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NO. 137
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Tax Bill Not Good for Nonprofits, But Not as Bad As It Might Have Been

Johnson Amendment remains to prevent electioneering, incentives for charitable giving eliminated for most taxpayers

The "Tax Cuts and Jobs Act" ultimately passed by Republicans in Congress and signed by President Trump is not good for most nonprofit organizations, but is not as bad as it might have been.

It eliminates tax incentives for charitable contributions for all but about 5% of U.S. taxpayers who will continue to itemize deductions, a number significantly less than the 30% of taxpayers who itemize currently. The National Council of Nonprofits has argued that this provision will reduce charitable contributions by about $13 billion a year.

The Act eliminates the "individual mandate" for individuals to obtain health insurance under the Affordable Care Act, which the Congressional Budget Office estimates will cause 13 million people to lose their health insurance over the next 10 years, and will raise insurance costs for others.

It will create additional federal debt of more than $1 trillion over the next 10 years, which will put severe pressure on Social Security, Medicare, and Medicaid and funding for social service programs. And it will impose new taxes on many nonprofits.

The one major provision opposed by most charitable organizations that did not make the final bill was the repeal of the Johnson Amendment, which was passed by the House in its version of the bill. The House provision would have allowed charities, particularly intended to include churches, to make statements in support of or in opposition to political candidates so long as it was within their normal course of their activities and required only incidental additional costs. Critics of the proposal said it would remove the political protection that charities now enjoy and would introduce tax-deductible "dark money" into politics for the first time. (See Ready Reference Page: "Keep Charities Out of Politics") The proposal was eliminated entirely in the final Conference Report and the Act.

Many of the impacts on nonprofits will arise indirectly. The final Act doubles the point at which federal estate tax is imposed on individuals from $5 million (indexed for inflation from 2010 and about $5.49 million in 2017) to $10 million per individual and $20 million for a married couple (both figures also indexed to about $11 million and $22 million). The final version applies to deaths occurring after December 31, 2017 and before January 1, 2016. Many charities fear that this will reduce the incentive for testamentary gifts to charity for many taxpayers.

(Like many of the tax cuts affecting individuals, this provision is not made permanent. It will apply only until January 1, 2026. The tax cuts for business were made permanent. If the individual tax cuts are reinstated later, as many Republicans predict they will, the addition to the deficit over ten years will be significantly greater.)

Tax on compensation over $1 million

A new section 4960 of the Tax Code imposes a 21% excise tax on compensation of more than $1 million paid by organizations exempt from tax under section 501(a), which includes 501(c)(6) trade associations and 501(c)(4) social welfare organizations as well as 501(c)(3) charities, section 115(1) governmental units, farmers' coops and section 527 political organizations. The tax is imposed on the compensation of any "covered employee" who is one of the five highest paid employees for the year or any person who was in such category for any year starting after December 31, 2016. Compensation includes wages (other than Roth IRA contributions) and deferred compensation included in gross income under section 457(f), but specifically excludes remuneration received by licensed medical or veterinarian professionals for their medical services.

Compensation is aggregated with compensation received from any "related organization," defined as any person or governmental entity that controls or is controlled by the organization, is controlled by one or more persons that controls the organization, or is a supporting defined in section 509(a)(3) or certain supported organizations defined in section 509(f)(3) with respect to the organization. Where multiple organizations contribute to the total compensation, their tax liability is proportionate to their contribution to such compensation.

The 21% tax is based on the new tax rate for business corporations and is intended to mimic the point at which business can no longer deduct compensation. (The business corporation exception for performance based pay and stock options has been repealed in the Act.) It will particularly hit highly-paid athletic coaches as well as top executives of colleges and medical systems.

The tax is in addition to any tax that may be due for payment of an excess benefit tax for unreasonable compensation under section 4958. Interestingly, the compensation excise tax is due even if the compensation is not deemed an excess benefit under section 4958, but the provision may put a higher premium on obtaining comparable salary studies to obtain the rebuttable presumption that compensation of more than $1 million is reasonable.

Tax on "excess parachute payments"

The same new section 4960 adds a separate new tax on "excess parachute payments" received by covered employees. A parachute payment is considered an "excess parachute payment" if it equals or exceeds three times the employee's base compensation for the five years prior to separation, with certain exceptions.

The taxes on compensation and excess parachute payments are both payable by the organization and not the individual and apply to taxable years beginning after December 31, 2017.

Tax on net investment income of colleges and universities

The Act imposes a totally new 1.4% excise tax on the net investment income of large and wealthy private colleges and universities (section 4968). It covers those with at least 500 full time "tuition paying" students, more than half of whom are located in the U.S., and where the aggregate fair market value of its assets (other than those "used directly" in their educational function) are at least $500,000 per student. The tax is estimated to cover only about 30 institutions, but the effect on Harvard University has been estimated to be $43 million if the tax had been in effect for 2017.

Congress had for many years considered imposing a tax on endowment income for particular purposes (See Ready Reference Page: "Congressional Research Service Lists Options to Regulate University Endowments"), but this provision is imposed without purpose other than to raise revenue from the wealthier schools. It was modified during the legislative process to exempt Berea College (in Sen. Mitch McConnell's home state of Kentucky) because most of its students attend tuition free.

