BDO KNOWS: **TAX REFORM**

Tax Reform - The Effect on Nonprofits

January 2018

BDO

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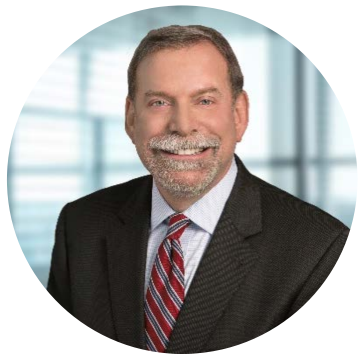

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Agenda

- Introduction and general parameters of tax reform
- Provisions that impact Charitable Giving
- Excise tax on Endowments of Colleges and Universities
- Excise tax on Executive Compensation
- Inclusion of certain Fringe Benefits in the calculation of UBTI
- Corporate and trust provisions
- UBIT Silos
- Tax exempt bonds
- Some additional provisions
- Questions and answers

Path to 2017 Tax Cuts and Jobs Act

- Tax reform: A priority of this and prior Congresses
- Concepts and framework have been brewing for several years
- 10-year Senate Reconciliation rules becoming a major factor in tax legislation
- Bullets that Nonprofit organizations dodged:
  - Taxation of royalties and certain research
  - Changes to deferred compensation
  - Changes to exclusion of housing provided for the "convenience of"
  - Expansion of the reach of Intermediate Sanctions to 501(c)(5) and (6) orgs
  - Elimination of the Rebuttable Presumption of Reasonableness
  - Elimination of the Estate Tax
  - Repeal of the Johnson Amendment
  - Elimination of Private Activity Tax Exempt Bonds

What's Next

- Treasury and the IRS have their work cut out
  - With a year reprieve for many provisions
- Regulatory and other guidance
- Joint Committee on Taxation Bluebook
- Technical corrections?
- 10-year sunset of most provisions
- CAUTION - THE LAW IS BEING ANALYZED AND IS SUBJECT TO INTERPRETATION

Provisions that Impact Charitable Giving

- *Estate and Gift Taxes* – Beginning in 2018, the exemption for estate and gift taxes is increased to $11,200,000 per taxpayer (indexed for inflation).
- *Ordinary income tax rates* - The current seven tax bracket system is retained, but the rates are lowered for all taxpayers and the thresholds are adjusted
- *The standard deduction* is increased to the following amounts:
  - Married Filing Jointly: $24,000
  - Head-of-Household: $18,000
  - All Other Taxpayers: $12,000
- *State and local tax deduction* --Limited to $10,000 (income, property, sales and use, etc.)

Charitable Contributions--Itemized Deductions

- Four modifications:
  - (1) Cash contributions to public charities now have a 60 percent of AGI limitation (previously it was 50 percent).
  - (2) Denial of charitable deduction for payments made in exchange for athletic seating rights (previously able to deduct 80 percent of amounts paid).
  - (3) Removal of substantiation exception for certain contributions reported by the charitable organization.
  - *(4) "Pease" Limitation Repealed* – The overall limitation on itemized deductions removed through 2025.

Charitable Giving

- Reduces Incentives for Charitable Giving by:
  - Doubling the Standard Deduction
  - Capping the State and Local Tax Deduction to $10,000
  - Doubling Estate Tax Exemptions
  - Repealing the deduction for Tickets to College Athletic Events
- Increases the Incentives for Charitable Giving by:
  - Repealing the “Pease” Limitation
  - Increasing the Charitable Contribution Deduction Limit
- Overall impact?

College and University Endowment Tax

IRC Sec. 4968, as added by 2017 Tax Cuts and Jobs Act §13701(a)

Imposes a tax of 1.4-percent on the net investment income of a private college or university which had:

- At least 500 tuition-paying students during the preceding taxable year and
- the aggregate fair market value of the assets (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
- more than 50% of the students are located in the US

Expected to impact only 30 to 60 institutions

Endowment Tax (continued)

- “Net investment income" is determined under rules similar to the rules of IRC Sec. 4940(c)
  - Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income.
- A college or university’s assets include the assets and net investment income of "related organizations“. An organization is treated as related to the institution for this purpose if the organization:

(1) controls, or is controlled by, the institution;

(2) is controlled by one or more persons that control the institution; or

(3) is a supported organization or a supporting organization during the taxable year with respect to the institution.

Excise Tax for Excessive Executive Compensation

- IRC Sec. 4960, as added by 2017 Tax Cuts and Jobs Act §13602(a)
- For employer's tax years beginning after December 31,2017
- "Applicable tax exempt organization" pays an excise tax equal to 21 percent (highest corporate rate) on:
  - Remuneration (other than excess parachute payments) over $1 million during the taxable year; plus
  - Excess parachute payments (even if less than $1 million)

“Applicable Tax-exempt Organization"

Organizations that are subject to the excise tax (IRC Sec. 4960(c)(1))

- Organization exempt from tax under IRC Sec. 501(a) ;
- A farmer's cooperative organization under IRC Sec. 521(b)(1) ;
- Organization with income excluded from tax under IRC Sec. 115(1) (referring to income from states, municipalities, etc.); or
- A political organization under IRC Sec. 527(e)(1)
- Are state schools exempt under IRC Sec. 115(1)?

