Higher Education and Taxation: Are We Getting Tax Policy Right for the Mission of Education?

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Teaching Taxation Session

The country is in a battle over the role, place, and funding of higher education. Who is it for? How should it be financed? What should it provide? The tax law impacts higher education in significant ways. This panel will examine those impacts and consider whether we get that policy right, and whether any changes are needed. The Tax Cut and Jobs Act imposed new taxes on colleges and universities with large endowments and big salaries. What will be the impact of these changes? Should public universities be able to elect in and out of section 501(c)(3) status? If so, should they be subject to a special set of rules? For-profit higher education providers are increasingly converting to nonprofit status in order to take advantages of benefits provided to tax exempt entities. Should there be rules limiting the entry of for-profit organizations? Tax law also impacts student borrowing. Do we get the incentives right or could we do better in structuring those incentives to benefit those in need?

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2017 Tax Act impact on Higher Ed tax-exempt organizations

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1) Provisions

a) Denial of charitable contribution deduction for college athletic event seating rights (section 170(l))
b) Unrelated business taxable income computed separately for each trade or business activity (section 512(a)(6))

In the case of any organization with more than 1 unrelated trade or business—

(A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12),

(B) the unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and

(C) for purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

c) Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction disallowed (section 512(a)(7))

Unrelated business taxable income of an organization shall be increased by any amount for which a deduction is not allowable under this chapter by reason of section 274 and which is paid or incurred by such organization for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)). The preceding sentence shall not apply to the extent the amount paid or incurred is directly connected with an unrelated trade or business which is regularly carried on by the organization.

d) Excise tax on excess tax-exempt organization executive compensation (section 4960)

(a) There is hereby imposed a tax equal to the product of the rate of tax under section 11 and the sum of—

(1) so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus

(2) any excess parachute payment paid by such an organization to any covered employee.

For purposes of the preceding sentence, remuneration shall be treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such remuneration.

e) Excise tax based on investment income of private colleges and universities (section 4968)

(a) There is hereby imposed on each applicable educational institution for the taxable year a tax equal to 1.4 percent of the net investment income of such institution for the taxable year.

f) Bonus provisions

i) Enhanced charitable contribution deduction

ii) Net operating loss deduction

iii) Corporate rate reduction
2) Denial of charitable contribution deduction for college athletic event seating rights
   a) Prior law
      i) If donor received right to purchase seats in exchange for charitable contribution, deduction limited to 80% of contribution (20% deemed quid pro quo)
         (1) Rev. Rul. 86-63 held that no deduction permitted where donor received quid pro quo
         (2) Technical and Miscellaneous Revenue Act of 1988 (Pub.L. 100-647) enacted 170(l), effective for tax years after 1988
      ii) Example: Season tickets for University’s football team available only to persons that make a charitable contribution of $10,000 to University’s Foundation results in $8,000 charitable contribution deduction.
   b) 2017 Tax Act (section 170(l))
      i) If donor receives right to purchase seats in exchange for charitable contribution, no deduction permitted
      ii) Example: In the example above, none of the donor’s $10,000 contribution to the Foundation would be deductible
      iii) Statutory provision
         (1) Amount paid to or for the benefit of an institution of higher education (section 3304(f)) described in section 170(b)(1)(A)(ii)
         (2) As a result of such payment, taxpayer receives (directly or indirectly) the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution
   c) Open questions
      i) Right to purchase tickets at a different athletic stadium (e.g., bowl games)
      ii) The implication of this provision on point systems
      iii) Availability of deduction for rights to other benefits (e.g., parking)

3) Unrelated business taxable income computed separately for each trade or business activity
   a) Prior law
      i) An organization subject to the unrelated business income tax (“UBIT”) computed its unrelated business taxable income (“UBTI”) by aggregating its income from all of its unrelated trades or businesses and subtracting the aggregate deductions allowed with respect to such activities.
      ii) Organization could use a deduction from one unrelated trade or business to offset income from another
      iii) College & University compliance project identified misclassification of activity as a trade or business due to lack of a profit motive as the first reason the IRS made adjustments on exam
   b) 2017 Tax Act (section 512(a)(6))
i) Applies to a tax-exempt organization that is subject to UBTI and that has more than one unrelated trade or business

ii) UBTI computed separately with respect to each trade or business without regard to the specific deduction ($1,000)

