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Enacted tax reform offers pitfalls for unprepared and planning opportunities for well-informed tax-exempt organizations

On Friday, Dec. 22, President Donald Trump signed "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (formerly referred to as the Tax Cuts and Jobs Act). Despite its innocuous, almost stultifying official name, the Tax Cuts and Jobs Act contains the most extensive changes to the tax code in more than a generation, serving up both pitfalls for unprepared and planning opportunities for well-informed leaders of tax-exempt organizations.

In this tax update, we have summarized six of the most sweeping changes in the Tax Cuts and Jobs Act, which may affect how tax-exempt organizations operate on a daily basis, as well as provided a reminder list of five widely-publicized provisions that were left on the cutting room floor during reconciliation and never made it into the Tax Cuts and Jobs Act.

Six sweeping changes in the Tax Cuts and Jobs Act

1. Fewer potential donors will qualify to itemize charitable deductions on their tax returns, but those still able to itemize may be able to deduct larger amounts.

Law prior to Tax Cuts and Jobs Act:

Under present law, individual taxpayers generally may claim charitable contribution deductions for up to 50 percent of their adjusted gross income (AGI), when contributing cash to Section 501(c)(3) public charities, private operating foundations and certain private non-operating foundations. Lower deduction limits (either 30 percent or 20 percent of AGI) generally apply to contributions of property other than cash and contributions to private non-operating foundations. When donors contribute more than $250, they must obtain a contemporaneous written acknowledgment of the contribution from the charity, unless the donee charity files a return including the required information in accordance with applicable Treasury Regulations. Taxpayers are also able to deduct amounts contributed to educational institutions in exchange for athletic seating event rights, even though they receive a benefit in exchange for the contribution.

For 2017, the standard deduction was $6,350 for single filers and $12,700 for joint filers, leading approximately 30 percent of households to itemize their deductions and 70 percent to take the standard deduction (only itemizers can deduct their charitable contributions). The 2017 tax brackets ranged from a low of 10 percent to a high of 39.6 percent.

The information in this article is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation."

Changes in Tax Cuts and Jobs Act:

The Tax Cuts and Jobs Act makes the following direct changes to the charitable contribution regime:

a. The limitation on cash contributions to Section 501(c)(3) public charities is increased from 50 percent to 60 percent of AGI;

b. The exception to the contemporaneous written acknowledgement rule for donations of $250 or more, where the donee organization files the required return, is repealed; and

c. Charitable deductions are no longer available for donations in exchange for athletic seating event rights at educational institutions.

Although the charitable deduction limit for cash gifts has risen, any potential benefit to public charities may be reduced by the indirect effects of other changes in the Tax Cuts and Jobs Act, including (i) an increase in the standard deduction to $24,000 for joint returns and $12,000 for individual filers, causing significantly fewer taxpayers to be able to itemize deductions on their tax returns and take advantage of the charitable deduction, and (ii) lower individual income tax rates (the top rate for ordinary income is reduced to 37 percent, with corresponding decreases most of the middle brackets), reducing the tax benefit of a charitable deduction to potential donors.

Planning opportunities available under the Tax Cuts and Jobs Act:

Given the significant increase in the standard deduction, which will cause fewer taxpayers to itemize deductions on their tax returns in any given year, taxpayers with sustained charitable giving plans should be encouraged to either bunch their charitable contributions from multiple years into a single year every few years or use donor advised funds (DAFs). Bunching planned charitable contributions that would normally be made over multiple years into a single year could allow taxpayers, who otherwise would not be able to itemize their deductions because their itemized deductions are typically less than the standard deduction, to lift their aggregate itemized deductions over the standard deduction in the bunched year. These taxpayers would presumably suspend charitable contributions in the intervening years. A more organized way to obtain a similar result would be for a taxpayer to make a contribution to a DAF. A DAF is a philanthropic vehicle established at a public charity, which generally allows a taxpayer to obtain an immediate deduction for all contributions to the DAF and then recommend grants from funds in the DAF over time. DAFs effectively function akin to charitable checking accounts without actual ownership; the donor contributes to the fund as often as they would like and then recommends grants to their preferred charities when ready.

2. Exempt organizations with multiple unrelated businesses may see their taxable income rise.

Law prior to Tax Cuts and Jobs Act:

If a tax-exempt organization operates a trade or business that is not substantially related to the organization's exempt purposes, the income derived therefrom is generally subject to unrelated business income tax (UBIT) at the same rates applicable to for-profit corporations. Under pre-existing law, a tax-exempt organization that operated multiple unrelated trades or businesses could aggregate the items of income, loss, credit and deduction from all of its unrelated activities. In other words, an exempt organization was able to use a loss or deduction from one unrelated business to offset income from another unrelated business, potentially reducing the organization's overall UBIT burden.

