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Tax Reform Bill Becomes Law: Lessons for Tax-Exempt Organizations

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Summary

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In Depth

Tax-exempt organizations—especially hospitals and health systems—face a new tax reality now that both houses of Congress have voted to pass the final tax reform bill (the Act) and send it to President Trump for signature.

The Act makes sweeping changes to the tax rules that impact exempt organizations on a daily basis. More significantly, it reflects a troubling reality: complex, diversified tax-exempt organizations will face increased pressure to defend their charitable status given the totality of their overall operations. This theme has emerged over the past few months from legislative discussions leading up to the Act, as well as increased Internal Revenue Service activity in the tax-exempt sector (including the revocation of the tax-exempt status of two Section 501(c)(3) hospitals in recent months). Exempt organizations that only focus on the specifics of the new tax law will be missing the forest for the trees.

Here are the top five takeaways for tax-exempt organizations about the most significant rewrite of the tax code in three decades.

1. The country's largest tax-exempt organizations will now find it more costly to recruit and retain their top talent.

For tax years beginning after December 31, 2017, a tax-exempt organization will now be required to pay an annual excise tax on compensation exceeding $1 million paid to any of its "covered employees." This tax is 21 percent of the amount exceeding $1 million (21 percent is the corporate tax rate under the new law), which is one percent higher than in previous versions of the bill. To provide $2 million of reasonable compensation to a covered employee in 2018, for example, an exempt organization will owe $210,000 in tax.

Several nuances exist within this new rule:

- The "covered employee" category is calculated anew for each year after 2017, and consists of the five highest-paid current or former employees for that year, as well as *former employees who were previously among the "high five" in any year after 2016* and are still being paid any form of post-termination compensation subject to withholding that exceeds $1 million in the current year. Therefore, the number of covered employees is not actually limited to five per year.
- This excise tax applies to: (i) current compensation, (ii) all forms of deferred compensation—in many cases, when it becomes vested, whether or not paid—and (iii) "excess parachute payments" to any high-five employee triggered by separation from employment, to the extent that the total "parachute payments" exceed three times the five-year average total compensation.

- For multi-corporate tax-exempt systems like large hospitals and universities, the excise tax applies on an entity-by-entity basis. Accordingly, if two tax-exempt entities within the controlled system each have five persons earning in excess of $1 million, all ten such employees will trigger the excise tax. With careful planning and structuring, a multi-corporate system may be able to restructure its top executives to meaningfully lower the excise taxes otherwise due.
- A limited carve-out was added to the final version of the Act so this excise tax does not apply to payments made to licensed medical professionals (physicians, nurses and veterinarians), *to the extent compensation payments relate directly to performance of medical services*. In other words, it is only the portion of the payment attributable to administrative and executive services that will count for purposes of the excise tax. This may present challenges for health systems that will now need to track (and categorize as clinical pay or nonclinical pay) compensation paid to physician-executives who perform multiple roles within the system.

This new excise tax is intended to place tax-exempt organizations in the same position as publicly-held companies subject to limits on the deductibility of high compensation amounts under Internal Revenue Code Sections 162(m) and 280G. But the new tax goes beyond this, putting tax-exempt organizations at a significant disadvantage with respect to for-profit companies that are not publicly traded, as tax exempts will have to pay a 21 percent surcharge to pay comparable salaries for comparable positions. Notably, private companies do not face such limitations, so tax-exempts are now at a distinct disadvantage to their private, for-profit competitors when it comes to executive compensation.

Tax-exempt organizations should consult with legal advisors to evaluate whether within the short remainder of 2017 there are any potential actions that could be taken to ameliorate the impact of the new excise tax. All tax-exempt organizations subject to the new tax should reconsider their executive compensation structures going forward. They should assess the possibility of modified vesting schedules or restructured severance arrangements, the impact of the excise tax on the rebuttable presumption analysis, and the use of offset or reduction provisions in compensation agreements with new executives who may in the future become covered employees (a standard practice by for-profit companies planning for potential Section 280G parachute payments).

2. Advance refunding bonds have been repealed, but tax-free bond financing otherwise remains available for Section 501(c)(3) organizations.

The House bill released in November had threatened to eliminate tax-exempt bond financing for Section 501(c)(3) organizations (so-called “private activity bonds”). This proposal caused great concern among the tax-exempt sector, as hospitals, universities and other exempt organizations rely on tax-free bonds as a major source of capital. As expected, this proposal was *not* included in the Act so private activity bonds will remain an important part of capitalizing tax-exempt operations.

Advance refunding bonds, however, have been eliminated, restricting certain refinancing options for exempt borrowers. To be clear, existing bonds will still be able to be refinanced, provided that they are callable at the time of the refunding. What was eliminated by the Act are only refundings where the bonds *are not yet callable* at the desired date of the refunding. (Typically tax-exempt bonds are only callable ten and one half years after the date of issuance.) If existing bonds are callable at the desired time of refunding, a “current refunding” may still be possible to refund the existing bonds. It will be interesting to see whether the Act results in the bond market moving to shorten the callable periods for tax-exempt bonds, thereby making refunding easier in the future despite the elimination of advance refundings.

