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How Did Nonprofits Fare In Tax Reform?

By **Alexander Reid and Kimberly Eney** (January 22, 2018, 4:31 PM EST)

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On Dec. 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, P.L. 115-97. TCJA enacts fundamental changes to U.S. tax law, affecting all sectors of the economy including nonprofits. Here are key highlights of the new tax law.

Charitable Giving and Charitable Financing

TCJA expands the standard deduction, increases the deductibility of cash contributions to charities and tightens some of the rules on the charitable contribution deduction.

The new tax law retains the charitable contribution deduction for those taxpayers able to claim itemized deductions. It also increases the deduction limitation for contributions of cash (but not securities) to public charities (and certain private foundations) to 60 percent of the donor's adjusted gross income (excluding net operating losses) for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

However, TCJA reduces individual tax rates, eliminates many other itemized deductions and nearly doubles the standard deduction by increasing it to $24,000 for married individuals filing a joint return, $18,000 for head of household filers, and $12,000 for individual filers. Further, these amounts will be adjusted for inflation based on the slow growing chained consumer price index (CPI) rather than the more swiftly growing unchained CPI. (The increase in the standard deduction sunsets and does not apply to taxable years beginning after Dec. 31, 2025.)

The implication of these changes for nonprofits is that only the top 5 percent of tax filers are likely to have sufficient itemized deductions to claim a charitable deduction from 2018 through 2025. Ninety-five percent of taxpayers will be unable to claim a charitable contribution deduction. Lower tax rates also reduce the tax incentive to make charitable contributions in 2018 and subsequent years. These changes create an incentive to bunch contributions into a single tax year, perhaps using a donor-advised fund, to exceed the standard deduction, and, for those at risk of exceeding the AGI percentage limitations, to give cash rather than stock. Overall, charitable giving is likely to be reduced starting in 2018, both in terms of the amount given to charity and the types of donors who are able to contribute. Over time, the TCJA may affect the priorities of charities, some of which may pivot to match the preferences of their donors.

TCJA closes a loophole that some taxpayers had attempted to exploit by amending the donee organization's Form 990 to claim that a charitable contribution had been substantiated in a prior year.

The new tax law repeals the "Pease" limitation (named for the late Ohio Congressman Don Pease) for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026. The Pease limitation set an overall limit or "haircut" on itemized deductions, including charitable contribution deductions. The temporary elimination of the Pease limitation increases the charitable deduction for those high-income taxpayers who had previously been subject to it.

TCJA doubles the amount eligible for exclusion from estate, gift, and generation-skipping taxes to $10 million, indexed for inflation occurring after 2011. The change applies to taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026. This change will reduce the incentive to make charitable bequests for those estates no longer subject to the estate tax.

The new law retains the ability of nonprofits to issue tax-exempt private activity bonds through a state government conduit. However, it repeals the ability to issue advance refunding bonds. Advance refunding is a means by which an issuer may refinance tax-exempt bonds issued more than 90 days previous by issuing more tax-exempt bonds at a lower interest rate and using the proceeds to repay the outstanding bonds. As a result of TCJA, tax-exempt bond issuers must use taxable bonds (with correspondingly higher interest rates) for advance refunding purposes.

Executive Compensation

TCJA creates a new excise tax (Internal Revenue Code Section 4960) equal to the corporate tax rate of 21 percent on an employer with respect to compensation paid by most nonprofits (and related organizations) to certain individuals in excess of $1 million, as well as to certain excess parachute payments, in tax years beginning after Dec. 31, 2017.

The tax applies to all remuneration in excess of $1 million, including cash and the cash value of all noncash items (including benefits). The definition of remuneration excludes any designated Roth contribution as well as the portion of any remuneration paid to a licensed medical professional (including veterinarians) for the performance of medical or veterinary services.

The tax also applies to excess parachute payments (under a new definition related solely to separation pay).

A covered employee is defined as an employee (including a former employee) who is one of the five highest paid employees of the organization for the taxable year or who was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after Dec. 31, 2016.

Applicable tax-exempt organizations include organizations exempt from tax under Section 501(a), political organizations described in Section 527(e)(1), and quasi-governmental entities with exempt governmental functions that have income excluded under Section 115(1) of the IRC. It is unclear whether this includes state universities that are not exempt under Section 501(a).

Special rules apply to compensation paid by controlled entities. Treasury will undoubtedly need to interpret these rules, possibly by reference to Section 414(c) of the IRC and Section 1.414(c)-5 of the

Treasury Regulations which provides that "control" means a person or entity with power to appoint 80 percent of the governing body.

Colleges and Universities

TCJA imposes a new 1.4 percent excise tax on the net investment income of private colleges and universities. Net investment income is defined to correspond to the definition of such under the private foundation rules. It 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 only applies to colleges and universities that have at least 500 students, more than 50 percent of whom are located in the United States and assets (other than those used directly in carrying out the institution's educational purposes) of at least $500,000 per student, as valued at the close of the preceding tax year. State colleges and universities are not subject to the provision. Private colleges and universities must include the net investment income and assets of related organizations — such as controlling and controlled organizations and supported and supporting organizations — in order to assess the applicability of the tax. This is another likely candidate for Treasury Regulations as the level of control and the amount of a controlled organization's assets that are subject to the tax may vary depending on the applicable facts and circumstances.