iii) UBTI is the sum of each unrelated trade or business UBTI less the specific deduction

iv) NOLs computed separately with respect to each trade or business
   (1) Applies to NOLs generated in tax years beginning after December 31, 2017
   (2) Pre-2018 NOLs are available to be used against any separate trade or business

v) Deduction from one trade or business may not be used to offset income from a different unrelated trade or business

c) Notice 2018-67 (August 21, 2018)
   i) Permits any good faith, reasonable interpretation of sections 511-514 until proposed regulations issued
   ii) Defines separate trades or businesses by excluding definitions found elsewhere in the Code
   iii) Creates safe harbor for 6-digit NAICS codes to identify trade or business
   iv) Establishes safe harbors and transition rules for partnership investments
      (1) De minimis test (generally no more than 2% of profits or capital interest)
      (2) Control test (generally no more than 20% of capital and no control or influence)
      (3) Transition rule (permits aggregation of separate trades or businesses within single partnership if interest acquired prior to August 21, 2018)
   v) GILTI generally treated as equivalent to a dividend

d) Open questions
   i) How will proposed regulations differ from Notice?
      (1) Fewer than 6-digit NAICS codes or different definition of trade or business
      (2) Continued application of transition rule
      (3) Different aggregation safe harbors for investments
   ii) Treatment of NOLs: separate trade or business NOLs before generally available NOLs or vice versa
   iii) How determine related party interests for de minimis and control test
   iv) Repeal?
      (1) H.R. 513 Nonprofits Support Act
      (2) Nonprofit Relief Act of 2019

4) Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction disallowed
   a) Prior law
i) Tax-exempt employers could offer qualified transportation fringe benefits to their employees without any impact to the employee or to the employer. Similarly, taxable employers could deduct costs associated with providing such benefits to their employees.

ii) Section 132(f) excludes certain “qualified transportation fringe benefits” (or QTFs) from the income of an employee (amount indexed for inflation)
   (1) Parking on or near the employer’s business premises or parking on or near a commuting location
   (2) Transit passes
   (3) Vanpools (i.e., commuter highway vehicles for travel between employee’s residence and place of employment)

iii) Amounts excluded
   (1) 2017 parking: $255; transit & vanpools: $255
   (2) 2018 parking $260; transit & vanpools: $260
   (3) 2019 parking $265; transit & vanpools $265

b) 2017 Tax Act (section 512(a)(7))
   i) New section 512(a)(7) requires the tax-exempt employer to include in UBTI the amount that would have been disallowed under section 274 if the employer were taxable
   ii) Amended section 274 disallows a deduction to taxable employers for QTFs
       (1) Includes amounts elected by an employee to be used on a pretax salary basis towards a QTF
       (2) QTFs include qualified parking, which includes costs associated with a parking facility maintained by the employer or parking on any portion of the employer’s business premises used in connection with qualified parking
       (3) Deduction disallowance not determined by reference to the value of the QTF under section 132(f) but rather by determining costs
   iii) Although the statutory provision refers to “on-premises athletic facilities,” section 274 does not disallow a deduction (except when discriminatory in favor of highly compensated employees); therefore, such facilities do not increase UBTI

c) Notice 2018-99 (December 10, 2018)
   i) Must use cost not value in determining amount to include in UBTI
   ii) Method used depends upon whether taxpayer pays a third party to provide parking for its employees or whether the taxpayer owns or leases a parking facility where the employees park.
   iii) Taxpayer pays a third party for employee parking
       (1) Generally, the amount paid to the third party is the amount included in UBTI
       (2) Any amount that exceeds the section 132(f) exclusion amount is included in employee compensation and not subject to UBIT (section 274(e)(2))
   iv) Taxpayer owns or leases all or a portion of a parking facility
(1) Any reasonable method of allocation permitted
   (a) Use of value is not reasonable
   (b) Tax years beginning after January 1, 2019 must allocate expenses to “reserved employee spots”

(2) Safe harbor
   (a) Percentage of parking spots reserved for employee use – included in UBTI
   (b) Primary use of remaining parking spots – if the primary use (greater than 50%) of the remaining spots is for the general public, no additional expenses included in UBTI
   (c) Percentage of parking spots reserved for non-employee use – excluded from UBTI
   (d) Reasonable allocation of remaining parking spots – reasonable determination of actual employee use of remaining spots and include in UBTI

