Proposed Tax Reform Bill Impacts Philanthropy and Tax-Exempt Organizations

On November 2, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) introduced H.R. 1, the "Tax Cuts and Jobs Act" (the "Bill"). At over four hundred pages, the Bill promises substantial changes to the Internal Revenue Code of 1986, as amended (the "Code"). Although the Bill could have significant and long-term impact for most U.S. taxpayers, we highlight below certain key provisions of particular interest in the worlds of philanthropic giving and tax-exempt organizations. We do not address provisions of broad, general applicability (such as the proposed phase-out of the estate tax, the proposed increase in the standard deduction, and the proposed elimination of the so-called "Pease limitation" on itemized deductions), even though such changes in the law obviously could have an impact on charitable giving. It is unclear which provisions of the Bill, if any, will ultimately become law. The Senate has not released its own tax proposal, and once it does the two bills will likely need to go to conference to arrive at a bill agreeable to both chambers. We will continue to monitor the Bill as it makes its way through Congress. The changes below would go into effect for taxable years beginning after December 31, 2017.

Education/Tuition Assistance (Bill Section 1204): The Bill would eliminate two forms of tax-free employer-provided tuition/education assistance under current law: (i) employer-provided education assistance programs (under Code Section 127) of up to $5,250 per year per employee which can pay for undergraduate or graduate courses taken by the employee and (ii) qualified tuition reductions (under Code Section 117) provided by educational institutions (i.e., schools and universities) to their employees (and employee dependents) to pay for primary, secondary, high school, or undergraduate education at eligible educational institutions.

Adjusting the Adjusted Gross Income Limitation (Bill Section 1306): Under current law, a taxpayer's itemized deduction for charitable contributions is limited to a percentage of adjusted gross income ("AGI"). Such limitation varies depending on the type of property contributed and the tax classification of the donee (e.g., whether it is a public charity or a non-operating private foundation). Broadly speaking, a taxpayer may deduct up to 50% of his or her AGI for cash contributed to public charities, private operating foundations and certain non-operating private foundations. If a taxpayer contributes more than the applicable AGI limits, the excess contribution generally may be carried over and deducted in the following five tax years.

The Bill would increase the AGI limitation for cash contributions to public charities and certain private foundations from 50% to 60%. The Bill would retain the five-year carryover period to the extent that the contribution amount exceeds the applicable portion (in this case, 60%) of the donor's AGI.

Eliminating the Alternative Gift Substantiation Exception (Bill Section 1306): Under current law, in order for a donor to claim a deduction for a charitable contribution of $250 or more, the donor must substantiate his or her contribution with a contemporaneous written acknowledgment from the donee organization, except where the organization files a return with the Internal Revenue Service which substantiates the deduction. Following the withdrawal of proposed regulations relating to this exception in 2016, the Bill would repeal the exception altogether.

Employer-Provided Housing (Bill Section 1401): Under current law, employer-provided housing for an employee (and his or her immediate family) is not taxable to an employee if such housing is provided for the convenience of the employer and the employee is required to accept lodging on the premises of the employer as a condition of employment. If the employer is an educational institution, the value of the housing provided to employees is also not taxable to the extent the rent paid by the employee is above certain thresholds. The Bill proposes to (i) limit the exclusion for these two types of employer-provided housing to $50,000 (or $25,000 for a married individual filing a separate return), (ii) phase out the exclusion for highly compensated individuals (income of $120,000 or more in 2017), and (iii) limit the exclusion to one residence.

Repeal of Authority to Issue Tax Exempt Bonds (Bill Section 3601): Under current law, organizations exempt under Section 501(c)(3) can issue tax-exempt bonds to finance qualifying expenditures. The Bill would repeal the authority to issue "qualified private activity bonds," including qualified Section 501(c)(3) bonds, after December 31, 2017. If the Bill becomes law, tax-exempt bonds for the benefit of organizations exempt under Section 501(c)(3), including hospitals, cultural institutions and universities, would not be able to be issued after December 31, 2017. No transition rules are proposed.

Taxation of Executive Compensation (Bill Section 3803): Although current law regarding excess benefit transactions effectively requires certain organizations—including public charities and social welfare organizations—to pay no more than reasonable compensation to their officers, key employees and other disqualified persons, these rules do not establish any dollar-amount caps or other limitations on the amount of compensation. The Bill would impose a 20% tax on the excess compensation (and certain severance payments) paid to an organization's five highest compensated employees whose compensation exceeds $1,000,000 (or who receive an excess severance payment) in a given year, effectively penalizing the organization for making such payments. This provision would apply to organizations exempt under Code Section 501(a) (e.g., 501(c) organizations such as private foundations, public charities, business leagues, social clubs, and social welfare organizations) and Code Section 115(1) (e.g., public universities). This provision would also apply to employees who met these thresholds in any taxable year beginning after December 31, 2016. The tax is payable by the tax-exempt organization and, if applicable, a related organization (on a proportional basis).

Modification to the Tax on Private Foundation Investment Income (Bill Section 5101): Code Section 4940(a) currently imposes an annual excise tax of 2% on the net investment income of private foundations. Code Section 4940(e) reduces this excise tax to 1% where the foundation increases its annual distributions for charitable purposes beyond a mandatory minimum. The Bill would replace this structure with a flat 1.4% excise tax rate on the net investment income of private foundations (regardless of the level of their charitable expenditures during the year) and the current rules providing for the reduction in the excise tax rate from 2% to 1% would be repealed.

