

Congress Passes Tax Cuts and Jobs Act

Understanding the Changes Affecting Tax-Exempt Organizations

In December 2017, Congress enacted a sweeping overhaul of the Internal Revenue Code (“IRC”). While the majority of the changes affected the taxation of for-profit entities and individuals, the new law does contain provisions that directly effect tax-exempt entities and their operations. This alert will discuss these provisions. As always, please contact any member of Bodman’s Nonprofit and Tax-Exempt Organizations Team listed on page 3 for more information.

Excise Tax on Excess Compensation Paid by Tax Exempt Organizations

For years, the IRC has imposed limitations on certain types of compensation paid by publicly held corporations. For example, publicly held corporations cannot deduct compensation paid to certain employees that exceeds \$1 million. Additionally, publicly held companies cannot deduct golden parachute payments (payments made to departing executives upon a change of control) and those individuals that received parachute payments have to pay an excise tax.

These limitations did not apply to tax-exempt entities. However, the new law adds a new code section, IRC 4960, imposing an excise tax on certain types of excess compensation paid to employees of tax-exempt organizations.

An organization that is tax-exempt under IRC 501 (a) that pays a “covered employee” more than \$1 million must pay an excise tax of 21% on the excess compensation. A “covered employee” includes any current or former employee if that individual (a) is one of the organization’s five highest compensated employees for the year, or (b) was a covered employee of the organization, or any predecessor organization, for any year after 2016.

Additionally, the tax-exempt organization must pay an excise tax of 21% if it makes an “excess parachute payment” to a “covered employee.” An “excess parachute payment” is any amount by which a “parachute payment” is more than the employee’s average taxable compensation over the prior 5 years. A “parachute payment” is any payment to or for the benefit of a covered employee if it is (a) contingent on the employee no longer working for the

organization, and (b) the aggregate present value of the payments is equal to or greater than three times the employee's average taxable compensation over the prior five years.

Excise Tax on Investment Income of Private Colleges and Universities

Starting in 2018, private colleges and universities may be liable for an excise tax of 1.4% of their investment income. A college or university is subject to the tax if: (a) it had at least 500 students during the preceding tax year, (b) more than 50% of its students are located in the U.S., (c) it is not a state college or university, and (d) in the prior year, the aggregate fair market value of its assets (other than those used directly in carrying out its exempt purposes such as buildings and classroom equipment) is at least \$500,000 per student. While "net investment income" is not specifically defined, it will be computed in a similar manner as a private foundation's net investment income and should generally include income items such as dividends, interest, rent and royalty payments.

New Calculation of Unrelated Business Taxable Income (UBTI)

Under prior law, a tax-exempt organization calculated its UBTI by aggregating all of its income and deductions from its unrelated trades or businesses. If an organization had gain from one activity and losses from a different activity, it could use the losses to offset the gains.

Now, as a result of the changes made by the recent tax legislation, an organization that has more than one unrelated trade or business computes UBTI separately for each trade or business. After adding together the result for each trade or business, the organization is allowed to deduct \$1,000 (overall and not for each activity). Tax-exempt organizations can no longer use a net operating loss (NOL) from one unrelated trade or business to offset gain from another unrelated trade or business. If the

organization has a NOL carryover from years before 2018, it can deduct the NOL against its aggregated UBTI. As the corporate rate has been reduced to 21%, the rate a tax exempt organization pays on its UBTI has also been lowered to 21%.

UBTI Increased by Disallowed Fringe Benefit Expenses

The new law eliminated a number of deductions that corporations and other taxable entities had taken advantage of prior to 2018. The eliminated deductions include deductions for providing employees with "qualified transportation fringe benefits" (van pools and transit passes), "qualified parking" (parking located on or near the employer's business premises or the location from which the employee takes public transportation to get to work) and on premise athletic facilities.

In order to equalize the treatment between taxable entities and tax-exempt entities, the new law requires tax-exempt entities to include as UBTI the amounts the organization provides to its employees for qualified transportation fringe benefits, qualified parking and on-premises athletic facilities. The organization does not have to include any of these benefits that are provided to employees connected with the organization's own unrelated trade or business.

Increase on Individual's Contribution of Cash to Charitable Organizations

The new law increases the contribution-base percentage limit for deductions of cash contributions only and not marketable securities or other property by individuals from 50% to 60% for contributions from 2018 through 2025. If the aggregate amount of an individual's cash contributions exceeds 60% of the contribution base, then the excess is carried forward and is treated as a deductible charitable contribution in each of the five succeeding tax years.

Charitable Contributions to Colleges and Universities

Prior to 2018, if a taxpayer made a donation to a college or university that would be a charitable deduction but for the fact the taxpayer received the right to buy tickets for an athletic event at the school, 80% of the payment was treated as a charitable contribution. Under the new law, no charitable deduction is allowed for a payment to a college or university in exchange for the right to purchase tickets to an athletic event.

Increase in Standard Deduction May Impact Charitable Giving

For 2018-2025, the standard deduction nearly doubles for taxpayers, to \$12,000 for single taxpayers, \$24,000 for married filing jointly and \$18,000 for head of household. With the increased standard deduction, it is likely that fewer taxpayers

will itemize their deductions. Only taxpayers that itemize deductions can take advantage of the charitable contribution deduction. This reduced ability to claim deductions for charitable contributions may have a negative impact on charitable giving.

Proposed Changes Not in the Final Bill

The various drafts of the tax bill (in particular the House version) had a number of other proposals that did not make it into the final version. In particular, the new law did not make any changes to the excise tax on net investment income of private foundations. Additionally, a modification of the Johnson Amendment had been proposed to permit 501(c)(3) organizations to make political statements in certain circumstances. The Johnson Amendment was not repealed or modified and the prohibition on political campaign intervention still applies to all 501(c)(3) organizations.

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