Changes in the Tax Cuts and Jobs Act:

On a positive note for UBIT payers, the Tax Cuts and Jobs Act lowered the top corporate tax rate from 35 percent to 21 percent for taxable years beginning on or after Jan. 1, 2018. Therefore, many tax-exempt organizations with only one unrelated trade or business or no unrelated trades or businesses generating substantial losses, may see their UBIT burden fall significantly. On the other hand, tax-exempt organizations with multiple unrelated trades or businesses are now required to compute UBIT in separately for each such trade or business. That is to say, losses from one unrelated business cannot be used to offset income from others. Illustratively, an exempt organization with two unrelated businesses, one annually generating profits equal to the losses in the other, would owe UBIT in every year. Effectively, the net operating losses from the unprofitable business would be segregated, available only to offset income within that business. When discussed in these broad strokes, the Tax Cuts and Jobs Act might appear to set clear rules, but in practice it may be hard for exempt organizations to determine how many unrelated trades or businesses they have and to which of their unrelated trades or businesses various expenses should be allocated.

Planning opportunities available under the Tax Cuts and Jobs Act:

Not being able to offset losses from one unrelated trade or business against income from another could vastly increase certain exempt organizations' total UBIT exposure. Tax-exempt organizations may no longer be on a level playing field with for-profit corporations, which remain able to aggregate profits and losses across all of their taxable activities. Restructuring or reclassifying unrelated activities could potentially soften the blow to exempt organizations. For instance, tax-exempt organizations operating multiple unrelated businesses should evaluate whether it would be desirable to move one or more of such businesses into a taxable subsidiary corporation, where it would be permissible to offset profits from one business against losses from another. Additionally, tax-exempt organizations should carefully reassess how many businesses they have, where the lines are between multiple businesses and to which businesses various costs are rightfully allocated. Properly allocating expenses and classifying unrelated activities could potentially allow an exempt organization to accomplish through appropriate delineation what it can no longer accomplish via aggregation. These types of restructuring or reclassification steps demand prudent consideration of all of the tax and legal implications before they are undertaken.

3. Hiring and keeping highly compensated nonprofit employees will be more expensive.

Law prior to Tax Cuts and Jobs Act:

In general, taxable employers may only deduct "reasonable" compensation expenses. Determining what is reasonable can occasionally be a murky endeavor, but in certain cases compensation exceeding specific levels is not deductible at all. Publicly held corporations generally cannot deduct more than $1 million of compensation for any "covered employee," generally defined as the corporation's chief executive officer and a limited group of the corporation's other highest compensated officers (subject to various exceptions and special rules). Until recently, these types of specific compensation deduction restrictions did not affect tax-exempt organizations.

Changes in Tax Cuts and Jobs Act:

Under the Tax Cuts and Jobs Act, for tax years beginning on or after Jan. 1, 2018, tax-exempt organizations will be subject to a 21 percent excise tax (this is the tax rate applicable to for-profit corporations) on compensation (i) in excess of $1 million paid to any of their "covered employees" and (ii) "excess parachute payments." For instance, in order to pay $1.5 million of compensation to a covered employee in calendar year 2018, a tax-exempt organization would have to pay $105,000 in excise tax.

Evaluating the burden of this new excise tax requires careful consideration of who is a covered employee and what remuneration counts as compensation subject to the excise tax,

A. **Covered employee** – For any given tax year, covered employees are the five highest compensated employees (current or former) of an organization, plus any employee (current or former) who was a covered employee in the top five (of the organization or any predecessor) in any tax year beginning on or after Jan.1, 2017. Thus, the excise tax can apply to payments to former employees who are paid post-separation compensation in excess of $1 million in the tax year under evaluation.

B. **Covered compensation** – Remuneration counts towards the $1 million limit if it is (i) taxable wages (other than designed Roth contributions) or (ii) deferred compensation, subject to tax under Section 457(f) (i.e., vested deferred compensation). An "excess parachute payment" is generally a compensation payment that is triggered by an employee's termination, if the total "parachute payments" to such employee exceed three times that employee's average total compensation over the previous five years. Compensation does not count towards either the $1 million limit or excess parachute payment limit, if (i) it is paid to licensed medical professionals, including doctors, nurses and veterinarians and (ii) the compensation is for the performance of medical services by the licensed professional. Thus, compensation for non-medical work, such as administrative or executive services performed by a medical profession, is potentially compensation subject to the excise tax.

