CHANGES FOR EXEMPT ORGANIZATIONS UNDER THE TAX CUTS AND JOBS ACT AND THE BIPARTISAN BUDGET ACT

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THE RECENTLY PASSED TAX CUTS AND JOBS ACT (TCJA) AND BIPARTISAN BUDGET ACT (BBA) INCLUDE A NUMBER OF PROVISIONS THAT DIRECTLY AFFECT TAX-EXEMPT ORGANIZATIONS.

Unrelated business taxable income separately computed for each trade or business activity

Prior to the passage of the TCJA, when determining unrelated business taxable income (UBTI), an organization that operates multiple unrelated trades or businesses **aggregated** income from all those activities and subtracted the aggregated deductions from the aggregate gross income. As a result, an organization was able to use a deduction from one unrelated trade or business to offset income from another, thereby reducing total UBTI.

The TCJA requires organizations operating one or more unrelated trades or businesses to compute UBTI separately for each trade or business (without regard to Section 512(b)(12) which provides a specific deduction equal to the lower of $1,000 or the gross UBTI).

The result is that a deduction/loss from one unrelated trade or business may not be used to offset the income from a different, unrelated trade or business. Net losses may be used to offset income from the same trade or business in another taxable year. Under a special transition rule, net operating losses arising in a taxable year before January 1, 2018 that are being carried forward are not subject to this new provision.

However, it remains unclear what separates lines of businesses under this fragmentation rule. For example, will all investment income reside in a single UBIT silo? If a tax exempt entity invests in several partnerships, does each investment constitute a single line of business? These questions may result in additional planning opportunities, pending further guidance.

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Many exempt organizations generate some unrelated business income. The inability to offset losses from one unrelated trade or business against gains from another (or against gains and losses from alternative investments or pass-through entities) would likely increase a tax-exempt organization's overall UBIT burden. On the positive side, if UBIT is triggered, it will now be taxed at the lower corporate rate of 21% instead of the higher corporate tax rates in effect prior to the TCJA .

Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed

Prior to the passing of the TCJA, tax-exempt organizations, like taxable entities, were able to provide their employees with transportation fringe benefits and

on-premises athletic facilities in a tax efficient manner. There were no tax consequences to the tax exempt organization and the employees did not have to recognize taxable income equal to the value of the benefit.

The TCJA amends the unrelated business income provisions by adding Section 512(a)(7) to the Internal Revenue Code (IRC), which imposes tax on exempt entities with respect to qualified transportation benefits, and any athletic facilities. The provision is intended to replicate the effect of a similar provision for taxable entities, which makes certain benefits non-deductible.

It should be noted that although employers may be taxed on the cost of providing these fringe benefits, employees can continue to receive them on a tax-free basis, as Internal Revenue Code Section 132(f) which excludes qualified transportation fringe benefits from gross income remains mostly untouched by the TCJA.

Recently, the IRS released the 2018 update of Publication 15-B, which includes information clarifying the changes to the tax treatment of commuter benefits and the suspension of qualified bicycle commute.

The publication states that "no deduction is allowed for qualified transportation benefits (whether provided directly by you, through a bona fide reimbursement arrangement, or through a compensation reduction agreement) incurred or paid after December 31, 2017."

A Compensation Reduction Agreement provides qualified transportation benefits on a pre-tax basis. Employees are offered a choice between cash or a qualified transportation benefit. Publication 15-B clarifies that the employer deduction for qualified transportation benefits is not available whether provided directly by the employer or through a Compensation Reduction Arrangement.

“IT SHOULD BE NOTED THAT THE PROVISION EXEMPTS COMPENSATION PAID TO NON-HIGHLY COMPENSATED EMPLOYEES FROM THE DEFINITION OF PARACHUTE PAYMENT, AND ALSO EXEMPTS COMPENSATION ATTRIBUTABLE TO MEDICAL SERVICES OF CERTAIN QUALIFIED MEDICAL PROFESSIONALS FROM THE DEFINITIONS OF REMUNERATION AND PARACHUTE PAYMENT; HOWEVER, COMPENSATION TO THESE INDIVIDUALS FOR NON-MEDICAL SERVICES WOULD STILL BE TAXABLE.”

As such, although employees continue to receive the full tax savings for any pre-tax deductions for qualified transportation, employers must reduce their wage expense by the amount of the pre-tax employee deductions. The employer, however, does see payroll tax savings on the reduced payroll expense.

It should also be noted that it remains unclear if these amounts will be considered unrelated business income and taxed at the state level.

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This provision of the TCJA introduces an additional tax burden and other complexities for tax-exempt entities, particularly for those that have specifically avoided engaging in activities which would subject them to unrelated business income tax (UBIT), but have been providing employees with transportation fringe benefits or access to gyms and other athletic facilities.

