

Tax Cuts and Jobs Act: Tax-Exempt Organizations

Richard S. Chargar, Pamela D. Kaplan, Victoria E. Anderson

May 3, 2018

As mentioned in our [January 2018 Client Advisory](#), the Tax Cuts and Jobs Act (the "Act"), signed into law at the end of 2017, contains significant changes affecting the tax treatment of certain fringe benefits and executive compensation packages tax-exempt organizations offer their employees. This advisory expands upon our prior discussion regarding certain changes that affect tax-exempt organizations and discusses related considerations in the implementation of benefit and compensation arrangements.

Fringe Benefit Tax

The Act requires tax-exempt organizations to recognize unrelated business taxable income ("UBTI") on certain fringe benefits provided to their employees and pay tax on the UBTI at a 21 percent rate. In addition to being a financial burden on affected tax-exempt organizations, this new requirement will also present additional administrative burdens for those organizations not previously subject to UBTI. (Prior to the Act, tax-exempt organizations would have been required to recognize UBTI on gross income derived from an unrelated trade or business regularly carried on by the organization that is not substantially related to functions the organization performs in connection with its tax-exempt status.) The Act added this provision in an attempt to create parity with for-profit employers, which are now prohibited from taking a tax deduction for the affected fringe benefits.

Pursuant to the Act, as of January 1, 2018, the amount of a tax-exempt organization's UBTI will include amounts paid or incurred for the following fringe benefits provided to employees:

- Qualified transportation fringe benefits (parking, mass transit, and vanpooling benefits provided under Internal Revenue Code ("IRC") section 132(f)),
- Parking facility costs incurred in connection with qualified parking benefits, and
- On-premises athletic facility costs.

The foregoing does not apply, however, to the extent the amount paid or incurred for the benefit is directly connected to an unrelated trade or business which is regularly carried on by the organization. That is, the manner by which UBTI is otherwise calculated has not been affected by the changes described above.

Many states requiring tax-exempt organizations to pay state tax on UBTI look to the amount of UBTI generated for federal tax purposes to determine the amount of UBTI that must be recognized for state tax law purposes. We hope states whose tax laws refer to federal UBTI determinations will issue guidance clarifying whether UBTI for state tax purposes needs to be increased due to this change in federal law.

In view of the UBTI implications of providing these benefits, tax-exempt organizations may want to consider eliminating such benefits. Alternatively, organizations might want to offer such benefits on a taxable basis, which would result in increased employer payroll taxes and additional taxable compensation to employees. Before an organization takes such steps with respect to a qualified transportation fringe benefit program, however, it should consider the impact of any local law requirements that employers offer a qualified transportation program to its employees (as is the case in New York City, for example).

Excise Tax on Executive Compensation

Effective for tax years after December 31, 2017, applicable tax-exempt organizations are liable for a 21 percent excise tax on the sum of (i) remuneration paid by such tax-exempt organizations to any covered employee in excess of \$1 million (not including any excess parachute payments), plus (ii) any excess parachute payments made by such tax-exempt organizations to any covered employee. The excise tax, therefore, applies to excess parachute payments paid to a covered employee, regardless of whether the covered employee's remuneration exceeds \$1 million. These changes create some parity between tax-exempt organizations and publicly held corporations, since the latter are generally not allowed a deduction for employee remuneration in excess of \$1 million for a taxable year.

Applicable tax-exempt organizations include those entities exempt from taxation under IRC section 501(a). Covered employees include any current or former employee of the tax-exempt organization who is one of the five highest compensated employees of the organization for the taxable year, or was a covered employee of the organization (or any predecessor) for any preceding taxable year after December 31, 2016. Accordingly, once an employee becomes a covered employee of an applicable tax-exempt organization, he or she continues to be treated as a covered employee of the organization in future taxable years.

For purposes of the excise tax on remuneration in excess of \$1 million, remuneration generally means wages, including amounts required to be included in income under IRC section 457(f) (e.g., a SERP), but does not include any qualified Roth contributions or remuneration paid to a licensed medical professional for the performance of medical or veterinary services. In addition, remuneration includes amounts paid with respect to the employment of the covered employee by certain organizations that are related to the tax-exempt organization.

For purposes of the excise tax on excess parachute payments, a parachute payment means any payment to (or for the benefit of) a covered employee that is conditioned on the employee's separation from employment and has an aggregate present value that equals or exceeds 3 times the employee's "base amount", although excise tax is applied to all of the parachute payment that exceeds the base amount. For purposes of the foregoing, the base amount is the employee's average annual compensation over the most recent 5 taxable years. Certain payments are not included in the determination of the parachute payment's aggregate present value, including payments under a qualified plan, annuity contract or deferred compensation plan of a government employer, payments to a licensed medical professional for the performance of medical or veterinarian services, and payments to an individual who is not a highly compensated employee, as defined under IRC Sec. 414(q) (e.g., an employee earning less than \$120,000 in 2018).

For purposes of avoiding an excise tax on executive compensation, applicable tax-exempt organizations should consider how they allocate and characterize compensation for covered employees. In addition, applicable tax-exempt organizations should maintain records of all covered

employees for all taxable years following December 31, 2016.

If you have any questions or compliance concerns, please contact our [Employee Benefits group](#).