

Public Universities and the Excise Tax on Tax-Exempt Employee Compensation

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The Tax Cuts and Jobs Act (TCJA), signed into law on December 22, 2017, constitutes the most significant change to the Internal Revenue Code in 30 years. This included numerous changes that affect institutions of higher education. One such change is new section 4960, in which Congress imposed an excise tax on tax-exempt employers who compensate an employee in excess of \$1 million annually.

Over the past year, tax professionals and scholars have scrutinized section 4960 to determine whether it applies to certain tax-exempt organizations. Finally, on December 31, 2018, the IRS issued [Notice 2019-09](#), providing interim guidance on the excise tax, including limited guidance on the excise tax's applicability to types of tax-exempt organizations.

In light of the IRS's limited guidance, we address here whether this new tax applies to public or state institutions of higher education.¹

Why should I care? A description of the new excise tax

Effective starting in tax year 2018, section 4960 imposes an excise tax on certain tax-exempt organizations if any of their five highest salaried employees receive more than \$1 million in annual compensation² or receive an “excess parachute payment”³; however, amounts paid to a licensed medical professional for medical or veterinary services is not counted as compensation.⁴ The excise tax is equal to 21% of every dollar of annual compensation in excess of \$1 million and 21% of any excess parachute payment.

The excise tax is imposed on four categories of applicable tax-exempt organizations, or “ATEOs.” Two of these categories are relevant to higher education: organizations exempt from tax under section 501(a) and those exempt under section 115(1).⁵

¹ We give credit and appreciation to Ellen P. Aprill, the John E. Anderson chair in tax law at Loyola Law School, Los Angeles, and the patron saint of government tax attorneys everywhere for her analyses of this issue. Additional credit and thanks go to Bertrand Harding, author of *The Tax Law of Colleges and Universities*, and Kyle ZumBerge, a colleague at the University of Texas System.

² Compensation includes some types of deferred compensation payments. For example, payments subject to IRC § 457.

³ For a detailed definition of the term “excess parachute payment,” see new IRC § 4960(c)(5).

⁴ IRC § 4960(c)(3)(B).

⁵ The applicable provision is in the definition section of the bill, at § 4960(c):

“(1) APPLICABLE TAX-EXEMPT ORGANIZATION.—The term ‘applicable tax-exempt organization’ means any organization which for the taxable year—

“(A) is exempt from taxation under section 501(a),

“(B) is a farmers' cooperative organization described in section 521(b)(1),

“(C) has income excluded from taxation under section 115(1), or

“(D) is a political organization described in section 527(e)(1).”

Section 501(a) catalogues a list of non-governmental nonprofits that benefit from statutory exemption, including entities that are exempt under section 501(c).

A private university is typically exempt from tax under section 501(a) by qualification under section 501(c)(3). Private universities are, therefore, ATEOs and subject to the excise tax. Public universities, however, are a different animal altogether.

The Tax-Exempt Status of Public Universities

Public universities may be exempt from income tax under any one of the following: (1) the doctrine of implied statutory immunity of the states; (2) section 115(1); or (3) section 501(c)(3). Public universities that are exempt under section 501(a) and (c)(3) or section 115(1) are ATEOs subject to the section 4960 excise tax. The tax-exempt status of public universities covered by implied statutory immunity, on the other hand, is not rooted in the Code nor referenced in section 4960, which makes them not ATEOs and not subject to the excise tax. The IRS's new guidance explicitly recognizes that a "state college or university" may, in some circumstances, be tax-exempt as a part of the state under implied statutory immunity, but the guidance lacks substantive detail on how make that determination.⁶

Determining whether a public university is considered part of the state for tax purposes is not as simple as summarily concluding that all state universities must be a part of their respective states and, therefore, covered by implied statutory immunity. Each school's relationship with its state must be examined on a case-by-case basis. The following summary may help you in making that determination.⁷

1. Implied Statutory Immunity of the States

States are exempt from federal taxes under implied statutory immunity unless a specific statute explicitly makes them subject to tax.⁸ The IRS recognizes two types of tax-exempt state governmental entities: political subdivisions of the state and integral parts of the state. This area of the law and the blurry lines between these entities are largely a product of sometimes confusing IRS interpretations and only a small handful of court cases.⁹

a. Political Subdivisions of a State

The IRS uses the Treasury Regulations for section 103, which define state and local government entities that are permitted to issue tax-exempt bonds, to determine whether an entity is an integral part of the state.¹⁰ A governmental entity qualifies as a political subdivision of a state if it is either a municipal corporation or an entity authorized to exercise sovereign powers of the state.¹¹ The three sovereign powers a political subdivision might exercise are the power to tax, the power of eminent domain, and police power.¹² Authority to exercise even one of these powers is sufficient for an entity to qualify as a political subdivision of a state; however, "possession of only an insubstantial amount of any or all

⁶ Notice 2019-09, pp. 9-10, 39-40.

