ROPES & GRAY

ALERT

Colleges & Universities ▪ Tax-Exempt Organizations

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Tax Reform: Key Provisions for Tax-Exempt Organizations

After much uncertainty surrounding competing bills, the House of Representatives voted to pass comprehensive tax reform legislation (the "Act") on December 20, 2017, shortly after the Senate passed the measure. The Act will now be sent to President Trump's desk, and it is expected that he will sign the bill into law. The Act contains a number of provisions relevant to tax-exempt organizations, and many provisions contained in earlier versions of the legislation have been eliminated. Key provisions of interest are summarized below.

Tax on Private University Endowments

The Act imposes a 1.4% excise tax on the net investment income of certain universities, effective for tax years beginning in 2018. The tax will apply to any private university with at least 500 students (provided more than 50% of its students are located within the U.S.) if the aggregate fair market value of the university's assets (other than those assets used directly in carrying out the university's exempt purposes) is at least $500,000 per student. For purposes of determining net investment income and whether the asset-per-student threshold has been met, net investment income and assets of related organizations are generally included. Related organizations include organizations controlled by the university (or by persons who control the university), organizations that control the university, supporting organizations of the university, and organizations considered supported organizations with respect to the university.

There remain significant interpretive issues with this provision, including:

- The definition of net investment income, which is the base on which the tax will be imposed. The statutory language indicates this will be determined under rules "similar to" the tax on net investment income of private foundations.
- The definition of assets used directly in carrying out the university's exempt purposes, important because these assets are excluded from total assets for purposes of determining whether the asset-per-student threshold has been met and therefore whether the excise tax applies.

The Joint Explanatory Statement of the Committee on Conference indicates that regulations will be promulgated to address these and other issues.

Executive Compensation and Employee Fringe Benefits

The Act imposes an excise tax at the corporate rate (21%) on many types of tax-exempt organizations, including all 501(c)(3) organizations, for tax years beginning in 2018 with respect to two categories of compensation paid to "covered employees" (the organization's five highest compensated employees for the year and anyone previously considered a covered employee in a preceding year). The excise tax applies to:

- Remuneration (generally wages and certain deferred compensation includible in income) in excess of $1 million paid to a covered employee during the organization's tax year; and
- Any "excess parachute payments" (in general, severance or severance-type compensation equal to or in excess of three times the covered employee's average annual compensation over a specified look-back period).

Remuneration paid by a related organization is generally taken into account for purposes of the excise tax. There is a carve-out from both categories of compensation subject to the excise tax for amounts paid to licensed medical professionals in connection with the performance of medical services, and the excess parachute payment rules do not apply to non-"highly compensated employees," as that term is specifically defined in the Internal Revenue Code. The legislation contemplates that regulations will be needed to prevent avoidance of this new excise tax, such as through performance of services as other than an employee or by using a pass-through entity to pay compensation.

The Act also suspends through the end of 2025 the exclusion from gross income for certain employer-provided fringe benefits, including the exclusion for qualified moving expense reimbursements and the transportation fringe applicable to qualified bicycle commuting reimbursement, and relatedly suspends the availability of the deduction for moving expenses for the same period.

Additionally, any amount paid by a tax-exempt organization for any qualified transportation fringe, any parking facility used in connection with qualified parking fringes, or any on-premises athletic facility will generally be treated as unrelated business taxable income for tax years beginning in 2018.

Unrelated Business Taxable Income (UBTI)

UBTI "Basket" Provision. The Act requires UBTI to be computed separately with respect to each unrelated trade or business of a tax-exempt organization. The organization will then be taxed on the sum of the separately computed UBTI "baskets," less a single $1,000 specific deduction. Each separately computed UBTI amount cannot be less than zero. As a result, the Act prevents tax-exempt organizations from offsetting UBTI in one unrelated trade or business with net losses from another unrelated trade or business.

This provision is effective for tax years beginning in 2018. The Act permits net operating losses ("NOLs") generated in taxable years beginning before January 1, 2018 to be used in subsequent years without the basketing limitation that would otherwise be imposed by the Act. Accordingly, such NOLs could be used generally against UBTI from any trade or business. It is not clear whether capital loss carryforwards generated in prior tax years will be subject to the same treatment.

