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LEGAL UPDATE

PRACTICAL INSIGHTS ON TAX REFORM: IMPACT ON EXEMPT ORGANIZATIONS

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On December 22, 2017, President Trump signed into law legislation, known as the Tax Cuts and Jobs Act ("TCJA"), which is the most extensive overhaul of the United States Internal Revenue Code (the "Code") in 30 years. In December, we issued a general advisory outlining the major changes to the tax code made by TCJA. This advisory focuses on the provisions of TCJA that affect tax exempt organizations and donors to charitable organizations. Unless otherwise noted, the changes described below are effective for taxable years beginning on or after December 31, 2017.

CHANGES TO CALCULATION OF UNRELATED BUSINESS INCOME TAX

Rate reduction. Tax exempt organizations are, generally speaking, exempt from income tax on income that is generated in the course of performing the organization's exempt mission and on certain passive income sources such as royalties, rental income from real property, interest, dividends, and capital gain. A major hallmark of this tax reform legislation is the reduction in the corporate income tax rate from a maximum 35% rate to a flat 21% rate, and the elimination of the corporate alternative minimum tax ("AMT"). This reduced rate and elimination of AMT also applies to the Unrelated Business Taxable Income ("UBTI") of nonprofit corporations. For exempt organizations operating as trusts, the new graduated rates applicable to individuals apply, bringing the top 39.6% rate down to 37%.

Calculation of UBIT on Activity-by-Activity Basis. Prior to the enactment of TCJA, exempt organizations calculated UBTI on an aggregate basis. Accordingly, if an exempt organization was engaged in multiple and varying unrelated trades or businesses, the unrelated expenses of one activity offset the unrelated income of another activity. Now, for taxable years beginning after December 31, 2017, income and losses only may be netted against each other if such tax items are generated from the same line of business. UBIT must be calculated separately for each separate trade or business conducted by an exempt organization.

The biggest challenge with this provision is where to draw the line in determining what constitutes a separate trade or line of business. For example, if an organization has invested in multiple partnerships for investment purposes, it is unclear whether or not each investment is a separate trade or business or whether investment activity generally is one line of business. The Department of Treasury issued, on February 7, 2018, an update of its Priority Guidance Plan for the year spanning July 1, 2017 through June 30, 2018 (the "Priority Guidance Plan"). This most recent version of the Priority Guidance Plan contains a list of items of guidance relating to TCJA that the IRS and Treasury plan to issue by June 30, 2018. That Priority Guidance Plan indicates that the IRS and Treasury plan to issue guidance with respect to section 512(a)(6) by June 30, 2018.

With regard to the effective date, note that loss carryovers from taxable years prior to January 1, 2018 may still be used to offset UBTI on an aggregate basis. Also note that, for organizations that use a tax year other than the calendar year, this provision is effective for taxable years that begin on the first date of the fiscal year that begins after December 31, 2017. So, these provisions do not apply to an organization with a June 30 or September 30 fiscal year end until July 1, 2018 and October 1, respectively.

CREATION OF UBIT DUE TO CHANGES IN TREATMENT OF CERTAIN FRINGE BENEFITS

New section 274(l) of the Code precludes employers from taking a deduction for "any expense incurred for providing transportation, or any payment or reimbursement, to an employee [] in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee." If an exempt organization provides company vehicles to employees in connection with an unrelated trade or business, the organization is not allowed to deduct its related expenses against the income generated by the activity. If, however, the expense of providing company vehicles to employees is party of a related activity, the organization will have UBIT to the extent of such expense.

