CLIENT ALERTS

How Will Tax Reform Affect Nonprofit Organizations?

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On Friday, December 15, 2017, Republican leaders in Washington released the final version of their proposal for tax reform. Within a few hours, two Republican senators, who had both opposed previous versions, announced that they were prepared to vote in favor of the final bill. Both houses have now passed the legislation and it is heading to President Trump's desk for his signature. But what will it mean for tax-exempt nonprofit organizations once it becomes law?

The final version mostly tracks the version that was adopted by the Senate on December 2. It includes several provisions that were aimed primarily at colleges and universities, tightens rules that have permitted exemptions on the Unrelated Business Income Tax ("UBIT"), and significantly increases the standard deduction (making itemized deductions for charitable contributions less attractive). Here is a brief summary of the key highlights:

Doubling of standard deduction and estate tax exemption. The new tax law nearly doubles the standard deduction and doubles the exemption for the estate tax. Although this does not single out tax-exempt organizations or explicitly affect them, it does have an impact on them. By nearly doubling the size of the standard deduction, the tax bill reduces the incentive that individual taxpayers have to itemize and claim a deduction for charitable contributions. Likewise, doubling the amount of estate tax exemption (from the current $5,000,000 to $10,000,000) reduces the incentive to convey part of the estate to charity in order to reduce the portion of the estate subject to tax.

New UBIT rules. Charities and other tax-exempt non-profits are required to pay taxes on income that they earn from businesses that are not related to advancing their charitable purposes. This is commonly referred to as the "unrelated business income tax" ("UBIT"). Under existing rules, nonprofits can use losses from one line of unrelated business to offset income from another

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unrelated line. Under the tax bill, the losses and gains from each line of business will need to be accounted for separately. This is likely to increase the importance of structuring business income, to the extent possible, so that it qualifies as passive investment income (such as most rents, royalties, and dividends) or as income from activities that advance the nonprofit organization's tax-exempt purposes. Both of these types of income are still typically exempt from federal taxation.

Elimination of tax deduction for purchasing seats at college sporting events. The current tax code permits individuals who purchase seats at sporting events of private colleges and universities to deduct 80% of the price of the tickets as a charitable deduction. The tax bill eliminates that deduction.

New excise tax on investment income of private colleges and universities. The tax bill imposes a new 1.4% tax on the net investment income that most private colleges and universities earn from assets that are not being used directly in carrying out the institution's tax-exempt purposes. The first $500,000 of such assets is exempt from the tax, and as to private colleges and universities only those with the equivalent of more than 500 full-time students located in the United States are subject to the tax. The purpose of the legislation is to impose similar tax treatment on the investment income of private colleges and universities (most of which are public charities) as currently exists for investment income earned by private foundations.

But the impact of this provision is uncertain because is leaving it to the IRS to issue regulations to clarify how it applies. Among other things, the IRS will need to issue regulations defining which assets are used in "directly carrying out" the tax-exempt purposes of the colleges and universities (and are thus exempt from the new tax) and defining how to calculate "net investment income." The IRS will probably also need to issue regulations defining which assets held by related organizations are also subject to the new tax and how to count full-time students in the United States. This will create significant planning and compliance challenges for private colleges and universities to plan for and comply with the new tax provision, which takes effect on December 31, 2017, while waiting for the IRS to issue regulations defining the scope and impact of the tax.

New excise tax on excessive executive compensation. The new tax law will impose an excise tax of 21% on any executive compensation over $1,000,000 that a charity pays to any of its five most highly-compensated employees. It will impose a similar excise tax on executive severance packages deemed to be excessive. But the tax bill leaves out a provision, which was in the original version reported out of the Senate Finance Committee, to turn the existing IRS safe-harbor for approving and justifying the reasonableness of executive compensation into a stricter provision setting more stringent compliance standards. Nonprofits will be able to continue to rely on the existing safe harbor as they have in the past.

Broadening of deduction for contributions to public charities. The new tax act increases the percentage of an individual's income that the person may claim as a deduction for a cash contribution to a public charity. Under existing law, the individual may claim no more than 50% of his or her income for a cash contribution to a public charity. The tax bill will increase that to 60%. The bill does not affect similar limits on the percentage of income that may be claimed for in-kind charitable contributions of real or personal property or for cash or property contributions to private foundations.

Proposals left out of the bill. The original House bill included many proposed revisions to the tax code that did not make it into the final bill. Among these were the following:

No change to the tax rate on private foundation investment income. The House proposal would have eliminated the current structure in which some private foundation investment income is taxed at 2%, while other income is taxed at 1%, and taxed all investment income subject to the tax at 1.4%.

No changes to tuition assistance programs. The original House version would have eliminated the tax exclusion for contributions that employers make to certain tuition assistance programs for their employees. The House bill would have treated those contributions as taxable income for the employees, thus reducing the incentive for employers and employees to enter into such arrangements.

No additional UBIT restrictions. The House bill would have taxed the income colleges and universities earn on fundamental research to the UBIT tax for any research that was not shared with the public. It would also have taxed all unrelated business income for all nonprofits even if the income was otherwise exempt from taxation under another provision in the tax code.

No additional reporting on Form 990 for donor advised funds. The original House bill would have required charities that administer donor advised funds to disclose additional information about how the charities managed and spent the funds.

No increase in mileage rate for using a personal vehicle for charitable purposes. Under current tax law, volunteers are allowed to deduct only 14 cents for each mile they use their personal vehicles to travel for activities benefiting a charity. The House bill would have allowed volunteers to use the IRS's standard mileage rate (currently 53.5 cents per mile, scheduled to increase to 54.5 cents per mile in 2018).

No new tax treatment for philanthropic business holdings. The House bill would have allowed a private foundation to hold all of the stock in a business corporation if (a) the private foundation did not purchase its ownership interest; (b) the corporation distributed all of its operating income to the private foundation; and (c) the corporation was independently operated.

No change concerning the political campaign activities of charities. The House bill would have allowed any charity to make statements during a political campaign – including endorsing or opposing candidates for public office – if (a) those statements were made in the ordinary course of the charity's ordinary course of regular and customary activities in carrying out its tax-exempt purpose and (b) the charity did not incur more than *de minimis* incremental expenses as a result. The proposal would not have otherwise changed the current law prohibiting charities from intervening in political campaigns, but it would have gone a long way to keeping a promise President Trump made during the presidential campaign to repeal that requirement. Since this has become a hot political topic, we anticipate that this proposal or something similar to it will resurface again in the future.

Effective date. The effective date of all of these changes is December 31, 2017, and will affect income earned or expenses incurred after that date. The UBIT transition rules, however, will continue to allow nonprofit organizations to use losses they incurred in prior years to offset future UBIT income provided that those losses may be properly carried forward under the existing tax rules. For the most part, these rules will not affect the 2018 tax returns for income earned or expenses in 2017, but will affect returns and tax liabilities for income earned and expenses incurred beginning on January 1, 2018.

We will continue to follow developments affecting nonprofit tax-exempt organizations and apprise you of them as they occur.

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