The Tax Cuts and Jobs Act: Implications for Tax-exempt Entities

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The Tax Cuts and Jobs Act (TCJA) enacted at the end of 2017 had an immediate impact on all taxpayers, including tax-exempt entities. Nonprofits are faced with new excise taxes, changes to unrelated business taxes, and shifts in charitable giving incentives. The U.S. Treasury Department has indicated that it expects soon to issue guidance on the new law; this should help tax-exempt entities determine that law's ultimate impact on their operations.

Below are the key changes that tax-exempt entities should keep at the forefront.

New excise tax on executive compensation (Section 4960[1])

Prior to the TCJA, the only limitations on compensation for tax-exempt organizations were the requirement of reasonableness and the prohibition against private inurement. The TCJA now specifies that for tax years beginning after December 31, 2017, a new excise tax will be imposed on tax-exempt employers that compensate certain executives in excess of $1 million in wages and deferred compensation for which there is no substantial risk of forfeiture. The tax will also apply to the amount of any "excess parachute payment." The tax rate is the same as the corporate income tax rate (lowered to 21% under the TCJA) and applies to covered employees. This provision represents a significant change to employee compensation for nonprofit organizations and might make it more difficult to attract talent to large nonprofit organizations such as educational institutions.

The definition of "covered employee" is broader than prior definitions in the taxable/for-profit organization context. "Covered employees" are current or former employees that (a) are one of the five-highest-compensated employees in the current tax year, or (b) were previously covered employees for any preceding tax year after December 31, 2016.

The language of the new excise tax uses the phrase “excess parachute payment,” which is also used in Section 280G (disallowing compensation deductions for golden parachute payments). However, these phrases are not synonymous. Section 280G applies to compensation payments that are contingent on a change in control or ownership of a corporation or its assets. Section 4960, the new excise tax, applies to any payment contingent on an employee’s separation from employment, regardless of reason. The new excise tax also refers to Section 280G to define the base amount for purposes of calculating an excess parachute payment under Section 4960.

In general, there is a safe harbor for payments with an aggregate present value less than three times the employee’s average annual compensation for the five years before separation. Once the payments equal or exceed this amount, the 21% excise tax will apply to any payment over the average annual compensation.

Changes to UBTI calculation (Section 512)

For tax years prior to 2018, an exempt organization that conducted more than one trade or business unrelated to its exempt purpose could calculate its unrelated business taxable income (UBTI) on an aggregate basis. This enabled income generated by one business to be offset by losses from another.

Under the TCJA, UBTI will now be calculated separately for each unrelated trade or business. Any losses incurred by an activity may now be carried forward indefinitely. However, the losses may offset only income from the same activity. Although the change will likely increase the amount of UBTI, the corporate tax rate has also been reduced to 21%, which will lower the impact of the tax on UBTI.

While this change in the calculation creates the potential for an increase in UBTI, it also highlights the importance of an exempt organization’s definitions of each “activity” for UBTI grouping purposes.

Additionally, prior to the TCJA, fringe benefits provided to employees did not affect UBTI. Since the TCJA, the value of certain fringe benefits including transportation, parking, and access to on-site athletic facilities must be added to an exempt organization’s UBTI if they are paid or incurred after December 31, 2017.

Tax-exempt organizations should review their UBTI-producing activities and consider restructuring if appropriate.

New excise on investment income of private educational institutions (Section 4968)

The TCJA imposes a new 1.4% tax on the endowments of private colleges and universities for tax years beginning after December 31, 2017. The Bipartisan Budget Act of 2018 has already modified the language of the new code section to provide that the tax is imposed on the net investment income of educational institutions that (1) have at least 500 tuition-paying students during the preceding tax year, 50% of whom are in the US; and (2) have assets with an aggregate fair market value at the end of the prior year of at least $500,000 per student.

It remains unclear what assets and income should be considered in the application of the excise tax or in the calculation of the tax itself. In particular, a parenthetical note in the definition of "applicable educational institution" in Section 4968(b) states that the fair market value of assets "other than those assets which are used directly in carrying out the institution's exempt purpose" will be aggregated for the purpose of determining the $500,000 per student threshold. The section also indicates that rules similar to those defining "net investment income" for foundations will apply. Generally, net income for foundations is the amount by which the sum of the gross investment income (income from interest, dividends, rents, payments with respect to securities loans, and royalties) and the capital gain net income exceeds permitted deductions (ordinary and necessary expenses, straight-line depreciation, and depletion). Guidance from the IRS (Internal Revenue Service) is expected in the coming months.

Provisions affecting donors and bondholders

The TCJA amended or repealed provisions that might affect how much money individuals might give to tax-exempt organizations:

- Lower individual tax rates, increased standard deductions, and an increased estate and gift tax exclusion may lead to lower charitable contributions.
- Contributions in exchange for college athletic event seating are no longer deductible as charitable donations, which may lower this category of contributions. Prior to the TCJA, they were 80% deductible.
- Increased cash contribution limits for individuals (from 50% to 60% of adjusted gross income) may increase this category of giving.
- Interest received on advance refunding bonds, which are used to refund the principal,

interest, or redemption price on a prior bond, is now included in income for bonds issued after December 31, 2017. For additional detail, please see our prior client alert on changes to tax-exempt bonds post-TCJA.

Please contact Malcolm Farmer III at (401) 457-5180, Avi Lev at (617) 378-4398, or any other member of Hinckley Allen's Nonprofit Group if you would like more information about how current or future tax law developments might affect your organization, or if you have any other tax matter you would like to discuss.

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[1] All references to "Section" refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

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