New section 512(a)(7) of the Code increases UBTI by any amount paid or incurred by an organization for which a deduction is disallowed by the newly revised section 274. While new section 512(a)(7) suggests that revised section 274 disallows deductions for qualified transportation fringe benefits, any parking facility used in connection with qualified parking fringe benefits, and any on-premises athletic facility, on its face, section 274 currently only disallows deductions for qualified transportation fringes. As a result, it appears that organizations will not be required to increase UBTI for amounts paid or incurred with respect to parking facilities or on-premises athletic facilities absent further guidance. The disallowed deduction is not UBTI, however, if it is incurred directly in connection with an unrelated trade or business regularly carried on by the organization – i.e., if the activity already is subject to UBTI. These provisions are effective for payments made after December 31, 2017, regardless of the exempt organization's tax year. The statute authorizes the issuance of regulations or other guidance to help with the implementation of this rule, but this provision is not listed on the Priority Guidance Plan.

IMPOSITION OF NEW EXCISE TAX ON EXCESSIVE COMPENSATION

TCJA adds new section 4960, which imposes an excise tax of 21% on (i) remuneration in excess of $1 million paid by "an applicable tax exempt organization" to a "covered employee", and (ii) certain "excess parachute payments" paid to "covered employees" upon a separation of service. In each case, the tax is payable by the organization, not the 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. As background, the Code historically has limited the deductibility of compensation paid to certain executives of a (x) publicly-held for-profit corporation in excess of $1 million, or (y) for-profit corporation in connection with a change in control. New section 4960 is intended to create parity between the for-profit and exempt sectors.

Under new section 4960, "covered employee" means one of the exempt organization's five highest compensated employees for the taxable year, or any individual that was previously one of the exempt organization's covered employees for any taxable year beginning after December 31, 2016. In essence, once an individual is a covered employee, he or she will always be a covered employee thereafter. As a result, the group of covered employees will likely exceed five individuals as an exempt organization's top-five paid employees shifts from year to year, including when departures occur. Remuneration for purposes of section 4960 would include all amounts included in the employee's taxable income (other than designated Roth contributions), including amounts paid or payable by a related person, but would not include any payments to licensed medical professionals (e.g., doctors, nurses, or veterinarians) for the performance of medical or veterinary services.

As noted above, the excise tax applies not only to remuneration in excess of $1 million but also to certain excess parachute payments. For this purpose, an excess parachute payment is an amount paid to a covered employee upon such employee's separation from service that equals or exceeds three times that employee's average annual compensation from the organization that is includible in taxable income for the five years preceding the year of the employee's separation from service.

As a result of these changes, exempt organizations should immediately do the following:

- Identify the organization's top-five compensated employees, based on the 2017 tax year;
- Implement a mechanism to identify the top-five compensated employees for each subsequent tax year, including those that were previously considered to be "covered employees";
- Immediately review the existing compensation arrangements of the covered employees identified above and determine whether such arrangements implicate section 4960;
- Work with counsel to amend compensation structures of covered employees, if permitted, to avoid the imposition of any penalties under section 4960; and
- Coordinate with the exempt organization's governing body to ensure that everyone is aware of the impact of this new rule on the organization's compensatory programs and the resulting impact balance sheets, including as a result of any excise taxes.

The new excise tax applies to amounts paid by tax-exempt organizations after December 31, 2017; however, as noted above, for purposes of determining who is a "covered employee" organizations will look to years occurring after December 31, 2016. The Priority Guidance Plan indicates that the IRS and Treasury plan to issue guidance with respect to new section 4960 by June 30, 2018.

CHANGES TO TREATMENT OF TAX-EXEMPT BONDS

The changes to the treatment of tax-exempt bonds are significantly more limited in scope than the provisions contained in earlier versions of TCJA. Earlier drafts contained provisions eliminating the tax exemption for interest on tax-exempt bonds. That provision was removed from the legislation prior to its passage.

The provision that remained repeals the tax-exemption for interest on so-called "advanced-refund" tax-exempt bonds. A refunding bond is any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). A bond is classified as an advance refunding, as opposed to a current refunding, if it is issued more than 90 days before the redemption of the refunded bond.

Under prior law, qualified bonds (i.e., governmental bonds and 501(c)(3) bonds) may participate in an advance refunding only once during the course of the bond. After the passage of TCJA, advance refundings no longer enjoy tax-exempt status.