(3) Parking expenses
   (a) Do not include depreciation
   (b) Include repairs; maintenance; utility costs; insurance; property taxes; interest; removal of snow, ice, leaf, and trash; cleaning; landscape costs; parking attendant expenses; security; rent or lease payment or portion thereof
   d) Notice 2018-100 (December 10, 2018)
      i) Relieves certain exempt organizations from the estimated tax penalty in 2018 for QTF benefits
      ii) Organization must have provided QTFs for which estimated payments would have been made on or before December 17, 2018 and did not have a Form 990-T filing requirement prior tax year.
      iii) To benefit from relief, organization must timely file Form 990-T and timely pay the tax due.

e) Open questions
   i) Repeal?
      (1) H.R. 1545
      (2) H.R. 513 Nonprofits Support Act
      (3) H.R. 1223 (S. 501) Stop the Tax Hike on Charities and Places of Worship Act
      (4) S. 632 LIFT (Lessen Impediments From Taxes) for Charities Act
   ii) Allocation of rent when parking not separately stated
   iii) After tax payment for parking (no subsidy)
   iv) Zero value parking

5) Excise tax on excess tax-exempt organization executive compensation
   a) Prior law
i) Provisions governing compensation paid by exempt organizations focus on reasonableness of compensation (intermediate sanctions under section 4958 and self-dealing under section 4941)

ii) Taxable employers generally may deduct reasonable compensation

(1) Section 162(m) generally disallows a deduction for compensation paid by a public company in excess of $1 million if paid to certain officers

(2) Section 280G generally disallows a deduction for certain severance payments that equal or exceed 3 times the employee’s average compensation over the most recent 5-year period

b) 2017 Tax Act (section 4960)

i) Imposes an excise tax equal to the corporate rate (currently 21%) on remuneration paid by an “applicable tax-exempt organization” (or ATEO) to a “covered employee” that exceeds $1 million and on any excess parachute payment

ii) Definitions

(1) Remuneration means wages as defined in section 3401(a), but timing for section 4960 is when vesting occurs under section 457(f)(3)(B).

(2) ATEOs are organizations described in section 501(a), exempt farmers’ cooperatives described in section 521(b), organizations that exclude their income by reason of section 115(1), and political organizations described in section 527(e)(1).

(3) Covered employees are the five highest compensated employees of the organization for the taxable year or was a covered employee of the organization for any preceding taxable year beginning after December 31, 2016.

(a) Look at compensation paid by ATEO and all related organizations

(b) Do not include remuneration paid to a licensed medical professional that is directly related to the performance of medical or veterinary services

(4) An excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment.

(a) A parachute payment is a payment in the nature of compensation to or for the benefit of a covered employee if the payment is contingent upon separation from employment and the aggregate present value of all payments exceeds three times the base amount.

(i) Parachute payments do not include payments under a qualified retirement plan, simplified employee pension plan, simple retirement account, or an eligible deferred compensation plan of a state or local government.

(ii) Payments to employees that are not highly compensated (120,000 in 2017 and 2018; 125,000 in 2019) and payments attributable to medical services of medical professionals are exempt from the definition of parachute payments

(b) The base amount is the average of annualized compensation includible in the employee’s gross income for the five taxable years ending before the date of the employee’s separation.
iii) Employer is liable for excise tax and where more than one employer, each is liable for its pro rata share of the excise tax.

c) Notice 2019-09 (December 31, 2018)
   i) 39 Q&As addressing the various aspects of section 4960
   ii) Q&A 1-3 are general provisions, including that the “tax year” for purposes of determining amount of remuneration paid is the calendar year ending with or within the organization’s tax year
   iii) Q&A 4-8 are for ATEOs and related organizations, including adopting the definition for related organizations that Form 990, Schedule R and section 512(b)(13) use
   iv) Q&A 9-10 address covered employees
   v) Q&A 11-14 cover excess remuneration
   vi) Q&A 15 relates to medical and veterinary services
   vii) Q&A 16-24 address excess parachute payments
   viii) Q&A 25-31 explain three times base amount
   ix) Q&A 32 discusses the computation of excess parachute payments
   x) Q&A 33-35 relate to reporting the 4960 liability
   xi) Q&A 36-38 are miscellaneous provisions
   xii) Q&A 39 is the effective date, which is tax years beginning after December 31, 2017

d) Open questions
   i) ATEOs intended to include state colleges and universities but JCT Blue Book notes that a technical correction may be necessary to reflect this intent.
   ii) Definition of control for for-profit organizations that control ATEO
   iii) Volunteer exception (e.g., Foundation officers employed by related corporation)
   iv) Methods for identifying and preserving list of covered employees