Furthermore, several jurisdictions such as New York City and Washington, D.C. require employers with 20 or more full-time employees to provide this benefit to employees. As such, for organizations operating in these jurisdictions, it is virtually impossible to avoid this tax.

Organizations should take steps to track the expenses related to these programs, such as a portion of salary of the individual responsible for administering the program and any other expense directly related to the generation of this “income,” as these can be used as a direct offset to any taxable income.

Excise tax on excess tax-exempt organization executive compensation

Prior to the passage of the TCJA, taxable employers typically could deduct reasonable compensation as a business expense; however, compensation exceeding specific levels was not deductible.

Additionally, a corporation generally could not deduct part of the aggregate present value of a "parachute payment" (typically compensation that is contingent on a change in corporate ownership) made to an officer, shareholder or highly compensated individual, if the aggregate present value of all payments equaled or exceeded three times the individual's base amount.

These deduction limitations were not applicable to tax-exempt organizations.

Under the TCJA, a tax-exempt employer is liable for an excise tax equal to 21% of the sum of: (1) remuneration (not including any an excess parachute payments) over $1 million paid to a covered employee, and (2) any excess parachute payment paid to a covered employee.

For purposes of this provision, a covered employee is an individual who was one of the five highest-compensated employees of the organization for the tax year or were a covered employee of the organization (or a predecessor) for any preceding tax year beginning after December 31, 2016.

It should be noted that the provision exempts compensation paid to non-highly compensated employees from the definition of parachute payment, and also exempts compensation attributable to medical services of certain qualified medical professionals from the definitions of remuneration and parachute payment; however, compensation to these individuals for non-medical services would still be taxable.

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The provision has a substantial financial impact on tax-exempt organizations that have highly-compensated individuals paid in excess of the relevant amounts noted above. Organizations should review their employees' total compensation arrangements to assess when they may become subject to the excise tax, and should closely monitor the amount and timing of compensation payments to their executives.

Excise tax based on investment income of private colleges and universities

Prior to the passage of the TCJA, only 501 (c)(3) private foundations had an annual excise tax on their net investment income.

Under the TCJA, a new 1.4% annual excise tax is imposed on the net investment income of an "applicable educational institution." Net investment income would be determined using rules similar to those for private foundations.

An "applicable educational institution" is described in Section 25A(f)(2) (Which discusses the Hope and Lifetime Learning credits) that:

1. Has at least 500 tuition-paying students during the preceding tax year, more than 50% of whom are located in the US;
2. Is not a state college or university and
3. Has assets with an aggregate fair market value of at least $500,000 per student at the end of the preceding tax year (other than those used directly in carrying out the organization's exempt purpose).

The BBA further provides that the “at least 500” and “more than 50 percent” of students tests above both refer to tuition-paying students. This provision is effective for tax years beginning after Dec. 31, 2017, as if it were a part of the original enactment of the TCJA.

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> *This provision effectively treats certain private colleges and universities as private foundations subject to an excise tax on their net investment income, even in instances where the university itself is a public charity.*

Exception from excess business holding tax for independently-operated philanthropic business holdings

Formerly, under section 4943 a private foundation that has any excess business holdings is generally subject to an initial tax equal to 10% of those excess holdings. As such, foundation ownership above certain percentages of a business would be required to be disposed of by the private foundation in order to avoid this excise tax.

The BBA added the “Newman’s Own” exception (named for the prime example of this case, the Newman’s Own Foundation, which receives 100% of the after-tax profits from the sale of Newmans Own products) to the private foundation excess business holdings rule, allowing business owners to make a charitable contribution of 100% of a business to their private foundation, and have it remain there.

Specifically, a new subsection (g) is added to section 4943, providing an exception from this tax for certain holdings of a private foundation in any business enterprise which meets the following requirements for the tax year:

1. The foundation owns all of the businesses voting stock at all times during the tax year.
2. The foundation acquired all of its interests in the for-profit business other than by purchasing it.
3. The business enterprise distributes all of its net operating income for any given tax year to the private foundation within 120 days of the close of that tax year.
4. The directors, executives, etc. of the business enterprise are not substantial contributors to the private foundation.
5. At least a majority of the board of directors of the private foundation are persons who are not directors or officers of the business enterprise or family members of a substantial contributor to the private foundation.

This new subsection was initially a part of the bill presented by the House of Representatives in Nov. 2017 as a part of the TCJA, but was removed from the final version that was signed into law in December 2017. It is effective for tax years beginning after Dec. 31, 2017.

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> *This provision opens up the opportunity for other private foundations to fully own a for-profit business.*

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