Tax Reform for Tax-Exempt Healthcare Organizations

BYU Healthcare Industry Network Conference

November 15, 2019

Today's agenda

1. Excise Tax on Excess Compensation
2. Qualified Transportation Fringe UBTI
3. UBTI "Silo-ing"

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Excise tax on excess compensation

Imposition of the tax

- Excise tax imposed on applicable tax-exempt organizations equal to 21% of
  - **Remuneration** in excess of $1 million paid to any covered employee and
  - Any **excess parachute payment** paid to any covered employee
- Tied to the corporate rate
- Parity for taxable entities; IRC Section 162(m)
- Effective date: tax years beginning after 12/31/17

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Interim guidance under § 4960

- **IRS Notice 2019-09**
  - Treasury and the IRS issued on December 31, 2018
  - Provides interim guidance on addressing frequently asked questions on the application of § 4960
  - States that Treasury and the IRS intend to publish proposed regulations under § 4960
  - Until proposed regulations are issued, taxpayers may use any good-faith, reasonable interpretation of § 4960 and rely on the guidance under Notice 2019-09
    - The notice identifies several positions that Treasury and the IRS have determined are not consistent with a good-faith, reasonable interpretation of the statute

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Common law employer liable for the excise tax

According to Notice 2019-09:

- The common-law employer, as determined generally for federal tax purposes, is liable for the excise tax imposed under § 4960
- A payment to an employee from a related or unrelated entity for services rendered to the common-law employer is considered a payment to the employee from the common-law employer
- *Takeaway:* The issuer of the Form W-2 is not necessarily determinative

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What is an applicable tax-exempt organization (ATEO)?

- Organizations exempt from tax under section 501(a),
- Exempt farmers' cooperatives (section 512(b)(1)),
- Political organizations (section 527),
- Organizations that have income excluded from gross income under section 115(1).

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What is remuneration?

- Wages under section 3401(a) (compensation subject to federal income tax withholding) and amounts included in gross income under section 457(f),
- No substantial risk of forfeiture,
- Remuneration paid to the employee by the ATEO plus any related persons or governmental entities,
- Does not include remuneration paid to a licensed medical professional for the performance of medical services. According to Notice 2019-09,
  - Only remuneration paid for the “direct performance” of medical services to patients is carved out,
  - Compensation for teaching, research, or managing medical operations is not carved out,
  - Medical services are defined as medical care within the meaning of section 213(d).

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What is an excess parachute payment?

- Payments contingent on an employee’s separation from employment if the aggregate value of the payments equals or exceeds three times the employee’s “base amount,”
- The “excess” is the payment over the employee’s base amount,
- No dollar threshold (like $1M for excess compensation),
- Amounts paid to individuals that are not highly compensated per section 414(q) excluded,
- Amounts paid to licensed medical professionals for the performance of medical services excluded,
- According to Notice 2019-09,
  - Payments made by related organizations also taken into account,
  - Only involuntary separation triggers the excise tax.

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Who are covered employees?

- Any employee who is one of the five highest compensated employees of the ATEO for the taxable year or was a covered employee of ATEO for any taxable year beginning after 12/31/2016.
  - Once a covered employee, always a covered employee.
  - ATEOs should start their list of covered employees for the first tax year beginning after 12/31/16.
- According to Notice 2019-09,
  - Each ATEO in a system of related organizations determines its covered employees separately but must take into account compensation paid by related organizations,
    - In determining covered employees, an employee cannot be considered one an ATEO's five highest compensated employees if the ATEO paid less than 10% of the employee's total remuneration (unless that ATEO paid the most remuneration),
  - Compensation defined as remuneration.

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Tax year and effective date

— Excise tax will be determined based on the remuneration paid and excess parachute payments made in the calendar year ending with or within the tax year of the employer,

— The effective date of the excise tax is the first tax year of the employer beginning after 12/31/2017,

— Remuneration paid or vested prior to the start of that year is not subject to the excise tax.

