SQUIRE PATTON BOGGS

Congress Considering Tax Reform Bills with Major Impacts on Tax-Exempt Organizations

The US House of Representatives and the US Senate Finance Committee begin consideration this week of tax legislation that could have a major impact on tax-exempt organizations. The Chairman's Mark of the Tax Cuts and Jobs Act (Senate bill) that the Finance Committee will consider differs in some important ways with H.R. 1, the Tax Cuts and Jobs Act (House bill) that the House of Representatives is expected to vote on this week.

This alert highlights provisions of the two bills that may affect tax-exempt organizations.

Charitable Giving

Both bills retain the deductions for charitable contributions but make other changes that could reduce charitable giving. With respect to individuals, both bills almost double the standard deduction and eliminate certain itemized deductions, thereby increasing the number of taxpayers who will claim the standard deduction and, therefore, do not have a tax benefit for charitable contributions. The House bill may have a bigger impact than the Senate bill because it eliminates almost all itemized deductions other than the charitable deduction, a limited mortgage interest deduction and a property tax deduction of up to $10,000 – meaning, fewer individuals are likely to itemize, which will generally suppress the tax benefit of charitable donations. The Senate bill retains most itemized deductions, other than deductions for state and local taxes, which could make it somewhat more likely that a greater number of individuals will continue to itemize.

Both bills also reduce the corporate income tax rate to 20%, but the Senate bill defers the reduced rate until 2019. This lower rate could reduce the incentive for corporate charitable giving. Both bills almost double the levels at which federal estate taxes begin to apply; the House bill repeals the estate tax effective January 1, 2025. Thus, both bills will reduce the number of estates that will claim the charitable deduction.

On the positive side for tax incentives for individual charitable giving, both bills:

- Retain relatively high tax rates for taxpayers in the highest tax brackets
- Repeal the Pease adjustments, which phase down itemized deductions as income increases
- Repeal the alternative minimum tax (which caused some taxpayers to have a lower effective marginal tax rate, which suppressed the value of charitable deductions)
- Increase the individual limitation for cash contributions to public charities and certain foundations to 60% of the taxpayer's adjusted gross income

Both bills repeal the special rule enabling a donor to take charitable deduction of 80% of the amount paid for the right to purchase tickets to athletic events.

The House bill increases the charitable mileage rate for inflation.

Tax-Favored Financing

The House bill repeals the exemption for interest paid on private activity bonds, including section 501(c)(3) bonds and qualified student loan bonds, for bonds issued after 2017. Both bills repeal the exemption for interest paid on advance refunding bonds issued after 2017.

The House bill repeals credits that certain tax-exempt organizations use directly or indirectly to help finance tax-exempt purposes, including the rehabilitation (historic) tax credit and the new markets tax credit. The Senate bill would neither repeal nor extend the new markets tax credit. It limits the rehabilitation credit to certified historic structures and cuts the credit in half.

All these provisions would decrease the tax-favored financing alternatives available to tax-exempt entities.

Governance and Compensation

Both bills impose a 20% excise tax on a tax-exempt employer with respect to remuneration in excess of $1 million paid to a covered employee. For these purposes, remuneration means wages as defined for income tax withholding purposes, but does not include designated Roth contributions. The bills would also apply "excess parachute payment" rules to severance payments made to covered employees. Covered employees include current and former employees who were one of the five highest paid employees of the organization or predecessor of 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.

The Senate bill subjects section 501(c)(5) organizations, such as labor unions, and section 501(c)(6) organizations, such as trade associations, to the excise tax on excess benefit transactions (EBTs). Thus, the IRS will be able to examine whether compensation paid to officers of the organizations are reasonable. This should cause the boards of those organizations to take better care in recording how they make compensation and bonus decisions. The Senate bill also expands the group of individuals considered "insiders" for purposes of EBT rules to include athletic coaches of eligible educational institutions and investment advisers.

The Senate bill modifies the "rebuttable presumption" provisions of regulations relating to EBTs. An organization that follows the current requirements for establishing a rebuttable presumption that compensation is reasonable (such as review of comparable compensation data, advance approval by an authorized body, recorded votes and contemporaneous documentation of decisions) would no longer have a "rebuttable presumption" of reasonableness. Instead, following such requirements could be used to establish that organization managers meet minimum standards for due diligence. The bill also eliminates the regulatory rule that an organization manager's participation in an EBT is automatically "not knowing" if the manager relied on professional advice or met the rebuttable presumption requirements.

