NONPROFIT ORGANIZATIONS ALERT
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House tax bill — what nonprofits need to know

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On November 2, 2017, the House Republicans released the proposed Tax Cuts and Jobs Act (the "Bill") which is intended to implement President Trump's campaign promise to simplify the tax code. Included in the Bill were provisions that will impact the operations of tax-exempt organizations. All provisions discussed below would be effective for tax years beginning after December 31, 2017.

Charitable contributions

The Bill would amend the law in a number of respects with respect to the income tax charitable contribution deduction. While the deduction has been present in the Internal Revenue Code ("Code") for a hundred years and would remain so, certain other changes in the Bill are expected to have a deleterious effect on charitable giving, including changes to the standard deduction, elimination of the alternative minimum tax and the repeal of the estate tax (with a delay in its effective date).

However, for taxpayers who still itemize deductions there are some increased incentives:

- the percentage limitation on adjusted gross income for an individual making a cash contribution to a public charity is raised from fifty percent to sixty percent (Section 1306 of the Bill);
- the limit on the amount of itemized deductions (the so-called "Pease limitation" mostly affecting high income taxpayers living in low- or no-income tax states) would be repealed (Section 1301 of the Bill); and
- the amount deductible per mile driven in service to a charitable organization would be adjustable for inflation (Section 1306 of the Bill).

Other changes in the charitable contribution context include repeal of the special valuation rule that provides a charitable deduction of 80% of the amount paid for the right to purchase tickets for athletic events as well as the ability to deduct any portion of this type of payment. (Section 1306 of the Bill). Commentators misconstrue this provision as a giveaway to university donors when, in fact, it was an accommodation to taxpayers and the IRS to avoid costly wrangling over valuation of the *quid pro quo* value of such payments. To be clear, Code Section 170(l) did not allow any additional deduction not already permitted by the Code.

The proposed Bill also repeals the mechanism that allowed charities to satisfy the contemporaneous written acknowledgment requirement on behalf of their donors of $250 or more. (Section 1306 of the Bill). Although many charities did not use this provision to stop providing individual donor receipts, the reason for its repeal is unclear.

Unrelated business income tax

Fringe benefit expenses

Section 3308 of the Bill proposes to tax at regular corporate rates amounts that exempt organizations provide to employees as tax-free fringe benefits—particularly transportation fringe benefits, and on-premises gyms as well as other athletic facilities. The stated concern is that exempt organizations have an advantage over tax-paying businesses in recruiting and retaining employees. Why that concern is limited to two specific fringe benefits, and not the ability to compensate employees generally, is unaddressed by the change. The long-standing income disparity between employees of tax-exempt and taxable business is apparently irrelevant as well.

The device by which this proposal arises is a novel one. The stated intent of the unrelated business income tax was to put tax-exempt and taxable entities on a "level playing field" with respect to earned income in the marketplace. Now the government wishes to insert itself into the ability to attract and retain employees as well.

Quasi-governmental entities

Section 5001 of the Bill attempts to address a perceived ambiguity in the law—whether certain state and local entities (such as public pension plans) whose income is excluded from income taxation under Code Section 115(l) as quasi-governmental entities can still be subject to unrelated business income tax as entities described in Code Section 501(a). According to JCT, resolution of the question would increase revenues by $1.1 billion over 2018–2027.

The provision raises more questions than it answers, however. Organizations performing an essential governmental function, the income of which is exempt from taxation under Code Section 115, may apply for recognition of tax-exempt status under Code Section 501(c)(3), for example as an entity relieving the burdens of government. But that recognition is not **mandatory** under the notice provisions of Code Section 508 as it is for most other charities (other than religious organizations).

Quasi-governmental entities that have not sought recognition of their organizational qualification under Code Section 501(c)(3) should reasonably expect that they would avoid the myriad other requirements attendant to that classification, such as exposure to UBIT and annual Form 990 information return filings. Indeed, these quasi-governmental entities would likely file a Form 1120 and except out income by virtue of Code Section 115.

