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The New Tax Reform Bill's Impact on Tax-Exempt Employers and Their Employees

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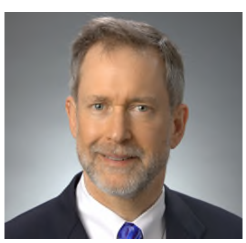

Samuel F. Hoffman
Partner
San Diego, CA

Belinda S. Morgan
Partner
Chicago, IL

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The Tax Cuts and Jobs Act of 2017

- Signed into law 12/22/17 after Republicans in the House and Senate voted to approve the legislation
- The most significant revision of the Internal Revenue Code in decades:
  - Slashes corporate tax rates
  - Lowers top marginal tax rate, adjusts individual tax brackets, increases standard deduction, changes itemized deductions, basically repeals the ACA individual mandate
  - Nearly doubles the estate tax threshold
  - Changes public company executive comp deductibility

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Impact on Tax-Exempt Organizations

- Tax-exempt organizations fear the Act's corporate and individual changes may reduce the tax incentive for charitable giving, thereby causing a drop in donations
  - For example, if taxpayers elect to use the increased standard deduction, they cannot deduct charitable gifts
  - Increasing the estate tax may reduce the use of planned charitable gifts to avoid it

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Provisions Affecting Tax-Exempt Organizations Starting January 1, 2018

- Imposes new excise tax on net investment income of certain private colleges and universities
- Changes unrelated business income tax ("UBIT") rules, potentially increasing UBIT liability
- Eliminates advance refunding bonds
- Imposes excise tax on certain compensation paid to "covered employees"

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Annual Excise Tax on Comp Exceeding $1 Million Paid to "Covered Employees"

- Under the Act, a tax-exempt organization must pay an annual excise tax, imposed at the current corporate tax rate (now 21%), on:
  - Compensation in excess of $1,000,000 (other than any excess parachute payments) paid by the organization to a "covered employee"; and
  - Excess parachute payments paid by the organization to any "covered employee"

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What is Included in Compensation?

- Compensation means "wages," as defined by Code §3401(a), paid to a covered employee, including:
  - Current salary/wages (including any non-cash benefits) paid by the tax-exempt organization
  - Current salary/wages (including any non-cash benefits) paid by any related person or governmental entity
  - Deferred comp included in income under Code §457(f) (due to vesting rules), whether or not immediately payable to the covered employee

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What Isn't Included in Compensation?

- Pre-tax and Roth contributions to qualified retirement plans and other amounts not includible in gross income
- Any portion of compensation paid to licensed medical professionals (physicians, nurses, veterinarians, etc.) for the performance of medical or veterinary services
  - However, amounts paid to such individuals for executive or administrative services are included
  - Organizations must bifurcate covered employees' compensation between medical/non-medical payments

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When is Compensation Deemed Paid?

- For purposes of the excise tax, compensation is treated as paid when it is no longer subject to a "substantial risk of forfeiture" (under Code §457(f)(3)(B))
- Applies to:
  - Current compensation
  - Deferred compensation when it becomes vested, whether or not currently payable to the covered employee

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Who is a "Covered Employee"?

- A "covered employee" is any employee of an "applicable" tax-exempt organization if:
  - The employee is one of the organization's 5 highest paid employees for the taxable year; or
  - The employee was a covered employee of the organization in any prior taxable year (beginning on or after January 1, 2017)

Who is a "Covered Employee"?

- Once a covered employee, always a covered employee
  - So long as an employee deemed to be a covered employee continues to receive compensation (including post-severance compensation), he/she will be a covered employee
  - As a result, an organization may have more than 5 covered employees with respect to any particular taxable year

Liability for the Excise Tax

- The excise tax applies on an entity-by-entity basis
  - Each tax-exempt entity in a controlled group must determine whether it is subject to the excise tax based on its own "covered employees"
- If the excise tax applies to a covered employee whose compensation comes from more than one related employer, the tax will be allocated ratably among all the employers
  - Employers can't avoid the excise tax by splitting a covered employee's comp between related organizations

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Excess Parachute Payments

- The excise tax also applies to "excess parachute payments" paid to a covered employee
- A payment is a "parachute payment" if it:
  - Is contingent on the covered employee's separation from employment with the tax-exempt employer; and
  - The aggregate present value of the payments to the covered employee equals or exceeds 3X the covered employee's "base amount"

