# The Changing Tax Law for Nonprofits

The Tax Cuts and Jobs Act, the most comprehensive tax overhaul in over thirty years, was signed into law (the "Act") in December 2017, prompting significant concern among nonprofits. Virtually every person and organization in America is affected by the Act, including nonprofits and those that donate to such organizations. In fact, many have been sounding the alarm that the Act has a substantial negative effect on the philanthropic world. While the ultimate effects of these sweeping tax law changes remain to be seen, nonprofits must brace themselves for whatever is to come.

## Impact on Individual Giving

There has been much speculation over how these changes to individual income taxes under the Act will affect charitable giving. Many think that by reducing the tax incentive to give, fewer people will contribute, which is a reasonable conclusion. However, it is also possible that people will instead change *how* they give, rather than *how much* they give.

For example, taxpayers may "bunch" their gifting into one large gift in a single year instead of spreading out gifts over several years. By using this strategy, itemizing deductions in the "bunching" year would yield greater tax savings than the standard deduction. Many people give regardless of the tax benefit, so people with that mindset will likely continue their historical giving pattern.

There may be a chance that reductions in individual giving may be more than offset by the gains to corporations, many of which have been left with more cash thanks to the corporate tax cut. There have been reports that several large companies have announced significant increases in their contributions, so we may see an increase in the amount that corporations give. However, it's important to note that corporations may be less incentivized to lower their tax bills with charitable donations.

### *Changes and Implications*

- **Standard Deduction -** The Act roughly doubles the standard deduction for individuals ($12,000 for individuals and $24,000 for joint filers) and generally lowers individual income tax rates across the board. The Act also places an annual limitation on the state and local tax deduction at $10,000 (for both individual and joint filers). These income tax changes are scheduled to remain in effect through 2025. Doubling the standard deduction makes *it much more likely that fewer people will itemize their deductions*. Because a taxpayer must itemize deductions in order to obtain any income tax benefit by making a charitable contribution, a taxpayer not itemizing deductions receives no tax benefit from such a contribution.

- **State and Local Deduction -** Capping the state and local tax deduction also makes it more likely that the standard deduction will be used. Even for those who will still itemize, the lower income tax rates reduces the value of the charitable deduction because with lower tax rates, less taxes are saved by taking a charitable deduction than before the Act. While an increase in the standard deduction benefits taxpayers, the increase, combined with the limitation on the deduction for state and local taxes, will cause fewer individuals to itemize, which many nonprofits fear may lead to a reduction in overall giving. It has been estimated by the Tax Policy Center that charitable giving will decline by between $12.3 billion and $19.7 billion.

- **Pease Limitation -** It is important to note that certain provisions of the Act may incentivize charitable giving. The so-called "Pease limitation," which formerly limited itemized deductions for upper-income individuals, has been repealed by the Act. Also, the limit on cash donations for itemizers is increased to 60% of adjusted gross income from 50% of adjusted gross income. With these changes, high earners who itemize their deductions may be more inclined to make charitable gifts.

- **Estate Tax Exemption -** the law doubles the gift and estate tax exemption. An increase in the estate tax exemption from $5 million to $10 million (adjusted for inflation) per individual beginning in 2018 could lead to less planned giving and less contributions received from estates. This provision will sunset in 2026, returning the exemptions to their current level.

## Impact on Nonprofit Tax Position

- **Excise Tax on Endowments of Nonprofit Colleges & Universities -** The bill includes a new excise tax of 1.4 percent on the net investment incomes of applicable educational institutions. The term 'applicable educational institution' refers to an educational institution which a) had at least 500 tuition-paying students during the preceding taxable year; b) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student of the institution; and c) more than 50 percent of the tuition-paying students are located in the United States.

  The new law only applies to private institutions. Under the new law, an educational institution will have to include the assets of related organizations when making the determination of whether the thresholds are met. Many initially thought the provision would only impact between 30 and 60 colleges and universities. However, large healthcare systems and other exempt groups may have nursing schools or other schools that could be impacted when the assets of the related entities are considered.

- **Modifications to the Unrelated Business Income Tax (UBIT) Losses - t**he Act disallows tax-exempt organizations to take the business losses from one economic activity and deduct them from the gains of another economic activity. Organizations could, however, use one year's losses on the same unrelated business to reduce taxes on another year's operation of the same unrelated business. There are many unanswered questions about the UBIT provision and there may be opportunities for tax planning. On the other hand, the corporate income tax rate is decreased from 35 to 21 percent, which means nonprofits will pay a lower tax rate on the UBIT than they are currently

- **Certain Fringe Benefits -** Unrelated business income of a tax-exempt organization would include employer costs for qualified transportation fringe benefits and parking facilities. These provisions were enacted to equalize the treatment between taxable corporations that can no longer deduct these amounts and nonprofits. The provision is effective as of 1/1/2018, so organizations should consider the impact on their current filings, as well as, estimated tax requirements.

