

# Let's Go to Tax Town!

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## Overview

- Taxes on high-end compensation at the intersection of sections 4958 and 4960
- Protecting against a community benefit audit
- Managing the UBIT burden
- Tax-exempt bonds with management contracts and joint ventures
- Tax-exemption and ACOs
- With a sprinkling of provisions from the One Big Beautiful Bill Act (“OBBA”)

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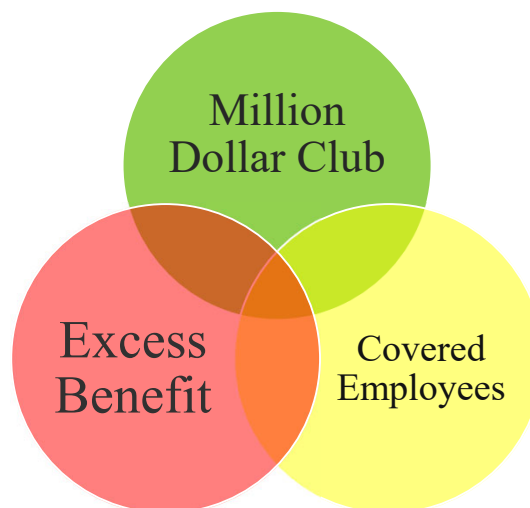
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# High-end Compensation (IRC §§ 4958 & 4960)

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## Overlapping Concepts – Pre-OBBBA

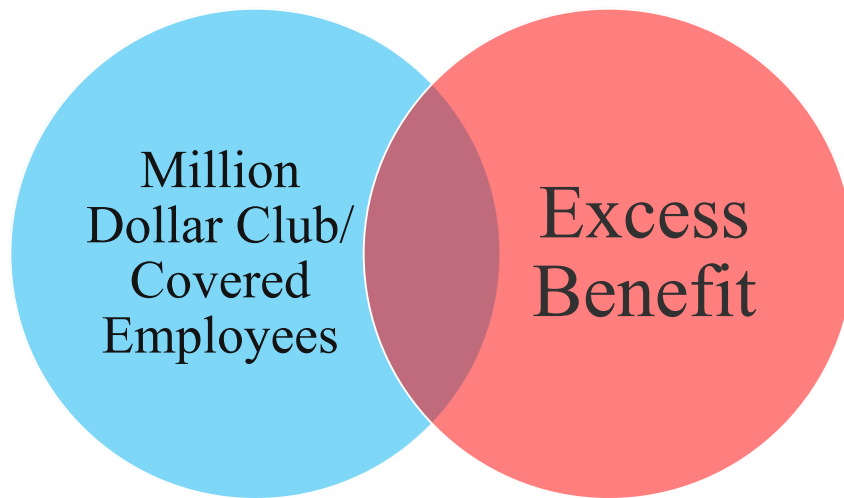


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## Overlapping Concepts – Post-OBBBA



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## Excess Benefit (IRC §4958)

- Applies to 501(c)(3) public charities and 501(c)(4) orgs. (5-year lookback)
- For any excess benefit provided to a disqualified person (5-year lookback)
- Three types of possible excess benefit (not FMV, certain loans and grants, automatic excess benefit)
- Tax paid and reported on Form 4720 at rates of:
  - 225% for DP, no intent requirement
  - 10% or \$20,000 per transaction for organization managers who knowingly participate without reasonable cause
- ATEO reports on Form 990
- Exemption risk if transaction calls into question satisfaction of organizational and operational tests
  - *Caracci v. Commissioner* (sale of home health agencies)
  - PLR 202001023 (multiple and repeated transactions, no correction)

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## Excise Tax (IRC §4960)

- Effective for tax years beginning after December 31, 2017.
- Applies to compensation payments by applicable tax-exempt organizations (ATEOs), including IRC §§115, 501(c)(3), 501(c)(4).
- 21% excise tax on compensation over \$1M paid to any covered employee of the ATEO or a related organization, and the excess of parachute payments over 1x the base amount (average compensation for past 5 years) whether or not it exceeds \$1M.
  - Does not include payment to licensed medical professionals for medical or veterinary services.
  - Covered employees include five highest compensated current or former employees for any year beginning after 12/31/16.
  - Parachute payments are contingent on separation from employment with a present value equal to at least 3x the base amount; if the threshold of 3x the base amount is met, payments over 1x the base amount are taxed.