Art Museums Classified as Operating Foundations (Bill Section 5102): The Bill would amend the definition of "operating foundation" in Code Section 4942(j) to exclude organizations that operate an art museum as a substantial activity, unless the museum is open to the public for at least 1,000 hours (during business hours—the equivalent of 125 business days, based on an eight-hour day) over the course of the taxable year. The Bill contains no definition of "art museum."

Taxing College and University Investment Income (Bill Section 5103): Under current law, public charities are not subject to excise tax on their net investment income. The Bill would impose an excise tax of 1.4% on the net investment income of private universities and colleges with over 500 students whose aggregate investment assets (those assets not used to carry out its educational purposes, such as academic buildings) equal at least $100,000 per student. The number of students is calculated by looking at the daily average of full-time students and can take into account part-time students on a full-time equivalent basis (for example, two part-time students who attend 50% of the time should equal one full-time student for the purposes of determining how many students an institution has). For example, a university with 5,000 full-time equivalent students would be subject to this new excise tax if its aggregate investment assets exceed $500,000,000.

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Excess Business Holdings Exception (Bill Section 5104): Under current Code Section 4943, a private foundation is restricted from owning more than specified percentages (generally 20%) of the vote or value of a business enterprise. A business enterprise generally does not include a "functionally related business" or an enterprise that derives at least 95% of its gross income from passive sources, such as dividends, interest and royalties. A private foundation that owns more than the prescribed amount of a business enterprise during a taxable year is subject to an initial excise tax of 10% of the value of the excess holdings.

The Bill would exclude from the definition of excess business holdings a private foundation's ownership of certain "independently operated philanthropic businesses." A business enterprise would qualify as such if (i) the foundation owns 100% of the voting stock of the business at all times during the taxable year, and acquired such stock other than by purchase, (ii) the business distributes all of its net operating income to the foundation within 120 days of the end of the taxable year, and (iii) the business demonstrates that it is independently operated. "Net operating income" means the gross income of the business, minus deductions that are directly connected with the production of such income, tax imposed on the business, and an amount for a reasonable reserve for working capital and other business needs.

To demonstrate that the business is "independently operated," the following conditions must be met at all times during the taxable year: (i) no substantial contributor to the foundation (or family member of a substantial contributor) serves as a director, officer, trustee, manager, employee, or contractor of the business, or has responsibilities or powers similar to any of the foregoing, (ii) at least a majority of the directors of the foundation are not also directors or officers of the business or family members of substantial contributors to the foundation, and (iii) there is no loan outstanding from the business to a substantial contributor to the foundation or a family member of a substantial contributor.

This new exception would not apply to donor advised funds, supporting organizations, charitable trusts, or split-interest trusts.

Political Campaign Intervention by Churches (Bill Section 5201): Under current law, commonly known as the "Johnson Amendment," all Section 501(c)(3) organizations, including churches, face an absolute prohibition on their ability to participate or intervene in political campaigns, whether or not such activities are consistent with or carried out as part of their overall exempt activities. The Bill would modify this prohibition by creating a "pulpit" exception for churches, their integrated auxiliaries and conventions or associations of churches to engage in political campaign intervention in the context of religious services or gatherings (via homilies, sermons, teachings, dialectics or other presentations), so long as such engagement is "in the ordinary course of the organization's regular and customary activities in carrying out its exempt purposes" and "results in the organization incurring not more than de minimis incremental expenses." For these purposes, the term "church" is used in its broad, tax law sense and would therefore include churches, synagogues, mosques, and other houses of religious worship.

Donor Advised Fund Reporting (Bill Section 5202): Under current law, a sponsoring organization of donor advised funds must annually report on Form 990 the total number of donor advised funds it owns at the end of the taxable year, the aggregate value of assets held in such funds at the end of the taxable year and the aggregate contributions to and grants made from the funds during the taxable year. The Bill would amend Code Section 6033(k) to require a sponsoring organization to also (i) report the average amount of grants made from its donor advised funds during the taxable year (expressed as a percentage of the value of assets held in such funds at the beginning of the taxable year) and (ii) indicate whether the sponsoring organization has a policy regarding the frequency and minimum level of distributions from its donor advised funds.

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1133 Avenue of the Americas New York, NY 10036-6710 212.336.2000 www.pbwt.com

If you would like more information about this report, please contact one of the following attorneys or call your regular Patterson contact.

Laura E. Butzel	212-336-2970	lebutzel@pbwt.com
Dahlia B. Doumar	212-336-2988	dbdoumar@pbwt.com
Tomer J. Inbar	212-336-2310	tinbar@pbwt.com
Robin Krause	212-336-2125	rkrause@pbwt.com
John Sare	212-336-2760	jsare@pbwt.com
Megan E. Bell	212-336-2077	mbell@pbwt.com
Janine Shissler	212-336-2213	jshissler@pbwt.com
Tanvi Mirani	212-336-2715	tmirani@pbwt.com
Lauren Simpson	212-336-2041	lsimpson@pbwt.com
Douglas L. Tang	212-336-2844	dtang@pbwt.com
Susan M. Vignola	212-336-2256	svignola@pbwt.com
Justin Zaremby	212-336-2194	jszaremby@pbwt.com
Antonia M. Grumbach	212-336-2840	amgrumbach@pbwt.com
Rochelle Korman	212-336-2680	rkorman@pbwt.com
Robert M. Pennoyer	212-336-2700	rmpennoyer@pbwt.com

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