C. **Compensation from related organizations** – Compensation from all entities within the same controlled group, as well as supporting and supported organizations, is added together for purposes of the excise tax. This requires an organization to know what compensation, if any, its covered employees earn from other employers in the controlled group. If the aggregate compensation of a covered employee from related organizations exceeds the $1 million limit, each organization is liable for its ratable share of the excise tax based on the amount of compensation it pays in relation to the total compensation paid by all related organizations. Therefore, an organization could be liable for the new excise tax even if it only pays compensation below the $1 million annual limitation.

Tax-exempt organizations have always been required to justify that the compensation paid to their employees is fair and reasonable under all the facts and circumstances, as opposed to excessive. While this requirement has not been removed, in the future, organizations will also have to factor in the burden of the 21 percent excise tax when analyzing the total cost of paying compensation to employees earning more than $1 million a year.

Planning opportunities available under the Tax Cuts and Jobs Act:

The excise tax applies to each individual organization within an affiliated or controlled group of tax-exempt organizations, which may dramatically increase its impact on certain conglomerates, such as large, tax-exempt health care or university systems. For instance, if three separate exempt entities within a single tax-exempt hospital system each have five covered employees earning more than $1 million per year, then all 15 employees could cause the excise tax to be imposed at their respective organizations. Prudent reassignment of highly compensated employees to fewer entities within a system of multiple affiliated or controlled exempt entities could potentially allow the overall system to reduce the total excise taxes due. In the prior example, it might be possible to employ all 15 employees at a single exempt entity in the system, potentially shielding the compensation paid to the lowest 10 employees from the excise tax. Restructuring and reassignment of this type would have to be undertaken carefully in light of all of the tax and legal considerations.

Within large health care systems, it will also be essential to carefully track and categorize the compensation of certain highly paid employees. To the extent it can be substantiated that physician-executives who wear multiple hats, such as dual clinician-administrators, earn less than $1 million in non-clinical pay and the excess over $1 million in clinical pay, the new excess compensation excise taxes may not be triggered for those employees. Additionally, nonprofits with highly compensated employees should evaluate the potential for modified vesting schedules for deferred compensation or revised severance packages that would not trigger the excise tax thresholds.

4. Well-endowed colleges and universities may find themselves subjected to a new tax.

Law prior to Tax Cuts and Jobs Act:

Since before the enactment of the Tax Cuts and Jobs Act, an excise tax has generally been imposed on the net investment income of certain Section 501(c)(3) private foundations, but not the investment income of any Section 501(c)(3) public charities.

Changes in Tax Cuts and Jobs Act:

The Tax Cuts and Jobs Act imposes a new 1.4 percent excise tax on the net investment income of certain private colleges and universities, which typically qualify as public charities that would otherwise be exempt from the private foundation net investment income excise tax. Generally, colleges and universities are subject to the tax if: (i) they have at least 500 students, (ii) at least 50 percent of those students are located in the U.S., (iii) they are not state colleges or universities operated by a government or political subdivision thereof, and (iv) they have assets with an aggregate fair market value of at least $500,000 per student (excluding those assets that are directly used in carrying out a college or university's exempt purpose, such as lecture halls or professors' offices and laboratories).

Planning opportunities available under the Tax Cuts and Jobs Act:

Various uncertainties exist under the Tax Cuts and Jobs Act regarding precisely how to aggregate assets held by related organizations or identify all exempt, educational purpose assets. In general, for purposes of calculating whether a given college or university meets the assets per student trigger and the amount of net investment income subject to excise tax, the assets of "related institutions" are added together. An entity is a "related organization" of a college or university, if (i) it controls or is controlled by the college or university, (ii) it is controlled by one or more persons who also control the college or university, or (iii) it is a supported organization of the college or university. Future treasury regulations may add further clarifications and specifics to the broad rules in the Tax Cuts and Jobs Act, making it possible for colleges and universities to determine if carefully planned and executed divestments or restructuring of operations could bring them under the number of students or assets-per-student thresholds.

5. Advance refunding bonds have been repealed.

Law prior to Tax Cuts and Jobs Act:

In general, Section 501(c)(3) organizations can partake in tax-exempt bond financing through qualified private activity bonds. Private activity bonds are bonds in which a state or local government acts as a conduit, providing financing to nongovernmental entities. Bonds issued to finance the activities of organizations described in Section 501(c)(3) may become "qualified 501(c)(3) bonds." Historically, tax-exempt organizations have used "advance refunding bonds" to refinance outstanding qualified 501(c)(3) bonds, which were not callable at the preferred date of the refinancing. Advance refunding bonds could be used to refinance debt at lower interest rates and to pay off the principal, interest or the redemption price due from an earlier bond issue. The interest on a bond issued to advance refund another bond could potentially be excluded from gross income.

