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NONPROFITS: INTERNAL REVENUE SERVICE

Nonprofits: What's in the New Tax Law

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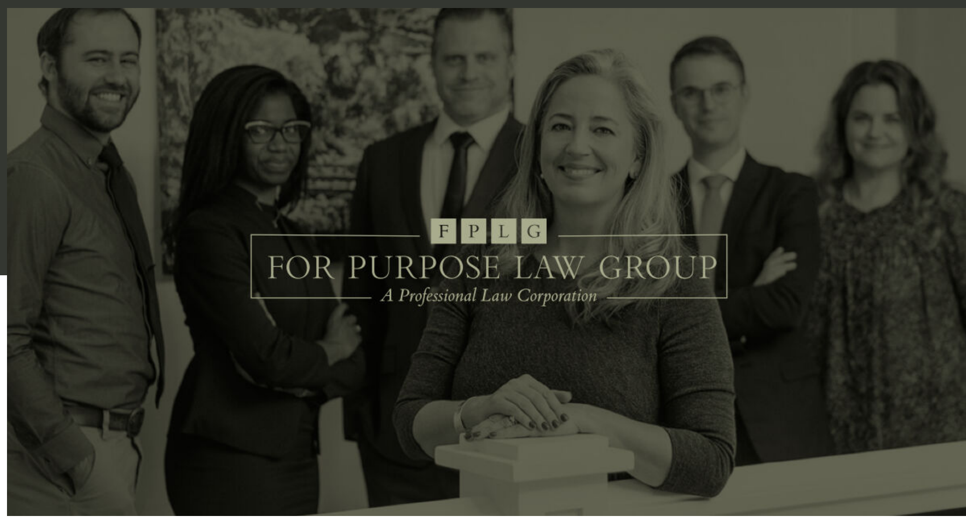

In *Nonprofits: Happy New (Tax Plan) Year!* , we caught up to date with a general overview of the whirlwind tax law changes proposed, adopted, and made effective by the federal government in late December 2017.

Some of the key concerns expressed by nonprofit organizations, experts, and advisers focused on the major changes to the standard deduction and to the federal estate tax which – many believe – will have a significant depressive effect on charitable giving.

As to specific tax changes that more directly relate to, or affect, nonprofits, it's useful to keep in mind that what is in the tax code now and what has been chopped out (or omitted for at least the time being) was not necessarily the result of a long, thoughtful policy process. Even the most ardent supporters of the new law will likely concede that getting to the final "yes" by Congress, including the slimmest of margins in the Senate, involved a lot of last-minute, horse-trading for votes.

What's In the Tax Law: The Good News

There is one feature of the new tax law that is good news for taxpayers who will continue to be able to take advantage of the itemizing deductions option on their federal tax returns. This change will, of course, encourage charitable giving and have a positive effect on philanthropic organizations that are chosen as recipients of this expanded largesse.

Under former tax law, a taxpayer was generally allowed to take a charitable deduction of up to 50% of adjusted gross income (AGI) for gifts of cash and certain property donated to public charities, private operating foundations, and some non-operating private foundations.

This AGI limit has now jumped from 50% to 60%. As with so many other provisions of the new tax law, it is effective immediately – for years beginning after December 31, 2017 – and continues for years until December 31, 2026, at which point – well, who knows?

But as we'll see in the next post, it's not all good news. Philanthropically minded individuals who take a charitable deduction for a contribution to an alma mater that guarantees the right to purchase tickets for seating at the big football game are out of luck for next season. This perk of deductibility even though there is a special benefit received has been plucked out of the available goodie bag.

What's In the Tax Law: Not Such Good News

UBI Changes

A provision of the new tax law that may have the widest potential impact is a significant change in the calculation of unrelated business taxable income (UBI).

If a nonprofit has income from a trade or business that it regularly carried on and which is not substantially related to its exempt purpose, it may be subject to taxation on that income. The new tax bill includes a significant change for organizations that carry on more than a single unrelated business trade or business. Under prior law, the organization was permitted to offset deductions or net operating losses from one business against the income of another business. The change made is that this offset is no longer allowed. This provision, like many others, is now effective for taxable years beginning after December 31, 2017. But unlike the abrupt change for other parts of the new tax code, there is a transition rule here that "grandfathers" already existing net operating losses into a current or future calculation to offset future income.

There is another change related to the UBI law. It relates to certain fringe benefits in connection with an unrelated business, including transportation, parking facilities and on-premises athletic facilities. Under the new law, these benefits are now subject to the unrelated business income tax. The effective date is for amounts paid or incurred after December 31, 2017.

