Tracking Tax Reform: Impact of Tax Cuts and Jobs Act on Tax-Exempt Organizations

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Under the recently enacted tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act (the "Act"), tax-exempt organizations are subject to new excise taxes and certain modifications to the unrelated business income tax calculation rules that may increase organizations' taxable income. Tax-exempt organizations should undertake careful planning in light of these new rules, particularly large, complex organizations which are expected to experience the greatest impact from the changes. The rules described below are generally effective for tax years beginning after December 31, 2017.

Excise Tax On Excess Executive Compensation

As discussed in a recently published Locke Lord QuickStudy, the Act introduced significant changes relating to executive compensation for tax-exempt organizations. Tax-exempt organizations are subject to a 21% excise tax on remuneration paid to a covered employee in excess of $1 million per year and excess parachute payments paid to a covered employee. If a covered employee receives compensation from multiple related entities, then those payments will be aggregated for this purpose and the excise tax will be paid on a pro rata basis by each of the entities.

A "covered employee" includes the five highest compensated employees of the organization for the taxable year, and any person who was a covered employee for any preceding taxable year after December 31, 2016. Remuneration includes all W-2 wages, other than designated Roth contributions, paid by the tax-exempt organization or any related organization. Deferred compensation taxable under section 457(f) of the Internal Revenue Code of 1986, as amended, (the "Code") is included as part of remuneration for the year it becomes vested.

Parachute payments, which are payments contingent on a covered employee's separation from employment, are subject to the 21% excise tax to the extent that they exceed three times the covered employee's five-year average W-2 compensation. A parachute payment does not include any payments made under qualified retirement plans, Code Section 403(b) or 457(b) annuity plans but may include payments under Code Section 457(f) plans.

Excise Tax on Net Investment Income of Private Colleges and Universities

Under the Act, a 1.4% excise tax will apply to net investment income of private colleges and universities with more than 500 tuition-paying students, at least 50% of whom are located within the United States, if the institution's aggregate assets exceed $500,000 per student. For purposes of determining "aggregate assets", an exclusion applies for assets used in carrying out the college or university's exempt purposes. For instance, campus buildings and facilities would not be included in determining the aggregate asset-to-student ratio.

The Treasury Department is expected to issue regulations clarifying certain aspects of this new rule, including the exempt purpose asset exclusion and the computation of net investment income.

Unrelated Business Taxable Income – New Loss Offset Limitation

The Act modifies the method tax-exempt organizations use for calculating unrelated business taxable income. Under the new rule, a tax-exempt organization with multiple unrelated trades or businesses must calculate taxable income separately for each business, whereas previously, tax-exempt organizations could aggregate income and losses from multiple unrelated businesses. Notably, under a special transition rule, net operating losses arising in taxable years beginning prior to January 1, 2018 that are carried forward to subsequent years are not subject to the new limitation.

The new rule may result in a greater amount of taxable income, as losses from one business can no longer be used to reduce taxable income from another business. However, because unrelated business income is taxed at the corporate rate, which was reduced to 21% under the Act, the amount of tax owed may actually be lower than the previous aggregate calculation method.

Transportation and Other Fringe Benefits Included in Unrelated Business Taxable Income

Under the Act, unrelated business taxable income now includes any expenses paid or incurred by a tax exempt organization for qualified transportation fringe benefits, including parking benefits, transit passes and other commuter benefits, or for a parking facility provided by a tax-exempt employer to its employees. Unrelated business taxable income also includes any expenses paid or incurred by a tax-exempt organization for an on-premises athletic facility. Such amounts are includible in unrelated business taxable income to the extent not deductible under Code Section 274.

Certain other generally-applicable provisions of the Act may also affect tax-exempt organizations, such as the elimination of advance refunding bonds. The overall impact of the Act on a particular organization should be evaluated in consultation with the organization's tax counsel.

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