SEYFARTH SHAW

Client Alert

Nonprofit Guide to the "Tax Cuts and Jobs Act"

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The 2017 "Tax Cuts and Jobs Act" impacts tax-exempt organizations in a variety of ways, including by reducing incentives for charitable giving, applying an excise tax on executive compensation in excess of $1 million per year, creating tax "silos" for each line of unrelated business taxable income (UBTI) producing businesses, and characterizing expenses for certain fringe benefits as UBTI.

This Nonprofit Guide briefly summarizes the provisions applicable to nonprofits and tax-exempt organizations, and provides guidance as to what the provisions may mean for nonprofits and how they might respond to and plan for the changes in their budgeting, unrelated business income tax (UBIT) planning, compensation decisions, and other areas.

Generally referred to as the Tax Cuts and Jobs Act (the name was dropped due to a legislative procedural issue), H.R. 1 became law on December 22, 2017.

The following provisions and their implications for nonprofits are addressed:

1. Excise tax on executive compensation
2. UBIT silos - computation of UBIT separately for each line of business
3. Inclusion of certain fringe benefits in the calculation of UBTI
4. Excise tax on investment income of certain "wealthy" private colleges and universities
5. Corporate and trust tax provisions / impact on UBIT
6. Net operating loss deduction
7. Selected provisions related to charitable giving:
    a. Reduction of top individual income tax rate (Temporary)
    b. Increase in standard deduction (Temporary)
    c. Reduction in Estate, Gift, and Generation Skipping Transfer Taxes (Temporary)
    d. Charitable contribution deduction limitation increased (Temporary)
    e. Overall limitation ("Pease" limitation) on itemized deductions suspended (Temporary)
    f. Denial of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights
    g. Repeal of Substantiation Exception in Case of Contributions Reported by Donee

As for charitable giving generally, this Nonprofit Guide does not attempt to predict the impact of the Act on charitable giving. Some are clearly displeased in this regard. For example, the National Council of Nonprofits, which advocates on behalf of charitable nonprofits nationwide, released a statement predicting that the Act will, among other things:

> damage charitable giving by $13 billion or more annually; destroy more than 220,000 nonprofit jobs; and impair the ability of nonprofits to address community needs by taxing tax-exempt organizations to fund tax cuts for wealthy corporations and individuals.

Fundraising charities may also pivot their attention and activities from attracting broad-based support from the many who formerly had charitable giving tax incentives (e.g., prior to the large increase in the standard deduction), focusing instead on the far fewer, but far wealthier, individuals who will continue to benefit from charitable contribution deductions.

Finally, in case you heard of one or another provision throughout the course of the legislative process and are wondering what happened to it, we include a section listing certain provisions from the House and Senate bills that did not make it through. See below under *The Ones that Didn't Make It*.

Excise Tax on Executive Compensation

Prior Law

Historically, tax-exempt organizations have not been subject to excise taxes on reasonable compensation paid to their executives.

Changes

The Act generally imposes an excise tax equal to 21% of annual compensation paid in excess of $1 million to the top five highest compensated employees, and to certain "golden parachute" separation pay. The tax is payable by the tax-exempt organization, not the employee.

Specifically, the new excise tax applies to: (1) "remuneration" (other than any "excess parachute payment") in excess of $1 million paid to a "covered employee" by an applicable tax-exempt organization (including all organizations exempt from tax under section 501(a)[1]) for a tax year, plus (2) any "excess parachute payment" paid by an applicable tax-exempt organization to a covered employee.

The two provisions operate independently, so the excise tax may be imposed on an excess parachute payment even if the covered employee's remuneration does not exceed the $1 million threshold amount.

The new excise tax applies to amounts paid by tax-exempt organizations after December 31, 2017.

Definitions

A "covered employee" includes an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the organization for any preceding taxable year beginning after December 31, 2016.

"Remuneration" includes all amounts treated as wages for federal income tax withholding purposes, but does not include designated Roth contributions. Remuneration also includes amounts vesting and taxable under section 457(f) with such amounts being treated as paid when the rights to the remuneration are no longer subject to a substantial risk of forfeiture. However, remuneration does not include loans, including loans made to executives under split dollar life insurance arrangements.

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[1] All section references are to the Internal Revenue Code.

Compensation paid by related persons is also added to the calculation of total remuneration. If a covered employee's remuneration from more than one employer is taken into account for these purposes, then the excise tax is pro-rated among the various employers in proportion to the remuneration paid by each.