The provision applies to advance refunding bonds issued after December 31, 2017.

IMPOSITION OF ENDOWMENT TAX ON CERTAIN COLLEGES AND UNIVERSITIES

Private foundations have for decades been subject to a tax on the net investment income earned on assets not used in the directly act of carrying on charitable activities. TCJA applies a version of this provision applicable to private foundations to certain private (but not public) colleges and universities. Specifically, a new 1.4% excise tax is imposed on the net investment income of these organizations. Net investment income generally is defined as interest, dividends, rents, royalties (and income from similar sources), and capital gain net income less expenses related to producing such income.

While this provision went through multiple versions, the tax applies only to private colleges and universities with at least 500 enrolled students, in which more than 50% of the students are located in the United States, and where assets not directly involved in carrying out the college or university's exempt purpose amount to at least $500,000 per full-time student as of the end of the prior taxable year. The $500,000 threshold is not indexed to inflation, so more private colleges and universities will be subject to this tax over time.

As with other provisions, there are several aspects of this new tax that will need clarification. Unfortunately, this provision is not included in the list of items for which guidance may be forthcoming by June 30, 2018. Once issued, however, guidance is expected to be provided with respect to clarifying which assets are exempt from this tax and how net investment income is calculated.

The provision applies to taxable years beginning after December 31, 2017. Again, note that for exempt organizations that follow a tax year other than a calendar year (e.g., a tax year that ends on June 30, 2018), these rules are effective as of July 1, 2018.

EFFECTS ON CHARITABLE GIVING

Some provisions of TCJA directly affect charitable giving provisions. Other provisions affecting the calculation of an individual's income and estate tax burden could affect the charitable giving patterns of taxpayers.

Increase in limit on cash contributions to public charities and private operating foundations. TCJA increases the percentage limit to 60% of adjusted gross income for contributions of cash made to public charities and private operating foundations. The previous limit was 50%.

Like many of the provisions affecting individuals, this provision is effective beginning with contributions made for taxable years beginning after December 31, 2017 through taxable years beginning before January 1, 2026. Any carryforwards available at that time, however, may be carried forward for up to five years.

Limitation on charitable contribution in connection with the purchase of athletic event tickets. Taxpayers no longer are allowed to claim a charitable contribution deduction for payments in exchange for the right to purchase tickets to athletic events. Prior to TCJA, a donor was allowed to take a charitable contribution deduction for 80% of the value of such contributions. Absent any exceptions or other special provisions, if a donor receives any substantial benefit in return for a charitable contribution, the donor's charitable contribution is reduced by the value of what is received in return. TCJA takes this provision one step further and eliminates the deduction in its entirety in this instance, even if the amount contributed exceeds the value of the right to purchase the tickets to the athletic event.

This provision is effective for contributions made in taxable years beginning after December 31, 2017.

Other provisions potentially affecting charitable giving. The reduction in the top marginal income tax rate for individuals, the increase in the standard deduction for individuals, and the increases in the exemption for estate and gift tax purposes all suggest that an individual donor may have a disincentive to make charitable contributions in the future. Offsetting these disincentives is the elimination of the phase out of itemized deductions, including charitable contributions, which will serve to increase the actual value of a charitable contribution made. While all of these provisions are temporary (generally in effect through 2025), the actual effect of these provisions on charitable giving is yet to be determined.

THIS ADVISORY WAS PREPARED BY MELISSA SAMPSON MCMORROW AND CRESCENT MORAN CHASTEEN OF NUTTER'S TAX DEPARTMENT. PLEASE STAY TUNED FOR THE NEXT ADVISORY IN OUR *PRACTICAL INSIGHTS ON TAX REFORM* SERIES. LEARN MORE ABOUT THIS LEGISLATION BY CONTACTING A MEMBER OF OUR TAX DEPARTMENT AT 617.439.2000.