6) Excise tax based on investment income of private colleges and universities
a) Prior law
   i) Private colleges and universities generally are exempt as section 501(c)(3) public charities because they are described in sections 509(a)(1) and 170(b)(1)(A)(ii)
   ii) Section 501(c)(3) private foundations, described in section 509, are subject to a variety of excise taxes (sections 4940-4945); section 4940 imposes a 1% or 2% excise tax on a private foundation’s net investment income
b) 2017 Tax Act (section 4968)
   i) Applicable educational institutions subject to 1.4% excise tax on their net investment income for the taxable year
   ii) Definitions
      (1) Applicable educational institution
         (a) Defined in section 25A
(b) Has at least 500 tuition-paying students during the preceding tax year
(c) More than 50% of students are located in the United States
(d) Not described in section 511(a)(2)(B)
(e) Aggregate FMV of all assets (other than those used in carrying out the institution’s exempt purposes) at the end of the preceding taxable year is at least $500,000 per student (part-time students computed on FTE basis)

(2) Related organizations
(a) Related if the organization controls or is controlled by the educational institution; is controlled by one or more persons that control the institution; or is a supported organization or supporting organization during the taxable year with respect to the institution
(b) Take into account assets and net investment income of certain related organizations
(c) Do not take into account assets or income that are not intended or available for use or benefit of educational institution unless the organization is controlled by the institution or a supported organization with respect to the institution during the taxable year

(c) Notice 2018-55 (June 8, 2018)
   i) One-time step-up in basis to FMV for property held as of December 31, 2017 and continuously thereafter
      (1) Use FMV as of December 31, 2017
      (2) To the extent that the property is loss property as of that date, use basis
   ii) No capital loss carryovers or carrybacks permitted

d) Open questions
   i) To what extent do “rules similar to section 4940(c)” not apply
   ii) Will institutions be able to discount for “cash”?
   iii) How does “used in carrying out the institution’s exempt purpose” differ from “exempt use assets”?

The Special Status of Governmental Charities

Ellen P. Aprill

A number of special rules apply to governmental charities. While the hesitancy of the IRS to impose various strictures on governmental charities is understandable, their treatment by
the IRS affords them a special status that is, arguably, inconsistent with important aspects of charitable tax policy.

Like other charities, governmental charities must file an application on Form 1023 and receive a determination letter from the IRS to be exempt under section 501(c)(3). A determination letter specifies the entity’s status under section 170(b) (for example, as a public charity or private foundation), whether it must file the Annual Information Return on Form 990, and, of particular importance, whether contributions to the entity are deductible. Potential donors often ask to see an entity’s determination letter. For this reason, even houses of worship, which are exempt from the determination letter requirement, often file for exemption. I understand from lawyers for governmental charities that, at least before the attempted SALT workarounds, the ability to receive a determination letter to use in fundraising was the key reason that governmental entities, such as public universities, choose to qualify under section 501(c)(3).

Governmental charities, however, avoid three sets of rules generally applicable rules to section 501(c)(3) organizations. First, the vast majority of tax-exempt organizations must file Form 990. The Form 990 requires a reporting organization to disclose a great deal of information. Forms 990, except for the names of donors, are publicly available. Indeed, it is a matter of policy that such public disclosure is a trade-off for the privilege of exemption under section 501(c)(3) and the public subsidy such status bestows. Under Revenue Procedure 95-48, however, a governmental charity need not file Form 990 (or 990-EZ.) Thus, governmental charities do not have to satisfy an important policy of tax exemption. (In order to have an exception from filing the Form 990, however, governmental charities must obtain a ruling from the IRS, which is now very expensive, or submit detailed information as part of the determination process to support the exception.

