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Decoding the Tax Cuts and Jobs Act – Part VIII: Charitable and Tax-Exempt Organizations / Estate and Gift Taxes

By Larry Brant and Steven Nofziger on 3.27.18 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

INTRODUCTION

Charitable organizations work hard to maintain exempt status. These organizations operate in a highly regulated landscape: In exchange for enjoying freedom from income taxes, they must comply with strict organizational and operational rules. Even before the Tax Cuts and Jobs Act ("TCJA"), adhering to these rules required constant oversight. The TCJA changes the rules, impacting both the operations and funding of these organizations.

On the operational side, we review below: Changes to the rules on unrelated business taxable income and employee fringe benefits, the new excise taxes imposed on executive compensation, and college and university endowments, and changes to substantiation requirements for certain donations.

On the funding side, we review below: How changes to the standard deduction (addressed in more detail in a prior blog post), cash contribution limits, deductions for payments to colleges and universities for the right to purchase athletic event tickets, and the estate tax may impact donors and charitable giving patterns.

OPERATIONAL MATTERS

Unrelated Business Taxable Income

Background/Prior Law

Tax-exempt organizations pay federal income taxes when they engage in income-producing activities unrelated to their exempt purposes. The income from such activities is subject to the unrelated business income tax ("UBIT"). The UBIT is a parallel regime that imposes a tax on all unrelated business income ("UBI") of tax-exempt organizations at the same rate that applies to corporations. By taxing UBI in this manner, the competitive advantage that tax-exempt organizations would otherwise have over taxable organizations solely due to their exempt status is eliminated.

Under prior law, tax-exempt organizations carrying on more than one unrelated trade or business could calculate UBIT on an aggregate basis. In other words, the sum of UBI from all unrelated trades or businesses was subject to tax, taking into account losses from unprofitable unrelated trades or businesses of the organization. Consequently, losses from one unrelated trade or business could be used to offset income derived from another unrelated trade or business.

TCJA

For tax years beginning after 2017, a tax-exempt organization that carries on more than one unrelated trade or business must calculate its UBIT separately for each unrelated trade or business. Losses from one unrelated business cannot be used any longer to offset income from another unrelated business. Instead, UBIT from each unrelated trade or business must be separately calculated and taxed.

On the positive side, the TCJA reduces the tax rate applicable to UBIT. It is now 21%.

Planning Tip

Tax-exempt organizations should carefully review all business activities to determine how the new law impacts them. While the new UBIT rate may be beneficial to some exempt organizations, the newly required activity-by-activity calculation will likely more than offset the rate benefit for most affected exempt organizations. A careful review is warranted.

Employee Fringe Benefits

Background/Prior Law

Pre-TCJA, certain employee fringe benefits were deductible to an employer as a compensation expense and excluded from the employee's income. While tax-exempt employers did not get the advantage of the compensation deduction, their employees did enjoy the income exclusion.

TCJA

As discussed in a prior blog post, the TCJA makes several sets of changes to the statutory framework surrounding employee fringe benefits. One change is the elimination of the employer deduction for the cost of certain employee fringe benefits. To keep the playing field level between taxable and tax-exempt employers, the TCJA includes a parallel provision under which tax-exempt organizations are subject to UBIT on the value of these nondeductible fringe benefits.

This rule applies to amounts paid or incurred after 2017. Affected benefits include: Qualified transportation fringe benefits (e.g., commuter transportation, transit passes, qualified parking or qualified bicycle reimbursement); any parking facility used in connection with qualified parking; and on-premises athletic facilities.

The rationale behind this change is to treat tax-exempt organizations comparably to for-profit organizations. Since tax-exempt organizations would be unaffected by loss of the employer deduction, they are actually taxed on the value of the benefit as a means of placing them on the same plane as taxable employers.

The good news is that the TCJA does not modify the existing income exclusion for employees receiving qualified transportation fringe benefits (other than the income exclusion for qualified bicycle commuting reimbursements).

Planning Tips

This change will impact many tax-exempt organizations, some of which were not previously subject to the UBIT. Now, any tax-exempt organization which provides any of the fringe benefits discussed above, including qualified parking or transit passes, will be subject to the UBIT.

Tax-exempt organizations need to evaluate how these changes will impact the organization and the employees. Some exempt organizations may consider eliminating these employee benefits and, instead, offering wage increases or other benefits of similar value to employees that will not trigger the UBIT. If tax-exempt organizations, however, opt to continue providing these benefits, they need to properly report and pay the UBIT.

