

The new year begins with changes in tax law that President Trump signed into law in December (the “Tax Act”).

Some of the changes will affect tax-exempt organizations in potentially significant ways. This alert addresses the impact the Tax Act will have on tax-exempt organizations.

Charitable Giving

Individual

The Tax Act retains the charitable contribution deduction from income, but as a result of other changes in tax law, fewer taxpayers will be able to take advantage of the charitable deduction. The Tax Act raises the standard deduction from US\$12,700 to US\$24,000 for joint filers, US\$9,350 to US\$18,000 for heads of households and US\$6,350 to US\$12,000 for most other filers in 2018 and indexes these amounts for inflation. The Tax Act also reduces or limits other commonly used itemized deductions. It caps the deduction for state and local property and income taxes at US\$10,000; repeals the itemized deduction for other state and local taxes; limits the mortgage interest deduction on new mortgages to interest on the first US\$750,000, rather than US\$1 million, of mortgage indebtedness for a “qualified residence”; and eliminates the deduction for miscellaneous itemized deductions. As a result, some taxpayers who received a tax benefit for charitable contributions will no longer receive a benefit or full benefit. For example, a couple that pays US\$9,000 of mortgage interest and more than US\$10,000 in state and local taxes and has no other itemized deductions would have to donate US\$5,000 to charities in a year before obtaining any benefit from charitable contributions. This may cause taxpayers to reduce charitable giving because the after-tax cost of giving is greater and/or to bunch their contributions in alternate years (e.g., odd-numbered years) and claim the standard deduction in other years (e.g., even-numbered years).

Upper income taxpayers will face a maximum tax rate on taxable income of 37% rather than the 39.6% rate applicable under current law. This could slightly reduce the incentive to make charitable contributions. However, the cap on the state and local tax deduction will actually result in an increase in the combined federal and state marginal income tax rate for upper income taxpayers in states with marginal income tax rates of 7% or more. Many higher income taxpayers may also benefit from bunching contributions.

The Tax Act retains the individual alternative minimum tax but increases the exemption amount for the tax. In addition, by capping the state and local tax deduction and placing new limits on the mortgage interest deduction, the Tax Act limits net tax preferences that certain taxpayers will have and should greatly reduce the number of taxpayers in the alternative minimum tax, which has a lower marginal tax rate (26% or 28% for alternative minimum taxable income in excess of the exemption amount) than the regular tax. This could provide an enhanced incentive for some contributors.

The Tax Act repeals the Pease adjustment, which phased down itemized deductions as income increases. While the Pease adjustment had no effect on the value of an additional itemized deduction for most taxpayers, it reduced the value of itemized deductions of the highest income taxpayers by 80%. The repeal of the Pease adjustment could greatly increase the incentive for charitable contributions by those individuals.

If taxpayers engage in bunching, charities could see contributions that otherwise would be made in December 2018 moved to January 2019. With no year-end deadline as an incentive, soliciting contributions in January may be far more challenging than solicitations in late December.

The Tax Act increases the amount of charitable deductions that an individual taxpayer can take into account in a year from 50% to 60% of the taxpayer’s contribution base. This could make bunching a little easier.

The individual tax changes described above are effective January 1, 2018, and are repealed effective January 1, 2026.

Corporate

The Tax Act reduces the maximum corporate tax rate from 35% to 21%, thereby reducing the after-tax benefit of charitable contributions made by corporations (other than S corporations). This could result in a decline in corporate giving, particularly for those corporations that do not receive a net tax benefit from the changes in tax law and, therefore, do not have extra after-tax cash.

Estate

Changes in the estate tax could also lead to a reduction in charitable bequests, which can be deducted in determining the amount that is subject to the estate tax. The Tax Act increases the estate tax exclusion amount from US\$5.49 million in 2017 to US\$10 million (indexed for inflation) from 2018 through 2025 (with a spouse being able to use the unused portion of a deceased spouse’s exemption amount). This will subject fewer estates to the estate tax and reduce the incentive to minimize estate taxes by making charitable bequests.

Partnerships

The Tax Act changes the way partnerships take into account charitable contributions of appreciated property.