⁷ Many universities have received letters from the IRS indicating that they are tax exempt. Many of those letters are cryptic and do not specifically state which type of entity the university is.

⁸ *E.g.*, see section 511(a)(2)(B) regarding the Unrelated Business Income Tax; *see*, Notice 2019-09, p. 39-40.

⁹ *E.g.*, IRS, *Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1990*, E. Instrumentalities, p. 7, <https://www.irs.gov/pub/irs-tege/eotopice90.pdf> (unlike other IRS guidance, lumping "integral part" into state and political subdivision with no separate test).

¹⁰ *E.g.*, Priv. Ltr. Rul. 200227023.

¹¹ Treas. Reg. § 1.103-1(b).

¹² *Commissioner v. Shamburg's Estate*, 144 F. 2d 998 (2d Cir. 1994), *cert. denied*, 323 U.S. 792 (1945).

sovereign powers is not sufficient.”¹³ When evaluating the extent of a governmental entity’s sovereign powers, the IRS considers the total facts and circumstances of each entity, including the public purpose of the entity and the degree of control the state holds over the entity.¹⁴

The IRS has, on one occasion, determined that a public university was not a political subdivision because it did not have “substantial” police powers. “[T]he limited power of regulating traffic within its confines,” “a limited arrest power,” and the power “to preserve order and campus safety” were not substantial police powers.¹⁵ Substantial police power “is much more than the power to maintain a corps of police officers.”¹⁶ It requires broader authority to issue “regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals or the public safety.”¹⁷ That said, if a public university has either broad eminent domain authority or, perhaps less common, taxing authority, it likely meets the definition of a tax-exempt political subdivision.

b. Integral Parts of the State

If a public university does not have the sovereign powers of a political subdivision, it may still qualify as a tax-exempt integral part of the state. The IRS considers all the facts and circumstances of each situation when making this determination, but it has indicated that some combination of the following facts indicates state involvement: “(1) creation of the organization by executive order of the governor of a state, (2) creation of the organization by executive order of the governor of a state as an official state agency, (3) a state or a state agency having the power to appoint and remove the organization's board, (4) a state or a state agency having the power to abolish the organization, (5) a state or a state agency monitoring the organization’s activities, and (6) the organization using government employees to conduct its activities.”¹⁸ More recently, the IRS has emphasized that it will scrutinize the state’s degree of control over and financial commitment to the entity, including providing operating funds or maintaining liability for the entity’s debts.¹⁹

3. Section 115(1) Entities

A public university may also qualify for tax-exempt status under section 115(1) as a separate entity from the state.²⁰ A section 115(1) entity is an entity that does not possess the powers of a political subdivision or have the characteristics of an integral part of the state (hence, a separate entity from the state), but

¹³ Rev. Rul. 77-164, 1977-1 C.B. 20; Rev. Rul. 77-165, 1977-1 C.B. 21.

¹⁴ *Id.*; IRS (Joseph O’Malley, Elizabeth Mayer, and Marvin Friedlander), *Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1996*, F. State Institutions – Instrumentalities, <https://www.irs.gov/pub/irs-tege/eotopic96.pdf>.

¹⁵ Rev. Rul. 77-165.

¹⁶ *Phila. Nat’l Bank and Phila. Nat’l Corp. v. U.S.*, 666 F.2d 834 (3d. Cir. 1981).

¹⁷ *Id.* (quoting *Chi., Burlington & Quincy Ry. Co. v. Illinois, ex rel. Drainage Comm’rs*, 200 U.S. 561, 592 (1906)); *cf.*, IRS Priv. Ltr. Rul. 201735020 (ruling “the power to pass rules and regulations proper and necessary to regulation use, operation, and maintenance of its property and facilities,” the power to “impose fines and penalties for violations of those rules and regulations,” and the power to provide “a police force to protect persons and property and enforce rules and regulations” constituted substantial police powers).

¹⁸ *Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1996*, F. State Institutions – Instrumentalities, p. 5.

¹⁹ See *e.g.*, Priv. Ltr. Ruls. 200012084, 200210024, 200307065, 200409033.

²⁰ Notice 2019-09, p. 39.

still generates income in the “exercise of any essential governmental function” and the income accrues to a state or political subdivision of a state.²¹ Although there is no definition of “essential governmental function” in statute or agency guidance, the IRS interprets this phrase broadly because “Congress did not desire in any way” to narrow the scope of activities that “may be the function of the sovereign to conduct.”²² It seems that any governmental entity that earns, invests, or saves money for a state can claim to exercise an essential governmental function.²³

The IRS also liberally construes the requirement that the income accrue to a state or political subdivision. An entity’s income accrues to a state if the state has an unrestricted right to the income or, if the state does not have a present right to the entity’s income or assets, if the assets of the entity are distributed to the state upon dissolution.²⁴ In addition, a section 115(1) entity must use its assets and income for public benefit, and any financial benefit to any private individual or interest must be merely incidental to the public benefit.²⁵

4. Section 501(c)(3) Entities

The definition of 501(c)(3) entities is well known. States, their political subdivisions, and integral parts of the state generally cannot qualify for tax-exempt status pursuant to section 501(c)(3).²⁶ However, because the tests for 115(1) status and 501(c)(3) significantly overlap and are not mutually exclusive, it is not uncommon for section 115(1) entities to also seek tax-exempt status pursuant to 501(c)(3).