Guidance will be needed on the extent to which tax-exempt organizations may aggregate activities as a single trade or business. For example, it is unclear from the Act whether an organization's investments in multiple private investment funds would be treated as a single trade or business of investing, a separate trade or business with respect to each fund investment, or a separate trade or business with respect to each portfolio company owned by each of several private equity funds. It is also unclear how certain losses from debt-financed investments will be treated for purposes of the basketing provision.

Reduction in Tax Rate. The Act replaces the graduated corporate income tax rate structure and maximum 35% marginal rate with a flat 21% corporate income tax rate. Accordingly, UBTI of tax-exempt organizations that are corporations will be taxed at a 21% federal rate for tax years beginning in 2018.

Tax-Exempt Bonds

While the initial House bill would have repealed tax exemption for "private activity bonds" – a broad category of tax-exempt bonds that includes bonds issued for the benefit of tax-exempt organizations – the Act does not repeal the private activity bond tax exemption.

Under the Act, bonds that "advance-refund" tax-exempt bonds will lose their tax-exempt status. Refunding bonds – bonds issued to pay principal, interest or the redemption price on a prior bond issue – are classified as "current refunding" bonds if the refunded bond is redeemed within 90 days of the issuance of the refunding bonds, and as "advance refunding" bonds otherwise. Beginning in 2018, interest on advance refunding bonds will no longer be exempt from tax.

Provisions Affecting the Charitable Contribution Deduction

Increase in the Charitable Contribution Deduction Limitation. The amount an individual may deduct for a charitable contribution is limited to certain percentages of the donor's "contribution base" (essentially, the donor's adjusted gross income). Donations of cash by individuals to a private foundation are generally limited to 30% of a donor's contribution base. Under pre-Act law, donations of cash by individuals to public charities and certain private foundations are generally eligible for a more generous 50% donation cap.

The Act increases the 50% limitation for cash contributions to public charities and certain private foundations to 60%. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years. The provision sunsets at the end of 2025.

Increase in the Standard Deduction. The Act increases the standard deduction to $12,000 for single filers, $18,000 for heads of household, and $24,000 for joint filers. Under prior law, the 2018 standard deduction amounts would have been: $6,500 for single individuals and married individuals filing separately; $9,550 for heads of household, and $13,000 for married individuals filing jointly. The standard deduction increases sunset at the end of 2025.

Increasing the standard deduction is expected to result in a dramatic reduction in the number of taxpayers who choose to itemize and claim the charitable deduction. Many in the charitable community anticipate that this change will result in a significant decline in charitable giving.

Repeal of the "Pease" Limitation. Under pre-Act law, certain taxpayers who itemized their deductions were subject to a limitation on these deductions (the so-called "Pease" limitation). For taxpayers who exceed the threshold, the total amount of most otherwise allowable itemized deductions was reduced by 3% of the amount of the taxpayer's adjusted gross income exceeding the threshold. The total reduction could not be greater than 80% of all itemized deductions. The Act suspends the Pease limitation through the end of 2025.

College Athletic Event Seating Rights. Under pre-Act law, a donor was permitted to claim a charitable contribution deduction for 80% of the amount paid for the right to purchase tickets for athletic events. The Act repeals this rule for contributions made in tax years beginning in 2018.

Notable Omissions

Several provisions relevant to tax-exempt organizations that were proposed in earlier House or Senate versions of the legislation are not a part of the Act. These include:

- Subjecting state and local government pension plans to the unrelated business income tax.
- Repealing the tax exemption for private activity bonds, including qualified 501(c)(3) bonds.
- Changing the "intermediate sanctions" excise tax regime to impose new organization-level excise taxes and treat all investment advisors and university athletic coaches as "disqualified persons."
- Repealing the tax-free treatment of tuition benefits provided to employees of educational institutions (and their spouses and dependents) and the tax-free treatment of educational assistance programs offered by employers to their employees.
- Repealing the tax-free treatment of housing benefits provided to employees who are required to accept housing on the business premises for the employer's convenience.
- Subjecting tax-exempt organizations to unrelated business income tax on royalties from licensing the organization's name or logo.

- Simplifying the existing two-tier excise tax rate on private foundation net investment income to a single rate of 1.4%.

- Permitting section 501(c)(3) organizations to engage in certain political speech carried out in the ordinary course of the organization's regular activities at *de minimis* expense (modifying the so-called "Johnson Amendment").

- Imposing additional reporting requirements on donor-advised funds.

If you have questions about the impact of the tax reform legislation, please contact a member of the tax group or the tax-exempt organizations practice.