Contributions in Lieu of Penalties

The Tax Act denies a deduction for any amount paid or incurred to, or at the direction of, a governmental entity in relation to the violation of law or the investigation and inquiry by a governmental entity of a violation of law. This eliminates the incentive for a taxpayer to negotiate an arrangement under which the taxpayer makes a contribution to charity instead of paying a fine.

Amounts Paid in Exchange for College Athletic Seating Rights

The Tax Act repeals the partial charitable deduction for amounts paid in exchange for college athletic seating rights. This could reduce the number of taxpayers who are willing to make such payments or drive down the cost of seating rights, both with an adverse effect on a college or university.

Unrelated Business Taxable Income

Separate Trades or Businesses

The Tax Act requires an organization with more than one unrelated trade or business to compute unrelated business taxable income (UBTI) separately with respect to each trade or business. Thus, the losses from one trade or business will not offset income from another trade or business. An exempt organization's UBTI for a year will be the sum of the positive amounts of UBTI for each trade or business with positive UBTI, less the specific deduction allowed in computing UBTI subject to tax. An organization can carry over a loss from one trade or business to apply against income from that trade or business in a later year.

This change will result in increased UBTI for organizations that offset income from one trade or business with losses from another trade or business. We also predict that this change will put greater pressure on the tax return function and disclosure for two reasons. First, in many cases organizations are uncertain about whether particular activities result in UBTI. Some may choose not to report the income from the activity as UBTI because they are comfortable that losses from other unrelated business activity would offset the UBTI if the IRS were to determine that the unreported activity was unrelated. Now, a decision not to report could have greater consequences and result in penalties that would not have been incurred under old law. Second, organizations will face questions about whether two activities constitute separate trades and businesses and will have to take return positions on that issue.

Depending on how new forms for reporting UBTI are developed, organizations that engage in two related activities that generate UBTI may be required to determine if each activity is a separate trade or business or whether to combine the two. Combining the activities initially listed as separate could constitute a change in accounting method, requiring IRS approval or disclosure on the Form 990-T.

Tax Rate

By reducing the maximum corporate tax rate to 21%, the Tax Act also reduces the tax rate on UBTI to 21%. In some cases, tax-exempt organizations seek to structure to avoid UBTI, resulting in business arrangements that are less than optimal. With a lower tax rate, some exempt organizations may be willing to seek an optimal business arrangement even if it results in UBTI.

Fringe Benefits

The Tax Act increases an exempt organization's UBTI by any amount for which a deduction is not allowable under Internal Revenue Code (Code) section 274 (as amended by the Tax Act) and which is paid or incurred for any qualified transportation fringe (as defined in Code section 132(f)), any parking facility used in connection with qualified parking (as defined in Code section 132(f)(5)(C)) or any on-premise athletic facility (as defined in Code section 132(j)(4)(B)). Qualified transportation fringes include transit passes (up to US\$100 per month adjusted for inflation), qualified parking (up to US\$175 per month as adjusted for inflation) and qualified bicycle commuting reimbursements among other things.

The new inclusion in UBTI is generally effective for amounts paid or incurred after December 31, 2017, but does not apply to qualified bicycle commuting reimbursements until January 1, 2026.

The new inclusions will increase the cost to an exempt organization of certain fringe benefits. They will also increase the administrative burdens of exempt organizations that provide qualified transportation fringes but do not currently file unrelated business income tax returns.

Estimated Taxes

Tax-exempt organizations should take the changes in UBTI rules into account in determining whether, and to what extent, they should make estimated tax payments in 2018 and later years.

Lobbying Expenditures

Membership organizations that lobby or incur political expenditures generally must either notify their members of the portion of their dues that are not deductible because they are attributable to lobbying or political expenditures or pay a proxy tax at the highest corporate rate on their lobbying or political expenditures. The Tax Act eliminated the exception to this rule for local lobbying. Membership organizations that engage in substantial local lobbying may seek to adjust their nondeductibility notices or (if they underestimate for 2017 or 2018) elect to adjust future percentages.

The reduction in the corporate rate to 21% reduces the proxy tax rate to 21%. In some cases, an organization with individual members who are engaged in a trade or business (other than as an employee) will be able to produce a combined net tax benefit for members and the organization if it stops notifying members of the portion of dues that are attributable to lobbying and begins paying a proxy tax.