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Qualified transportation fringe UBTI & notice 2018-99

UBTI increased for disallowed fringe benefits

- **UBTI includes the value of certain transportation fringe benefits if such benefits would not be deductible by taxable employers, unless the amount paid or incurred is directly connected to an unrelated trade or business regularly carried on by the organization**
  - — Parking
  - — Transit passes

- **Applies to amounts paid or incurred after December 31, 2017**

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Parking expenses for qualified transportation fringes under § 274 and § 512(a)(7)

- IRS Notice 2018-99
  - Issued on December 10, 2018
  - Provides interim guidance on how to determine the amount of parking expenses that is nondeductible or treated as an increase in UBTI
  - IRS and Treasury intend to publish proposed regulations under § 274 and § 512
  - Until proposed regulations are issued, taxpayers may rely on the guidance under Notice 2018-99 to determine the nondeductible amounts and the increase in UBTI

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Payments to a third party for parking

- Notice 2018-99 makes clear that if an employer pays a third party an amount for its employees to park at the third party's parking lot or garage and does not tax employees on this amount, the amount paid is included in UBTI
- But if the amount the employer pays to a third party for an employee's parking exceeds the monthly limitation on exclusion ($260 per employee for 2018), that excess amount
  - Is treated as compensation and wages to the employee
  - Is not treated as UBTI
    - See § 274(e)(2)

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Questions

- Is a payment to a related party a payment to a "third party"?
  - Notice appears to assume payment to third party equals FMV
  - If payment to a related party is less than FMV, could IRS apply section 482 to increase UBTI?
- Related question: Is a payment to a partnership in which the tax-exempt employer is a partner a payment to a "third party"?
  - Aggregate vs. entity treatment
- Where does one draw the line between a payment to a third party so employees may park at a garage and a lease of parking spaces in the garage?
  - As we'll see, this could make a difference if some of the spaces being paid for are for the "general public"

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Taxpayer owns or leases parking facility

- UBIT may be calculated using “any reasonable method”
  - Using the value of employee parking to determine UBTI is not a reasonable method

- Notice establishes a *four-step method* that may be used as a safe harbor
- Applies if taxpayer owns or leases all or *a portion* of a parking facility
- If a taxpayer owners or leases more than one parking facility in a “single geographic location,” the taxpayer may aggregate when using the four-step method
  - Examples suggest that a city is a single geographic location

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Taxpayer owns or leases parking facility

— The four-step method:

1. *Percentage of parking spots reserved for employee use.* This percentage of parking expenses is nondeductible under § 274(a)(4)
2. *Primary use of remaining parking spots.* If the primary use of the remaining parking spots is for the general public, the remaining parking expenses remain deductible
3. *Percentage of parking spots reserved for non-employee use.* If the primary use of the remaining parking spots is not for the general public, then the percentage of parking expenses attributable to reserved spots for non-employee use remain deductible
4. *Reasonable allocation of remaining parking spots.* Taxpayer must reasonably determine the employee use of any remaining parking expenses not specifically categorized in steps 1–3

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Step 1

Parking reserved for employees

Determine the percentage of reserved employee spots in relation to total parking spots and multiply that percentage by the taxpayer's total parking expenses

— Employee spots may be exclusively reserved by, e.g., specific signage ("Employee Parking Only") or a barrier to entry or terms of access

— For tax years beginning on or after 1/1/19, a method that fails to allocate expenses to reserved employee spots cannot be a reasonable method

— *But,* until 3/31/19, organizations that have reserved employee spots may change signage, access, etc. to decrease or eliminate their reserved employee spots and treat those parking spots as not reserved employee spots retroactively to 1/1/18

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Step 1

Reserved parking: Questions

- What about spots that are reserved for employees during normal business hours but open to students, patients, and/or visitors in off-hours?
  - Can taxpayer allocate some portion of the costs to off-hour use?
- What about spots reserved for “physicians” generally that include both employed and staff physicians (but not specific spots reserved for either)?
- How about a spot reserved for security employees?
  - If the spaces are reserved for security cars, these spaces would presumably be a working condition fringe, not a QTF, and expenses allocable to those spaces would not be included in UBTI

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Step 2

Primary use by the general public

If the primary use of the remaining parking spots (after applying step 1) in the parking facility is to provide parking to the general public, then the remaining total parking expenses for the parking facility may be excluded from UBTI