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Excess Parachute Payments

- Parachute payments do not include:
  - Payments from qualified retirement plans, Code § 403(b) plans, and Code §457(b) arrangements;
  - Payments made to covered employees who are not "highly compensated employees" (under Code §414(q)); and
  - Payments made to licensed medical professionals (physicians, nurses, veterinarians, etc.) for the performance of medical or veterinary services

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Excess Parachute Payments

- A covered employee's "base amount" is calculated in the same way it is determined for for-profit entities (no change in control is required, however)
- A covered employee's "base amount" is equal to the employee's average taxable compensation for the five taxable years ending before the date of the employee's separation from employment

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Excess Parachute Payments

- If the payments to a covered employee upon his/her separation from employment exceed 3X the employee’s base amount, the tax-exempt organization will be liable for the excise tax
- The excise tax will apply to the amount by which the separation payments to the covered employee exceed 1x the covered employee’s base amount

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Intended to Level the Playing Field

- The imposition of the new excise tax on covered employee compensation and parachute payments appears to be Congress’ attempt to level the playing field between tax-exempt organizations and publicly-held, for-profit entities
  - Similar to limitations imposed by under Code §§162(m) and 280G on executive compensation
- The excise tax will make it more expensive for tax-exempt organizations to recruit and retain top executives

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- New excise tax should not by itself render otherwise reasonable executive compensation unreasonable
- However, tax-exempt employers should stay alert for any resulting changes in executive compensation levels or future IRS guidance in this regard

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- Code §501(c)(3) tax exempt entities can only pay "reasonable compensation" to their executives
  - Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax exempt, in like circumstances (See Treas. Reg. §53.4958-4(b)(1)(ii))

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- Payment of unreasonable compensation to an executive can result in:
  - a 25% excise tax to the executive;
  - a 10% excise to the board members who approved the compensation; and
  - in very bad situations, a loss of the employer's tax exempt status

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- A tax-exempt organization's Board can create a 'rebuttable presumption of reasonableness' if it:
  - first obtains appropriate data regarding comparability or reasonableness, usually in the form of a report from a reputable compensation consultant;
  - the compensation is approved in advance by directors who, after reviewing and considering the data, do not have a conflict of interest; and
  - the Board documents this process in writing

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- Earlier versions of the Act would have eliminated the ‘rebuttable presumption of reasonableness’, but those provisions were not adopted by the final law
- Therefore, so long as an executive’s compensation continues to meet the ‘rebuttable presumption of reasonableness,’ imposition of the new excise tax should not alone affect the reasonableness of the executive’s compensation

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Impact of New Excise Tax on Reasonableness of Executive Compensation

- However, if tax-exempt entities begin reducing executive compensation to avoid the new excise tax, that might eventually affect what is considered “reasonable” executive compensation in the future
- Future IRS guidance could also impact this issue

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Next Steps and Questions to Ask

- Determine who the organization’s “covered employees” are and whether their compensation is currently subject to the excise tax or may be in the future (upon separation from employment)
- Review executive employment agreements, severance agreements, and non-qualified deferred comp plans to ensure the payments required and any vesting schedules are, to the maximum extent possible (or desired), structured to avoid the new excise tax

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The Act’s Other Benefits Changes

- In addition to imposition of the new excise tax, the Act includes other changes that will affect the benefits tax-exempt organizations offer their employees
- These changes apply to both tax-exempt organizations and to for-profit entities
  - Some changes may have more of an effect on tax-exempt entities because they limit the “perks” such organizations can offer employees in lieu of increased salary or wages

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What Didn't (and Did) Change

- Prior to the finalization of the Act's language, rumors swirled about the possibility of significant changes being made to the rules governing retirement plans, health and welfare plans, and fringe benefits
- Given the procedural circus that accompanied the Act's passage, it may be helpful to clear the air about those proposals that weren't included in the final Act, as well as to discuss those that were

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What Didn't Change – General Tax Issues