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## Excise Tax (IRC §4960)

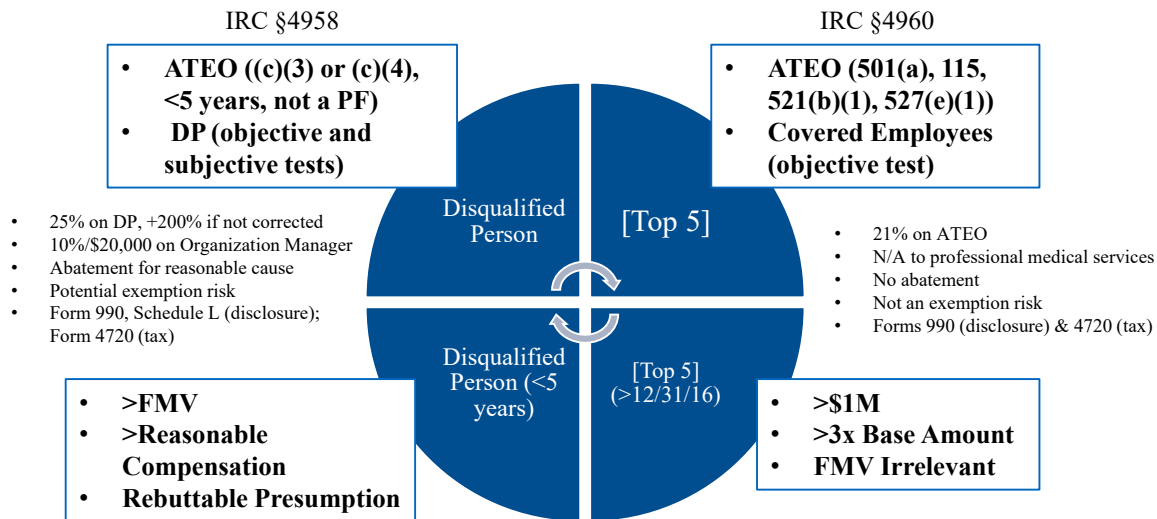
- Covered Employees
  - Originally included five highest compensated current or former employees for any year beginning after 12/31/16 .
  - OBBBA §112020 changed to all current and former employees of the ATEO effective for tax years beginning after 12/31/25
- IRS adopted a compliance strategy aimed at addressing the continued “high volume of exempt organizations that paid compensation of over \$1 million to at least one ‘covered employee’ but did not report IRC Section 4960 excise tax on Form 4720 ... The approved workstreams for this strategy are compliance checks and examinations of Form 4720.”

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# Comparing Excise Tax Regimes



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# Protecting Against Excess Benefit

- **Potential Defenses**
  - Disqualified person status – planning vs. audit defense
  - Rebuttable presumption procedure/FMV
  - Initial contract exception (there can be more than one)
  - Organization managers may rely on written, reasoned opinion of counsel or consultant
  - Provide new or amended W-2 (for certain automatic excess benefits, before notice of IRS audit)
  - PLR or declaratory judgment
- **Effective Correction**
  - Repay excess benefit amount plus interest at or above the Applicable Federal Rate
  - Protect exemption by pursuing recovery (at least if economically feasible), improving processes, see Treas. Reg. §1.501(c)(3)-1(f)

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# Minimizing Impact of IRC §4960

- FMV is irrelevant for purposes of section 4960
- Use of SMLLCs instead of tax-exempt subsidiary corporations can reduce the number of Covered Employees
- Independent contractor (group, solo, friendly or captive PC) vs. employment by nonprofit
- Single employer for a system
  - Common law control considerations for non-officers
  - Consider provider number implications
  - Anti-abuse rules not yet released

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# Other Considerations

- Lake Wobegon Effect ... we're all #1!
- Perquisites vs. cash and how that compensation plays on the front page
- It's not just the amount, compensation can be reasonable but defectively structured
  - A health system is not a VC or PE fund
  - 1,001 uses for blockers
- State attorney generals' role in enforcing fiduciary duties, statutory standards
- Property tax exemption and other state standards on use of charitable assets (e.g., Tower Health hospitals(PA), reversed on appeal, Pottstown School District v. Montgomery County Board of Assessment Appeals, 2025 WL 1534294 (Pa., May 30, 2025); California Nonprofit Integrity Act, Cal. Gov't Code § 12586(g))
- Bulletproofing executive and physician compensation
  - Critical review of peer group for comparables and mix of for-profit/non-profit
  - Emphasize a mission component for incentive compensation

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# 501(r) and Community Benefit Audits

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## Section 501(r)