New Excise Tax on Executive Compensation

Background/Prior Law

Taxable employers generally can deduct reasonable compensation paid to employees; however, certain limitations apply. Publicly-traded corporations cannot deduct payments to covered employees in excess of $1 million; nor can they deduct excess parachute payments (as defined in IRC Section 280G). Further, an excise tax applies to any excess parachute payments (the rate used to be 20 percent). Covered employees include CEOs or other members of the corporation who rank among the four highest paid officers and whose compensation must be reported to the corporation's shareholders.

These historic limitations did not impact tax-exempt organizations. Tax-exempt organizations only needed to meet reasonableness requirements with respect to the magnitude of an employee's compensation, and had to ensure that compensation did not constitute private inurement.

TCJA

For tax years beginning after 2017, the TCJA imposes a 21 percent excise tax on compensation paid by certain tax-exempt employers to covered employees in excess of $1 million or on excess parachute payments paid to covered employees. This change in the law is designed to create parity with for-profit organizations.

Organizations subject to the new excise tax include:

- Organization exempt from tax under IRC Section 501(a) (i.e., most tax-exempt organizations);
- Farmers' cooperatives exempt under IRC Section 521(b);
- Federal, State or local governmental entities with income excludable under IRC Section 115; and
- Political organizations under IRC Section 527(e).

The TCJA defines "covered employee" as any current or former employee of a tax-exempt organization who: (a) is among the top five highest compensated employees of that organization for the current tax year; or (b) was a covered employee of the organization or any predecessor for any tax year after December 31, 2016.

The TCJA defines "compensation" (called "remuneration" for these purposes) as including all wages, as defined for income tax withholding purposes, not subject to a substantial risk of forfeiture (as defined under IRC Section 457(f)), but excluding designated Roth contributions and including amounts taxable under IRC Section 457(f) deferred compensation plans. Under this framework, the tax may apply to certain vested deferred compensation amounts even if the employee has not yet received them.

"Parachute payments" are defined in a manner similar to the definition under IRC Section 280G, that is, payments contingent on a separation from service with an aggregate present value equal to or greater than three times the employee's annual base compensation. Payments are considered "excess parachute payments" to the extent they exceed that threshold.

There are certain exceptions, including payments made under annuities or qualified retirement plans, payments to persons who are not highly compensated employees (within the meaning of IRC Section 414(q)) and payments to licensed medical professionals, including veterinarians, for services.

Congress has directed Treasury to issue regulations to prevent tax avoidance, including regulations that would prevent employees from being misclassified as independent contractors or from being compensated through a pass-through entity to circumvent these rules.

Planning Tip

Tax-exempt organizations should carefully review all current executive compensation arrangements to determine whether this new excise tax is triggered. Affected organizations should consider whether to modify existing compensation arrangements, if modifiable, taking into account the need to attract and retain top organizational talent.

New Excise Tax on Colleges and University Endowments

Background/Prior Law

Private colleges and universities are generally treated as public charities rather than private foundations. Therefore, they are not subject to the 2 percent (1 percent in some cases) excise tax imposed by IRC Section 4940 on the "net investment income" of private foundations.

IRC Section 4940(c) sets forth the rules for calculating "net investment income," which includes the amount by which the sum of gross investment income (e.g., interest, dividends, rents, royalties and income from similar sources) plus capital gain net income exceeds allowable deductions, but excludes tax-exempt interest and related deductions.

Prior to the TCJA, there was no excise tax on the net investment income of private colleges or universities.

TCJA

For tax years beginning after 2017, the TCJA imposes a new excise tax on each "applicable educational institution" in the amount of 1.4 percent of the institution's net investment income for the tax year.

Congressional Committee Reports provide that this tax reflects the reality that, while college tuition has risen faster than inflation, private colleges and universities' endowment balances have enjoyed dramatic growth to the point where endowment balances no longer seem commensurate with the scope of the institutions' educational activities. Accordingly, Congress saw fit to impose a tax on what it deemed outsized endowments.