The Senate bill also modifies the EBT rules by more broadly imposing a 10% excise tax on the exempt organization if an initial tax is imposed on a "disqualified person" as recipient of the excess benefit. (Currently, the EBT taxes are imposed only on the disqualified person and organization managers (including directors) who make the decision to provide the excess benefit.) The tax would not apply if the organization establishes that it met minimum standards for due diligence or that it used other reasonable procedures to prevent excess benefits.

Political Activity

The House bill provides a waiver to the "Johnson Amendment" by permitting section 501(c)(3) organizations to make political statements "in the ordinary course of the organization's regular and customary activities" if the organization does not incur more than a *de minimis* incremental expense. For example, if the modification is adopted, a pastor could endorse or criticize a candidate during a sermon without jeopardizing the tax-exempt status of the church. Similarly, an organization could identify on its website opposition to candidates who propose defunding the organization. The waiver expires for tax years beginning after 2023. The loosening of the Johnson Amendment is controversial; the Senate bill has no similar provision.

Unrelated Business Taxable Income

The Senate bill requires that an organization with more than one unrelated trade or business compute unrelated business taxable income (UBTI) separately with respect to each trade or business. Thus, the losses from one trade or business could not offset income from another trade or business. The organization's UBTI for a year would 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. The Senate bill also treats income from the licensing of an exempt organization's logo or name as UBTI. The House bill does not include similar provisions.

The House bill limits the UBTI exception for fundamental research organizations to income arising from research the results of which are freely available to the public. The House bill subjects certain state and local entities, such as public pension plans, that are exempt under section 115 to the unrelated business income tax. This could have a major impact on pension plans that invested, without use of corporate blockers, in partnerships that generate active business income. The Senate bill does not include similar provisions.

The House bill, but not the Senate bill, includes in UBTI the amount of certain fringe benefits for which the House bill denies businesses a deduction in the "for profit" world. These include qualified transportation fringe benefits, costs of on-premise athletic facilities and costs of parking facilities used in connection with qualified parking.

Private Foundations and Donor Advised Funds

The House bill, but not the Senate bill, changes tax rules relating to private foundations and donor advised funds by:

- Simplifying the excise tax on private foundation net investment income by adopting a single rate of 1.4%
- Denying private operating foundation status to art museums not open to the public during normal business hours for at least 1,000 hours per year
- Requiring sponsoring organizations of donor advised funds to disclose policies on inactive donor advised funds and average amounts of grants made from their donor advised funds

The House bill also includes a tightly tailored provision exempting certain business holdings from the tax on excess building holdings applicable to private foundations. The provision reportedly benefits the Newman's Own Foundation.

Colleges and Universities and Educational Benefits

Both bills impose a new 1.4% excise tax on the net investment income of private colleges and universities that have at least 500 students and assets, other than those used directly in carrying out the institution's educational purposes, of at least $250,000 per full-time student. The excise tax takes into account the net investment income of related organizations, such as supporting and supported organizations.

The House bill, but not the Senate bill, repeals certain tax benefits associated with saving for, payment of or borrowing to pay tuition, including (i) above-the-line deductions for interest payments on qualified education loans and qualified tuition and related expenses and (ii) income exclusions for:

- Interest on US savings bonds used for qualified higher education expenses
- Qualified tuition reductions provided by educational institutions
- Employer provided educational assistance

The House bill, but not the Senate bill, integrates Coverdell savings accounts with section 529 plan accounts by expanding the uses of section 529 plan accounts and eliminating new Coverdell accounts. The House bill also integrates tax credits for education.

Professional Sports Leagues

The Senate bill, but not the House bill, denies professional sports leagues tax-exempt status under section 501(c)(6) effective for taxable years beginning after 2017.

What's Next?

We expect the House to vote this week on the House bill as reported by the Ways and Means Committee this past Thursday. We expect the Senate Finance Committee to revise significantly the Chairman's Mark of the Senate bill to enable it to be considered under the expedited reconciliation rules, as well as to reflect interests of members of the Senate Finance Committee. In addition to Committee member amendments, we expect to see one or two amendments proposed by Senate Finance Committee Chair Hatch that make numerous changes in his initial Chairman's Mark.

The bills could hit obstacles in either chamber of Congress because of their impact on the budget deficit. If both bills pass, the House of Representatives could accept the Senate bill, particularly if there is a risk that the legislation would not pass if resubmitted to the Senate, or seek a conference. A conference bill would address and resolve the many differences between the two bills. While both chambers will be under heavy pressure from the White House to adopt tax reform legislation this year, the legislation could run into roadblocks in either chamber.

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