Client Alert *December 20, 2017*

SIGNIFICANT CHANGES AFFECTING TAX-EXEMPT ORGANIZATIONS INCLUDED IN TAX BILL

On November 16, 2017, the United States House of Representatives passed its tax reform bill entitled the Tax Cuts and Jobs Act.[1] On December 2, 2017, the Senate passed its tax reform bill, also entitled the Tax Cuts and Jobs Act.[2] The House and Senate recently reconciled the remaining differences between their two bills through a joint conference committee, generating a "conference report." On December 20, 2017, the House and Senate voted to pass the conference report to the Tax Cuts and Jobs Act (the "Tax Bill").[3] The Tax Bill will now be sent to the President to sign into law as early as Wednesday, December 20, 2017. The Tax Bill would significantly change the federal income taxation of exempt organizations. This Client Alert focuses on the provisions related to private foundations and universities, the charitable donation deduction, unrelated business income taxes ("UBIT"), and tax-exempt bonds. Generally, the proposed changes would be effective for tax years beginning after 2017 unless otherwise noted.

PRIVATE FOUNDATIONS AND UNIVERSITIES

1. Private Colleges and Universities Investment Income

The excise tax on net investment income that applies to private foundations does not currently apply to private colleges and universities. The Tax Bill would impose a 1.4% excise tax on the net investment income of a private educational institution that has (i) at least 500 students during the taxable year, and (ii) assets (other than those used for educational purposes) with an aggregate fair market value exceeding $500,000 per full-time student.[4] State colleges and universities would continue to be excluded from the excise tax. It is estimated that the provision would affect approximately 60-70 schools.[5] Private universities with large endowments may need to adjust their investment strategies or adjust their current endowment spending policies to account for the potential implementation of new excise taxes.

2. Excise Taxes on Executive Compensation

Section 501(c)(3) and Section 501(c)(4) tax-exempt organizations are prohibited from paying compensation that exceeds the fair market value of relevant services, but no specific dollar cap on compensation is currently imposed. The Tax Bill would impose a 20% excise tax on compensation paid to an exempt organization's five highest-paid employees ("covered employees") in excess of $1 million per year, including

[1] H.R. 1, 105th Cong. (as passed by House, November 16, 2017).
[2] H.R. 1, 105th Cong. (as passed by Senate, December 2, 2017).
[3] H.R. REP. NO. 115-466 (2017) (Conf. Rep.) [hereinafter Tax Bill].
[4] Tax Bill § 13701.
[5] Nick Anderson and Danielle Douglas-Gabriel, *House GOP Trims Total of Colleges Targeted for New Endowment Tax*, WASH. POST, Nov. 7, 2017, https://www.washingtonpost.com/news/grade-point/wp/2017/11/07/house-gop-trims-total-of-colleges-targeted-for-new-endowment-tax/?utm_term=.a16b0e5fb34e.

excess parachute payments.[6] For these purposes, compensation includes all wages, including benefits, except for tax-qualified retirement plans and amounts that are excludable from the covered employee's gross income. An excess parachute payment is an amount paid to a covered employee upon the employee's separation from employment with a present value exceeding three times the base amount. The provisions in the Tax Bill would apply to charitable and religious organizations as well as public utilities and municipalities, tax-exempt under either Section 501(a) or Section 115(1) of the Internal Revenue Code (the "Code").

Similar to other provisions in the Tax Bill, the executive compensation rules attempt to provide parity between tax-exempt entities and for-profit entities, many of which cannot deduct compensation in excess of $1 million paid to a single employee.[7] The Ways and Means Committee noted in its summary that the case for discouraging excess compensation paid out to tax-exempt executives may be even stronger than it is for publicly traded companies. The Tax Bill is expected to raise $3.6 billion over 10 years by imposing the excise tax on salaries paid by tax-exempt organizations that are deemed to be high. Going forward, tax-exempt organizations subject to this provision would need to closely monitor the amount and timing of compensation payments to their highest-paid employees.

CHANGES TO CHARITABLE DONATIONS

1. Increase in Standard Deduction

Taxpayers generally can claim a deduction for charitable contributions made during the year as part of their itemized deductions, in place of the "standard deduction" available to all taxpayers. Accordingly, a taxpayer receives a tax benefit for the charitable contribution deduction only to the extent that the taxpayer's itemized deductions exceed the standard deduction. The Tax Bill would double the standard deduction to $12,000 and $24,000 for individuals and married couples, respectively, thereby significantly decreasing the number of taxpayers who can benefit from a charitable contribution deduction. This change may potentially lead to less charitable giving.

2. Increase in Percentage Limitation

The charitable contribution deduction is limited to a certain percentage of the taxpayer's adjusted gross income ("AGI"), which varies from 20% to 50% in the aggregate depending on what type of asset is contributed and whether the donee is a public charity or a private foundation. The Tax Bill would increase the AGI limitation for cash contributions to public charities and certain private foundations to 60%.[8] Additionally, the Tax Bill would repeal a current rule permitting a taxpayer to treat 80% of a payment to a university for athletic seating rights as a charitable contribution.[9]

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[6] Tax Bill § 13602.
[7] Under the current rules governing publicly traded corporate employers, Section 162(m) of the Code denies a deduction for compensation paid to covered employees in excess of $1 million per year, subject to an important exclusion from this rule for performance-based compensation. The Tax Bill would eliminate the performance-based compensation exclusion and provide a broader rule for public companies that is more similar to the rules it would impose on tax-exempt organizations.
[8] Tax Bill § 11023.
[9] Tax Bill § 13704.