The TCJA defines "applicable educational institutions" to include all accredited public, nonprofit and proprietary (for profit) postsecondary institutions:

- With at least 500 students in the prior tax year;
- With more than 50 percent of students located in the U.S.;
- That are not state[1] colleges or universities; and
- Owning assets with an aggregate fair market value of at least $500,000 per student as of the end of the preceding tax year (excluding those assets used directly in carrying out the institution's exempt purposes).

The calculation of the number of students is measured by the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis (e.g., two ½-time students = one full-time student).

When calculating assets and net investment income, the TCJA requires the inclusion of the assets and net investment income of any related organization, with two exceptions. First, to prevent double-counting, amounts are not taken into account with respect to more than one educational institution. Second, assets and net investment income that are not intended or available for the educational institution's use and benefit can generally be disregarded. For these purposes, a "related organization" is any organization that: (1) controls or is controlled by the educational institution; (2) is controlled by one or more persons that control the educational institution; or (3) is a supported organization (as defined in IRC Section 509(f)(3)) or an organization described in IRC Section 509(a)(3) with respect to the eligible educational institution.

The TCJA directs the Treasury to promulgate regulations to carry out the intent of this provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution. Guidance in these areas will be helpful. Stay tuned!

Private colleges and universities need to evaluate at least annually whether they are subject to this tax, including reviewing the assets and net investment income available to them through any related organizations.

Minor Change to Substantiation Requirements

Background/Prior Law

Pre-TCJA, taxpayers making donations of $250 or more to charitable organizations were not allowed a charitable contribution deduction unless they received a contemporaneous written acknowledgment of their donation from the organization receiving the donation.

Prior law authorized Treasury to issue regulations exempting donors from this requirement if the organization receiving the donation instead filed a return reporting the same information the donor would have received in the written acknowledgement. In 2015, proposed regulations were issued, which provided this very exception. Unfortunately, the regulations were promptly withdrawn due to privacy concerns surrounding the fact that charitable organizations would have been required to collect and maintain donors' taxpayer identification numbers. Consequently, without regulations providing an exception, most commentators asserted that donors had to obtain a contemporaneous written acknowledgment to substantiate their donation.

TCJA

The TJCA expressly removes all doubt. The donee reporting exception is eliminated. As a result, donors must continue to substantiate donations through contemporaneous written acknowledgments.

Planning Tip

Charitable organizations should continue providing contemporaneous written acknowledgement of donations of $250 or more. Donors who intend to deduct their charitable contributions need to retain this document in their tax records.

FUNDING MATTERS

Charitable organizations typically rely on donor contributions to fund operations. Likewise, donors have historically enjoyed tax deductions for donations. The TCJA has changed the tax landscape for some donors. These changes directly impact donors, possibly resulting in less donative activity going forward.

Standard Deduction

As covered in a prior blog post, the TCJA doubled the standard deduction (through December 31, 2025), and eliminated many itemized deductions. Accordingly, fewer taxpayers will benefit from itemizing.

This impacts charitable organizations. Under both prior law and the TCJA, donations to qualifying charitable organizations are tax-deductible, but only for those taxpayers who itemize. Since fewer taxpayers will benefit from itemizing under the TCJA, fewer taxpayers will see a tax benefit from making charitable contributions. Some taxpayers will continue their giving patterns regardless; others may not. Time will tell! Charitable organizations need to plan for some unpredictability in future charitable giving.

On a somewhat brighter note, prior law imposed some limits on charitable giving that no longer apply—the Pease limitation was repealed. This rule limited the total amount of otherwise allowable itemized deductions available for certain high-income taxpayers. Under this rule, otherwise allowable itemized deductions were reduced by 3 percent of the amount by which the taxpayer's adjusted gross income (AGI) exceeded specified thresholds (but not by more than 80% overall). In 2017, the thresholds were:

- $261,500 for single filers;
- $313,800 for joint filers and surviving spouses;
- $287,650 for heads of household; and
- $156,900 for marrieds filing separately.

Since this rule has been repealed, some affected higher-income taxpayers who still itemize may be incentivized to increase their charitable giving and enjoy a slightly more generous tax deduction. Charities can only hope this theory holds true.

Cash Contribution Limits

Background/Prior Law

Deductions for charitable donations are generally limited based on a complex set of factors that depend on the type of charity, the nature of the contribution (whether it is "to" or "for the use of" a charity), and what type of property is donated (e.g., capital gain property).