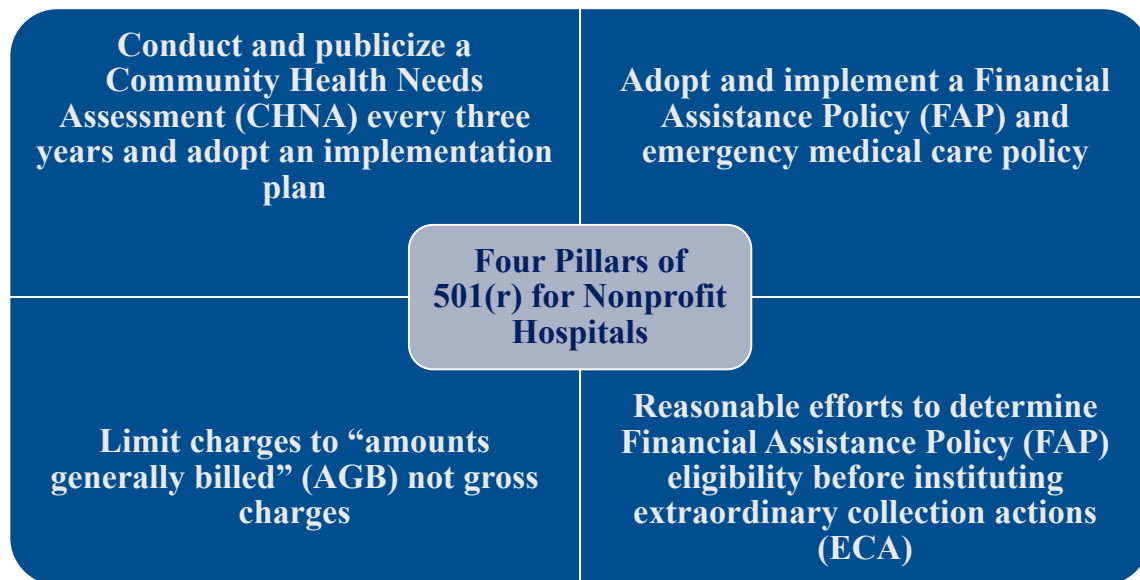
- Additional exemption requirements for nonprofit hospitals in four basic areas
- Applies to all hospitals operated by an organization described in section 501(c)(3)
  - N/A to governmental entities relying on section 115 or intergovernmental immunity for exemption
  - Dual status entities can renounce 501(c)(3) status
- For hospitals operated in a pass-through joint venture, if the nonprofit does not have the power to control compliance with IRC §501(r) then all of its allocable share of income and loss is subject to UBIT

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# The Four Pillars of Section 501(r)

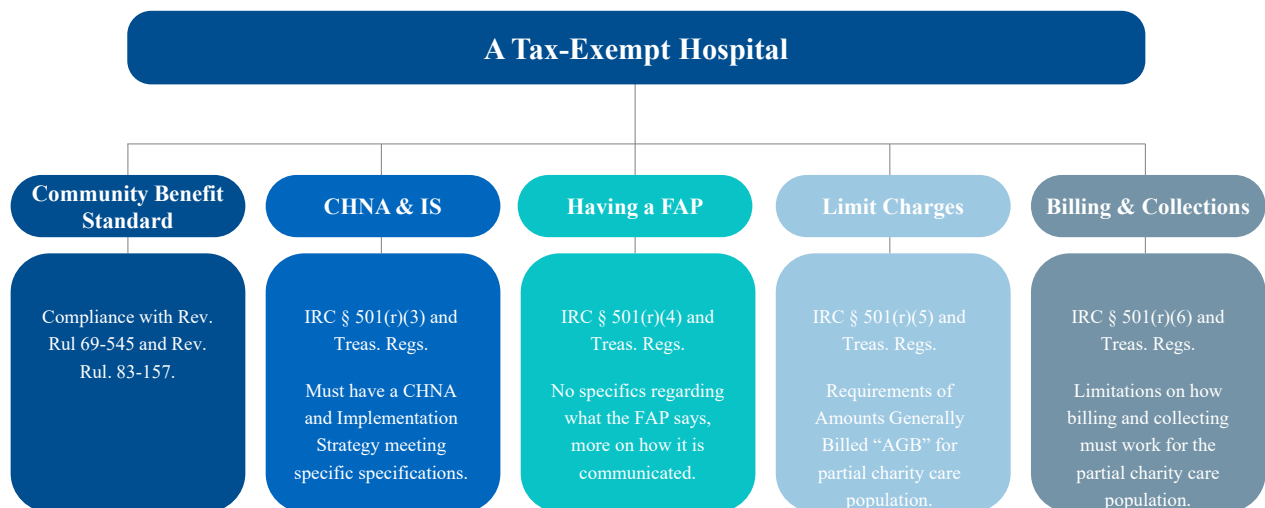


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## Compliance with IRC §501(r) and The Community Benefit Standard



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# Community Benefit Standard

