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Tax reform's impact on exempt organizations

TAXING MATTERS
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The news coverage regarding tax reform has focused on the impact it has on tax-paying entities. However, the law changes will also have a very significant impact on exempt organizations.

This article reviews the provisions of Tax Cuts and Jobs Act that impact exempts. The changes span topics ranging from unrelated business income tax to executive compensation. While the changes that were enacted were not as extensive as some of the proposals that were made, they will still have a significant impact, especially on larger organizations.

Unrelated business income tax

While exempt organizations are, by definition, exempt from tax, they are subject to a tax on their income from unrelated businesses.

The new law makes significant technical changes to the computation of unrelated business income tax (UBIT). Specifically, if an organization has more than one unrelated trade or business, it provides that deductions from one business may not offset income from another business. This would increase tax on organizations that make money in one unrelated line of business but lose money in other unrelated lines of business.

One significant impact of this change will be on investment activity by nonprofits. Larger nonprofits with endowments often invest in alternative investments, such as private equity funds. These funds can sometimes be organized as passthrough entities, giving rise to unrelated business taxable income. Inevitably, some funds will give rise to gains in a given year and other funds will give rise to losses.

It is not clear how the revised UBIT rules will apply in this situation. Will each fund be treated as its own bucket, such that an exempt organization will pay tax on gains even if its overall alternative investment portfolio has losses? Or will the IRS treat all funds together?

Similar questions arise regarding how to group other activities. Many of these issues will come up in the context of colleges and universities. For example, take a university that sells membership in a fitness or recreation center to the public and also operates a sports camp for children. (Assume for the sake of discussion that these activities are subject to UBIT.)

Are these the same activity or different activities for this purpose? What if the university also operates a golf course and allows the public to use it for a fee? Should this be its own bucket or is it the same as the recreation center?

The IRS has issuing guidance on these topics in its priority guidance plan. However, in the interim, there are rules in other areas of the tax law that taxpayers may be able to use as a model in determining how to file, such as the rules relating to passive activities conducted by individuals.

Exempt organizations that have significant trades or businesses whose gains and losses offset each other may want to consider forming a taxable corporate subsidiary to hold these activities.

In a taxable corporation, gains and losses from one line of business can be offset against gains or losses from another line of business. So, by contributing their UBIT generating activities to a taxable corporation, exempt organizations can avoid the issues presented under the new law. However, it may make sense to hold off on doing this until after the IRS issues guidance.

Finally, some good news: First, as UBIT applies at the corporate rate, the reduction in corporate tax rates to 21% has decreased the rate that applies to UBIT.

Universities with endowments over $250,000 per student are now required to pay a 1.4 percent excise tax on investment earnings.

Second, the tax reform allows net operating losses to be carried forward indefinitely. Accordingly, though the IRS does not always agree with this position, in my view there should be no limit on the number of years UBIT losses can be carried forward. However, NOLs can now be used only against 80 percent of taxable income.

Fringe benefits

Nonprofits that make certain fringe benefits available to their employees will now need to pay tax on these benefits as if they were unrelated business income. These include certain parking benefits or access to athletic facilities.

Congress seems to have been trying here to put nonprofits on equal footing with taxable organizations that can no longer deduct these benefits under tax reform. However, there are many things exempt organizations can't deduct—because they don't pay tax—and they do not give rise to unrelated business taxable. Singling out these particular benefits is quite peculiar.

Whether the law makes sense or not, nonprofits will need to review their fringe benefit programs and share relevant information with their accountants to compute the tax.

Deductibility of contributions

First, the bad news: As has been covered in detail in the press, the standard deduction has been increased under the new law. While this simplifies tax filings, it also makes charitable giving more costly for most Americans, by effectively eliminating their ability to deduct the gift.

Commentators have indicated that together, these provisions could have a major negative impact on charitable giving. However, the ultimate impact will depend on how much Americans actually factor in the tax deduction in determining whether to give to charity. As expressed before in these pages, I hope that readers will continue to support local charities at the same level as prior to tax reform.

Second, a small bit of good news: The law increases the amount of gifts to charities that would be currently deductible.

While many people think of all charitable contributions as deductible, there are actually limits on the amount of charitable gifts that individuals can deduct each year. The amount depends on the type of gift, but maxes out at 50 percent of income for gifts to operating charities. Any income that is not deductible is carried forward. The law increases this percentage from 50 to 60 percent for gifts to public charities, modestly expanding the current tax benefit from certain giving.

One strategy that individuals may wish to pursue is "bunching" gifts into a single tax year. If you would previously make a gift of $5,000 a year that you can't deduct anymore as you don't itemize, you could instead give $10,000 every two years to a donor advised fund such as those maintained by the Rochester Area Community Foundation (RACF), and then have RACF disburse $5,000 a year. Because the gift for income tax purposes occurs when the gift is made to RACF, the $10,000 may be enough to get you to the land of itemization and deductibility.

Investment excise tax

Colleges and universities with endowments over $250,000 per student are now required to pay a 1.4 percent excise tax on investment earnings. This is big money for the small number of colleges and universities to which it applies. (Though estimates vary, it is expected to be well under 100.) Harvard University alone will pay an estimated $43 million per year. However, review of the public tax forms filed by local colleges and universities confirms that this tax will not apply locally at this point in time.

Executive compensation

The new law imposes a tax on compensation in excess of $1 million paid to any of the five most highly-compensated employees of an exempt organization as well as certain separation payments made to these individuals.

There are many subtleties to the definition of compensation. Compensation attributable to medical services provided by physicians is exempt. Therefore, the highly compensated surgeon is exempt, but a doctor who serves in a purely administrative role is not.

This provision also seems to be aimed to put nonprofits on equal footing with for-profits, in this case, public companies who are not allowed to deduct certain payments to highly compensated employees under a new code section. Again, however, it's not clear whether parity is achieved, as there is a difference between a taxable corporation not getting a deduction and an exempt organization paying a tax.

Based on review of the public tax filings local organizations, there are local organizations that will be affected, but the number is small.

'Newman's Own' exception

Both the House and the Senate bills contained a special provision that was inspired by a problem faced by Newman's Own Inc. While this was not enacted as part of the Tax Cuts and Jobs Act, it was passed in February as part of another bill.

The issue is that, as defined under technical rules, private foundations are not permitted to own operating businesses. The law now contains an exception for independently-operated philanthropic businesses, whose profits are donated to the charity, and which are 100 percent owned by a charity. In other words, Paul Newman's Foundation can own stock in Newman's Own.

There were many other proposals for exempt organization tax reform, some of which were quite significant, which did not pass. For example, the House proposed to allow significant exceptions to the ban on political activity by exempt organizations. On our website, www.hselaw.com/tax-reform you can find a grid showing each of the proposals that were not enacted. Stay tuned for the next legislative cycle, where many of these will surely be proposed again.

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