Second, section 501(c)(3) organizations are generally subject to the intermediate sanctions regime of section 4958. Congress adopted the intermediate sanction rules in 1996 for public charities and social welfare organizations to prevent insiders from receiving disproportionate benefits from these exempt organizations, particularly in connection with compensation. Insiders who engage in “excess benefit transactions” are subject to excise
taxes, both on the initial transaction and on any failure to correct. The regulations under section 4958, however, except a “governmental unit or affiliate” from the definition of “applicable tax-exempt organization.” Thus, governmental charities are not subject to this important set of rules that govern other section 501(c)(3) organizations.

Third, section 501(c)(3) organizations generally cannot voluntarily relinquish exempt status. To shed exempt status, with its burdens as well as benefit, they must instead violate some requirement of section 501(c)(3), such as engaging in campaign intervention or failing to file Form 990 for three years in a row. Governmental charities, however, can voluntarily relinquish this status. Notice 2019-9, Interim Guidance under Section 4960 (issued December 31, 2018) specifically noted this option. Recently issued Revenue Procedure 2019-5 (January 2, 2019), like annual revenue procedures regarding exempt organizations dating back to 2012, describes the procedure for them to do so. Governmental charities are unique in this ability, an ability first established when governmental hospitals that had received a section 501(c)(3) determination decided they preferred not to be subject to the requirements of section 501(r), which was enacted in connection with the Affordable Care Act.

In short, the rules applicable to governmental charities create an odd, hybrid creature, a platypus of the tax world, with parts that do not seem to fit well together. These entities can obtain many of the benefits at the same time that they escape many of the burdens of exemption under section 501(c)(3). I find this special status troubling.

The category of governmental charities distorts the boundaries of section 501(c)(3) because of exemptions from key requirements. Prior to the attempt by various states to create SALT workarounds, the need to obtain a determination letter assuring donors of deductibility provided the key motivation for governmental entities to qualify as charities. The IRS governmental information letter does not adequately substitute for a determination letter addressed to the particular entity seeking tax deductible contributions. Once the SALT workaround issue is resolved, whatever the resolution, I urge that the IRS (or Congress – need to think about who get do it) develop a process for providing a determination letter to governmental entities as such to assure potential donors to them. With such assurance, the
category of governmental charities, which blurs the distinctions between tax treatment of
governments and of charities, will wither – and perhaps die an honorable death.

**Income-Driven Repayment of Federal Student Loans**

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**2019 ABA Tax Section May Meeting, Teaching Tax Committee**

I. Conceptual Framework: As income-driven repayment (and eventual forgiveness) of federal student loans gets more comprehensive, it makes sense to think of it as a stand-alone policy (not just insurance against default for under-earning students). Income-driven repayment of federal student loans looks a lot like a partial income tax dedicated to payment for higher education (a quasi-public good) that is paid by those citizens who made private use of the quasi-public good (and whose parents or selves did not have the ability or chose not to pay for it with an upfront payment).

**QUESTION 1:** How comprehensive is income-based repayment now?

**QUESTION 2:** What changes are being discussed/likely?

**QUESTION 3:** What policy changes would our conceptual shift suggest?

II. Justification for and Brief Survey of Federal Aid for Students: Higher education is a quasi-public good; it is practically difficult for the market to provide optimal financing for individual investment in education (Milton Friedman); BUT, there are very substantial private benefits (including higher earnings), which justify significant individual investment and sharing of the cost. So, state and federal governments have provided support for higher education for decades BUT students and/or parents have been asked to contribute the vast majority (and growing) proportion of the cost of higher education.

A. Grants (Pell, etc.)

B. Direct Subsidized/Unsubsidized Loans

C. Parent PLUS Loans

E. Income-Driven Repayment (IDR) and Public Service Loan Forgiveness (PSLF)

F. Multiple Expansions of Income-Based Repayment (ICR, IBR, PAYE, REPAYE)

II. Current State of Income-Driven Repayment and Loan Forgiveness

A. For Undergraduates

B. For Graduate and Professional Schools Students

C. For Borrowers in Repayment

III. Current Controversies

A. Denials of Loan Forgiveness

B. Proposals to Limit IBR
IV. Policy Suggestions

A. Taxation of Loan Forgiveness
B. Dealing with Trust/Consistency/Reliance
C. Dealing with Complexity/Administration
D. Dealing with Adverse Selection
E. Dealing with Moral Hazard
   1. Of Borrowers
   2. Of Universities
F. Accurately Estimating Cost to General Public ("subsidy" component)