This is one of several items in the new tax code that were included to attempt "parity" between exempt organizations and taxable, for-profit businesses.

Endowments

It's no surprise, really, that Congress has taken a significant swipe at large endowments of certain colleges and universities. We've covered the many skirmishes that have taken place – and, indeed – escalated over the past two years or so. The revelations of the Paradise Papers – splashed across headlines nationwide last fall – did nothing to tamp down Congressional resolve to take some action. Among the people, businesses, and organizations worldwide revealed to stash money in tax havens in the tropics, are many U.S. institutions of higher learning.

A new excise tax of 1.4 percent now applies to college and university endowments with assets of at least $500,000 per full-time student and with enrollments of more than 500 full-time students. There are additional, fine-print, details, of course.

This 1.4 percent threshold is higher than the one originally floated, and applies only to the "larger" endowments, but it sends a message that is undoubtedly being heard loud and clear in higher academia. Estimates are that the new tax will affect only about 70 or so "elite" private colleges. It does not apply to public institutions.

For purposes of this rule, the assets and net investment income of related or controlled organizations are brought into the calculation unless they are not available to the educational institution.

The effective date, once again, is immediate: for taxable years beginning after December 31, 2017.

Executive Compensation

Under the new law, there will be a 21 percent excise tax on nonprofits that pay (total) compensation of $1 million or more to any of their five highest-paid employees. The $1 million figure includes "remuneration" of all kind not subject to a "substantial risk of forfeiture," including non-cash benefits, but excluding payments to tax-qualified retirement plans. It applies as well to certain excess "parachute" payments.

The tax is paid by the exempt organization. This new provision applies also to amounts paid by related organizations as well as by government entities; each organization pays a pro rata share.

But it does not apply to any compensation amounts that are paid to licensed medical professionals for performance of medical or veterinary services.

The provision is effective for taxable years beginning after December 31, 2017.

The Department of the Treasury has been given express authority to write regulations aimed at institutions trying to get around this law by devices including designating the "employee" as something other than an in-house worker, or by using pass-through or other entities.

Of course, not all nonprofits have such highly paid executives, but the trend is significant enough in that direction to make Congress decide to act. According to a report in the Wall Street Journal last year, the most recently available IRS data shows that some 2,700 employees at U.S. nonprofit received compensation of over $1 million in 2014. Undoubtedly, the current figures are higher.

Tax-Exempt Bonds

For everyone whose eyes glaze over at the mere mention of tax-exempt bonds, suffice it to say at this point that there have been some changes in the new law – specifically concerning "advance refunding" bonds.

What are “advance refunding” bonds? They are used to refinance debt at better rates and to pay off items related to a prior bond issue, including principal, interest, or the redemption price. Issued more than 90 days before the redemption of the prior issue, they may be issued only once, and apply only to governmental and qualified 501(c)(3) bonds.

What does the new tax law do? It repeals an existing exclusion from gross income of interest on a bond issued to advance refund another bond. The effective date is for such bonds that are issued after December 31, 2017.

The new law also repeals existing rules relating to, and prospective authority to issue, tax credit and direct-pay bonds, after December 31, 2017. Anyone interested enough in these arcane provisions relating to tax-credit and direct-pay bonds likely already knows what they are so a further definition and explanation will cause the eyes of everyone else to further glaze over.

Conclusion

A major drawback to the new tax law – aside from specific policy issues – is that so much of it had an effective date of January 1, 2018.

Responsible policy-making takes into the effect how new legislation will affect the economy overall as well as specific sectors. Often new laws are enacted with staggered and delayed effective dates to allow those affected to respond appropriately and make future plans. Dramatic changes with immediate effective dates create chaos and confusion and may overtake any good that will come (from the perspective of lawmakers) from the newly passed laws.

What is in the Tax Cuts and Jobs Act of 2017 right now will likely not be the final word. The GOP House Budget Chairman is already eyeing a “technical corrections” bill to address acknowledged confusion and errors.

What was omitted from the final legislation is also not the last word in that regard, either. Some wish-list provisions (again, from the legislative majority’s view) did not make the final cut because of parliamentary rules obstacles associated with the “budget reconciliation” procedure used. They may, and likely will, pop up again soon for further action. Among the most likely candidates for renewed attention is the Johnson Amendment. What happened in December was a skirmish in that battle; the war is not over by a long shot.