UNRELATED BUSINESS INCOME TAX

1. UBIT Increased by Certain Fringe Benefits

Under current law, all employers may provide their employees with certain fringe benefits that are free from income tax at both the employer and employee level. Taxable entities may deduct the expenses related to these benefits, while tax-exempt entities have no need to deduct such expenses. Employees in both cases may exclude the value of these fringe benefits from their taxable incomes. Such benefits include, among other things, transportation fringe benefits and on-premises athletic facilities.

Under the Tax Bill, funds used to pay for certain transportation fringe benefits and on-premises athletic facilities would no longer be deductible by taxable employers and, correspondingly, would be treated as unrelated business taxable income for tax-exempt employers.[10] Specifically, UBIT would be increased by any expenses for which a deduction is not allowable by reason of Section 274, paid or incurred for qualified transportation benefits, parking facilities used in connection with qualified parking, and on-premises athletic facilities (except to the extent such expenses are directly connected to an unrelated business carried on by the organization, in which case they would still increase UBIT because they would be non-deductible expenses). The new fringe benefit provisions may present problems for entities with a policy against engaging in activities subject to UBIT, but that historically have provided employees with transportation fringe benefits or access to on-premises athletic facilities that are considered non-deductible under Section 274.

2. Separate Computations of Unrelated Business Income

Under the current Treasury regulations, an organization calculates its UBTI by aggregating the income from all of its unrelated trades or businesses and subtracting its aggregate deductions.[11] Thus, organizations may reduce their total UBIT by using deductions from one unrelated trade or business to offset the income of another. The Tax Bill contains a provision that would require UBTI to be calculated separately with respect to each trade or business.[12] This separate calculation would prevent net operating losses attributable to one business from offsetting income of another unrelated trade or business. This may lead to higher UBIT for organizations operating (directly, or indirectly as a partner in a partnership) multiple unrelated trades or businesses. These provisions would also add complexity to an organization's calculation and reporting of its UBIT on IRS Form 990-T, Exempt Organization Business Income Tax Return, and may make it more difficult in the future for organizations to project their UBIT with reasonable accuracy.

CHANGES TO TAX-EXEMPT BONDS

1. Private Activity and Advance Refunding Bonds

Gross income generally does not include interest paid on state or local bonds. State and local bonds can be classified as either government bonds or private activity bonds. Government bonds are primarily used to finance governmental functions. Private activity bonds permit state or local governments to serve as conduits in

[10] Tax Bill § 13703.
[11] Treas. Reg. § 1.512(a)-1(a).
[12] Tax Bill § 13702.

providing financing to private businesses, charities, or individuals. Nonprofit hospitals, nursing homes, and colleges and universities frequently use private activity bonds to finance capital projects.

The exclusion from gross income for interest paid on state and local bonds also applies to refunding bonds, subject to some limitations. Refunding bonds are used to pay principal, interest, or redemption price on previously issued bonds. If a bond is issued more than 90 days before the redemption of the refunded bond, it is classified as an advance refunding bond.[13]

The Tax Bill would retain the exclusion from gross income for interest paid on both government bonds and private activity bonds, but would repeal the exclusion for interest paid on any bond issued to advance refund another bond.[14] The advance refunding repeal would apply to government bonds as well as qualified 501(c)(3) bonds. The proposal would likely raise the cost of borrowing for all tax-exempt entities and may reduce the use of tax-exempt bond financing for all projects except those directly used by state and local governments.

2. Tax-Credit Bonds

Section 54 of the Code currently allows holders of certain bonds (tax-credit bonds) a credit against their income taxes to replace a proscribed portion of their interest cost. Current tax-credit bonds include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds. Additionally, the Code allows an issuer to elect to issue certain tax-credit bonds as "direct-pay" bonds. Instead of a credit, a direct-pay bond entitles the issuer to a payment from the federal government of a percentage of the bond's interest. Under the Tax Bill, all existing authority for issuing tax-credit bonds would be prospectively repealed.[15] Accordingly, the borrowing costs for these projects would increase if the repeal is enacted.

CONCLUSION

The Tax Bill contains many provisions that would significantly change the federal tax treatment of tax-exempt organizations. Many of the changes to the UBIT regime would likely increase the tax burden on organizations operating businesses unrelated to their tax-exempt function. Notably, however, nonprofits would pay a lower tax rate on UBIT going forward, as the Tax Bill would lower the maximum corporate income tax rate from 35% to 21%.[16] Moreover, Congress seems intent on implementing various excise taxes on private endowments and compensation, while removing potential financing opportunities for tax-exempt entities.

Both the House of Representatives and Senate passed the Tax Bill by majority vote. Barring an unlikely presidential veto, the Tax Bill could be signed into law as early as Wednesday, December 20, 2017. Thompson & Knight will continue to carefully monitor tax reform developments. Please contact one of the attorneys below if you have any questions about the proposed legislation.

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[13] I.R.C. § 145(d)(5).
[14] Tax Bill § 13532.
[15] Tax Bill § 13404.
[16] Tax Bill § 13001.

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