The tortured language of the Bill—that an "organization or trust shall not fail to be treated as exempt from taxation under this subtitle by reason of [S]ection 501(a) solely because such organization is also so exempt, or excludes amounts from gross income, by reason of any other provision of this title"—does not address the simplest issue: How can a quasi-governmental entity be subject to UBIT as an organization in Code Section 501(a) when it has not applied for recognition of such status, and in most cases is barred from doing so?

Research income

The law currently allows exempt organization to play their essential role in the promotion of research by excepting from taxation income received from research performed: for the United States (including agencies and instrumentalities); any state (or political subdivision); by a college, university or hospital for any person; and by an organization operated primarily for the purposes of carrying on fundamental research, the results of which are freely available to the general public. Code Sections 512(b)(7)-(9).

Section 5002 of the Bill clarifies that in research organizations operated primarily to conduct fundamental research, the results of the specific research generating the income must be freely available to the general public. Otherwise, the income will become subject to unrelated business income tax.

Exempt organizations—excise taxes

Executive compensation excise tax

Under Section 3803 of the Bill, exempt organizations would now be treated like publicly traded C corporations by imposing a similar limitation on the ability to compensate executives more than $1 million annually. The change would subject tax-exempt organizations to a twenty percent excise tax on all compensation in excess of $1 million paid to any of its five highest paid employees for the tax year, as well as any individual who was a covered employee of the organization (or any predecessor) for any preceding tax year beginning after December 31, 2016, including world-renown neurosurgeons and perhaps even better known athletic coaches. Remuneration from related organizations would be aggregated for purposes of calculating total compensation. Contributions to a tax-qualified retirement plan and amounts excludable from gross income are excepted. Separation payments with an aggregate present value of three times the employee’s base compensation or more are also subject to the excise tax. Also of note is that once an employee becomes subject to this provision, the employee is always treated as such.

The limitation applies not only to Code Section 501(a) organizations, but also to quasi-governmental entities with merely a dollar excepted from taxation under Code Section 115. Political organizations described in Code Section 527 are covered as well.

The explanation accompanying the change asserts that “[c]urrent law generally has no limit on excessive compensation paid by a tax-exempt organization to its senior management other than the limitation on private inurement, the consequence of which can be revocation of the organization’s exemption.” That assertion is patently false. Congress years ago imposed a pervasive reasonable compensation regime under Code Section 4958 on both charities and civic organizations, which regime is now even reflected in certain state laws.

Private foundation investment income excise tax

Since the Tax Reform Act of 1969, private foundations have not been wholly tax-exempt. Their net investment income is subject to a two percent excise tax under Code Section 4940, based upon the conclusion that private foundations should share some of the burden of paying the cost of government, especially the cost of a more extensive and vigorous enforcement of tax laws relating to exempt organizations.

A feature of the law is to allow private foundations to lower the rate to one percent if they, in essence, grant out that one percent difference as qualifying charitable grants in addition to their regular five percent grantmaking obligation under Code Section 4942. The ability of private foundations to benefit from the lower tax is a practical challenge in managing a thoughtful charitable grantmaking program. Section 5101 of the Bill removes the one percent option and drops the two percent levy to 1.4%.

Private art museums

Section 5102 of the Bill cracks down on so-called "private" art museums by limiting the ability for classification as private operating foundations unless their facilities are open during normal business hours to the public for at least 1,000 hours during the taxable year. Private operating foundations are relieved from complying with certain rules that generally apply to private foundations, including Code Section 4942, which imposes a thirty percent excise tax on certain undistributed earnings.

Projected estimates by JCT indicate that the expected increased revenues from recalcitrant private museums would be less than $50 million from 2018 through 2027.

Private college and university investment income

The large endowment earnings for several private colleges and universities seem to be the driving Section 5103 of the Bill. This provision seeks to impose a one and four-tenths percent (1.4%) excise tax on the net investment income (as defined in Code Section 4940(c)) of private colleges and universities eligible to participate in Title IV funding and that have at least 500 students during the preceding tax year. State colleges and universities, while they are subject to unrelated business income tax under Code Section 511(a)(2)(B), are not subject to this excise tax. There is no mention in the Bill of university foundations or affiliates, or charitable trusts with eligible educational institutions as their beneficiaries.