- The "general public" includes (but is not limited to) students, patients, congregants, customers, clients, visitors, deliverers
  - Doesn't include the taxpayer's employees, partners, independent contractors
  - How about staff physicians? Employees of other employers?
- "Primary use" means greater than 50% of actual or estimated usage of the parking spots in the parking facility
- Primary use of the parking spots is tested during the normal hours of the organization's activities on a typical day
  - Non-reserved parking spots that are available to the general public but empty during normal business hours are treated as provided to the general public
  - If the actual or estimated usage of the parking spots varies significantly between days of the week or times of the year, the taxpayer may use any reasonable method to determine the average actual or estimated usage

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Step 2

Use by the general public: Questions

- What are the “normal business hours” of a hospital or a university?
  - E.g., can one say a hospital operates on a 24-hour basis, even if use of the facility is less in the night-time hours?
- What is a “single geographic location” for purposes of aggregation?
  - Examples in the notice bless a city, but could this be extended to a metropolitan area?
  - May taxpayers “pick and choose” what parking facilities in a single geographic location they want to aggregate?
- *Shared parking among tenants:* How does one apply the primary use test in situations where tenants (and perhaps owner as well) share parking and no tenant is allocated any particular number or portion of the parking facility in their leases?

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Step 3

Parking reserved for non-employees

- If the primary use of a taxpayer's remaining parking spots is *not* to provide parking to the general public, the taxpayer may
  - Identify the number of reserved non-employee spots
  - Determine the percentage of reserved non-employee spots in relation to the remaining total parking spots and multiply that percentage by the taxpayer's remaining total parking expenses
  - Exclude the resulting product from UBTI

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Step 4

Remaining parking expenses

- If the taxpayer has any remaining parking expenses not specifically categorized in Steps 1-3, the taxpayer must reasonably determine the employee use of the remaining parking spots
- Methods may include specifically identifying the number of employee spots based on actual or estimated usage based on
  - Number of spots
  - Number of employees
  - Hours of use
  - Other measures

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Post- and pre-tax solutions

- Is charging employees a fair market value price on a "post-tax" basis one way to avoid UBIT?
  - Notice 2018-99 asks whether sale of parking in "bona fide transaction for an adequate and full consideration" could qualify for exception under section 274(e)(8).
  - Does it matter if FMV price is significantly less than the allocable expenses?
- Is it a better solution for the employer and employee to recoup the amount paid in UBIT through increases in pre-tax charges?

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Example

Primary use not for the general public

Taxpayer H, a large hospital organization, owns multiple parking lots and garages adjacent to its complex in the city of X. H owns parking lots and garages in other cities as well. For purposes of applying the methodology in this notice, H chooses to aggregate the parking spots in the lots and garages at its complex in city X. However, H may not aggregate the spots in parking lots and garages in other cities with its parking spots in city X. H incurs $50,000 of total parking expenses related to the parking lots and garages at its complex in city X. H's parking lots and garages at its complex in city X have 10,000 spots in total that are used by its visitors and employees. H has 500 spots reserved for management and has approximately 8,000 employees parking in the garages and lots in non-reserved spots during normal business hours on a typical business day at H's complex in city X. Additionally, H has 100 reserved non-employee spots for visitors.

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Example

Primary use not for general public (continued)

- *Step 1.* Because H has 500 reserved spots for management, $2,500 ((500/10,000) x $50,000 = $2,500) is the amount of total parking expenses that is treated as UBI for reserved employee spots.
- *Step 2.* The primary use of the remainder of H's parking facility is not to provide parking to general public because 84% (8,000/9,500 = 84%) of the remaining parking spots in the facility are used by its employees. Thus, expenses allocable to these spots are not excepted UBI.
- *Step 3.* Because 1% (100/10,000 = 1%) of H's parking lot spots are reserved non-employee spots, the $500 allocable to those spots ($50,000 x 1%)) is not UBI.
- *Step 4.* H must reasonably determine the employee use of the remaining parking spots during normal business hours on a typical business day and the expenses allocable to employee parking spots at its complex in city X. Because 85.11% (8,000/9,400 = 85.11%) of the remaining parking spots in the lot are used by its employees during normal business hours on a typical business day, H reasonably determines that approximately $40K (($50,000-$3,000) x 85.11%) of H's remaining parking expenses is additional UBI.

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UBTI “Silo-ing”

Internal revenue code section 512(a)(6)

Special rule for organization with more than 1 unrelated trade or business. 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.

