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Changes ahead for exempt organizations as vote nears on tax reform

Tax Alert I December 18, 2017

At 5:40 p.m. eastern time on Friday, Dec. 15, 2017, the final version of the Tax Cuts and Jobs Act (TCJA) was released for public inspection. The vote by both the House and the Senate is scheduled for the week of December 18th before it goes to President Trump for what is expected to be a swift signing of the bill into law.

A statement made by Representative Brady, Chairman of the Ways and Means Committee, caused concern when he was quoted as stating that the House version and the Senate version were to be melded together. For tax-exempt organizations, this would have been the worst case scenario, since many provisions impacting tax-exempt organizations in the House version were not in the Senate version and vice versa, except for a few items. In addition, all of the provisions impacting tax-exempt organizations directly were said to be considered revenue raisers so we really did not know how much would be put into play when the final version of the TCJA was ready for release.

Major tax law changes for tax-exempt organizations

There are a few provisions that made it into the final TCJA that may be of concern to exempt organizations. While we consider all of these major law changes, some that apply across the board, notwithstanding the paragraph an organization may be considered exempt under section 501(a). In addition, there are a lot of provisions that were dropped and are not in the final bill. For those provisions not in the final bill, they may remain in the minds of Congress as they are looking for new ideas, and could be brought up again in the future.

Changes to charitable contributions deductions

TCJA provisions provide for an increase in the adjusted gross income (AGI) limitations for cash contributions made by individuals. Generally, for gifts to certain types of charitable organizations, the AGI limitation for cash contributions has been limited to 50 percent of AGI of the donor. The law change increases this limitation for cash contributions to these organizations to 60 percent of AGI. In addition, carryovers of unused charitable contributions due to this limitation retain this 60 percentpercent limitation treatment during the five year carryover period applicable them. The TCJA also makes nondeductible in full, a deduction for college athletic event seating rights. Lastly, the donee reporting exception was removed from the law. This exception stated that if another method was used by donee charities to disclose contributions from donors, this could be an alternative to sending a contemporaneous acknowledgment of cash contributions over certain amounts. The government tired of taxpayer arguments that when they were disclosed on a charity's Schedule B, Form 990 on an annual basis this should be a valid replacement for a contemporaneous acknowledgement to substantiate a charitable contribution deduction claimed. Congress showed these arguers, by just removing this exception language entirely from the Internal Revenue Code. So now, if a taxpayer does not have in its possession a contemporaneous written acknowledgement from a charity substantiating his/her charitable contribution deduction amount in cash, this deduction will not be allowed. A provision in the House version of the TCJA calling for an improved standard mileage rate for charitable mileage for tax deduction purposes was not adopted in the final version of the law, so charitable mileage for tax deduction purposes will remain at its $0.14 per mile level.

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Unrelated business income increased by certain fringe benefits provided which are disallowed

Unrelated business taxable income of an organization will be increased by any amount for which a deduction is not allowable for income tax purposes by reason of section 274 and which is paid or incurred by such organization for any:

- Qualified transportation fringe (as defined in section 132(f)),
- Any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or
- Any on-premises athletic facility (as defined in section 132(j)(4)(B)).

Excise taxes on excess tax-exempt organization executive compensation

This provision was adopted almost verbatim as it first arose in the 2014 Camp proposed legislation regarding tax reform at that time. Compensation paid by any tax-exempt organization exempt under section 501(a), including farmers' cooperative organizations, certain governmental units or political organizations may be subject to a new excise tax if it is excessive in amount. The amount of excessive compensation is determined to be set at $1,000,000 for the organization's top five highest paid employees. In determining the amount of compensation subject to this provision, any set aside to a Roth IRA account is not taken into account.

The excise tax is assessed against the tax-exempt organization itself and equals 21 percent of the excess compensation paid over $1,000,000. Once a person is counted as a highest paid under this provision, he/she must either quit, retire or be paid less than $1,000,000 annually to drop off the list, so in later years a tax exempt organization may have more than 5 persons to pay excise tax on. The reason for this is because the excise tax applies to a covered person and a covered person is defined as one of the top five highest paid employees of the organization, and employees who after Dec. 31, 2016 were treated as a covered employee for the purposes of this excise tax. As such, a top five highest paid employee in 2018 may remain one of those where the penalty may apply even though others may be hired making more than he/she is earning. Once covered, a person is always a covered person as long as that person is over the $1,000,000 dollar annual compensation threshold. The rules under section 3401(a) are used and which set forth exempt income from income tax reporting and benefits which are not counted, in essence, it is reportable compensation as reported on Form W-2 (excluding ROTH items) reported on Form W-2 (and potentially on Form 1099). It is clarified that reportable compensation includes section 457(f) payouts and that amounts are considered compensation immediately upon the lapse of any substantial risk of forfeiture.

This penalty will also apply to certain separation payments (called parachute payments in the provision) as well if the amount paid is over three times a base amount, which is calculated as the annualized compensation for an individual for the five previous periods before the year the separation payment is received. Excluded from this provision (parachute provision) are those that are not considered HCEs via level of compensation being paid. For the purposes of a parachute payment, a person who may not be considered a highest compensated employee (HCE), are not subject to the parachute rule. For 2017 an HCE is defined at compensation of over $120,000.