- Proposal to treat tuition waivers as taxable income by eliminating the favorable tax treatment afforded to such waivers was not adopted
  - Would have required doctoral and graduate students to include the value of those waivers in taxable income, thereby increasing their tax burden
  - Students and educational institutions protested the change, arguing the elimination of the waivers' favorable tax treatment would discourage participation in post-secondary education and make college more expensive

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What Didn't Change – Retirement Plans

- Proposals to limit catch-up contributions were not adopted
  - Catch-up contributions for highly-compensated employees ($500,000 +) were not eliminated
  - The special catch-up contribution available to participants in Code §§403(b) and 457(b) plans (if permitted by the plan) was not eliminated

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What Didn't Change – Retirement Plans

- Proposals related to the aggregation of deferrals and contributions were not adopted
  - Proposal to aggregate deferrals to Code §457(b) plans with those of §§401(k) and/or 403(b) plans for purposes of the Code §402(g) limit was not adopted
  - Proposal to aggregate all contributions to any defined contribution plan (Code §§401(k), 403(b), 457(b)) for purposes of the Code §415 limit was not adopted
- Proposal to eliminate contributions to a Code §403(b) plan after an employee's termination was not adopted

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What Didn’t Change – Retirement Plans

- Proposals related to hardship withdrawals were not adopted
  - Proposal to expand sources available for hardship withdrawals was not adopted
  - Proposal eliminating the requirement that an employee take plan loans before requesting a hardship withdrawal was not adopted
  - Proposal eliminating the 6-month suspension on making deferrals after taking a hardship withdrawal was not adopted

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What *Did* Change – Retirement Plans

- Very little, from an employer perspective
  - The deadline to make plan loan offset payments is extended from 60 days to the due date of the employee’s tax return for the year of the offset
    - Gives terminated employees additional time to “repay” plan loans in order to avoid adverse tax consequences arising from the offset
  - Additional relief for employees who take plan distributions to deal with disasters that occurred in 2016
    - Such distributions will not be subject to the 10% early withdrawal penalty and may be taxed over a 3-year period
- No employer action required unless an employer wishes to implement these changes

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What Didn't Change – Health and Welfare Plans

- Proposal to eliminate dependent care flexible spending accounts was not adopted
- Proposal to eliminate adoption assistance programs was not adopted

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What *Did* Change – Health and Welfare Plans

- For all intents and purposes, the ACA's individual mandate is repealed
  - Effective January 1, 2019, there will be no tax penalty for failing to obtain minimum health coverage
- This change has no effect on employers – the remaining provisions of the ACA, including the ACA's employer mandate, remain in effect

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What Didn't Change – Fringe Benefits

- Proposals to eliminate various benefits were not adopted:
  - Educational assistance programs
  - Employer-provided housing
  - Teachers' deduction for classroom and job-related expenses

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What *Did* Change – Fringe Benefits

- The employer deduction for qualified transportation fringe benefits (parking, transit passes, etc., covered by Code §132(f)) was eliminated
  - While tax-exempt organizations are not directly affected by the elimination of this deduction, effective for amounts paid on or after January 1, 2018, they may be required to include the amount of such expenses in unrelated business taxable income in certain circumstances

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What *Did* Change – Fringe Benefits

- Employer deduction for business-related meals and entertainment expenses under Code §274 was eliminated
  - Unlikely to have much effect on tax-exempt organizations
- Employee deduction/exclusion from income for moving expenses was eliminated (some exceptions still apply for military personnel)
  - Tax-exempt organizations should ensure that employer payments for moving expenses are correctly included in an employee's income
  - May want to "gross up" the employee for such expenses

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Final Thoughts

- Congress' proposals to reform the taxation of tax-exempt organizations (whether adopted or rejected) reflect many lawmakers' skepticism about the value of granting tax-exempt status to various entities (healthcare entities, in particular)
  - Congress may, in the future, tinker with the application of the excise tax and other provisions or revisit rejected proposals
  - When recruiting, tax-exempt organizations should highlight their charitable work to distinguish themselves from for-profit entities in the same or similar industries

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Questions

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- CLE questions? Contact Kayla Huven at khuven@foley.com. Certificates of attendance will be distributed via email to eligible participants approximately 8 weeks after the web conference.

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Thank You.

Sam Hoffman
848.847.6735
Shoffman@foley.com

Belinda Morgan
312.832.4562
Bmorgan@foley.com

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