- Rev. Rul. 69-545, amplified by Rev. Rul. 83-157
  - Promotion of health of a broad cross section of the community in a charitable manner
  - Access to care for all regardless of ability to pay (e.g., ER) or specialty hospital
  - Surplus revenues are used “to improve the quality of patient care, expand its facilities, and advance its medical training, education, and research programs”
  - Open medical staff (all qualified physicians, consistent with size and scope of facility)
  - Controlled by an independent community board
- TIGTA Report No. 2025-100-019 (May 15, 2025) describes this as a flexible but vague standard lacking clear criteria for compliance (e.g., does not specify eligibility levels for, or amount of, financial assistance required)
- State law equivalents (<https://hilltop.institute/our-work/hospital-community-benefit/hcbp-state-comparison/?select=fap>)

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# Community Benefit Standard

- Importance of quantifying and communicating community benefit
  - Scrutiny from advocacy organizations (e.g., Lown Institute report), Congress (e.g., Sens. Warren/Grassley 11/19/24 letter), press, and state governments
- In March 2024, IRS Tax-Exempt & Government Entities (TE/GE) added tax-exempt hospitals’ compliance with the community benefit standard and Section 501(r) as a new compliance strategy
  - “The focus of this strategy is on compliance with the Patient Protection and Affordable Care Act (PPACA). We will verify whether tax-exempt hospitals are complying with their statutory obligations under Internal Revenue Code Section 501(c)(3), including the community benefit standard, and Section 501(r). The treatment stream for this strategy is examinations.”

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# Community Benefit Standard

- Key Prep Questions in Anticipation of IRS Exam
  - Do you know where your FAP is?
  - Ongoing training for patient accounts and other staff
  - Monitoring outside collection agencies
  - Budgeting for community benefit
  - Schedule H = Story Time
  - Dollars vs. (common?) sense – track and publicize the impact of the community benefit spend
  - Money-losing services
    - Top Ten I/P and O/P service lines AHA Study (<https://www.aha.org/costsofcaring>)
    - Medical clinics subject to FAP
    - Certain governmental programs

Knock, knock  
“Who’s there?”  
“Friendly”  
“Friendly who?”  
“Your friendly neighborhood IRS Agent”

## IRS Exam IDR

### Community Benefit

- License(s) and applications for each hospital and explanation for license covering multiple locations
- Confirmation of hospital not being included on any other 990
- Schedule H worksheets
- CHNA and discounts provided, whether or not covered by the FAP

### Strict IRC § 501(r) Compliance

- Very systematic approach through the statutory and regulatory requirements of IRC § 501(r)(3)-(6).
- FAP, CHNA, Implementation Strategy and proof of Board approval.
- Communications with patients that applied under the FAP
- Facility tours checking for signage and availability of FAP related materials

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## IRS Exam IDR

### Other IRS Agent Efforts

- Copies of agreements with third party collection agencies
- Patient records along with billings and other communications to patients
- Detail on the calculation of Amounts Generally Billed including which facilities the AGB applies to.
- Training materials
- Completed financial assistance applications
- Schedule of patient accounts in which ECAs were initiated.
- Extensive minutes of meetings for board committee meetings under which FAP, CHNA, Billing and Collection along with any other policy covered by Section 501(r)
- Copy of all workpapers utilized to estimate the portion of bad debt expense attributable to FAP-eligible patients for the tax year under audit

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# 2024 IRS Report to Congress

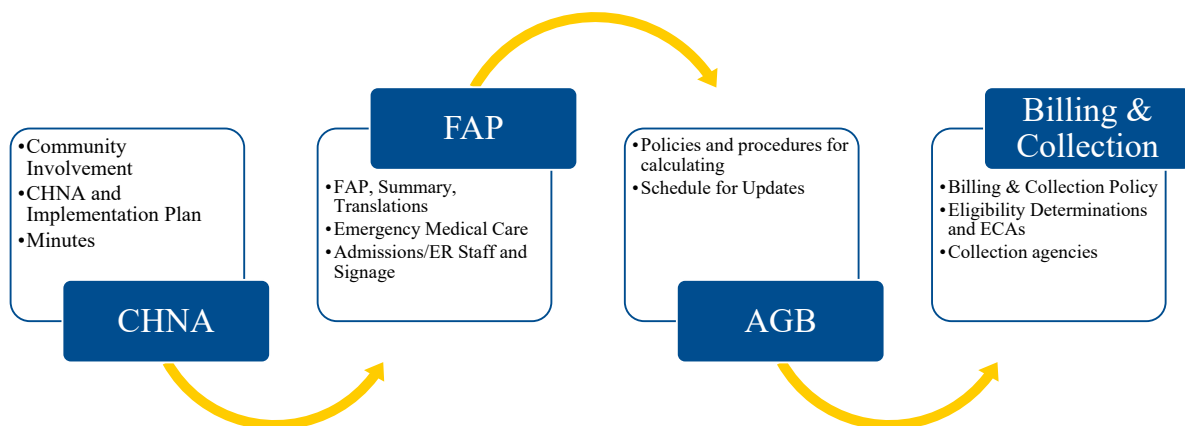
- Annual reports to Congress on uncompensated care by all hospitals (P.L. 111-148, §9007(e))
- Uncompensated care as a percentage of total expenses for nonprofit hospitals (2016-2020):
  - Charity Care **+13.96%**
  - Bad Debt **(27.74%)**
  - Non-Means Tested **(28.06%)**
  - Means Tested **+2.67%**
- Changes in nonprofit hospitals' net community benefit expense from 2016-2020:
  - Total Community Benefits **+12.70%**
    - Charity Care & Means-Tested **+10.69%**
    - Other Community Benefits **+18.01%**