An "excess parachute payment" is an amount paid to a covered employee upon such employee's separation from employment in an amount with a present value that equals or exceeds three times the employee's base amount. Excluded from the definition of an excess parachute payment are: (i) payments under qualified plans; (ii) any payment under or to an annuity contract described in section 403(b) or a plan described in section 457(b); and (iii) any payments made to an individual who is not a highly compensated employee (within the meaning of section 414(q)).

The Surgeon Exception?

Compensation attributable to medical services provided by doctors, nurses, and veterinarians is excluded. Specifically, for purposes of determining who is a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical services by such professional is not taken into account, whereas remuneration paid to such professional in any other capacity is taken into account.

So, if a nonprofit hospital system pays five surgeons each in excess of $1 million annually, while all other employees make less than $1 million annually (and no excess parachute payments are made), then the hospital, having no covered employees, can expect to be immune from the excise tax.

Implications

- From a tax policy perspective, the excise tax appears intended to create a sort of parity between tax-exempt organizations and taxable entities or, at least, publicly held corporations. Under section 162(m), publicly held corporations cannot deduct compensation in excess of $1 million per year with respect to certain employees. Effectively, this generates tax on those excess amounts at the corporate tax rate, now 21% per the Act, the same rate as the excise tax.

  Notably, the Act eliminates performance-based compensation and commissions exceptions from section 162(m), and the excise tax on tax-exempt organizations likewise has no such exclusion from the calculation of remuneration.

- Tax-exempts can expect to continue to have to pay market rates for recruiting and retention purposes, and still compete with for-profits for talent.

- Particularly in the case of compensation owed under employment agreements already in effect, the obligation to make these excise tax payments when paying reasonable compensation (or a reasonable amount on separation pursuant to a "golden parachute" arrangement) would not appear to amount to an automatic excess benefit transaction, private inurement or a violation of the limitation on private benefit.

- The Act may put added pressure on compensation determinations in any case where the excise tax will or could become payable (compensation in excess of $1 million or golden parachute severance arrangements). In those cases, it may be even more important to meet the requirements to establish the "rebuttable presumption of reasonableness" and procure a reasonableness opinion in each such case (with updates as appropriate).

- Affected tax-exempt organizations should maintain a roster of their "covered employees" and "related" entities, and track the total amount of "remuneration" being paid.

- If compensation could appropriately be paid by an affiliate which is not "related" for this purpose, tax-exempt organizations may seek to bifurcate a covered employee's compensation to reduce or avoid the excise tax.

UBIT Silos - Computation of UBIT Separately for Each Line of Business

Prior Law

Tax-exempt organizations that operated multiple unrelated trades or businesses historically were permitted to aggregate income and expenses and other deductions from all unrelated trade or business activities. This allowed tax-exempt organizations to use net operating losses (NOLs) from one unrelated trade or business to offset UBTI from another, reducing UBIT overall.

Changes

The Act requires tax-exempt organizations operating one or more unrelated trades or businesses to compute UBTI separately for each unrelated trade or business activity. So, NOLs from one line of business will not be available to offset taxable income from another. However, NOL carryovers from years prior to January 1, 2018 can still be used to reduce all UBTI.

This provision applies to taxable years beginning after December 31, 2017.

Implications

- The inability to now offset losses from one unrelated trade or business against gains from another (including, for example, gains and losses from alternative investments or pass-through entities) may result in an increase the amount of UBIT owed.
- Nonprofits may wish to consider auditing their UBTI producing activities, including their UBTI producing private equity and other investments, in order to capture and report all expenses reasonably allocable and directly connected to that activity. This may include allocable amounts of employee compensation, investment advisory fees, and other administrative overhead.
- It is unclear what separates lines of unrelated businesses under the fragmentation rule. For example, will all investment income reside in a single UBIT silo? Does each K-1 received from an investment in a partnership constitute a single line of business? Can the losses from one hotel be used to offset UBTI from another, more successful hotel investment? These questions will require careful consideration and planning pending further guidance.
- Tax-exempt organizations engaged in multiple lines of unrelated business may wish to consider housing those operations in a single taxable corporate subsidiary, so that expenses and income can again be "cross-pollinated."
- From the perspective of the IRS, this change appears to simply make a statute of their already existing position on the matter. That is, on audit, the IRS has been known to take the position that NOLs from a "losing" line of business cannot be utilized to offset other income anyway, because either (i) the "losing" business had no profit motive (making the expenses non-deductible - a "hobby" loss rule of sorts), or (ii) the "losing" business was substantially related to the tax-exempt organization's exempt purposes (and not an unrelated trade or business).

