

HOW WILL TAX REFORM AFFECT NONPROFITS?





PRESIDENT TRUMP SIGNED THE TAX CUTS AND JOBS ACT INTO LAW ON DECEMBER 22, 2017. WHILE THE LAW DOES NOT SIMPLIFY THE TAX CODE, IT IS EXPECTED TO CAUSE SOME CHALLENGES FOR MOST IN THE NONPROFIT INDUSTRY.

The sweeping changes made by the 2017 Tax Cuts and Jobs Act, impacts nearly all taxpayers. Nonprofit organizations are also affected by the legislation.

Here's how:

- » Changes the computation of unrelated business taxable income (UBTI) if an organization has more than one unrelated trade or business
- » Increases UBTI by the amount of certain fringe expenses for which a deduction is disallowed
- » Imposes a 21% excise tax on compensation over \$1 million for the five highest paid employees
- » Imposes a 1.4% excise tax on net investment income of certain educational institutions
- » Modifies the rules for charitable contributions:

Repeals the special rule in Code Sec. 170(l) that provides a charitable deduction for the amount paid for the right to purchase tickets for athletic events;

Repeals the Code Sec. 170(f)(8)(D), effectively ensuring that donee organizations will not be allowed or required to report details of donations of \$250 or more

Increases the 50% limitation under Code Sec. 170(b) for cash contributions to public charities and certain private foundations to 60%

Suspends the overall limitation on itemized deductions

Unrelated Business Taxable Income

Sec. 13702 of the Act amends Code Sec. 512(a). Previously, the gross receipts from any unrelated trade or business regularly conducted were netted together to determine UBTI. If, for example, an organization conducts unrelated business A for a profit, and the organization also conducts unrelated business B and gross income less cost of goods sold is a loss, the previous rules allowed the organization to net the activity from A and B. The income from A would be reduced by the loss from B in calculating UBTI.

The new rules do not allow the two trades or businesses to net. The income from A will be reported and the loss from B will create a net operating loss to carry forward and only be applied to future UBTI generated by B. The specific deduction of \$1,000 in computing UBTI is maintained, but is not included in determining the separate UBTI calculation of each unrelated trade or business.

This new rule applies to tax years beginning after December 31, 2017. Any net operating loss from tax years beginning before January 1, 2018, can be carried forward and applied to any income in subsequent years, regardless of which trade or business created it.

Organizations must carefully consider if their activities constitute more than one unrelated trade or business and report accordingly going forward. It is likely that the overall tax burden will increase for exempt organizations, as gains from one unrelated trade or business can no longer be offset by the losses from another unrelated trade or business. Organizations should give careful consideration to restructuring or moving activities to taxable subsidiaries and consider all the possible implications.

In addition, UBTI is changed by Sec. 13703 of the Act. Previously, organizations could provide employees with transportation fringe benefits and on-premises gyms and other athletic facilities. Employees did not have to include those amounts in their taxable income and there was no tax effect for nonprofits (for-profit entities could deduct these expenses from their taxable income).

Under the new provision, the amounts paid for such benefits will be included in unrelated business taxable income, effective for amounts paid or incurred after December 31, 2017. For-profit entities will no longer be able to deduct these costs. The effect is that for-profit entities and nonprofit organizations will be treated the same, both paying tax on these transportation fringe benefits and on-premises gyms and other athletic facilities provided to their employees.

With the overall reduction of the corporate tax rate to 21%, exempt organizations who already pay tax on UBTI could benefit from the lower tax rate.





WITH THE OVERALL REDUCTION OF THE CORPORATE TAX RATE TO 21%, EXEMPT ORGANIZATIONS WHO ALREADY PAY TAX ON UBTI COULD BENEFIT FROM THE LOWER TAX RATE.

