Impact on Higher Education of Tax Reform and New FASB Standards

By Dave Moja, Partner and Fran Brown, Managing Partner

We now have the first tax code reform since 1986, plus nonprofit financial reporting standards changes in Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-14. Is your institution ready for these big changes? There are several specific elements of both that higher education leaders need to be aware of and actively planning for. What do you need to know about the impact on higher education of tax reform and new accounting standards?

The Impact on Higher Education of Tax Reform

The Tax Cuts and Jobs Act (H.R. 1) was signed into law at the end of 2017. Here are key elements for your institution to know:

- Corporate tax rate – This decreased to a flat rate of 21%, down from a top rate of 35%.
- Charitable contributions – The deduction limit increased to 60% from the current 50% adjusted gross income (AGI) limit. The five-year carryover period is retained to the extent that the contribution amount exceeds 60% of the donor's AGI.
- Unrelated business income tax (UBIT) on certain fringe benefits – The bill includes a provision under which UBIT includes any expenses paid or incurred by a tax-exempt organization for the following, provided such amounts are not deductible under section 274:
    - Qualified transportation fringe benefits,
    - A parking facility used in connection with qualified parking, or
    - Any on-premises athletic facility (but note that current IRC section 132(j)(4) defines on-premises athletic facilities as gyms or other athletic facilities that are located on the employer's premises, operated by the employer, and with substantially all use by the employer's employees and their spouses and dependent children)
- Unrelated business activities – Each unrelated business activity stands alone with respect to profit or loss, which could result in additional taxes for your institution. Specifically, institutions that have more than one unrelated trade or business must first separately compute the unrelated business taxable income with respect to each unrelated trade or business and without regard to the specific $1,000 deduction. Losses resulting from one trade or business would not be permitted to offset income from another trade or business. There is a transition rule for net operating losses (NOLs) arising in a taxable year before January 1, 2018. Such NOLs that are carried forward to a future taxable year are not subject to this rule.
- Excise tax on some private colleges and universities – The Act includes a 1.4% excise tax on the net investment income (not yet defined) of private colleges and universities that are "applicable educational institutions" (AEIs). This will generally mean schools that have at least 500 students, with 50% of students located in the U.S. The threshold computation would be for AEIs whose aggregate fair market value of assets is at least $500,000 per student at the end of the preceding taxable year. (This would not include assets used directly in carrying out the institution's exempt purpose.) Note: Earlier versions of the bill had qualified that the students must be "tuition-paying" students, but this was removed from the final text of the Act.
- Excess compensation – There is a 21% excise tax on compensation in excess of the $1 million paid by an applicable tax-exempt organization to one of its five highest-compensated employees when there is no substantial risk of forfeiture of the rights to such remuneration, as defined at IRC section 457(f)(3)(B)C. This rule has several exemptions and limitations.

- Repeal of advanced refunding bonds – Interest on advance refunding bonds (refunding bonds issued more than 90 days before the redemption of the refunded bonds) issued after 2017 will be taxed. Interest on current refunding bonds remains tax-exempt.
- Moving expenses – The moving expense deduction and qualified moving expense reimbursements are suspended through 2025. There are exclusions for active duty military members.
- Estate tax – The estate tax was retained, with the exemption amount doubled. This will expire in 2026.

When considering the impact on higher education of tax reform, note that many of the provisions of this bill will end on December 31, 2025. Be sure to consider the longevity of provisions when making any plans related to the new tax law.

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What Higher Education Institutions Need to Know About the FASB Financial Reporting Standards Changes

In August of 2016, the FASB issued the first of a few major revisions to financial reporting for not-for-profit entities. Accounting Standards Update (ASU) 2016-14, Not-for-Profit Entities (Topic 958): *Presentation of Financial Statements of Not-for-Profit Entities* is the first substantive update to not-for-profit financial reporting since FAS 116 and 117 in 1993.

The impact will be substantial for many institutions. Two of the changes deal with reporting on restricted net assets and "underwater" endowments. Below, we explain these and other key reporting changes.

Restricted Net Assets

Many institutions have net assets that are restricted by the donor or state law. These restricted net assets are either temporarily restricted or permanently restricted. In addition, institutions have unrestricted net assets. Under the former reporting, financial reports had up to three columns to show the activity in each. Under the new standards, you will only report on net assets with restrictions (temporarily and permanently restricted) and net assets without restrictions (unrestricted).

The day-to-day accounting treatment for net assets is unchanged, as are the laws surrounding the use and protection of the assets. The only change is the reporting. Going forward, temporarily restricted and permanently restricted net assets will be combined for financial statement reporting purposes.

Net assets that are for the acquisition or construction of long-lived assets (i.e., property, plant, and equipment) will be required to be released from restrictions when the asset is placed in service. For example, if your institution is conducting a capital campaign, the full amount received will be released from restriction when the building is completed and placed in service — not when the funds are used to construct the building or when the pledges are collected.

"Underwater" Endowments

"Underwater" endowments — those endowment funds that have depreciated in value — have been shown as offsets to unrestricted net assets. Under the new standards, these will stay within the "Net Assets with restrictions" category. This will affect larger institutions more than most.

Expense Reporting

A big change impacting all institutions, however, is expense reporting. Until now, expenses were reported in broad categories such as program, general and administrative, and fundraising. The new standards require disclosure of expenses by function and by natural classification. In addition, your institution will need to disclose the methods used to allocate expenses among program and support functions.

Expense reporting is a big change affecting all institutions.

Required Disclosures

One of the new disclosures requires qualitative and quantitative information on how your institution will manage its liquidity risk — in other words, how you will meet your current obligations within one year. This new disclosure should provide meaningful information on how your institution will meet current obligations regardless of the appearance of health on the face of the statement of financial position.

Additional changes include disclosures around investment return and the related expenses, cash flow reporting options, and disclosures around reporting when using an operating measure. The option to use the direct method for the statement of cash flows is still optional — however, unlike previous standards, if you choose this method you no longer need to provide an indirect reconciliation.

Effective Date

These new changes are in effect for fiscal years beginning after December 15, 2017. If you are a calendar year-end institution, your first fiscal year beginning after December 15, 2017 is January 1, 2018. If you use a fiscal year end, such as June 30, your first fiscal year-end to show the new reporting standards will be June 30, 2019. Early adoption is permitted.

When implemented, the new reporting and disclosures will apply retrospectively to all years presented for most items.

It's important to plan for these changes now. CapinCrouse can help you prepare for these changes to make the process as easy and effective as possible. Please contact us at info@capincrouse.com to learn more.

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As Managing Partner, Fran leads the firm and guides the implementation of strategic plans and objectives. He is also involved in client acquisition meetings, significant board meetings, and representing the firm nationally. Fran has more than 30 years of experience providing audit and management consulting services to a variety of nonprofit entities, including colleges and universities. Fran previously led the New England Higher Education and Not-for-Profit Practice at Grant Thornton and was partner-in-charge of the not-for-profit practice at CCR LLP. His expertise includes strategic planning, budgeting, financial statement preparation, exempt-organization tax filing, real property sales and leases, board training, and enterprise risk management (ERM) training.

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