Net investment income will be determined in the same way it is determined for private foundations under section 4940. The tax is imposed on the aggregate investment income of the specific college or university and any "related" organization. A related organization is one that controls or is controlled by the institution, is controlled by one or more persons who also control the institution, or is a supporting organization or supported organization with respect to the institution.

The tax applies to taxable years beginning after December 31, 2017.

Computation of UBIT separately for each line of business

Previous law required nonprofits to pay unrelated business income tax ("UBIT") on their net unrelated business taxable income ("UBTI") over $1000. They were permitted, however, to offset losses in one line of business against profits in another line of business. Under the Act, nonprofits operating more than a single line of business will not be permitted to offset losses in one line of business against profits in another line. The Act adds a new section 512(a)(6) providing that an exempt organization must calculate UBTI separately for each "trade or business." The IRS is supposed to issue guidelines on distinguishing different trades or businesses in order to make the proper calculations.

Because the tax rate is dropped from the old corporate rate of 35% to the new corporate rate of 21%, an organization is likely to pay less total tax than it would have under the old rules but will have more difficulty in determining the separate lines of business.

The provision applies to taxable years beginning after December 31, 2017 but net operating losses from years prior to 2018 can be carried over to offset any UBTI.

Inclusion of fringe benefits in calculation of UBTI

A new section 512(a)(7) attempts to put nonprofits on a parity with business corporations that may not deduct certain fringe benefits by increasing UBTI by any amount paid or incurred for those fringe benefits such as qualified transportation benefits, use of qualified parking facilities and on-premises athletic facilities. Some nonprofits may want to avoid the UBIT by increasing salaries to cover the costs of these benefits.

This provision applies to payments made or incurred after December 31, 2017, not just to payments made in the years commencing thereafter.

Repeal of deduction for payments for right to buy college athletic tickets

The Act repeals the old provision of section 170(l) that allowed an 80% charitable contribution deduction for payments to colleges and universities that grant the right to purchase athletic tickets in return for the payment. The specific deduction had been added in 1990 because of concern about quid pro quo rules concerning a deduction when something of significant value was received in return. The change could have an adverse impact on some college and university booster clubs where tickets are not so hard to get or the teams are not as good as they once were.

The provision applies to contributions in taxable years beginning after December 31, 2017.

Increased deduction limit for charitable gifts

In another temporary benefit for individual taxpayers, the Act provides that cash contributions to public charities, private operating foundations and certain governmental units may be deducted up to 60% of the taxpayer's contribution base, essentially adjusted gross income, by the 5% of taxpayers who continue to itemize their deductions. (Section 170(b)(1)(A).) It also repealed the so-called "Pease limitation" which reduced the amount of itemized deductions certain high earning taxpayers could take. Both of these provisions last only until January 1, 2026.

Repeal of substantiation by donee

The Act repealed the alternative provision for substantiation of charitable contributions based on reporting by the recipient charity directly to the IRS. Although the IRS had recently proposed rules that would have effectuated the provision, it was quickly shot down by charities that did not want to release the social security numbers of their donors and has never been implemented. The IRS and donors will have to rely on the basic and traditional substantiation from the charities to their donors. (See Ready Reference Page: "IRS Requires Substantiation of Contributions")

Provisions that were not included

The final Act did not include:

- A provision from the House Bill that would have indexed for inflation the standard 14 cents a mile deduction for charitable volunteers.
- A provision from the House Bill that would have essentially eliminated private activity bonds that many charities utilize to finance facility construction and rehabilitation at tax-exempt bond interest rates. Authority to refinance such bonds was severely limited, however.
- A provision in the House Bill that would have reduced the 2% (or 1% under certain circumstances) excise tax on net investment income of private foundations to a single tax of 1.4% under all circumstances.
- A provision of the House Bill limiting the exclusion from UBTI for research income only if the research is made publicly available.
- A provision of the Senate Bill that would have applied UBIT to revenue from the sale or licensing of name and logo, which would have particularly hurt higher educational institutions.
- A provision of the House Bill that would have required private operating foundations operating art museums to be open to the public for at least 1000 hours a year.
- A provision of the Senate Bill imposing additional reporting requirements on sponsors of donor advised funds.
- A provision of the Senate Bill that would have imposed a 10% excess benefit tax on the organization in addition to the tax on the beneficiary and possibly a foundation manager.
- A provision of the Senate Bill that would have extended the excess benefit tax rules to 501(c)(5) agricultural associations and labor unions and to 501(c)(6) trade associations.

Newman's Own Provision

The final Act also did not include a provision from the House Bill that would have eliminated the requirement for Newman's Own Foundation to divest its 100% interest in the Newman's Own food company because of the excess business holdings limitation in the law for private foundations.

But a special provision (section 4943(g) of the Tax Code) was included in the Bipartisan Budget Act of 2018 to allow the Foundation to continue to hold the stock. A private foundation may now hold 100% of the shares of a business if it acquired the shares other than by purchase, the business distributes all of its net operating income except for "reasonable reserves" within 120 days of the end of each quarter, and the business is operated independently of the foundation. The rule is not applicable to donor advised funds or non-functionally integrated Type III supporting organizations, which are still subject to the regular excess business holding limits.