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# Finding Noncompliance with 501(r)

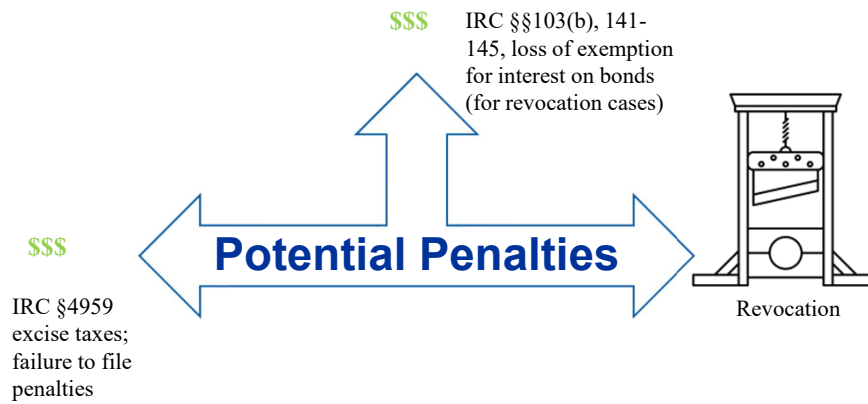


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# Potential Penalties



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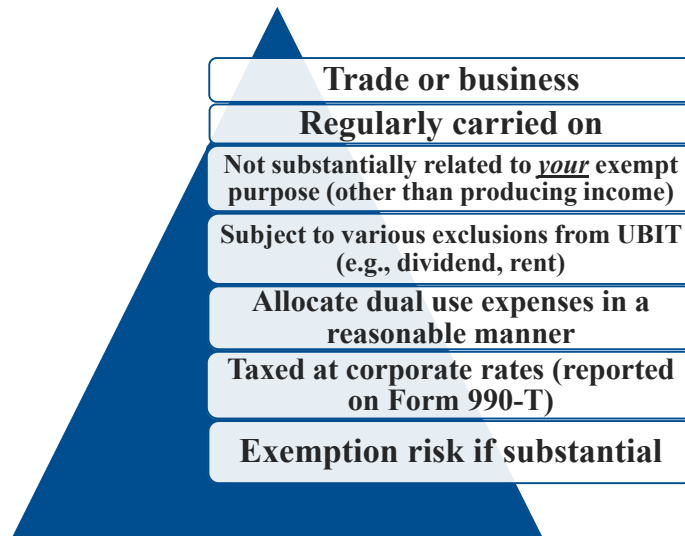
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# UBIT

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# UBIT Overview



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## Common UBIT Exclusions

- Common Exclusions
  - Dividends
  - Interest
  - Royalties
  - Rents from real property and incidental personal property
  - Gains from disposition of property other than inventory or stock in trade
  - Research for Federal or State government
  - College, university and hospital research
  - Income from affiliated offshore captives for certain insurance coverage
- Limitations
  - Debt-financed income
  - Specified payments from controlled organizations

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# TCJA Changes to UBIT

- Section 512(a)(6) requires calculating income/loss separately for each unrelated trade or business
  - Effect is referred to as “siloing” because if section 512(a)(6) applies, losses from one business may not be used to offset gains from another.
  - Taxed at new corporate rate of 21%
- Interaction with new NOL rules in IRC § 172(a)
  - NOL carryforwards cannot be used to offset more than 80% of taxable income in any year, and cannot be carried back, but they may be carried forward indefinitely. Pre-2018 NOLs retain 2-year carryback, 20-year carryforward, and can offset 100% of taxable income.
  - NOLs are computed for each business and carried forward only to that business.
  - NOLs arising in tax years beginning before 1/1/18 may still be used to reduce aggregate UBI for years beginning on or after 1/1/18.