3. Private colleges and universities with substantial endowments will be subject to a new excise tax.

Not surprisingly, the earlier proposals by both the House and the Senate to impose a 1.4 percent excise tax on the net investment income of certain private educational institutions were retained in the final law. This tax applies to private colleges and universities with more than 500 students and aggregate assets exceeding $500,000 per student (excluding those assets used directly in carrying out the institution’s exempt purpose, such as classroom buildings and office equipment). One caveat added in the final law was to limit this tax only to those institutions with more than 50 percent of their students located in the United States. Certain ambiguities exist regarding calculating aggregate assets held by related organizations, computation of net investment income and defining exempt-use assets. Further detail is intended to be provided through regulations.

4. Tax-exempt organizations with unrelated businesses may owe additional tax.

Many exempt organizations generate some unrelated business income. Under the new law, this income may trigger more unrelated business income tax (UBIT). On the positive side, if UBIT is triggered, it will now be taxed at the lower corporate rate of 21 percent instead of the higher corporate tax rates in effect prior to the Act.

Until now, a tax-exempt organization could aggregate all profits and losses from its various unrelated businesses and pay tax only on any resulting net income. Going forward, losses from one activity cannot offset profits from another. This "siloing" of unrelated business activities likely sounds easier on paper than actual implementation will prove in practice, as it may be difficult to draw the line between where one activity ends and another begins, particularly in the allocation of expenses.

Like the executive compensation changes, this new provision also has the effect of placing exempt organizations at a competitive disadvantage to for-profit corporations, which are permitted to offset profits and losses from across the business. Tax-exempt organizations with a variety of unrelated business activity should consider whether now is the time to incorporate a taxable subsidiary in which to conduct such operations, which would permit this aggregation and place them back on par with the private sector.

5. Exempt organization leadership should be prepared with proactive defenses of their exempt operations.

As discussed above, tax-exempt organizations merely looking at the specific changes in the tax laws and how they affect day-to-day operations are not listening to Congressional and public concerns about the tax-exempt sector. Going forward, boards of directors and executive leadership of tax-exempt organizations will be called upon to invest greater effort toward communicating the worth of their charitable purposes and activities for both internal and external audiences. For health care entities, for example, the key will be how the delivery of health care services through a tax-exempt, nonprofit model is distinguishable from the delivery of such services in a proprietary model.

This effort can be manifested in a series of tangible ways: emphasizing the achievement of charitable purposes through the strategic plan; including language in board resolutions about how specific actions serve charitable purposes; highlighting emphasis on research and education; confirming that the compliance officer monitors compliance with the various Section 501(r) requirements for charitable hospitals; and negotiating provisions in key service agreements, joint venture agreements and major transaction documents that preserve the tax-exempt organization's control over exempt purposes and prevent unreasonable benefits to private parties. For colleges and universities, the task will be to better demonstrate not only how their endowment size is consistent with the charitable purposes and benefit of their activities, but how each and every affiliation, joint venture, technology transfer and similar activity directly supports its charitable mission. All tax-exempt organizations with highly paid executives should be better able to defend not only why such compensation is fair market value and in the best interests of the organization, but why paying a 21 percent excise tax on top of such amounts benefits the organization. As has always been the case, corporate minutes supporting any activities that are in commercial in nature should explain in great detail how such activities directly further charitable purposes. Focusing primarily on the financial aspects of such arrangements is not sufficient.

The Bigger Picture

The whirlwind discussions over the past several weeks have provided insight into the current political attitude toward the tax-exempt sector. A meaningful number of legislators are expressing concern as to when and why tax-exempt operations should appropriately be exempt from income taxation. These concerns emerged clearly during the legislative process in both the House Ways and Means Committee and in the Senate Finance Committee, with their many respective punitive proposals for tax-exempt organizations, some of which survived and some of which were last minute deletions.

Beyond addressing the tax law changes set forth in the Act, all tax-exempt organizations will need to expend greater organizational effort to support a continued claim to tax-exempt status. This includes, at a minimum, a governing board that will be even more engaged in assuring operation of the system as a whole for exempt purposes. Tax-exempt health care organizations, in particular, should pay attention to these pressures as both the Act itself and its legislative history reflect much greater Congressional skepticism as to whether large, sophisticated tax-exempt health care systems are worthy of the benefits of exempt status.

Finally, but notably, several previous House and Senate tax reform proposals were not retained in the final Act. Specifically, the following provisions were dropped: multiple revisions to the intermediate sanctions regime (and its "rebuttable presumption of reasonableness"), sweeping changes to executive deferred compensation plans, taxation of name and logo licensing income, relaxation of the "Johnson amendment" prohibiting political campaign speech by exempt organizations, an exception to the excess business holdings rules for philanthropic business holdings, and repeal of tax exemption for professional sports leagues. While these provisions did not survive the final legislative language cuts, they are nevertheless instructive and could appear again in the future if tax-exempt organizations are perceived as continuing to ignore the underlying issues that prompted such proposed changes in the first instance.

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