Some public universities that may otherwise qualify as political subdivisions or integral parts of a state have previously requested and received 501(c)(3) qualification letters from the IRS that have confused analyses and conclusions. Notice 2019-09 helpfully reiterates that universities, including those who actually qualify for implied statutory immunity, may, after considering their circumstances and the implications, voluntarily relinquish their 501(c)(3) tax-exempt.²⁷

Analysis

Public universities who are concerned that they may be subject to the section 4960 excise tax under the IRS’s new guidance should carefully review and determine the source of their tax-exempt status. Again, because this categorization is so fact-specific for each state and each university, there is no way to set a hard and fast rule that all public universities qualify as political subdivisions, integral parts of the state, 115(1) entities, or 501(c)(3) entities. Public universities should review the governing law of their states, including statutes, regulations, and other authorities, to determine which category applies to them based on their specific facts and circumstances. Public universities may request a determination from the IRS regarding their status as a state governmental entity or a section 115(1) entity by following the procedures described in Revenue Procedure 2017-1, however, the IRS may or may not provide a specific answer to that question.

²¹ IRC § 115(1).

²² Rev. Rul. 77-261, 1977-2 C.B. 45.

²³ *E.g.*, Rev. Rul. 77-261; Rev. Rul. 90-74, 1990-2 C.B. 34; Priv. Ltr. Rul. 200736022.

²⁴ Rev. Rul. 90-74. *E.g.*, Priv. Ltr. Rul. 200909019.

²⁵ *Id.*

²⁶ See, IRS, *Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1990*, E. Instrumentalities, p. 14, <https://www.irs.gov/pub/irs-tege/eotopice90.pdf>.

²⁷ Notice 2019-09, p. 40

How Did This Happen?

The context of this law suggests, and [the Joint Committee on Taxation \(JCT\) has confirmed](#), that Congress intended to make all public universities subject to this excise tax. But Congress may not have understood that it was not applying the excise tax to all of the country's public universities when it applied the excise tax to section 115(1) entities. In fact, even early analyses of the TCJA generally assumed that [section 4960 would apply to all universities](#). But, with more time, academics and practitioners now generally agree that some public universities are not subject to the excise tax. The IRS's guidance in Notice 2019-09 validates that consensus.

Despite this consensus, public commentary on the excise tax has provided few details about how to determine whether a university is a political subdivision or an integral part of the state. Even Ellen Aprill, who wrote [the seminal law review article](#) on this issue, seemed to downplay the fact-specific nature of determining which category a public university might fall into. In a [guest blog post](#) published on Daniel Hemel's "[Whatever Source Derived](#)" blog (and published again in EO Tax Journal), Aprill explained that "[p]ublic universities and colleges, however, rarely based their tax-free status on section 115(1)." She went on to note that if Congress intended to make public universities subject to the excise tax, "lawmakers failed to achieve their goal." Nevertheless, public universities should apply the fact specific inquiry outlined in Aprill's earlier article and briefly outlined above.

Is Congress Going to "Fix" This?

That's not clear.

Lawmakers have noticed the issue. Veena K. Murthy, Legislative Counsel for the JCT, [stated](#) that some entities "could get out of [the excise tax] because of this glitch." The [JCT's official explanation of the TCJA](#) addressed this by noting that "[a] technical correction may be necessary to reflect" Congress's intent to tax all public universities. Despite the JCT's hedging language, it seems clear that an amendment to statute, rather than a clarifying regulation, is necessary to fix the law.

This statute is one of many portions of the TCJA for which lawmakers have considered a technical corrections bill. [Republican congressmen](#) and the [Trump administration](#) sent conflicting messages throughout 2018 over the likelihood of such a bill, but finally began considering bills by the end of the year. This January, Representative Kevin Brady, Ranking Member of the House Ways and Means Committee, [released a discussion draft for a bill](#) that would make numerous changes to the TCJA, including section 4960. The bill would make all entities described in section 511(a)(2)(B), which includes all public universities, subject to the excise tax. The [JCT agreed](#) that the bill "clarifies that all State colleges and universities described in section 511(a)(2)(B)" are subject to the excise tax. To date, the new Democratic leadership of the House has not shown any interest in passing this or any other tax bills.

For now, public universities with concerns regarding the applicability of section 4960 or potential legislative changes to this section might consider consulting with internal subject-matter experts or outside counsel.