Inclusion of Certain Fringe Benefits in the Calculation of UBTI

Prior Law

Prior to the Act, tax-exempt organizations could provide employees with certain fringe benefits free from tax at the employer level.

Changes

The Act treats amounts used by tax-exempt organizations to pay for certain fringe benefits offered to employees as UBTI (provided that the amounts are not deductible under section 274).

The triggering fringe benefits include qualified transportation fringe benefits, any parking facility used in connection with qualified parking, and on-premises athletic facilities. This provision does not apply to payment of amounts that are directly connected with a regularly carried-on unrelated trade or business.

This provision applies to amounts paid or incurred after December 31, 2017.

Implications

- From a tax policy perspective, this provision attempts to create parity with another newly-enacted provision applicable to taxable organizations that eliminates a tax exemption for certain employer-provided fringe benefits. Given this change, tax-exempt organizations providing these types of fringe benefits to their employees will be required to pay a corporate tax rate on the value of such benefits.
- Tax-exempt organizations may wish to consider replacing these benefits with higher compensation or other benefits of equivalent value to their employees, but which do not trigger UBIT.

Excise Tax on Investment Income of Private Colleges and Universities

Prior Law

Historically, private colleges and universities have not been subject to excise taxes on their net investment income.

Changes

The Act imposes a new 1.4% excise tax on the net investment income (i.e., endowment earnings) of certain private colleges and universities and their related organizations. State colleges and universities are not subject to the new tax.

Net investment income is defined to correspond to the definition under the private foundation rules, which generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, reduced by expenses incurred to earn this income.

The tax applies only to private colleges and universities with at least 500 students, more than 50% of the students of which are located in the United States, and with assets valued at the close of the preceding taxable year of at least $500,000 per full-time student.

Assets used directly by the institution in carrying out its educational purpose (e.g., classroom buildings and physical facilities used for educational activities) are not included in this calculation. The assets and net investment income of related organizations, such as controlling and controlled organizations and supported and supporting organizations, generally are treated as the assets of the private college or university.

Per the conference report that accompanied the Act, it is expected that future regulations will provide guidance regarding: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the private college or university.

The provision applies to taxable years beginning after December 31, 2017.

Implications

- Initially, the excise tax is expected to apply to approximately 30 private colleges and universities.
- Because the assets-per-student threshold of $500,000 is not indexed for inflation, schools near the threshold may wish to plan ahead and adjust their projections accordingly.
- Private colleges and universities may wish to consider reviewing the related organizations listed on their latest Form 990 filing. This can then be used to determine what assets may need to be combined with the college or university's for purposes of calculating total assets-per-student and overall net investment income.

Corporate and Trust Tax Provisions / Impact on UBIT

Prior Law

Prior to the Act, the corporate tax rate (and the UBIT rate) was determined under a graduated rate structure. The top corporate tax rate was 35% on taxable income in excess of $10 million. In addition, the highest rate applicable to tax-exempt trusts was 39.6%.

An alternative minimum tax (AMT) was also imposed to the extent that the AMT exceeded regular tax. The tentative minimum tax was computed at a rate of 20% on the alternative minimum taxable income (AMTI) in excess of a $40,000 exemption amount that phased out. AMTI consisted of regular taxable income that was increased for certain preference items and adjusted by determining the tax treatment of certain items in a manner that negated the deferral of income resulting from the regular tax treatment of those items.

Changes

The Act eliminates the graduated rate structure and instead taxes corporate income at a flat 21% rate. The Act also repeals the corporate AMT and allows prior year AMT credits to offset regular tax liability for any taxable year. Taxpayers with AMT credit carryforwards are allowed to claim a refund of 50% of the remaining credits for any taxable year between 2018 and 2021, and then can claim the full amount of any remaining credits in taxable years beginning in 2021.

These provisions are effective for taxable years after December 31, 2017.

Implications

- The UBIT rate applicable to tax-exempt trusts is 37%, creating an impetus to reevaluate use of the charitable trust form for tax-exempt organizations with UBTI.
- The lower corporate tax rate may serve to increase post-UBIT profits from a tax-exempt organization's unrelated businesses, including taxable investment income.
- Repeal of the corporate AMT can be expected to reduce the tax compliance costs and administrative burdens associated with operating unrelated trade or business activities.

