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# Tax Reform and Nonprofits: The Law Formerly Known as the Tax Cuts and Jobs Act

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Today, US President Donald Trump signed H.R. 1, enacting fundamental changes to the US tax law that affect all sectors of the economy, including nonprofits.

Earlier this week, the US House of Representatives and the US Senate passed the long-awaited conference version of H.R. 1 (the "Act"), which merged, with revisions, the respective House and Senate tax reform bills.[1] Key highlights of the Act, signed into law by President Trump on December 22, 2017, are as follows.

## Charitable Giving and Charitable Financing

- *The Act expands the standard deduction, increases the deductibility of cash contributions to charities, and tightens some of the rules on the charitable contribution deduction.*

- The Act retains the charitable contribution deduction for those taxpayers able to claim itemized deductions, and increases the limitation for cash contributions to public charities (and certain private foundations) to 60% of the donor's adjusted gross income (AGI) for taxable years beginning after December 31, 2017 and before January 1, 2026.
- However, the Act also reduces individual tax rates,[2] eliminates many other itemized deductions, and nearly doubles the standard deduction by increasing it to $24,000 for married individuals filing a joint return, $18,000 for head of household filers, and $12,000 for individual filers. These amounts will be adjusted for inflation based on chained consumer price index (C-CPI-U). The increase in the standard deduction sunsets and does not apply to taxable years beginning after December 31, 2025.
- The implication of these changes for nonprofits is that only the top 5% of tax filers are likely to have sufficient itemized deductions to claim a charitable deduction in the new year, and 95% of taxpayers will be unable to claim a charitable contribution deduction. Lower tax rates also reduce the tax incentive of charitable contributions in 2018 and subsequent years. These

changes create an incentive to accelerate contributions into the remaining days of the 2017 tax year, and, for those at risk of exceeding the AGI percentage limitations, to give cash (starting next year). Overall, charitable giving is likely to be reduced starting in 2018, both in terms of the amount given to charity and the types of donors who are able to contribute. Over time, the Act may affect the priorities of charities, some of which may pivot to match the preferences of their donors.

- The Act repeals the IRS's authority to prescribe a tax form for substantiating charitable contributions. Some taxpayers have attempted to exploit the existing rule by amending the donee organization's Form 990 to claim that a charitable contribution was substantiated in a prior year.

- The Act repeals the "Pease" limitation, which sets an overall limit on itemized deductions including charitable contribution deductions for taxable years beginning after December 31, 2017 and before January 1, 2026.

- *The Act doubles the amount eligible for exclusion from estate, gift, and generation-skipping taxes to $10 million, indexed for inflation occurring after 2011.* The change applies to taxable years beginning after December 31, 2017 and before January 1, 2026. This will reduce the incentive to make charitable bequests for those estates no longer subject to the estate tax.

- *The Act eliminates advance refunding bonds.*

    - The Act retains the ability of nonprofits to issue tax-exempt private activity bonds through a state government conduit; however, it repeals the ability to issue advance refunding bonds after December 31, 2017. Advance refunding is a means by which an issuer may refinance tax-exempt bonds issued more than 90 days previous by issuing more tax-exempt bonds at a lower interest rate and using the proceeds to repay the outstanding bonds. Private activity bonds can't be refunded, but other bonds can be refunded one time. The Act eliminates the "one bite" rule, with the result that issuers must use taxable bonds (with correspondingly higher interest rates) for advance refunding purposes.

## Executive Compensation

- *The Act creates a new excise tax (Section 4960), equal to the corporate tax rate of 21%, on an employer with respect to compensation paid by most nonprofits (and related organizations) to certain individuals in excess of $1 million, as well as to certain excess parachute payments, in tax years beginning after December 31, 2017.*

    - The tax applies to all remuneration in excess of $1 million, including cash and the cash value of all noncash items (including benefits), except for designated Roth contributions and medical services.

    - The tax also applies to excess parachute payments (under a new definition related

solely to separation pay).

  - A covered employee is defined as an employee (including a former employee) who is one of the five highest paid employees of the organization for the taxable year or who was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016.
  - The definition of remuneration excludes any designated Roth contribution as well as the portion of any remuneration paid to a licensed medical professional (including veterinarians) for the performance of medical or veterinary services.
  - Applicable tax-exempt organizations include organizations exempt from tax under Section 501(a) of the Internal Revenue Code.
  - Special rules apply to compensation paid by related entities.