The limits apply as a percentage of a taxpayer's "contribution base"—that is, the taxpayer's adjusted gross income (AGI) without any deduction for net operating loss carrybacks to that year. (In some situations, taxpayers can elect a higher ceiling for contributions of capital gain property if they reduce the amount of their contributions.)

Before the TCJA, the limits were:

- Taxpayers could deduct contributions "to" the following charitable organizations (called "50 percent charities") up to 50 percent of their contribution base:
  - Churches;
  - Educational organizations or state college and university foundations;
  - Hospitals and medical research organizations;
  - Agricultural research organizations;

- Government bodies;
- Publicly supported organizations;
- Certain membership and other broadly supported organizations;
- Supporting organizations; and
- Certain private foundations.

- Contributions "for the use of" the 50 percent charities, and contributions "to" or "for the use of" any charitable organization that is not a 50 percent charity (called "30 percent charities"), were deductible up to 30 percent of the taxpayer's contribution base.

If a taxpayer's charitable contributions in any tax year exceeded the allowable limitation, the excess could be carried forward for up to five years, subject to the taxpayer's contribution limits in future years. Carryforwards retained their initial category of percentage limitation.

TCJA

The TCJA has made several changes to this framework. For cash donations—only cash—"to" 50 percent charities, the TCJA has increased the limitation from 50 percent to 60 percent of a taxpayer's contribution base.

Additionally, cash contributions taken into account for purposes of applying the 60 percent limit are not taken into account again in applying the 50 percent limit for non-cash contributions. However, both the 30 percent and 50 percent (now non-cash) limits are applied by reducing them to take into account the aggregate cash contributions allowed under the 60 percent limit. Taxpayers can still carry forward amounts in excess of the contribution limits for up to five tax years—so long as the taxpayer's contributions in those years fall within the contribution limits, taking into account the carryovers.

An example of the new framework may be helpful. Assume taxpayer X has a contribution base of $100,000. X's cash contribution limit "to" a 50 percent charity is $60,000 (60% of $100,000) and X's general limit on contributions "for the use of" that charity is $30,000 (30% of $100,000). However, the $30,000 limit must be reduced by any cash contribution X actually makes to the charity. If X donates $25,000 in cash to the charity and a car worth $10,000 for the use of the charity, X's $30,000 "for the use of" limit is reduced by the $25,000 cash donation. As a result, X can only deduct $5,000 of the value of the car in the current year and must carry forward the remaining $5,000 to future years.

These changes are in effect for tax years after 2017 and before 2026.

Congressional committee reports state that the purpose for increasing the cash contribution limit was to encourage charitable giving in order to ensure that the charitable sector of the U.S. economy thrives. That is somewhat ironic given the other changes wrought by the TCJA will

most likely reduce charitable giving.

Planning Tips

This rule makes it more complicated for donors who give both cash and noncash gifts ("to" and "for the use of" charities, respectively). Taxpayers and their advisors should plan carefully to ensure the correct amounts are deducted and carried forward, and the necessary records are maintained.

College/University Contributions in Exchange for Seats at Athletic Events Not Deductible

Background/Prior Law

Generally, donors are not entitled to an itemized deduction for charitable contributions to the extent they receive a benefit or value in exchange for their donation (i.e., a *quid pro quo*). A deduction is generally only allowed for the donation amount in excess of the value of any benefit received.

Pre-TCJA, a special exception to this general rule existed for certain donations to colleges and universities if a taxpayer made an otherwise deductible payment and, as a result, received the right to buy tickets for seating at athletic events held in the school's stadium. For such quid pro quo "donations," the taxpayer could deduct 80 percent of the amount donated. The 80 percent limit only applied to payments in exchange for the right to purchase tickets. Any payment for actual tickets was excluded and nondeductible. This deduction was allowed regardless of whether the taxpayer could have readily bought the tickets separately, and even if the taxpayer received the right to purchase premium seats.

This exception to the quid pro quo rule effectively allowed college athletic departments to require season ticket holders to make "donations" for the right to buy season tickets at sporting events—over and above the cost of the tickets themselves—and the "donor" was allowed to deduct 80% of the "donation." Because donors could deduct 80% of the "donation," colleges started to hold down the cost of the season tickets while increasing the required "donation amounts," which benefited the donors. As the practice grew, it wasn't unheard of for the required "donation" amount to exceed the cost of the underlying ticket prices. For good seats, the required "donation" could easily be a multiple of two or more times the cost of the underlying game tickets.