Net Operating Loss Deduction

Prior Law

Prior to the Act, NOLs could be carried forward 20 years to offset taxable income in such years. NOLs could be carried back 2 years to offset income recognized in the past, sometimes generating a refund of previously paid taxes. NOLs could be used to offset a full 100% of a corporation's taxable income.

Changes

Under the Act, carrybacks of NOLs incurred in 2018 and beyond are no longer permitted. In addition, a carryforward of any 2018 or later incurred NOL may only be used against 80% of a corporation's taxable income. The 20 year limit is eliminated, so that NOLs can be carried forward indefinitely, along with an interest factor to preserve their value.

This provision applies to losses arising in taxable years beginning after December 31, 2017.

Implications

- No longer can NOLs be used to entirely eliminate the income that is earned from unrelated business activities. As a result, tax-exempt organizations with significant NOL carryforwards may now become subject to tax on at least 20% their UBTI.

- The endless life of NOLs makes it all the more important for a nonprofit to identify and report all appropriate UBIT deductions and expenses on their Form 990-Ts, particularly while the activities are in “startup” mode.

Selected Provisions Impacting Charitable Giving

Reduction of Top Individual Income Tax Rate (Temporary)

The Act reduces the top marginal tax rate from 39.6% to 37% for taxable years beginning after December 31, 2017 and before January 1, 2026. Generally, a reduction in the top marginal tax rate decreases the value of charitable contributions for the highest-income taxpayers, reducing the tax incentive to contribute.

Increase in Standard Deduction (Temporary)

While the deduction for charitable contributions remains in place, taxpayers have to itemize deductions to claim a charitable contribution deduction on their federal income tax return. An estimated 94% of taxpayers are now expected to claim the increased standard deduction, up from approximately 70% under pre-Act law. So, 94% of taxpayers are expected to have no tax benefit from their charitable giving.

Prior to the Act, an individual who does not itemize deductions could reduce adjusted gross income (AGI) by the standard deduction. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer’s filing status. For 2017, the amount of the basic standard deduction was $6,350 for single individuals and married individuals filing separate returns, $9,350 for heads of households, and $12,700 for married individuals filing a joint return and surviving spouses.

Under the Act, the amount of the basic standard deduction increases to $12,000 for single individuals and married individuals filing separate returns, $18,000 for heads of households, and $24,000 for married individuals filing a joint return and surviving spouses for taxable years beginning after December 31, 2017 and before January 1, 2026. The standard deduction amounts will be adjusted for inflation in taxable years beginning after December 31, 2018.

Reduction in Estate, Gift, and Generation Skipping Transfer Taxes (Temporary)

The Act doubles the estate and gift tax exemption for estates of decedents and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) from $5 million to $10 million. The $10 million exclusion is indexed for inflation (after 2011) and is expected to be approximately $11.2 million in 2018.

Increasing the exclusion is expected to reduce the tax incentive for wealthy individuals to make deductible charitable bequests.

Charitable Contribution Deduction Limitation Increased (Temporary)

Under pre-Act law, the deduction for charitable contributions of cash by an individual taxpayer to certain tax-exempt organizations (those described in section 170(b)(1)(A) - including public charities and private operating foundations) was limited to 50% of the taxpayer’s adjusted gross income.

Solely for cash contributions made in taxable years beginning after December 31, 2017, the Act temporarily (through taxable years beginning before January 1, 2026) increases the percentage limit, including in carryforward years, from 50% to 60% of AGI. Excess amounts can continue to be carried forward for up to 5 years.

Overall Limitation (“Pease” Limitation) on Itemized Deductions Suspended (Temporary)

Under pre-Act law, higher-income taxpayers who itemize their deductions were subject to a limitation on these deductions, including charitable contribution deductions (commonly known as the “Pease limitation”).

For taxpayers who exceeded the applicable threshold, the otherwise allowable amount of itemized deductions was reduced by 3% of the amount of the taxpayer’s adjusted gross income exceeding the threshold.

For 2017, the threshold amounts (which are indexed for inflation) were $261,500 for single taxpayers, $287,650 for heads of household, $313,800 for married couples filing jointly, and $156,900 for married taxpayers filing separately. The otherwise allowable itemized deductions could not be reduced by more than 80% by reason of the overall limit on itemized deductions.