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UBTI “silo-ing”

Summary: For tax-exempt organizations that carry on more than one unrelated trade or business activity—

- UBTI must be calculated separately for each unrelated trade or business activity
- Losses from one unrelated trade or business activity may not be used to offset income derived from another unrelated trade or business activity
- NOLs arising from an unrelated trade or business activity may only offset income from the trade or business activity from which they arose

Timing:

- Silo-ing required for tax years beginning after December 31, 2017
- This change does not apply to any NOLs arising in a tax year beginning before January 1, 2018. Such historical NOLs may be applied to reduce aggregate UBTI arising from all unrelated businesses.

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Notice 2018-67

Separate trade or business

- Congress did not provide criteria for identifying separate unrelated trades or businesses
- Treasury and the IRS intend to propose regulations for such determination
- Pending issuance of the proposed regulations, exempt organizations "may rely on a **reasonable, good-faith interpretation** of [IRC] § 511 through 514, considering all the facts and circumstances . . .."

North American Industry Classification System (NAICS)

- Use of NAICS 6-digit codes will be considered a reasonable, good-faith interpretation for these purposes
- Codes are currently used for Form 990-T, Block E
  - Range from 2 (broader) to 6 (more specific) digit codes
  - 2018 Form 990-T instructions allow reliance on NAICS codes in the instructions
- Notice 2018-67 requests comments regarding whether using less than 6 digits of the NAICS codes, or adding additional criteria, would appropriately identify separate trades or businesses for purposes of the new law

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NAICS codes examples

- 621110 Offices of Physicians (5-digit code in the Form 990-T instructions)
  - 621111 Offices of Physicians (except Mental Health Specialists)
  - 621112 Offices of Physicians, Mental Health Specialists
- 621300 Offices of Other Health Practitioners (4-digit code in the Form 990-T instructions)
  - 621320 Offices of Optometrists
  - 621330 Offices of Mental Health Practitioners (except Physicians)
  - 621340 Offices of Physical, Occupational and Speech Therapists, and Audiologists
  - 621399 Offices of All Other Miscellaneous Health Practitioners
- 621400 Outpatient Care Centers (4-digit code in the Form 990-T instructions)
  - 621410 Family Planning Centers
  - 621420 Outpatient Mental Health and Substance Abuse Centers
  - 621492 Kidney Dialysis Centers
  - 621493 Freestanding Ambulatory Surgical and Emergency Centers

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Interim rules for partnerships

Investment activities

— Treasury and the IRS intend to propose regulations treating all "investment activities" as one trade or business

— "Investment activities" should "capture only partnership interests in which the exempt organization does not significantly participate in any partnership trade or business"

Interim rule for investments through partnerships: In the case of partnership interest that meets a "***de minimis test***" or "**control test**"—

— An organization may aggregate its UBTI from the interest even if the partnership has multiple trades or businesses (including trades or businesses conducted by lower-tier partnerships)

— An organization may aggregate all such partnership interests and treat the aggregate interests as comprising a single trade or business

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De minimis test

***De minimis* test**

— Organization must hold directly no more than 2% of the profits interest **and** no more than 2% of the capital interest of the partnership

— Organization does **not** meet the *de minimis* test if profits interests is not listed on the K-1

— Reliance on capital interest on the K-1 is acceptable but not required

Percentage Determination

— Take the average of the organization's percentage interest on the K-1 at the beginning and the end of the partnership's taxable year

— When determining percentages, the interest of a disqualified person (§ 4958), a supporting organization, or a controlled entity (§ 512(b)(13)) in the same partnership will be taken into account

- How will ownership percentages of disqualified persons be monitored?
- Partnerships will not know aggregate percentage interest for purposes of K-1s

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Control test

Control test

- Organization must directly hold no more than 20% of the capital interest **and** not have control or influence over the partnership
- Average of percentages on K-1 may be relied upon, but not required
- Must take into account the interests of a disqualified person, a supporting organization, or a controlled entity

An exempt organization has control or influence if

- It may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership
  - Could certain standard approval rights in a partnership agreement trigger this?
- Any of its officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business
- It has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees

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Transition rule

Alternative transition rule

— For a partnership interest acquired prior to August 21, 2018, each partnership interest may be treated as comprising a single trade or business

— Unclear whether this transition rule may still be relied upon if ownership percentage increases after August 21, 2018

Aggregation

— Each directly-owned partnership interest is treated as a **separate** trade or business; such partnership interests *cannot* be aggregated together

— However, trades or businesses directly or indirectly conducted by any one partnership or by lower-tier partnerships may be aggregated

— In the case of separate partnership interests that qualify for the transition rule, may taxpayers aggregate trades or businesses conducted by the separate partnerships (or lower-tier partnerships) using NAICS codes (or other reasonable methods)?

