Patterson Belknap Webb & Tyler LLP

Tax-Exempt Organizations Alert January 2018

# Sweeping Tax Reform Impacts Tax-Exempt Organizations

After a short period of deliberations by the House of Representatives (the "House") and the Senate, President Trump signed the final version of H.R. 1 into Public Law No. 115-97 on December 22, 2017 (the "New Law"). Our previous alerts discussed the evolution of the New Law in detail and the impact on tax-exempt organizations of certain provisions of the initial bills introduced by the House and the Senate.

The following is a discussion of the provisions of the New Law most likely to impact tax-exempt organizations, as well as a summary of the provisions that appeared in initial versions of the New Law but ultimately were not included in the final version. All of the below provisions will be effective for taxable years beginning after December 31, 2017, unless otherwise noted. All Code and Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

## Provisions Included in the New Law

(1) Excise Tax on Excess Executive Compensation (*New Law Section 13602; new Code Section 4960*)

The New Law imposes an excise tax equivalent to the new 21% corporate tax rate on excess compensation (and certain severance payments) paid to an applicable tax-exempt organization's "covered employees." The tax is payable by the tax-exempt organization and, if applicable, a related organization (on a proportional basis). The relevant definitions and terms are outlined below.

"Excess compensation" includes the amount of (a) remuneration, other than "excess parachute payments," in excess of $1 million paid with respect to any covered employee and (b) any excess parachute payment made to any covered employee.

In general, a "parachute payment" is a payment "in the nature of compensation" contingent on an employee's separation from the employer and equal to at least three times the employee's five-year average total compensation (referred to as the "base amount"). An "excess parachute payment" is the amount by which a parachute payment exceeds the employee's base amount. Therefore, if an employee receives severance payments or other payouts on separation that are more than three times his or her base amount, those payments constitute parachute payments, and the excise tax is applied to the amount by which those payments exceed one times the base amount. As with remuneration, parachute payments exclude payments made to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services by such professionals, and do not include payments made to individuals who are not "highly compensated employees" as defined in Code Section 414(q).

An "applicable tax-exempt organization" means any organization 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) or that has income excluded from taxation under Code Section 115(1) (e.g., public universities, although some commentators have questioned whether the language of the New Law will in fact reach these institutions), as well as exempt farmers' cooperatives and Code Section 527 political organizations.

A "covered employee" means any current or former employee who is one of the five highest compensated employees of the organization in a given taxable year, or any person who was a covered employee for any preceding taxable year beginning after December 31, 2016.

"Remuneration" generally means wages, excluding designated Roth contributions and amounts paid for the performance of medical or veterinary services paid to licensed medical professionals (including veterinarians). Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration (within the meaning of Code Section 457(f)(3)(B)).

Remuneration also includes remuneration paid by a related organization. A "related organization" includes any person or governmental entity that controls, is controlled by, or is under common control with the applicable tax-exempt organization, or that is a supported organization described in Code Section 509(f)(3) or a supporting organization described in Code Section 509(a)(3) with respect to the applicable tax-exempt organization. If remuneration from more than one employer is included in determining the excise tax, each employer is liable for its proportional share of the tax.

The New Law provides that Treasury Regulations will be issued as necessary to prevent avoidance of this new excise tax. Note that this provision is separate and independent from the "intermediate sanctions" regime under Section 4958 (relating to excess benefit transactions), and an applicable tax-exempt organization must pay this new excise tax even if it has separately determined that the compensation is reasonable for intermediate sanctions purposes.

(2) UBTI Separately Computed for Each Trade or Business Activity (*New Law Section 13702; new Code Section 512(a)(6)*)

The New Law requires an exempt organization with more than one unrelated trade or business to compute unrelated business taxable income ("UBTI") separately with respect to each trade or business and without regard to the specific deduction allowed under Code Section 512(b)(12). Per the New Law, the organization's UBTI for a particular taxable year will be the sum of the amounts computed separately, less any specific deduction allowed under Code Section 512(b)(12). Exempt organizations will require further guidance from the IRS on how to distinguish lines of unrelated trades or businesses for purposes of computing their UBTI.

Under new Code Section 512(a)(6)(A), a net operating loss deduction is allowed only with respect to the trade or business from which the loss arose (though this restriction would not apply to net operating losses carried over from taxable years beginning before January 1, 2018). Accordingly, organizations generally will not be able to use a deduction for one unrelated trade or business to offset income from another unrelated trade or business for the same taxable year.

The New Law also adds new Code Section 512(a)(7), which provides that an exempt organization's UBTI will be increased by amounts paid or incurred for certain fringe benefit expenses for which a deduction is not allowed under Code Section 274. Our previous alert provides more information about this provision.

The New Law also reduces the top corporate tax rate to 21%. Since this rate is also applicable to an exempt organization's UBTI, exempt organizations will likely see a reduction in their unrelated business income tax.

(3) Excise Tax Based on Investment Income of Private Colleges and Universities (*New Law Section 13701; new Code Section 4968*)

The New Law imposes an annual excise tax of 1.4% (similar to the 1% or 2% excise tax currently applicable to private foundations) on the net investment income of an applicable educational institution. Generally, this means a private college or university that has (a) more than 50% of its students located in the United States, (b) at least 500 students during the preceding taxable year, and (c) at least $500,000 in assets per student, other than those assets which are used directly in carrying out the institution's exempt purpose. We anticipate that the IRS will issue regulations clarifying how a university's assets are measured for purposes of qualifying for the tax.