Under the Act, the "Pease limitation" on itemized deductions is suspended for taxable years beginning after December 31, 2017 and before January 1, 2026.

So, the ultimate value of charitable contribution deductions will increase for taxpayers who would otherwise have been subject to the Pease limitation.

Denial of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights

A taxpayer can usually deduct a contribution of money or property made to a qualified organization. No charitable contribution is generally allowed to the extent that the taxpayer receives or expects to receive a benefit in return. Notwithstanding this prohibition, pre-Act law permitted taxpayers to claim a charitable contribution equal to 80% of the amount paid to an educational institution for the right to purchase tickets for seating at an athletic event in the stadium at such institution.

The Act eliminates this exception and makes these type of quid pro quo contributions non-deductible, regardless of the amount involved. As such, taxpayers will no longer be able to claim charitable contribution deductions for any amounts paid for college athletic seating rights.

This provision applies to contributions made in taxable years beginning after December 31, 2017.

Repeal of Substantiation Exception in Case of Contributions Reported by Donee

Generally, no charitable contribution deduction for any single contribution of $250 or more is allowed unless a taxpayer substantiates the contribution with a contemporaneous written acknowledgment of the contribution by the donee organization. Pre-Act law authorized the IRS to develop optional donee reporting procedures for substantiating charitable contributions of $250 or more that could be used in lieu of a contemporaneous written acknowledgment.

In September 2015, the IRS issued proposed regulations which adopted donee reporting as an alternative means for satisfying the substantiation requirements for charitable contributions. In response to those proposed regulations the IRS received a substantial number of public comments questioning the need for the donee reporting option and expressing significant concerns about organizations collecting and storing donee taxpayer identification numbers. As a result of those comments, the IRS decided to withdraw the regulations.

The Act repeals the IRS's authority to develop optional reporting procedures for substantiating charitable contributions. As such, taxpayers making any single charitable contributions in the amount of $250 or more will need to substantiate the contribution with a contemporaneous written acknowledgement in order to be claim a charitable contribution deduction for such contribution on their tax return.

The Ones That Didn't Make It

Along the way, the following selected provisions were included in the House bill, the Senate bill, or both, but did NOT end up included in the Act:

- Clarification that an organization is not exempt from UBIT solely because the tax-exempt organization also is exempt, or excludes amounts from gross income, by reason of another provision of the Code (in addition to section 501) - in effect clarifying that state and local government section 401(a) plans are subject to UBIT regardless of the application of section 115.
- Limiting to publicly available research the exclusion of research income from UBTI.

- Application of UBIT to revenue from the sale or licensing of name and logo.
- Elimination of tax exemption for professional sports leagues.
- Simplification of excise tax on private foundation investment income by replacing the two-tiered tax (2% or 1%) with a single rate of 1.4%
- Private operating foundation requirements relating to operation of an art museum which would require them to be open to the public during normal business hours for at least 1,000 hours per year.
- Exception to the private foundation excess business holding rules for philanthropic business holdings (the "Newman's Own" rule).
- Exception under the Johnson Amendment which would permit section 501(c)(3) organizations to make statements relating to political campaigns.
- Addition of reporting requirements for the sponsoring organizations of donor advised funds.
- Modifications to intermediate sanctions excise tax on excess benefit transactions, including:
    - the imposition of a 10% excise tax on a tax-exempt organization if an initial tax is imposed on a disqualified person for purposes of the intermediate sanctions rules,
    - the elimination of the rebuttable presumption of reasonableness,
    - the elimination of the special rule providing that an organization manager's participation in an excess benefit transaction is not knowing if the manager relied on professional advice and the rule that a manager does not act knowingly where the organization satisfies the rebuttable presumption,
    - the addition of investment advisors and athletic coaches to the definition of "disqualified persons" for the purposes of the excess benefit transactions rules, and
    - the extension of the intermediate sanctions excess benefit transactions rules to section 501(c)(5) and section 501(c)(6) organizations.
- Adjustment of the charitable mileage rate.

Conclusion

Tax-exempt organizations and nonprofits should consider carefully the impacts of the Act on their operations, including fundraising, budget projections, executive compensation and fringe benefits decisions, and structuring (or spinning off) unrelated/taxable business operations.

If you have any question about this Nonprofit Guide to the Tax Cuts and Jobs Act or would like further information, please contact Ofer Lion at olion@seyfarth.com, or Douglas Mancino at dmancino@seyfarth.com.