- **Tax-Exempt Treatment of Interest Income from Advance Refunding Bonds -** Nonprofits often use advance refunding bonds to help reduce the cost of borrowing to finance projects like construction or other capital investments. The Act repeals the exclusion from gross income for interest on a bond issued to advance refund another bond. Interest paid to advance refunding bond investors is now taxable.

- **New Code Section 512(a)(6) –** UBIT "Silo-ing" is a special rule which applies to organizations with more than one (1) unrelated trade or business. Unrelated business taxable income will now be computed separately with respect to each such trade or business and likewise any net operating loss will only be available to the separate trade or business which created the loss.

- **Excise Tax on Compensation –** The Act imposes a new 21% excise tax on nonprofits that pay compensation of $1 million or more to any of their five highest-paid employees. There will also be a tax on certain employee benefits. Tax is paid by the **exempt organization** and applies to **all** remuneration of a covered employee (including non-cash benefits), except tax-qualified retirement plans, amounts that are excludible from the covered employee's gross income. If an employee qualifies as a covered employee for any year, the excise tax applies to compensation in excess of $1 million and certain parachute payments paid to the person by the organization in any future year.

- **Employees' Moving Expenses -** Effective for taxable years 2018 through 2025, moving expenses must now be included in an individual's taxable income, and may not be deducted. Reimbursements are no longer excluded from taxable income and deductions are no longer permitted. This applies to all expenses for the packing and moving of personal effects, as well as for any travel and lodging expenses incurred during the move. Members of the Armed Forces, however, who are on active duty and who move pursuant to a military order and incident to a permanent change of station may still be able to exclude reimbursements or deduct expenses from their taxable income.

- **Deduction for College Event Seating Rights -** Prior to January 1, 2018, donors could take a charitable deduction for 80% of a payment made to an institution of higher education that gave the taxpayer the right to purchase tickets for an athletic event at the institution's stadium. The remaining 20% wasn't deductible because it was treated as a quid pro quo for the value of the seating rights. This alleviated the college or university's responsibility to value the return benefit received by the donor, reducing the burden on the school.

  The new tax reform law repeals this 80–20 split. However, it doesn't affect laws relating to charitable contributions and quid pro quo rules that allow a donor to take a tax deduction for payments made in excess of return benefits received—as long as there's charitable intent. If the payment amount doesn't exceed the fair market value of the benefits received by the donor, or if the institution has told the donor no portion of their payment is tax deductible, no charitable deduction will be allowed. The institution must determine the value of the benefits it provides to the donor. The difficulty of valuing seating rights was the reason the 80–20 rule was added to the Internal Revenue Code (IRC). The institution must issue donor letters that acknowledge receipt of a donation and report the value of return benefits received.

## Suggestions for Tackling Tax Reform

Nonprofits stand to be impacted significantly by various aspects of the new law, and will need to reassess their tax positions for financial reporting purposes. Nonprofits, which often struggle with a lack of internal capacity, need to be sure to allocate adequate resources to work with these changes, beyond just the provisions for tax-exempt organizations.

Many of the changes on the individual level, i.e. limiting state and local tax deductions, nearly doubling the standard deduction and the estate and gift tax exemptions—could leave organizations facing significant cutbacks in donations. Comprehensive fiscal management that takes a holistic approach including the tax, audit, fundraising, and executive functions will be more vital than ever.

- ✓ ***Assess impact***. Tax professionals will likely need to review the law to measure their organization's specific circumstances against it to assess the impact of each provision, as well as the holistic effect on their bottom line.
- ✓ ***Assemble a team***. While the heaviest burden may fall on accountants, organizations and their finance teams will have an important role to play to gather all the necessary data.
- ✓ ***Dig into the data***. Assessing the impact of tax reform requires a substantial amount of data to be readily available. Nonprofits need to move from modeling the impact of tax reform to focus on data collection and computations as soon as possible.
- ✓ ***Establish priorities***. Focus on the areas that could have the greatest impact on your organization.
- ✓ ***Initiate tax reform conversations with your tax advisor***. Tax reform of this magnitude is the biggest change we've seen in a generation, and will require intense focus to understand not only how the changes apply at a federal level, but also how to navigate the ripple effect this is likely to have on state taxation as well.

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***For further discussion on the Tax Reform Act or if you have questions, please contact our Nonprofit Team.***

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