The New Law treats the assets and net investment income of any related organization as the assets and net investment income of the applicable educational institution. A related organization is any organization that controls, is controlled by, or is under common control with the private college or university, or that is a supported organization described in Code Section 509(f)(3) or a supporting organization described in Code Section 509(a)(3) with respect to the applicable educational institution. However, a related organization's assets and net investment income won't be treated as the assets and income of the educational institution if such assets and income are not intended or available for the educational institution's use or benefit, unless the related organization is controlled by or is a supporting organization of the educational institution.

The New Law states that net investment income will be determined under rules similar to those of Code Section 4940(c), which defines net investment income for private foundations. We anticipate that the IRS will issue Treasury Regulations to clarify this determination process and provide additional guidance on determining whether an organization is "related" to an applicable educational institution.

(4) Changes to Charitable Contribution Rules (*Code Section 170*)

a. Increase in Standard Deduction; Temporary Suspension of Pease Limitation (*New Law Sections 11021, 11046*)

The New Law increases the amount of the standard deduction for individuals for an eight year period (taxable years 2018-2025) to $24,000 for married individuals filing jointly, $18,000 for head of household filers, and $12,000 for all other taxpayers. Since only taxpayers who itemize their deductions may avail themselves of the charitable contribution deduction, this provision could decrease popular interest in making charitable contributions. However, the New Law also temporarily suspends the "Pease Limitation" found in Code Section 68. This section reduces the amount of certain itemized deductions that high-income taxpayers may take. Specifically, the Pease Limitation reduces the allowable amount of such itemized deductions by 3% of the amount by which a taxpayer's adjusted gross income exceeds certain inflation-adjusted thresholds. The reduction is capped at 80% of the otherwise allowable itemized deductions for the tax year. The New Law suspends the Pease Limitation for tax years 2018-2025.

b. Adjustment of Adjusted Gross Income (*New Law Section 11023*)

An individual taxpayer's itemized deduction for charitable contributions is generally limited to a percentage of the individual's adjusted gross income ("AGI"). Such limitation varies depending on the type of property contributed and the tax classification of the donee organization. Broadly speaking, an individual has been able to deduct up to 50% of his or her AGI for cash contributed to public charities, private operating foundations and certain private non-operating foundations. If the individual contributes more than the applicable AGI limits, the excess contribution generally may be carried over and deducted in the following five years.

The New Law increases the AGI limitation for cash contributions to public charities and certain private foundations from 50% to 60% for an eight year period (taxable years 2018-2025). The New Law retains 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.

c. Repeal of Alternative Gift Substantiation Exception (*New Law Section 13705*)

The New Law repeals Code Section 170(f)(8)(D). Upon issuance of final Treasury Regulations, this Code section would have permitted a donor to deduct a charitable contribution of $250 or more to a tax-exempt organization even if the donor did not obtain a contemporaneous written acknowledgment of the contribution from the donee organization, as long as the donee organization filed a return with the IRS (e.g., Form 990) that included the same information required in a contemporaneous written acknowledgment. The repeal of this Code section means that donors must substantiate their contributions with contemporaneous written acknowledgments from donee organizations in order to claim deductions for such contributions. The repeal will be effective for taxable years beginning after December 31, 2016.

**Provisions Excluded from the New Law**

Earlier versions of the tax reform legislation introduced in the House and Senate included proposed provisions that were excluded from the New Law. The substance of the below provisions could resurface in future legislation. Our prior alerts discussed these provisions in more detail.

(1) Political Campaign Intervention by Section 501(c)(3) Organizations (*Code Section 501*)

This provision – the repeal of the so-called Johnson Amendment – would have eliminated the absolute prohibition on political campaign activities by Code Section 501(c)(3) organizations. Exempt organizations would have been permitted to engage in limited political campaign activity through "statements" made in the ordinary course of their regular and customary activities that resulted in not more than *de minimis* incremental expenses.

(2) Excise Tax on Private Foundations (*Code Section 4940*)

This provision would have replaced the current private foundation net investment income excise tax structure with a flat 1.4% excise tax on a private foundation's annual net investment income, and the current rules providing for the reduction in the excise tax rate from 2% to 1% in certain circumstances would have been repealed.

(3) Elimination of Education/Tuition Assistance Provisions (*Code Sections 117, 127*)

This provision would have eliminated two forms of tax-free employer-provided education/tuition assistance available under current law.

(4) Excess Business Holdings Tax Exception for Private Foundations (*Code Section 4943*)

This provision would have excluded from the definition of excess business holdings a private foundation's ownership of certain "independently operated philanthropic businesses."

(5) Name and Logo Royalties Treated as UBTI (*Code Sections 512, 513*)

This provision would have subjected royalty income derived from the licensing of an exempt organization's name or logo (including any trademark or copyright relating to such name or logo) to unrelated business income tax, and would have repealed the exclusion of royalties or other income derived from any licensing of a name or logo of the organization from UBTI.

(6) Excess Benefit Transaction Changes (*Code Section 4958*)

Among other changes, these provisions would have eliminated the "rebuttable presumption of reasonableness" with respect to excess benefit transactions under Code Section 4958.

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Stay tuned for updates in the event of any further guidance on the provisions found in the New Law (e.g., Treasury Regulations, Revenue Rulings, etc.), and on modifications made in future Congressional sessions.


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

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