From an economic and funding standpoint, since a substantial portion of the underlying season ticket package cost was deductible, colleges could effectively charge more in the aggregate than they could if the required "donation" wasn't deductible. That is, fans are more likely to spring for season tickets that cost several thousand dollars if they can write off much of the total cost. This was a big taxpayer give-away to college athletic programs. But no more.

TCJA

The TCJA eliminates the prior exception to the quid pro quo rule. For tax years starting after 2017, no charitable deduction is allowed for payments to colleges and universities where the donor receives the right to buy tickets or seats at an athletic event. Colleges and universities may charge separately for such rights, but sports fans can no longer deduct the payment. Ouch!

Planning Tip

Donors, colleges and universities alike should consider separating donative transactions from transactions surrounding rights to purchase premium tickets or seats. Colleges and universities may continue to charge separately for the latter, but they should alert their sports fans about the loss of the deduction and encourage potential donors (sports fans or otherwise) to make charitable donations unconnected to the ticket rights. We assume regulations will be issued by Treasury to clarify these new rules. IRS enforcement in this area may intensify to police likely attempts to circumvent the rules. Stay tuned!

Estate and Gift Tax Changes

Background and Prior Law

Pre-TCJA, each individual had a combined lifetime exemption (called the "unified credit") under the federal and estate and gift transfer tax regimes that allowed up to $5 million (as adjusted for inflation in years after 2011) to be transferred tax free by gift or inheritance. The chart below sets forth the exemption amounts and inflation adjustments under prior law: **Amounts Exempt from Tax Pre-TCJA Law (2011) Pre-TCJA Law (2017, adjusted for inflation) Individuals** $5 million $5.6 million **Married Couples** $10 million $11.2 million

Many people with taxable estates (that is, estates worth more than the exemption amounts) use charitable giving as one means of reducing the value in their estates subject to tax.

TCJA

The TCJA temporarily doubles the amount of the exemption. For decedents dying and gifts made after 2017 and before 2026, the TCJA doubles the base estate and gift tax exemption amount from $5 million to $10 million, and that amount is indexed for inflation after 2011, as set forth below: **Amounts Excluded from Tax TCJA (indexed back to 2011) TCJA (2018, adjusted for inflation) Individuals** $10 million $11.2 million **Married Couples** $20 million $22.4 million

The increased exemption expires at the end of 2025, unless Congress extends it.

A related transfer tax called the generation-skipping transfer (GST) tax is designed to prevent avoidance of estate and gift taxes by transfers of wealth which skip a generation. The TCJA doesn't specifically mention generation-skipping transfers, but since the exemption from the GST is this same basic exclusion amount, generation-skipping transfers will benefit from the increased exclusion.

Planning Tip

Charities should understand that by doubling the amounts excluded from estate tax, Congress has removed or reduced the tax incentive for taxpayers to make charitable gifts (i.e., in lieu of gifts to family). The precise financial impact of this change on charitable organizations is not yet known, but charitable organizations should expect and plan for this additional reason for uncertainty in the coming years with respect to funding.

For all individual taxpayers affected by this change, given its enormity, this is a good time to revisit existing estate plans to determine whether changes are appropriate.

Planning Tips on Funding Matters

The changes to the standard deduction and the estate tax will likely reduce charitable giving nationwide. Many, if not all, charitable organizations will be impacted. To stay afloat during unpredictable times, charitable organizations should refocus on their missions and their donor marketing efforts. Now is the time to think creatively about how to reach out to passionate donors who are likely to support charitable organizations regardless of whether they receive a corresponding personal tax benefit.

We will continue to report on the TCJA and its impact on taxpayers. Stay tuned!

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[1] This requirement is defined in reference to IRC Section 511(a)(2)(B), which refers to colleges and universities that are: (1) agencies or instrumentalities of any government or political subdivision; (2) owned or operated by a government or political subdivision; and (3) any corporation that is wholly owned by one or more such colleges or universities.

Tags: athletic events, charitable contributions, charitable organizations, college and university endowments, Decoding the Tax Cuts and Jobs Act, deductions, donations, donors, employee fringe benefits, estate & gift tax, excise tax, executive compensation, Internal Revenue Code, Internal Revenue Service, itemized deductions, standard deductions, Tax Cuts and Jobs Act, Tax Reform, unrelated business taxable income