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## 85 Fed. Reg. 77952 – Final Regulations Effective 12/2/20

Separate T or B	Specified Payments	Investment Activities	Other Items to Note
<ol style="list-style-type: none"> <li>1. Two digit NAICS Codes should be used.</li> <li>2. Can only be used once.</li> <li>3. Debt Financed Income and partnership investment income and QPIs can be combined in one code.</li> <li>4. Should not identify exempt activities.</li> </ol>	<ol style="list-style-type: none"> <li>1. Specified payments are not investment activities</li> </ol>	<ol style="list-style-type: none"> <li>1. All Qualified Partnership Investments “QPIs” can be combined in one NAICS code.</li> <li>2. In order to be a QPI de minimis and participation test must be met.</li> <li>3. Generally speaking if you own less than 20% and there is no indicia of control – QPI.</li> </ol>	<ol style="list-style-type: none"> <li>1. Charitable Contribution amount is taken against all siloed amounts.</li> <li>2. Allocation of expenses on gross-to-gross basis not reasonable if cost in both related and unrelated the same, but price charged for unrelated business is higher.</li> <li>3. Public Support Test expanded; can calculate using UBI for each silo or aggregate.</li> </ol>

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## NOLs After the TCJA

- Pre-2018 NOLs should be taken against total UBIT in a way that maximizes the use of post-2017 NOLs in that taxable year.
- The final regulations acknowledge those commentators who requested guidance on the interaction between the CARES Act and Section 512(a)(6) and provides that additional guidance will be published.
- Publication 598 (03/21) clarifies that the CARES Act provides for carryback of NOLs arising in 2018, 2019, and 2020 to each of the 5 years preceding the tax year in which the NOL arose.
- An organization that wishes to carry these NOLs forward must waive the carryback.
- TCJA, as modified by the CARES Act, provides that the NOL deduction for tax years beginning in 2021 cannot exceed 80% of taxable income.
- An organization that had an NOL in a tax year beginning in 2018 or 2019 can file amended returns Form 990-T to carryback the NOL.

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## Corporate Structure Considerations

- Creation of for-profit subsidiary
  - Siloing not required; NOL changes still apply
  - Parent and subsidiary are typically recognized as Separate corporate identity respected (legitimate business purposes, solvency, corporate formalities)
  - Potential for higher taxes if a mix of related and unrelated businesses are included in the for-profit
- Conversion to taxable status
  - Conversion subject to §337(d) “toll tax” but avoids siloing, excess benefit (after 5-year lookback), 21% excise tax on high-end compensation, IRC §501(r) (other than certain joint ventures), and Form 990 disclosure
  - Access to PE/VC funding; lose tax-exempt bonds and donations
  - Significant hurdles, including AG approval

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## Parking Tax (Section 512(a)(7))



- IRC §512(a)(7) was repealed retroactively
- Refund guidance issued January 21, 2020
  - Claim refund or credit by filing an amended 990-T labeled “Amended Return – Section 512(a)(7) Repeal”
  - Attach a statement describing changes by line number
  - File by later of 3 years after original 990-T or 2 years after payment of the tax

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## Just Kidding ...

- OBBBA §112024 reinstates the §512(a)(7) tax on the amount paid by the organization for qualified transportation fringes or parking facilities used in connection with qualified parking (§132(f)) if:
  - Not connected with an unrelated trade or business regularly carried on by the organization, and
  - Which is not deductible under §274
- Does not apply to churches and church-affiliated organizations
- Treated as a separate trade or business (or silo) for purposes of §512(a)(6)
- Treasury to issue regulations or other guidance on allocation of costs

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# Concierge Medicine

- What is Concierge Medicine? Does it get me playoff tickets?
- UBIT Analysis
  - Likely not substantially related to charitable purposes if limited to a small group of paying patients without a subsidized option for Medicaid/FAP-eligible patients (see *Vision Service Plan v. U.S.*, 265 Fed. Appx. 650 (9th Cir. 2008); *Memorial Hermann Accountable Care Org.*, 120 F. 4th 215 (5th Cir. 2024)).
- IRC §512(a)(2) Convenience Exclusion (activities carried on “primarily for the convenience of its members, students, patients, officers, or employees”)
  - Difficult argument if the service is provided only for an extra charge with a profit motive (and by definition provides preferential treatment to patients paying extra for extra service); not (intended/affordable) for all patients like a campus parking garage.
  - *St. Luke’s Hospital of KC v. U.S.*, 494 F. Supp. 85 (W.D. Mo. 1980) (treated medical staff as members and applied 512(a)(2) to lab revenue); Rev. Rul. 85-109, 1985-2 C.B. 165 (IRS declined to follow portion of the decision treating medical staff as members for the convenience exclusion).
- Structure service agreements to fit bond private use safe harbor if operating from bond-financed space. See Rev. Proc. 2017-13.

