BCLP. Client Intelligent

BCLPCharityLaw.com

THE GOOD, THE BAD, AND THE TAX-EXEMPT ORGANIZATION: THE NEW TAX BILL'S EFFECT ON BENEFITS AND COMPENSATION OFFERED BY INSTITUTIONS OF HIGHER EDUCATION

Jan 23, 2018

On December 22, President Trump signed "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" ("Bill") into law. The Bill was previously named the much-shorter "Tax Cuts and Jobs Act," but was changed after a senator pointed out that the name violated an obscure Senate rule.

The new employee benefit and executive compensation provisions in the Bill affect both individuals and employers. The good news for colleges and universities is that the harshest employee benefit provisions directed at colleges and universities were not included in the final Bill. The bad news is that the executive compensation and fringe benefit changes directed at tax-exempt organizations are unfavorable to institutions of higher education.

THE GOOD: CHANGES EXCLUDED FROM THE FINAL BILL

The House passed a version of the Bill that would have repealed the exclusion from income for qualified tuition reductions provided by educational institutions to (i) employees and their spouses or dependents and (ii) graduate teaching assistants. The House's version of the Bill also eliminated the exclusion for education assistance (up to $5,250 per year per employee) that was available to all employers.

Fortunately, both of these changes were eliminated in the final Bill.

THE BAD: EXCISE TAX ON EXCESS COMPENSATION PAID TO COVERED EMPLOYEES

The Bill places a 21% excise tax on the amount of annual compensation in excess of $1,000,000 paid to covered employees of most tax-exempt organizations, including tax-exempt institutions of higher education.

Covered Employees

A “covered employee” is any employee—including a former employee—who is either one of the five highest compensated employees of the organization for the taxable year, or an employee who was a covered employee of the organization (or any predecessor to the organization) for any preceding taxable year beginning in 2017.

Compensation

Compensation generally includes all taxable remuneration payable to a covered employee (“Compensation”). For purposes of this rule, remuneration is considered payable in the first year that it is no longer subject to a substantial risk of forfeiture, regardless of when actually paid. A substantial risk of forfeiture exists when a person’s rights to remuneration are conditioned upon the future performance of substantial services or the occurrence of a condition related to the purpose of the remuneration. So, to determine the total Compensation of a covered employee in any year, an employer must add together current salary and other current taxable remuneration as well as any future rights to payments (but only for the first year in which such future payments are no longer subject to a substantial risk of forfeiture).

Compensation does not include designated Roth contributions or amounts paid to licensed medical professionals for medical or veterinary services. Licensed medical professionals include doctors, nurses, and veterinarians. The Bill does not provide any guidance on what qualifies as medical or veterinary services, but the IRS may promulgate regulations to clarify the provisions of this Code section.

Compensation of a covered employee by an applicable tax-exempt organization includes amounts paid by all related tax-exempt organizations and governmental entities. So, if two related organizations each pay a covered employee $900,000, even though neither organization pays the covered employee more than $1,000,000 individually, both will be liable for a 21% tax on a portion of the amount over $1,000,000 that the covered employee receives (here, $800,000). Each related organization is liable for the amount of taxes proportional to Compensation it pays the covered employee during the year. In the example above, each organization would be liable for half of the taxes assessed because each organization paid the covered employee an equal amount. However, if one organization paid $450,000, and the other paid $1,350,000, the first organization would owe one-quarter of the total tax assessed and the other organization would owe three-quarters of the total tax assessed.

EXCISE TAX ON EXCESS PARACHUTE PAYMENTS TO COVERED EMPLOYEES

The Bill also places a 21% excise tax on the amount of “excess parachute payments” paid to covered employees of most tax-exempt organizations, including tax-exempt institutions of higher education.

Parachute payments are taxable payments available to a covered employee contingent on the employee’s termination of employment (“**P**arachute Payments”). An excess parachute payment is

any such taxable payment in excess of three times the base amount allocated to such payment. The base amount is the annualized includable Compensation of the covered employee for the five taxable years ending before the date of the employee's separation from employment. So, if an employee's annualized Compensation (including amounts not subject to a substantial risk of forfeiture) is $200,000, any amount over $600,000 paid to the employee contingent upon his separation from service would be taxed at a rate of 21%.

Many of the concepts described in the preceding section apply in the Parachute Payment context. The definitions of "covered employee" and "Compensation" are the same, and Parachute Payments do not include amounts paid to licensed medical professionals for medical or veterinary services. In addition, amounts payable to non-highly compensated employees and distributions from qualified plans, 403(b) plans, and 457(b) plans do not count as Parachute Payments.

One element of uncertainty associated with the Parachute Payment excise tax relates to amounts which become fully vested upon an involuntary termination of employment under a Section 457(f) plan. Assume, for example, that a covered employee would be entitled to a $300,000 payment under a Section 457(f) plan on the earlier of an involuntary separation from service without cause or March 1, 2025. Assume further that the covered employee is involuntarily terminated without cause on January 1, 2025 and receives a lump sum payment of $300,000. By analogy to the golden parachute payment regulations issued under Internal Revenue Code Section 280G, the value of such payment for purposes of the 21% excise tax should equal at most the value of the two-month vesting acceleration rather than the full $300,000, but this is not clear pending further guidance from the Internal Revenue Service.

If an amount is subject to the Parachute Payment excise tax, it will not also be subject to the Excess Compensation excise tax described in the preceding section.

NEXT STEPS FOR COLLEGES AND UNIVERSITIES POTENTIALLY AFFECTED BY EXCISE TAXES

The first step for employers potentially affected by either of these excise taxes will be to identify their covered employees and the covered employees' annual Compensation and potential Parachute Payments due upon severance from employment. After identifying the Compensation and potential Parachute Payments associated with each covered employee, employers may want to restructure certain covered employees' compensation. Affected employers will need to weigh competing interests: (i) the need to retain skilled executives and other key employees against (ii) the added tax costs and the perception of donors and the public in the event either excise tax might apply to payments to a covered employee.

UNRELATED BUSINESS TAXABLE INCOME INCREASED

The Bill also increases the amount of unrelated business taxable income of a tax-exempt organization by any amount that is paid or incurred by the organization (i) as a qualified transportation fringe, (ii) made to a parking facility used in connection with qualified parking, or (iii)

towards any on-premises athletic facility. For example, if an organization pays $100 a month for an on-premises gym on behalf of an employee, $1,200 ($100/month x 12 months) will be added to that organization's unrelated business taxable income.

When considering this new provision, employers will want to weigh their own financial interests with the interests of their employees. While no longer providing the fringe benefits discussed above may save unrelated business income taxes, doing so would undoubtedly be viewed unfavorably by employees.

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be "Attorney Advertising" under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP's principal office and Kathrine Dixon (kathrine.dixon@bclplaw.com) as the responsible attorney.

© 2024 Bryan Cave Leighton Paisner LLP.