The change in the treatment of local lobbying expenditures was effective for expenditures paid or incurred on or after the date of enactment of the Tax Act. Therefore, it may apply to some expenditures paid or incurred at the end of 2017.

Executive Compensation

The Tax Act imposes a 21% excise tax on a tax-exempt employer on the sum of remuneration in excess of US\$1 million paid to a covered employee and any "excess parachute payments" paid by the organization to a covered employee.

For these purposes, remuneration means wages as defined for income tax withholding purposes, but does not include designated Roth contributions. Remuneration includes amounts required to be included in income under Code section 457(f) (relating to income attributable to nonqualified deferred compensation plans). Remuneration excludes amounts paid to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services by such professionals.

Covered employees include current and former employees who were one of the five highest paid employees of the organization or predecessor in the current taxable year or in any preceding taxable year beginning after 2016. Compensation paid by related entities is aggregated and the tax apportioned in the case of a covered employee working for multiple organizations.

A parachute payment is a severance payment, the present value of which exceeds three times the "base amount." An excess parachute payment is the portion of a parachute payment that exceeds the base amount allocated to the payment. Rules similar to those in Code section 280G(b)(3) apply in determining the base amount. Thus, the base amount is generally an individual's average includible compensation determined over the five taxable-year period ending before the separation. The Tax Act includes some special exclusions from the calculation, including payments to licensed medical professionals.

The excise tax is effective for taxable years beginning after December 31, 2017.

Exempt organizations that pay employees more than US\$1 million per year may have to adjust their budgets to take into account the tax liability.

Colleges and Universities

The Tax Act imposes a new 1.4% excise tax on the net investment income of a private college or university if (i) it had at least 500 students during the preceding taxable year, (ii) more than half of its students are located in the US, and (iii) the aggregate fair market value of its assets at the end of the preceding taxable year (other than assets used directly in carrying out the school's tax-exempt purposes) is at least US\$500,000 per student. For purposes of these rules, part-time students are taken into account on a "full-time student equivalent basis." The excise tax takes into account the net investment income of related organizations, such as supporting and supported organizations.

Private colleges and universities will face questions about the meaning of "assets used directly in carrying out the school's tax-exempt purpose." Educational institutions that are part of larger nonprofit organizational structures (such as a hospital and university or a religious organization) will face questions as to what portion of their assets to take into account in determining the excise tax.

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

Education

The Tax Act treats amounts distributed from a section 529 account to pay tuition in connection with enrollment or attendance at an elementary or secondary public, private or religious school as qualified distributions (i.e., federal income tax and penalties are not imposed on the earnings component of the distribution). Some states allow contributors to section 529 plans to deduct all or a portion of their contributions for state income tax purposes. Thus, this change in law may allow for a back-door state tax deduction for private and religious school tuition. However, if a state law does not track the federal law provisions on distributions that do not result in tax or penalty, use of section 529 account funds to pay elementary or secondary school tuition could result in a recapture of state tax benefits. Private and religious schools that may want to encourage parents to contribute to a state plan to obtain a back-door deduction should check the state law carefully to see if the deduction will have to be recaptured. The new rules apply to distributions made after December 31, 2017.

The Tax Act allows for tax-free rollovers from a 529 account to an ABLE account, increases contribution limits to ABLE accounts and makes other changes in rules applicable to ABLE accounts.

The Tax Act excludes from cancellation of indebtedness income student loans and private education loans discharged before 2026 if the discharge is pursuant to section 437(a) or (d) of the Higher Education Act of 1956, a parallel provision in part D of title IV of such act or section 464(c)(1)(F) of such act, or if the debt is discharged on account of death or permanent disability.

Tax-Favored Financing and Credits

The Tax Act repeals the exemption for interest paid on advanced refunding bonds issued after 2017. Tax-exempt organizations that wish to refinance tax-exempt debt will have to do so on a concurrent basis. The Tax Act also repeals tax credit bonds.

The Tax Act limits the rehabilitation tax credit to qualified historic structures and requires that it be spread over five years.

Conclusion

Each tax-exempt organization should consider the impact, if any, of the changes in tax law on its operations and make appropriate adjustments to its budget and estimated tax payments as well as to employment contracts that it negotiates in the future. Some organizations should also consider adjustments to take into account the lower tax rate on UBTI and the lower proxy tax rate on lobbying expenditures.

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