Changes in Tax Cuts and Jobs Act:

Effective for advanced refunding bonds issued after Dec. 31, 2017, the Tax Cuts and Jobs Act repeals the exclusion from gross income for interest on a bond issued to advance refund another bond. This limits the refinancing options available to tax-exempt borrowers. Tax-exempt organizations will not be able to refinance outstanding bonds on a tax-free basis, if the outstanding bonds are not callable at the time of the refinancing.

Planning opportunities available under the Tax Cuts and Jobs Act:

There are not substantial planning opportunities to avoid the repeal of advancing refunding bonds. However, tax-exempt organizations should be aware that interest from the initial issuance of qualified 501(c)(3) bonds remains tax-exempt. Only the interest on any bonds issued as part of an advance refunding of qualified 501(c)(3) bonds is no longer exempt.

Tax-exempt organizations will also still be able to refinance outstanding bonds, as long as the bonds are callable at the chosen refinancing date. In other words, current refunding of callable, outstanding bonds remains a viable refinancing option. The principal effect of the advance refunding bond repeal in the Tax Cuts and Jobs Act is that Section 501(c)(3) organizations will be restricted from refinancing bonds that are non-callable or not yet callable on an advance basis.

6. The 527(f) tax applicable to political organizations has been significantly decreased.

Law prior to Tax Cuts and Jobs Act:

Political organizations are subject to tax on their "political organization taxable income." The rate of the tax is the highest marginal income tax rate applicable to for-profit corporations, which for taxable years beginning before Jan. 1, 2018 was 35 percent. Political organization taxable income generally equals gross income (excluding "exempt function income") less deductions for certain activities directly connected with producing the gross income. Excluded exempt function income is income that a political organization segregates only for use in its exempt functions that is received from one of the following sources: (i) contributions of money or other property; (ii) membership dues, fees or assessments from a member of the political organization; (iii) proceeds from a political fundraising or entertainment event or from the sale of political campaign materials, which are not received in the ordinary course of any trade or business; or (iv) proceeds from conducting certain bingo games. Accordingly, a political organization's investment income or income derived from a trade or business (such as leasing office space to an unrelated organization) is not exempt function income and is subject to tax. Additionally, political organization taxable income includes all exempt function income for any taxable year that a political organization fails to file a Form 8871 as required.

Changes in Tax Cuts and Jobs Act:

The Tax Cuts and Jobs Act reduced the corporate tax rate to a flat 21 percent for taxable years beginning on or after Jan. 1, 2018.

Unlike the reductions to individual income tax rates, there is no expiration date for the corporate tax cut. Therefore, the tax rate applicable to political organization taxable income has decreased from 35 percent to 21 percent for taxable years beginning with 2018.

Given the significant reduction in the tax rate applicable to political organization taxable income, political organizations may be less motivated to ensure that their sources of funding qualify as exempt function income. Additionally, the penalty for failing to file Form 8871 (inclusion of exempt function income in taxable income) has effectively been reduced.

Five widely publicized changes that never made it into the Tax Cuts and Jobs Act

1. **Section 501(c)(3) organizations allowed to make political statements:** The Tax Cuts and Jobs Act *did not* repeal the "Johnson Amendment," which generally forbids 501(c)(3) entities from participating in or intervening in political campaigns, including making political statements in favor of or in opposition to any candidate for public office.

2. **Simplification of private foundation net investment income excise tax:** The Tax Cuts and Jobs Act *did not* replace the two-tier private foundation net investment income excise tax, which can be imposed at either two percent or one percent, with a single-tier 1.4 percent rate structure.

3. **Additional reporting requirements for donor advised funds:** The Tax Cuts and Jobs Act *did not* impose new information reporting requirements on donor advised funds.

4. **Repeal of private activity bonds:** The Tax Cuts and Jobs Act *did not* repeal the provisions treating interest from qualified private activity bonds as exempt from tax.

5. **Special exception from private foundation excess business holdings excise tax:** The Tax Cuts and Jobs Act *did not* exempt private foundations that own independently-operated, wholly-owned philanthropic businesses, which distribute all of their income to their foundation-owners, such as the Newman's Own Foundation, from the private foundation excess business holdings tax.

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