The new law creates a potential trap for the unwary by eliminating charitable deductions to educational institutions if any portion of the payment entitles the donor to the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution, regardless of the value of the seating rights. This modifies the special rule in IRC Section 170(l) that enabled a donor to take a charitable deduction of 80 percent despite access to seating rights to athletic events and is a departure from the general rule that reduces the value of a charitable contribution deduction by any quid pro quo received in exchange, but does not eliminate the deduction altogether.

Unrelated Business Income Tax and Other Issues

TCJA requires that an exempt organization with more than one unrelated trade or business compute unrelated business taxable income (UBTI) separately with respect to each trade or business and without regard to the specific deduction allowed under IRC Section 512(b)(12). Informally, this is known as the UBTI "siloing" rule. The organization's UBTI for a taxable year is the sum of the amounts for each unrelated trade or business, less the specific deduction allowed under IRC Section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. As a result, unrelated trade or business gains/losses will be siloed to their respective businesses. This may create an incentive to use blocker corporations to achieve consolidated tax treatment. A special transition rule provides that NOLs arising in a taxable year beginning before Jan. 1, 2018 that are carried forward to a taxable year beginning on or after such date are not subject to the provision, so it should not be necessary to trace existing NOLs to the respective trade or business from which they arose.

Another new provision subjects tax-exempt organizations to UBIT on the amount of certain fringe benefits for which a deduction would be disallowed under Section 274 of the IRC if the organization were a taxable employer. These include qualified transportation fringe benefits and any parking facility used in connection with qualified parking. The provision, found in Section 512(a)(7) of the IRC, also lists on-premises athletic facilities as giving rise to UBIT; however, a last-minute change to Section 274 deleted the provision that would have denied the deduction for on-premises athletic facilities to taxable employers. As a result, it is unlikely that the use of on-premises athletic facilities will give rise to UBIT, unless Treasury Regulations provide otherwise. The provision doesn't apply to the extent that the amount is directly connected with a regularly carried-on unrelated trade or business. The provision is intended to bring parity between taxable and tax-exempt employers; however, it is odd as a matter of tax policy because the payment of fringe benefits is not an unrelated trade or business and ordinarily should not give rise to income taxation.

The new tax law also repeals the deduction for local lobbying expenses for taxable entities. TCJA amends IRC Section 162(e) to repeal the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments. The removal of this exception means that Section 501(c)(4), 501(c)(5), and 501(c)(6) organizations will need to account for these expenses in evaluating the proxy tax, the deductibility of membership dues and nonprofit information reporting under IRC Section 6033.

What Is No Longer in the Act

A few provisions affecting nonprofits that had been in either the House or Senate versions of the TCJA were deleted from the final bill signed into law by President Trump. These provisions included the repeal of estate and generation-skipping taxes, the elimination of private activity bonds, the simplification of the private foundation tax on net investment income, the exception for independently operated philanthropic business holdings from the private foundation tax on excess business holdings, requirements on art museums seeking to qualify as private operating foundations, reporting requirements applicable to the sponsoring organizations of donor-advised funds, the special exception under the "Johnson Amendment" permitting Section 501(c)(3) organizations to make political statements under certain circumstances, the repeal of above-the-line deductions for certain educational expenses and exclusions of certain educational expenses, the inclusion of inflation in the calculation of the charitable mileage rate, the applicability of UBIT to Section 115 government-sponsored entities, the modification to the UBIT exception for fundamental research organizations and, for a hot second, the ability to deduct tuition paid for religious instruction.

Will We See Technical Corrections Any Time Soon?

In short, no, we will not. While there are numerous errors and ambiguities in the TCJA, a technical corrections bill is highly unlikely for a number of reasons. A true technical corrections bill is a very special type of legislation because it is deemed to have no revenue cost to the U.S. government. This is because the purpose of technical corrections is to align the text of the statute with the legislative intent of Congress. Given that the legislative text but not the congressional intent is changed in a technical corrections bill, there is no need for a new revenue estimate because the original revenue estimate captured the intent of Congress. As a result, technical corrections cannot, by definition, raise or lose revenue.

This has two implications. First, technical corrections cannot be passed under the Senate's 50-vote budget reconciliation procedure because provisions that do not affect federal revenues are not germane to the budget under the Byrd rule (a Senate rule named for the late Senator Byrd of West Virginia that requires budget reconciliation measures to affect federal revenues or outlays within the budget window in order to be germane). As a result, a technical correction would be ineligible for budget reconciliation and would require 60 votes in the Senate and, therefore, the support of at least 9 Democrats. Second, technical corrections require unanimous consent by majority and minority staff of the House Committee on Ways and Means and the Senate Finance Committee, and consent from Treasury. If staff disagree about the legislative intent of a provision and whether the statute reflects that intent, the provision is deemed not to be a technical correction but, rather, a change in policy. Given the polarized environment in Washington, it is unlikely that we'll see a long list of bona fide technical corrections.

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