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# Tax-exempt Bonds

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# Private Use

- Private use includes:
  - Ownership, lease or other use in the trade or business of a private party
  - UBI activities are private use
- Safe Harbors for Management/Service Contracts
  - Rev. Proc. 97-13, 2001-39; Notice 2014-67 (5 specific safe harbors with rules on term, termination, compensation, D&O overlap)
  - Rev. Proc. 2016-44, 2017-13 (single combined safe harbor, more flexibility)
- Compensation cannot be based on net revenues of the bond-financed property (hospital or department)

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## Old Private Use Safe Harbors

Compensation	Maximum Term	Termination Rights
≥95% fixed fee (set amount or objective formula); plus one-time incentive	Lesser of 15 years or 80% of useful life	N/A
≥80% fixed fee; plus one-time incentive	Lesser of 10 years or 80% of useful life	N/A
≥50% fixed fee, 100% capitated or combination	5 years	Reasonable notice, w/o cause or penalty, after 3 years
100% per unit fee (e.g., per read) or combine with fixed fee; includes “bill and collect”	3 years	Reasonable notice, w/o cause or penalty, after 2 years
100% based on percentage of fees charged or a combination of per unit fee and percentage of revenue or expense (not both)	2 years	Reasonable notice, w/o cause or penalty, after 1 year
For start-up period, percentage of either gross revenues, adjusted gross revenues, or expenses	2 years	Reasonable notice, w/o cause or penalty, after 1 year

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## Notice 2014-67

- Participation in an MSSP ACO is not private use if:
  - ACO meets the five factors outlined in Notice 2011-20
  - Qualified user does not contribute or otherwise transfer bond-financed property to a non-501(c)(3) ACO
- Additional Safe Harbor for Support Service Agreements
  - Recognized "quality of services" payments as a permitted compensation methodology if not based on increases in revenues or decreases in expenses of bond-financed facility
  - Quality payment must be stated dollar amount, periodic fixed fee, or a tiered system of stated dollar amounts or periodic fixed fees
  - Five year term, no requirement for early termination rights

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## New Safe Harbor (Rev. Proc. 2017-13)

- Terms up to 30 years (80% of useful life); no specific termination rights
- Reasonable compensation that does not take into account, and is not contingent upon, net profits from operation of the financed property
- Qualified user must maintain control of the property and responsibility for any net losses from operations and any damage or destruction of the property
- Service provider cannot take an inconsistent tax position from the qualified user
- Qualified user must be independent from the service provider
  - Service provider cannot exceed 20% of qualified user's board; service provider's CEO or chair cannot sit on qualified user's board
  - Parties cannot have the same CEO or board chair

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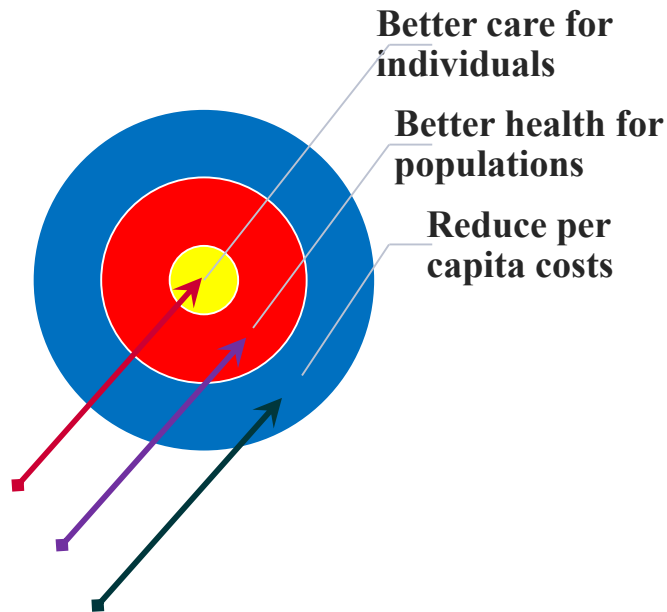
# Nonprofit/For-profit Partnerships

- Historically, any joint venture with a for-profit partner involving bond-financed facilities would result in private use by partnership and/or the for-profit partner
- October 2015 regulations
  - Allow use of tax-exempt bonds to finance a 501(c)(3) organization's proportionate share of facility owned by partnership
  - Provide method for measuring private use by the partnership
    - Private use equals the for-profit partner's largest percentage share of partnership items (income, gain, loss, deduction, credit) during the measurement period

# ACOs



## MSSP ACO Triple Aims



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## Basic Tax Issues with ACOs