Excise Tax-Covered Employees

- Covered Employees -Any current or former employee of an applicable tax-exempt organization if
  - One of the five highest compensated employees of the organization for the tax year, or
  - Was a covered employee of the organization, or any predecessor of the organization, for any tax year after Dec. 31, 2016. (IRC Sec. 4960(c)(2))
- Not required to be an officer, director, key employee or one of the “five highest compensated” for purposes of Form 990 reporting
- Once a covered employee always a covered employee, even after termination

Remuneration

- GENERALLY "remuneration" is considered to be wages subject to federal income tax withholding as defined under IRC Sec. 3401(a)
- LESS any designated Roth contribution
- PLUS amounts required to be included in gross income under IRC Sec. 457(f) relating to vested ineligible deferred compensation plans
- EXCEPT for payments to licensed medical professionals, including veterinarians, for the performance of medical or veterinary services

Remuneration Includes Payments by a Related Entity

Remuneration of a covered employee paid by an applicable tax-exempt organization includes amounts paid by a related person or government entity if the person or entity:

- Controls, or is controlled by, the applicable tax-exempt organization;
- Is controlled by a person, or persons, that control the organization;
- Is a supported organization under IRC Sec. 509(f)(3) ;
- Is a supporting organization under IRC Sec. 509(a)(3) ; or
- If the organization is a VEBA under Code Sec. 509(c)(9), establishes,

If remuneration from more than one employer is used to calculate the excise tax, then each employer will be liable for its proportionate share.

Excess Parachute Payments

- Mirrors IRC Sec. 280G
- Definition of excess parachute payment
  - Payment of compensation that is contingent on the employee's separation from employment, and
  - The aggregate present value of the payments equals or exceeds 3 times the employee's base amount
  - Does not include payments
    - From qualified retirement, 403(b) or 457(b) plans
    - To licensed medical professionals for medical services
    - To an individual who is not a highly compensated employee as defined in IRC Sec. 414(q) earning $120,000 for the year

Excess Parachute Payments

- Base amount equals
  - Average of Form W-2 (and Form 1099 compensation) in five (5) calendar years prior to the severance
- If the three (3) times threshold is met,
  - Excise tax rate is applied to payments in excess of one (1) times the base amount
  - Tax is due on a larger amount than the amount over the threshold

Planning

- Review all existing documents and projected payouts
- Identify covered employees based on organization's 2017 tax year and keep cumulative list
- Perform preliminary excess compensation calculations
- Structure arrangements to be under $1 million
  - Consider changes to avoid large vesting in a single year in order to avoid 457(f) inclusion in remuneration (no reduction from extended payouts of vested amounts)
- Excess parachute payments
  - Avoid separation as the only payout trigger (pay at specified age or separation)
  - Extend payout for modest reduction of the present value of parachute payments
  - Provide separation payments up to 2.99% of the base amount
  - Consider provisions to return amounts above the threshold to the employer
  - Increase base amount by recognizing Form W-2 compensation in years prior to termination
  - Fully utilize excludible compensation such as 457(b) and other qualified plans

Inclusion of Certain Fringe Benefits in UBTI

IRC Sec. 512(a)(7), as amended by 2017 Tax Cuts and Jobs Act §13703(a)

- A tax- exempt organization includes as UBTI any amount (i) for which a deduction is not allowed under IRC Sec. 274, and (ii) which is paid by the organization for any qualified transportation fringe, any parking facility used in connection with qualified parking, or any on-premises athletic facility.
  - UBTI does not include the amounts described above to the extent the amount paid or incurred is directly connected with an unrelated trade or business.
- "Qualified transportation fringe" for purposes of IRC Sec. 512(a)(7) is considered to be any of the following provided by an employer to an employee:
  - (A) commuter transportation
  - (B) transit passes;
  - (C) qualified parking;
  - (D) qualified bicycle benefit (may not create UBI)

Effective: For amounts paid or incurred after Dec. 31, 2017

Qualified Transportation Benefits

- Change to employees – taxable to employee for 2018-2025 while IRC Sec. 132(f)(1)(D) is suspended
  - $20 monthly benefit for qualified bicycle commuting reimbursement
- No change to employees - benefits still excludible from employee's income
  - Transportation to and from work in a commuter highway vehicle and passes for mass transit - $260 maximum monthly benefit in 2018 (as indexed for inflation)
  - Qualified parking - $260 maximum monthly benefit in 2018 (as indexed for inflation)
- Only UBTI if deduction excluded under IRC Sec. 274
- IRC Sec. 274 deduction unavailable for benefits provided or reimbursements made to employees as qualified transportation fringe benefits
  - Exceptions: Bicycle commuting reimbursements included in the employee's income
- No authority to support including the benefits in employee's compensation in order to obtain a deduction or to avoid UBIT inclusion
  - To receive a deduction/avoid UBIT, the benefit must be provided via cash payment with out proof of payment for qualified transportation

Athletic facility

Under IRC Sec. 132(j)(4)(B) , an "on premises athletic facility" is any gym or other athletic facility (such as a swimming pool, tennis court or golf course) which is:

- Located on the premises of the employer;
- Operated by the employer; and
- Used, with substantial exclusivity, by the employer's employees, their spouses and their dependent children.