One welcome exclusion from the overall application of this penalty are for licensed medical professionals, e.g., doctors, nurses, veterinarians, if they are paid for those services. In the event they are paid for other services not considered a licensed medical profession service, then they are subject to the penalty (i.e., c-suite executives). So the unintended consequence discussed related to this provision applying to highly paid surgeons, etc., in the tax-exempt health care arena, are removed from its application. For other exempts, it looks like this excise tax will apply to c-suite level personnel, and for educational institutions, for athletics coaches (who were the focus of the Senate Finance Committee when this provision was first talked about in 2014).

Excise tax based on investment income of private colleges and universities

This new excise tax is in the amount of 1.4 percent and is assessed on the net investment income of a private college and/or university which has at least 500 students during the preceding tax year, and which is not described as a state college or university, and the aggregate fair market value of the assets held by such entity (other than exempt use assets), is at least $500,000 per student of the institution. Related organizations controlled by the educational institution are also taken into account. Supporting organizations are also taken into account. Questions still remain for independently governed section 509(a)(1) foundations. One final rule put into this version of the TCJA provides that at least over 50 percent of the tuition paying full time students be from the United States at that applicable educational institution. For the purposes of any student count, part time students are counted in a partial full time student (FTS) basis.

Unrelated business taxable income separately computed for each trade or business

This law is not the first time we have seen it written as it was a part of the 2014 Camp tax reform legislation. Under this law, and for an organization with more than one unrelated trade or business activity, the provision requires that unrelated business taxable income be computed separately with respect to each trade or business activity. Losses from one activity may only be carried over to offset income from future years to that specific activity only. Losses from such activity are therefore separated and no longer can be separately used to offset income from another activity.

One big question that remains is related to the limitation on the use of a net operating loss (NOL carryover for corporate taxpayers limited to 80 percent of taxable income for regular tax purposes. Will this limitation also apply to this very unusual limitation that only applies to tax exempt organizations with unrelated business income (UBI)? Future guidance should address this issue.

Other items making into the final TCJA bill

Corporate alternative minimum tax structure is repealed and no longer exists beginning in 2018 and subsequent tax years. The corporate rate of 21 percent applies to UBI for corporate exempt organizations filing Form 990-T. There is a substantial deduction limit imposed on corporations in future year in the form of an +overall net operating loss carryforwards limited to 80 percent of taxable income (as stated we will need additional guidance related to the separate trade or business loss provision applicable to UBI producing activities and how it will interact with this provision for carryforwards, and whether a loss carryforward for an activity will be limited to only 80 percent of that activity's income, is the question in that future year?)

As far as a few benefits are concerned that made it past the finish line and into the TCJA, moving expense reimbursement benefits are repealed for 2018 and all future years. In addition, bicycling commuting benefits are repealed and no longer tax free but do come back into the code in a future year and employee achievement awards are basically changed substantially as to their form so it appears that only very limited items may be given tax free which don't include cash, cash equivalents, stocks, bonds, vacations, meals, etc.

Lastly, an advance refunding bond issue will not be tax-exempt beginning in 2018.

Provisions not in the final bill

The following provisions did not make it into the proposed new law, so if they existed before 2018 they remain in their current state, and if not, they are not implemented. The list includes some highly contested areas of concern by tax-exempt organizations, in particular educational institutions and those with employees overseas. The following items are not in the final version of the TCJA:

- Housing allowance exclusions under section 119 did not get changed or repealed, the rules will stay the same for future years as they are today, as such no change.
- New markets tax credits will continue until its anticipated normal date of expiration at the end of 2019.
- Private activity bond financing remains a viable financing alternative for tax-exempt organizations as the repeal of this financing method was stricken from any final version of the TCJA.
- Expansion of the UBI regime to all 115(1) entities is stricken from the final act so current law remains intact.
- Research income exclusion from UBI treatment continues under its current favorable rules and are not changed.
- Private foundation excise tax on investment income smoothing to 1.4 percent is stricken from the final version of the TCJA. Therefore, the 1 percent/2 percent investment income excise tax regime remains intact.
- Private operating foundations as art museums time requirements for public viewing of its artwork is stricken from the final act so it is not a new rule.
- Private foundation excess business holdings exception for certain 100 percent owned businesses is stricken from the final act and is not new law, so all the old excise business holdings rules remain intact.
- Churches and political activities from the pulpit provision was stricken from the final act so the Johnson amendment is fully intact with this prohibition in order to retain tax-exempt status.
- Donor advised fund sponsoring organization expanded Form 990 reporting was stricken from the final act so at this time there is no additional reporting requirements for sponsoring organization of donor advised funds.
- Educational assistance (section 127) plans (the $5,250 exclusion) repeal and tuition reduction/remission (section 117(d)) repeal are not in the final bill, as such, both provisions remain untouched, and continue forward as in prior law, as does section 129 child care assistance programs exclusion from income will not be repealed and also remains in the future.

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Conclusion

As can be seen, there are some provisions in the final version of the TCJA that will be considered major changes for tax-exempt organizations. We also see that some provisions in the benefits arena, were not repealed and will continue into future years after passage of the TCJA by the end of 2017. RSM will continue to monitor developments related to these proposed new laws that may need to be applied beginning for tax years beginning in 2018.

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