## Colleges and Universities

- *The Act imposes a new 1.4% excise tax on the net investment income of private colleges and universities.* Net investment income is defined to correspond to the definition of such under the private foundation rules, which generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, reduced by expenses incurred to earn this income. The tax only applies to colleges and universities that have at least 500 students, more than 50% of whom are located in the United States, and assets (other than those used directly in carrying out the institution's educational purposes) of at least $500,000 per full-time student, valued at the close of the preceding tax year. State colleges and universities are not subject to the provision. Private colleges and universities must include the net investment income and assets of related organizations—such as controlling and controlled organizations and supported and supporting organizations—in order to assess the applicability of the tax.

- *The Act eliminates the ability of donors to claim any portion of an amount paid to educational organizations as a charitable deduction if the amount includes the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.* This modifies the special rule in Section 170(l) that currently enables a donor to take a charitable deduction of 80% despite access to seating rights to athletic events.

## Unrelated Business Income Tax (UBIT) and Other Issues

- *The Act requires that an exempt organization with more than one unrelated trade or business compute UBIT separately with respect to each trade or business and without regard to the specific deduction allowed under Section 512(b)(12).* The organization's UBIT for a taxable year is the sum of the amounts for each unrelated trade or business, less the specific deduction allowed under Section 512(b)(12). A net operating loss (NOL) deduction is allowed only with respect to a trade or business from which the loss arose. As a result, unrelated trade or business gains/losses will be siloed to their respective businesses. This may create an incentive to use blocker corporations to achieve consolidated tax treatment. A special

transition rule provides that NOLs arising in a taxable year beginning before January 1, 2018 that are carried forward to a taxable year beginning on or after such date are not subject to the provision, so it should not be necessary to trace existing NOLs to the respective trade or business from which they arose.

- *The Act subjects exempt organizations to UBIT on the amount of certain fringe benefits for which a deduction is disallowed.* These include qualified transportation fringe benefits, any parking facility used in connection with qualified parking, and on-premises athletic facilities. The provision doesn't apply to the extent that the amount is directly connected with a regularly carried-on unrelated trade or business.

- *Repeal of deduction for local lobbying expenses.* The Act amends Section 162(e) to repeal the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian Tribal governments. The removal of this exception means that Section 501(c)(4), 501(c)(5), and 501(c)(6) organizations will need to account for these expenses in evaluating the proxy tax, the deductibility of membership dues, and nonprofit information reporting under Section 6033.

## What Is No Longer in the Act

The Act no longer includes some provisions affecting nonprofits that either the House or Senate bill contained. These provisions included the repeal of estate and generation-skipping taxes, the elimination of private activity bonds, the simplification of the private foundation tax on net investment income, the exception for independently operated philanthropic business holdings from the private foundation tax on excess business holdings, requirements on art museums seeking to qualify as private operating foundations, reporting requirements applicable to the sponsoring organizations of donor-advised funds, the special exception under the "Johnson Amendment" permitting Section 501(c)(3) organizations to make political statements under certain circumstances, the repeal of above-the-line deductions for certain educational expenses and exclusions of certain educational expenses, the inclusion of inflation in the calculation of the charitable mileage rate, the applicability of UBIT to Section 115 government-sponsored entities, the modification to the UBIT exception for fundamental research organizations, and, for a hot second, the ability to deduct tuition paid for religious instruction.

## Will We See Technical Corrections Any Time Soon?

A technical corrections bill is highly unlikely for a number of reasons. First, technical corrections legislation is a very special procedure which is not "scored" by the Joint Committee on Taxation. The purpose of technical corrections is to bring the text of the statute into accord with the legislative intent of Congress. The original revenue estimate captured the intent of Congress, so technical corrections cannot, by definition, raise or lose additional revenue.

This has two implications. First, this means that technical corrections cannot be passed under budget reconciliation because provisions that do not affect federal revenues are not germane to the budget under the Byrd rule. As a result, a technical correction would require 60 votes in the Senate regardless. Second, technical corrections require unanimous consent by both the majority and minority staffs of the House Committee on Ways and Means and the Senate Finance Committee. If

anyone disagrees about the legislative intent of a provision and whether the statute reflects that intent, then the provision is not a technical correction but, rather, a change in policy. Given the polarized environment, it is unlikely that we'll see a long list of bona fide technical corrections.

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[1] The full title of the Act is "an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." The House and Senate bills had been known by their short titles, the "Tax Cuts and Jobs Act." The short title of the Act, however, was struck by the Senate Parliamentarian for failure to satisfy the Byrd rule as germane to the budget.

[2] The 2018 top marginal tax rate for individuals with income over $500,000 and married taxpayers filed jointly with income over $600,000 is 37%, a reduction from the 2017 rate of 39.6% applicable to individuals with income over $418,400 and married taxpayers filing jointly with income over $470,700.

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