Fringe Benefits-Allocation of expenses

- Treasury may issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of IRC Sec. 512(a)(7), including regulations or other guidance providing for the appropriate allocation of depreciation and other costs with respect to facilities used for parking or for on-premises athletic facilities.
- Query - Can one look to the allocation regulations for “dual-use” facilities and use a “reasonable method” or whether the IRS will take the opportunity to specifically dictate a new method.
- Organizations will have to keep track of whether parking facilities and on-site athletic facilities are used by employees or students or patients or patrons or members or the general public.

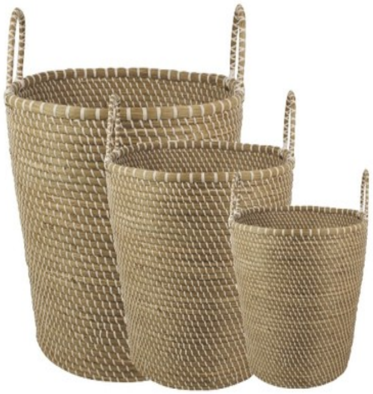
Selected Non-EO Specific Provisions Impacting Computation of Unrelated Income Business Tax

- Tax rates lowered beginning in 2018
  - Corporate rate is 21%
  - Top Trust rate is 37%
- Trusts are allowed the Section 199A deduction on business income
- Corporate AMT repealed
  - Prior AMT Credit allowed against regular tax and is a refundable credit over time
- 100% expensing temporarily allowed for certain business assets
- Business interest expense deduction limited
- Use of net operating losses limited to 80% of taxable income
  - Unlimited carryover to future years of post-2017 losses
- Taxation of international investments/operations radically changed
- State Tax Conformity (“Adjustments”)

Unrelated Trade or Business Income Losses

- The Act disallows tax-exempt organizations from taking the business losses from one unrelated trade or business and deducting them from the income of another unrelated trade or business.
- Organizations could, however, carryforward losses from an unrelated business to reduce income from another year's operation of the same unrelated business.
- Unanswered questions:
  - What constitutes "one unrelated trade or business"?
  - Are passive activities that generate unrelated business income one trade or business (e.g., are alternative investments considered one unrelated trade or business or is each investment a separate unrelated trade or business)?
  - Is trade or business grouped by geography, activity, or management?

Allocation of Expenses



Three baskets of expenses:

- Directly connected to UBI activity--deduct in full—Will need a basket for each unrelated activity
- Directly related to Exempt activity—do not deduct at all (e.g., development officer, government affairs/lobbying, etc.)
- Dual use expenses–allocate on a “reasonable” basis (current rule to allocate overhead and other dual-use expenses between related uses and all unrelated uses--Time, space, other)
- Now will have to allocate multi-use expenses among related uses and each unrelated activity

Tax Exempt Bonds

- The Act repeals the exclusion from gross income of interest on a bond issued to advance refund another bond
- Prior to the change each tax-exempt bond issue was permitted to be advance refunded once
- The ability to currently refund bonds remains in place
- Change is effective for advance refunding bonds issued after December 31, 2017
- May result in changes to how tax-exempt bond issues are structured

Other Provisions Impacting Employers and Employees

- Achievement awards
  - Clarifies cash & equivalents and non-tangible property (e.g., theatre tickets) awarded for long service/safety achievement are included in income
- Qualified bicycle commuting reimbursements
  - Suspends exclusion from gross income for periods for 1/1/2018 – 12/31/2026
- Qualified moving expenses (employer-paid)
- Suspends exclusion for 1/1/2018 – 12/31/2026
- Denial of deduction for dues with respect to membership in any club organized for business, pleasure, recreation or other social purposes

Employer Credit for Paid Family and Medical Leave

- Allows employers to claim a credit equal to 12.5 percent of the amount of wages paid to employees during a family and medical leave
  - Pay must be at least 50 percent of wages normally paid to the employee
  - Credit is increased 0.25 percent (up to 25 percent) for each 1 percent by which the rate of pay exceeds 50 percent
  - 12 weeks maximum duration each taxable year
- Any leave which is paid by a state or required by state law will not be taken into account in determining the amount of paid family and medical leave provided by the employer
- Program sunsets on December 31, 2019

Summary of Impact of Tax Cuts and Jobs Act on EOs

- Charities should review their donor base to determine how to focus giving campaigns
- Nonprofits should review compensation arrangements, including compensation from related organizations, that could be impacted by the new excise tax on excess compensation. Planning opportunities may exist.
- Nonprofits should review transportation benefits; establish a system to determine who uses parking facilities besides employees and consider whether cash payments to employees for parking may provide a better solution than paying UBIT.
- Nonprofits will have to separate out different unrelated activities and establish systems for tracking expenses.

Q&A

Questions?

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