TAX REFORM

UPDATE ON PENDING TAX REFORM LEGISLATION

NONPROFIT ORGANIZATIONS ALERT
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Tax reform and exempt organizations — the Senate Finance Committee speaks

By Michael J. Cooney

Senate Bill

The Senate released its version of the proposed Tax Cuts and Jobs Act (the "Bill") last week. Working from the description of the available Chairman's mark, there are several fundamental differences between the House and Senate Bills, which in the normal course would be taken up in conference in order to assure a well-thought-out proposal that a majority of both houses could support. Those differences include provisions impacting the operations of tax-exempt organizations. All provisions discussed below would be effective for tax years beginning after December 31, 2017.

Charitable contributions

Like the House Bill, the Senate proposal increases from 50% to 60% the income-based percentage limit described in section 170(b)(1)(A) for certain charitable contributions of cash to public charities and certain other organizations by an individual taxpayer.

The Senate Bill mirrors the House Bill in doing away with the "Pease limitation" on total itemized deductions and the repeal of any charitable deduction accompanying a payment to an institution of higher education in exchange for which the donor receives the right to purchase tickets or seating at an athletic event. The Senate Bill contains no mention of the House's proposed mileage deduction adjustment for inflation nor repeal of the mechanism to allow charities to satisfy the contemporaneous written acknowledgment requirement on behalf of their donors giving $250 or more.

The Pension Protection Act of 2006 made certain adjustments in the computation of adjustments to basis where a subchapter S corporation contributed appreciated property to charity. That change was made permanent in the Tax Increase Prevention Act of 2014, putting S corporation shareholders on par with a partner in a partnership making a charitable contribution of appreciated property. Importantly, those downward adjustments to basis in the S corporation context limit the availability of losses. The Senate Bill would impact partnerships so that the basis limitation on

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partner losses also applies to the partner's distributive share of charitable contributions and foreign taxes.

Unrelated business income tax

Taxation of name and logo royalties. The Senate report accompanying the creation of the unrelated business income tax (UBIT) regime decades ago concluded that, "[d]ividends, interest, royalties, most rents, capital gains and losses[] and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income." So, while taxing royalty income derived from an exempt organization's licensing of its name and logo would represent a substantial policy shift in the application of the UBIT, Congress has for years entertained just that change.

The Senate Bill proposes to do away with the long-standing UBIT exception for royalties, but only with respect to the licensing of an organization's name or logo. The policy basis for such a change is unclear.

Disallowing losses from distinguishable unrelated business activities. The stated purpose for the imposition of UBIT on tax-exempt organizations in 1954 was to "level the playing field" between taxable and tax-exempt entities competing in the same market. Accordingly, a tax-exempt organization may engage in numerous types of income-generating activities that are subject to UBIT at regular corporate tax rates. These may be as diverse as earnings from a hospital pharmacy that sells to the public as well as to hospital patients, to the allocation of income from a partnership investment. Just as with for-profit businesses, tax-exempt organizations incurring UBIT from multiple sources may aggregate income and deductions from all such activities. Treas. Reg. § 1.512(a)-1(a).

As we learned from the Colleges and Universities Compliance Project in 2013, the generation of continued net losses from a particular activity allows the IRS to assert that there was no profit motive—no trade or business was effectively being pursued—thereby disallowing those losses against other income-generating activity.

The Senate Bill now proposes to change the law in place for fifty years, and attempts to segregate out lines of business to disallow a net operating loss deduction, except with respect to a specific trade or business from which the loss arose. The policy basis for such a change is unclear.

Fringe benefit expenses. In an accommodation to the for-profit athletic club industry, the House Bill would penalize exempt organizations for making on-premises gyms as well as other athletic facilities (think of the pool at the YMCA) available to their employees. The same approach—based on the imposition of UBIT to the exempt organization's expenditures, not income—would burden employee transportation fringe benefits.

The Senate Bill does not contain this serving of athletic club pork, but employee fringes are curtailed from current law. On that basis this bizarre approach to "leveling the playing field" between for-profits and tax-exempts might find refuge.