The levy is not based on the size of the institutional investments, but rather a formula comparing the aggregate fair market value of what amounts to the non-charitable use (e.g., investment) assets against the number of students. Amounts of $100,000 or less per student avoid taxation, which computed on a five percent endowment investment draw means that support of more than $5,000 per student is taxable. For purposes of calculating the number of students, part-time students are taken into account on a full-time student equivalent basis.

Private foundation excess business holdings

Code Section 4943 (and its accompanying regulations) is part of the suite of Chapter 42 provisions imposed on private foundations since 1969. It substantially prevents a private foundation from being employed as a device to control or operate a functioning business, and instead concentrates on promoting charity. Of course, the history of funding private foundations with substantial business holdings—especially as a measure to avoid the imposition of estate tax—is an important element of the excess business holding rules, Code Section 4943(c)(5) and (6), as is the ability to operate a functionally related business under Code Section 4943(d)(3)(A).

The proposed exception from Code Section 4943 included in Section 5104 of the Bill is highly selective. The exception would allow a private foundation to wholly own a for-profit business gifted to it as long as all net operating income is paid out to the private foundation within 120 days of year-end and the subsidiary's directors and executives are independent from the private foundation.

As such, it is less valuable as a legitimate charitable tax planning tool and more akin to private letter ruling relief to a single company and private foundation.

It is interesting that JCT estimates that this provision would increase revenues, albeit by less than $50 million from 2018 through 2027.

Churches and political activity

The so-called "Johnson amendment" of 1954 prohibited all Code Section 501(c)(3) organizations from electioneering. The law defines a charity as one "which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." Congress strengthened the ban with the passage of the "Bork amendment" in 1987 to clarify that the prohibition also applies to statements opposing (as well as in support of) candidates.

Charities generally have grown to appreciate the limitation, as it keeps them from being targets in the political machinations that have so divided our country, and allows them to concentrate on mission.

Candidate Trump offered: "I think maybe that [repeal of the Johnson Amendment] will be my greatest contribution to Christianity . . . ," and signed an Executive Order in May 2017, limiting the actions of Treasury "against any individual, house of worship[] or other religious organization on the basis that such individual or organization speaks or has spoken about moral or political issues from a religious perspective . . . ."

The relief contemplated in Section 5201 of the Bill would on its face provide certain safeguards against IRS enforcement against religious entities, but would have the effect of subjecting these charities to the same political pressures that fueled the controversy surrounding civic organization electioneering back in 2013.

This provision would be effective immediate after the Bill is enacted. As a revenue measure, it is contemplated that this change would cost the government $2.1 billion over from 2018 through 2027.

Donor advised fund sponsoring organizations

Congress (finally) defined donor advised funds (DAFs) in order to regulate them in the Pension Protection Act of 2006. Their widespread use has resulted in substantial additional sums gifted to charity. Since that time, Congress and the IRS have expressed varying concerns about the use of DAFs, even after imposing a variety of private foundation-like restrictions on the public charities that maintain them. While DAFs are not currently subject to the private foundation's mandatory five percent payout requirement, the vast majority of DAF sponsors already require some type of mandatory distribution requirement. Earlier this year, the Council on Foundations urged DAF sponsors to commit to adopting a spending policy on orphan DAFs.

Despite these protections, Section 5202 of the Bill would require public charity sponsors of DAFs to disclose annually their policies on inactive DAFs, as well as the average amount of grants made from their DAFs.

The projected effect on this proposal is zero and appears to be an effort to further regulate the use of DAFs.

For more information on potential limitations on issuers of tax-exempt bonds, please click here for our client alert on this topic. For more information on the provisions affecting employee benefits and executive compensation, please click here for our client alert.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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