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Other interim guidance

Treatment of qualified transportation fringe benefits (QTFs)

— Although included in UBTI under new IRC § 512(a)(7), QTFs are not considered an unrelated trade or business and are therefore not subject to the silo-ing provision

— If a tax-exempt organization has only one unrelated trade or business (e.g., partnership UBTI from K-1s) and UBTI from QTFs, it may aggregate the gains/losses

"Deemed UBTI"

— Notice 2018-67 states that Treasury and the IRS currently "see no distinction" between amounts included in UBTI under IRC § 512(b)(4) (unrelated debt-financed income), (13) (income from controlled entities), or (17) (certain insurance income) and amounts derived from an unrelated trade or business

— The Notice recognizes that aggregating income included in UBTI under such provisions "may be appropriate in certain circumstances"

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IRS 2018 Form 990-T draft instructions

Separate UBTI calculation for each trade or business

— 2018 Form 990-T instructions state that an organization with more than one unrelated trade or business is—for each additional unrelated trade or business—to:
  - Complete Part I and Part II on Page 1 of the Form 990-T for the first trade or business;
  - Complete Schedule M for each additional trade or business; and
  - Complete and attach statements containing the information required by Schedules A through K as necessary

Charitable contribution deductions

— Report the charitable contribution deduction in Part II of the Form 990-T (or Schedule M) "in any manner that results in full use of the allowable charitable deduction"

— If after reporting in Part II, an organization still has allowable charitable deductions remaining, it may use them to offset any section 512(a)(7) UBTI reported in Part III

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New NOL deduction rules

New rules

- Use of NOL carryforward limited to 80% of taxable income
  - *Effective date:* Losses arising in tax years beginning after 12/31/17
  - Another reason pre-2018 and post-2017 NOLs must be tracked separately
- NOL carrybacks eliminated
  - *Effective date:* Losses arising in tax years ending after 12/31/17
- Indefinite carryforward of NOLs
  - *Effective date:* Losses arising in tax years ending after 12/31/17

Mismatch

- What is the result of these mismatching effective dates for a fiscal-year organization in first tax year ending after 12/31/17 (e.g., 9/30/18)?
- NOLs generated in that year are not subject to 80% limitation but may be carried forward indefinitely (and not carried back)

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NOL ordering

What is the ordering rule when an organization subject to Section 512(a)(6) has pre-2018 and post-2017 NOLs?

- Notice 2018-67 and the draft Form 990-T and Form 990-T Instructions suggest that post-2017 NOLs will be calculated and taken into account before pre-2018 NOLs but requests comments
- UBTI for each separate trade or business is calculated before calculating total UBTI
- Violates the "first in, first out" principle that usually applies to NOLs
- Creates risks that pre-2018 NOLs will expire

Open questions

- What if pre-2018 NOL may be traced to a specific trade or business? May it be used when calculating UBTI for that trade or business silo?
- Is the 80% limitation applied separately within each silo in applying post-2017 NOLs generated within that silo?

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Other open questions

Becoming subject to silo-ing at a later date

— What if a post-2017 NOL is derived from an organization's only trade or business (so silo-ing does not apply at the time) but a second trade or business is subsequently started?
  - Is the NOL from the first trade or business applied in calculating the UBTI for that trade or business once it becomes silo-ed under IRC § 512(a)(6)?
  - May the NOL be used in calculating total UBTI, since it was derived when IRC § 512(a)(6) did not apply?

NOLs that an acquiring hospital succeeds to in a merger or acquisition

— Does the acquiring hospital have to "fit" these acquired NOLs into a silo?

Silo-ed business sales

— What happens when the organization sells one or more of the unrelated trade or business silos?
  - May post-2017 NOLs from that silo be applied to any taxable gain from the sale of that trade or business?
  - May those NOLs be used to offset UBTI from other sources?

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What questions do you have?

Thank you

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