- Exempt status for nonprofit ACO
  - Rev. Rul. 86-98 (IPA not exempt as contracting agent)
  - More active role in quality of care, cost control than PHOs
  - IRS approved exemption for over two dozen MSSP ACOs
- Exemption/UBI risk for (c)(3) members of LLC
  - Joint venture control test (St. David's, Redlands, Rev. Rul. 98-15, Rev. Rul. 2004-51)
  - Sharing of savings, shortfalls, costs
    - Inurement, private benefit, excess benefit issues
  - Commercial-type insurance (IRC 501(m))
- Private use of bond-financed facilities by ACO

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## IRS Guidance on ACOs

- MSSP Notice 2011-20; Fact Sheet 2011-11
  - Five factor test and a lessening the burdens of government rationale that ignores similarity of the triple aims (better care for individuals, better health for populations, and lower per capita cost) with the hallmarks of community benefit (improved quality, increased access, and cost containment)
  - IRS defers to CMS oversight, flexible approach to sharing control with physicians, expansive view of benefits to the hospital from participation in an MSSP ACO; dozens of favorable determination letters recognizing MSSP ACOs as 501(c)(3) organizations

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## IRS Guidance on ACOs

- PLR 201615022 (denied 501(c)(3) status for a commercial ACO)
  - ACO was designed to improve quality of care by providing financial incentives for collaborating to provide better care at lower cost and gathering and analyzing clinical data to help providers meet performance goals
  - IRS Appeals denied exemption for ACO based on more than incidental private benefit to physicians
  - IRS viewed primary activity as negotiating payment for physician services
- PLR 202210023; Memorial Hermann Accountable Care Organization v. Commissioner, T.C. Memo 2023-62 (upheld denial of exemption for a hybrid MSSP and Commercial ACO); affirmed, 120 F.4th 215 (5th Cir. 2024)

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# Memorial Hermann ACO

- MHACO participated in MSSP as well as commercial programs (with similar but separately negotiated metrics to measure savings) and applied for 501(c)(4) status
- Competing indicia of primary purpose—the number of enrollees (80/20 split, commercial to Medicare) vs. sources of revenue (Medicare averaged 65%)
- IRS viewed MHACO as more of a contracting agent for participating physicians and did not credit the significance of population health management activities in promoting the health of the community
- Tax Court found MHACO's activities primarily benefitted payors and physicians
- Fifth Circuit affirmed and also invalidated the portion of the 501(c)(4) regulations interpreting exclusively to mean primarily engaged in promoting social welfare as inconsistent with the statute, citing Loper Bright to invalidate the government's own regulation

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# Planning Tips for ACOs

- Helpful facts for an ACO seeking a 501(c)(3) or 501(c)(4) determination letter from the IRS in the future might include:
  - Adherence to MSSP principles for determining cost savings and metrics
  - Publicizing the data
  - Reducing barriers to patient participation in the program
  - Comparison of performance statistics for population health with and without the assistance of the ACO (to show improvement in metrics)
  - Applying the learnings from the ACO across the hospital system's patient base (including charity care patients). In other words, show how the ACO is Making America Healthy Again.
  - Ability to disclose commercial contracts to IRS to show similarity to MSSP model

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# One Big Beautiful Bill Act of 2025 ... Other Tax Provisions

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## College and University Endowment Tax

- IRC §4968 provides for a 1.4% excise tax on the net investment income of colleges and universities with at least 500 tuition paying students, more than 50% of whom are located in the US
  - Does not apply to state colleges and universities
- Includes assets and net investments of related organizations
  - Organizations controlled by more than one educational institution are not counted
  - Unless the related organization is controlled by, or a 509(a)(3) supporting organization of, the educational institution, only assets and investment income intended or available for the use or benefit of the educational institution shall be taken into account

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# College and University Endowment Tax

- OBBBA §112021 amends IRC §4968 for tax years beginning after 12/31/25
- Provides for a graduated excise tax rate on net investment income of applicable educational institutions based on the size of the Student Adjusted Endowment
  - 1.4% for endowments between \$500,000 - \$750,000
  - 7% for endowments above \$750,000 up to \$1,250,000
  - 14% for endowments above \$1,250,000 up to \$2,000,000
  - 21% for endowments above \$2,000,000
- Does not apply to state colleges and universities or qualified religious institutions

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# College and University Endowment Tax

- Student Adjusted Endowment is the FMV of the assets of the institution, excluding assets used directly in carrying out the institution's exempt purpose, divided by the number of eligible students (daily average number of full-time equivalent students)
- Net investment income takes into account any interest income from student loans, and any Federally-subsidized royalty income as gross investment income (essentially income from federally funded R&D that is otherwise excluded from UBIT under 512(b)(2))
- Continues related organization provision and exclusions
- Anti-abuse rule requires regulations or sub-regulatory guidance to prevent tax avoidance through restructuring
- Additional reporting requirements

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