognition of deferred tax assets.

Organizations that may be facing a significant increase in unrelated business taxable income (UBTI) with the new

[1] P.L. 115-97

separate computation rules might consider transferring some or all of their unrelated business activities to a taxable corporation. This entity could net gains and losses on an aggregate basis, though many other considerations could come into play.

Excess compensation tax

For tax years beginning after December 31, 2017, the new IRC Section 4960 requires most tax-exempt organizations to pay a 21 percent excise tax on the following payments to covered employees.

- Compensation more than $1 million paid within a taxable year
- Any "excess parachute payments"

This new tax draws some inspiration from the IRC Section 162(m) limitation on deductibility for certain compensation payments by publicly traded companies, but the details are very different.

The mechanics of IRC Section 4960 are complex and include rules for related-entity compensation. Organizations can use the following general analysis to model the potential effect of the tax.

Identify covered employees – Develop a list of each tax-exempt organization's covered employees by identifying the five highest-paid employees for the organization's first tax year beginning after December 31, 2016, and for each subsequent tax year.

The statutory language may be interpreted to apply the excise tax and the covered employee determination on an entity-by-entity basis. Future IRS guidance might allow this determination to be made on a controlled group basis, like the way IRC Section 162(m) works, but that rule is not explicitly in the statute.

For purposes of determining the entity's covered employees, compensation paid to a licensed medical professional for medical services would not be included. Compensation a professional receives for administrative or management services would be included.

Once employees meet the definition of covered employees, they remain covered employees for all future years (and thus their compensation could be subject to the excise tax). The requirement applies regardless of whether they are among the five highest-paid employees in those future years.

Obtain paid compensation – For the tax year being modeled, determine the aggregate amount of compensation paid to each covered employee over $1 million. Exclude excess parachute payments, if any; these are addressed below. Compensation for this purpose generally is all wages reported on the Form W-2, Box 1, but, again, does not include the portion of compensation paid to a licensed medical professional for medical services.

Tax-exempt organizations operating multiple unrelated businesses must compute UBIT separately for each trade or business.

Identify excess parachute payments – For the tax year being modeled, determine the value of separation payments. If the value is three times or more of the employee's average compensation over the prior five-year period (the base amount), then the excess of the payment over the base amount is subject to the excise tax.

Compute excess compensation – Add the amounts of paid compensation and excess parachute payments, and multiply by 21 percent to estimate the excess compensation tax the organization would need to pay for that year.

Processes need to be set up for tracking covered employees (including former employees), as well as for allocating a medical professional's compensation between medical services and other services. Healthcare systems with multiple related entities will need to understand how the tax applies across the system, and may want to consider restructuring an entity that employs highly compensated individuals.

Ways to limit the effect of the tax, depending upon each organization's situation, might include the following.

Smooth compensation – Avoid spikes in compensation payments due to large amounts of deferred compensation becoming vested all at one time. Consider designing nonqualified deferred compensation programs that provide for deferred amounts to vest gradually over a period of years, rather than all at once, to limit the amount considered paid in any given year.

Losses from one trade or business can no longer be used to offset gains from another.

Use qualified plans – Consider increasing executives' tax-qualified retirement plan benefits in a manner that follows the tax-qualification requirements. Qualified retirement plan benefits are not included in compensation for purposes of the IRC Section 4960 excise tax.

Use life insurance – Consider offering a split-dollar life insurance policy because the build-up in a life insurance policy is not included in compensation for purposes of the IRC Section 4960 excise tax. However, such policies can be complex and carry added tax risks for certain types of tax-exempt organizations.

Limit separation payments – To avoid triggering the tax on excess parachute payments, consider limiting payments and benefits that may be provided upon a separation to less than three times an individual employee's base amount.

Fringe benefits

Another change is the new IRC Section 512(a)(7), which makes certain fringe benefits provided by tax-exempt employers includable in the organization's UBTI. Importantly, this provision is effective for expenses paid or incurred after December 31, 2017, regardless of the organization's tax year. This concept was an attempt to mirror a companion provision in the TCJA for taxable entities under IRC Section 274.

Both taxable and tax-exempt entities will have their taxable income increased by roughly the same amount because of these changes. The change creates significant challenges for tax-exempt entities, particularly for those that have historically avoided any UBTI-generating activities but do provide employees with transportation fringe benefits, including parking.

For purposes of illustration, organizations can ask the following questions to model the potential effect of the tax.

- Is the employer providing benefits to employees that are excluded from the employees' income under IRC Section 132? Examples include transportation, parking or on-premises athletic facility.
- If yes, would IRC Section 274 prohibit deducting expenses paid or incurred in giving those benefits?
- If yes, what does the employer spend on the benefits? In the taxable context, the expense will not be deductible, and in the tax-exempt context, the employer will pay taxes on the expense.

Tax-exempt organizations must pay a 21 percent tax on excess compensation to certain employees.

The added UBIT can be significant, although some steps are available to limit the effect on the organization.

For example, giving a benefit to employees on a taxable basis may be less costly than continuing to offer the benefit on a pre-tax basis. But offering the benefit on a taxable basis may be contrary to local law or poorly received by employees.

Investment income excise tax

For tax years beginning after December 31, 2017, the TCJA adds a new IRC Section 4968 that imposes an annual 1.4 percent excise tax on the net investment income of an “applicable educational institution.” Tax-exempt healthcare organizations that maintain their own schools or that are affiliated with academic institutions must be aware of this tax because the tax applies to more than just colleges and universities.

The tax encompasses institutions that are eligible to take part in student aid programs run by the U.S. Department of Education, and rules are included that can pull in the income

Expenses for certain employee fringe benefits are considered taxable income for the tax-exempt organization.

and assets of related entities. The tax is similar in concept to the tax that private foundations must pay on their net investment income.

In general, an "applicable educational institution" subject to this tax is an institution eligible to take part in U.S. student aid programs that also:

- Has at least 500 tuition-paying students
- Has more than 50 percent of tuition-paying students in the U.S.
- Is not a state college or university
- Has an aggregate fair market value of investment assets of at least $500,000 per student (assets, such as buildings, that are used directly in carrying out the institution's exempt purpose are not included)

Organizations subject to this tax and their affiliated healthcare organizations must pay close attention to Section 4968's related-entity rules. For purposes of deciding whether an institution meets the asset-per-student threshold and determining net investment income, assets and net investment income can include assets and income of related organizations.

For organizations controlled by the applicable educational institution, or that are their IRC Section 509(a)(3) supporting organizations, 100 percent of that controlled or supporting organization's assets and income are treated as the assets and income of the applicable educational institution. In addition, the assets and income of other related organizations, such as those under common control with the applicable educational organization, will be considered if those assets and income are intended for, or are available for the use or benefit of, the educational institution.

Thus, healthcare organizations that are controlled by an applicable educational institution, or are related and hold assets of that institution, can significantly increase the educational institution's tax burden. Organizations subject to this tax will need to have systems for tracking investment assets and income, and plan for this additional tax.

Conclusion

The TCJA includes many new tax provisions that impose financial burdens and will need added compliance processes for tax-exempt healthcare organizations. Organizations should model the expected effect on their finances and operations and plan accordingly. Their internal auditors should ensure that systems and processes can capture and summarize the information needed for compliance. **NP**