Quasi-governmental entities. The Senate Bill does not address the taxable income of certain state and local entities whose income is excluded from income taxation under Code Section 115(l).

Research income. The Senate Bill does not address the attempted clarification that research organizations operated primarily to conduct fundamental research must make the results of the specific research generating the income freely available to the general public, or be subject to UBIT.

Exempt organizations — excise taxes

Executive Compensation Excise Tax. The Senate Bill, like the House Bill, imposes a 20% excise tax equal to the value of remuneration in excess of $1 million to certain employees. Like the House Bill, this new tax would apply cumulatively to the organization's five highest compensated employees in any tax year beginning after December 31, 2016. Employees of federal, state[] or local governmental entities with a dollar of excludable income under Code Section 115 would also be included, as well as political organizations exempt under Code Section 527. Remuneration from related entities (which is broadly defined) is counted as well.

Code Section 4958 — Intermediate Sanctions. The Senate Bill proposes to make substantial modifications to the long-standing intermediate sanction or excess benefit transaction rules that have governed charity and civic organization compensation for over two decades.

> Rebuttable presumption of reasonableness. In particular, the Senate seeks to eliminate the rebuttable presumption of reasonableness (Reg. § 53.4958-6(a)), which requires the IRS to develop sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the exempt organization. Lawmakers are apparently concerned that the IRS's own regulations (in place for more than a decade) compromise the Agency's ability to enforce the statute, and so creates purposeful ambiguity about whether or not the appropriate standard is satisfied.
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> Organization managers "knowing" participation. The Bill also proposes eliminating the current standard allowing organization managers to rely on expert, third-party professional advice, deeming this industry standard little more than "a relevant consideration in determining the manager knowingly participated in an excess benefit transaction."
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> Disqualified person expansion. Athletic coaches and investment advisors are also identified for increased scrutiny in the Senate Bill. Colleges and universities participating in the Title IV program would now have to consider all their athletic coaches as disqualified persons for the application of the excess benefit rules. Why the coaches of the men's golf or women's lacrosse teams should be subject to such scrutiny belies belief. Also impacted is the compensation received by investment advisors—even those completely independent from the exempt organization—thereby extending a little-known regulatory requirement otherwise limited in application to donor advised funds by the Pension Protection Act in 2006. This proposal demonstrates the Finance Committee's appetite for enacting and then later expanding complicated tax regimes into exempt organization activities.
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> Expansion of exemption organizations covered. The Bill also seeks to expand the types of organizations subject to Code Section 4958 to include labor and certain other organizations (described in Code Section 501(c)(5)) and business leagues (described in Code Section 501(c)(6)).

Private college and university investment income. Like the House Bill, the Senate Bill would impose a one and four-tenths percent (1.4%) excise tax on the net investment income of certain private

colleges and universities, again using the approach historically limited to private foundations under Code Section 4940(c). The House approach was amended to comport with the $250,000 per student standard in the Senate Bill. Unlike the House Bill, the Senate would amalgamate the investment holdings of related entities, such as those which control, are controlled by[] or are under common control (by one or more individuals), including for example supported organizations. The addition of related entities would likely be of greater impact to public institutions, were these institutions subject to this new tax levy.

Private foundation investment income excise tax. While the Senate Bill makes extensive reference to the private foundation net investment income tax under Code Section 4940 for purposes of analogizing to a new levy on university investments, it fails to adjust the amount of that tax to a uniform 1.4% as proposed in the House Bill.

Private art museums. The Senate Bill has no provision with respect to "private" art museums.

Private foundation excess business holdings. The Senate Bill does not contain the narrow exception for Code Section 4943 excise taxes offered in the House Bill.

Churches and political activity

The Senate Bill does not contain the repeal of the so-called "Johnson Amendment" of 1954 in favor of religious organizations.

Donor advised fund sponsoring organizations

The Senate Bill does not contain the various additional restrictions the House Bill would impose on donor advised funds.

As with the House draft legislation, there are a number of elements of impact on tax-exempts, such as the repeal of the estate tax and continued ability to benefit from tax-exempt bond financing.

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