Excise Tax

Sec. 13602 of the Act adds Code Sec. 4960. Currently, taxable employers face deduction limits regarding excess compensation. Until now, exempt organizations have not had comparable rules. The new provision subjects tax-exempt organizations to a 21% excise tax on the sum of:

- 1) the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of \$1 million, plus*
- 2) any excess parachute payment paid by such an organization to any covered employee.*

Remuneration is treated as paid when there is no substantial risk of forfeiture. It includes any remuneration paid by a related entity, but does not include amounts paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.

An excess parachute payment is the excess amount of any parachute payment over the portion of the base amount. A parachute payment is any compensation paid to or for a covered employee if the payment is contingent on their separation from employment and the aggregate present value equals or exceeds three times the base amount. The base amount is the annualized includible compensation for the most recent five taxable years ending before the date of separation (see Section 280G(b)(3)).

An applicable tax-exempt organization includes an organization exempt under Section 501(a), an exempt farmers' cooperative, a federal, state or local governmental entity with income excludable under Section 115, or a Section 527 political organization.

A covered employee includes the five highest compensated employees (including former employees) for the taxable year, or a covered employee for any previous taxable year beginning after December 31, 2016.

This provision will have a significant impact on covered organizations with highly compensated individuals. Such organizations need to assess the total compensation for their executives and closely monitor the amount and timing of compensation payments.



It's important to note that once an employee is a covered employee, they remain a covered employee. And, even if a covered employee's compensation does not exceed \$1 million, excise tax would apply to the excess parachute payment for such an employee. Impacted organizations will want to keep a close eye on additional details sure to develop.

Sec. 13701 of the Act adds Section 4968. Previously, the excise tax imposed by Code Sec. 4940 on the net investment income of private foundations did not apply to public charities, including colleges and universities that may have had substantial investment income. Going forward, certain private colleges and universities will be subject to a 1.4% excise tax on their net investment income.

Institutions subject to the excise tax include:

- 1) those with more than 500 daily average full-time students in the preceding taxable year and*
- 2) those with an aggregate fair market value of assets (other than those assets which are used directly in carrying out the institution's exempt purpose) of more than \$500,000 per student at the end of the preceding tax year.*

In addition, assets and net investment income of related organizations would be treated as assets and net investment income of the institution. The new provision applies to taxable years beginning after December 31, 2017.



Charitable Contributions

- » **Sec. 13704** of the Act changes Code Sec. 170(l). Previously, individuals could deduct 80% of the amounts paid to colleges and universities which includes the right to purchase tickets for seating at an athletic event in an athletic stadium of such an institution.
The changes disallow the deduction for the portion paid in exchange for the seating rights, effective for contributions made in taxable years beginning after December 31, 2017.
- » **Sec. 13705** of the Act changes Code Sec. 170(f)(8). This section disallows a deduction for any contribution of \$250 or more unless it is substantiated by a contemporaneous written acknowledgment.
Previously this did not apply to a contribution if the donee organization filed a return which included the required information. This change ensures that there is no possibility of regulations that would allow or require charities to report details of donations of \$250 or more.
- » **Sec. 11023** of the Act changes Code Sec. 170(b)(1). Individuals may deduct charitable contributions limited to 50%, 30% or 20% of their adjusted gross income. The deduction class depends on the donee organization's classification and the type of property.

The new regulations increase the 50% limitation to 60% for cash contributions to public charities and certain private foundations. Amounts exceeding 60% of adjusted gross income can be carried forward for five years. This change may provide an incentive to donors to make significant gifts after December 31, 2017, and before January 1, 2026.

This may help exempt organizations that are nervous about how the higher standard deduction for individuals will affect charitable giving in the future. Because the standard deduction is nearly doubled, fewer taxpayers will itemize and be able to see a tax benefit from charitable donations.

- » **Sec. 11046** of the Act indirectly affects charitable contributions and suspends Code Sec. 68 for taxable years beginning after December 31, 2017, and before January 1, 2026. Previously, this section limited the overall itemized deductions for higher-income taxpayers. This may provide some taxpayers an incentive to donate larger amounts to exempt organizations.



Conclusion

Several changes included in the 2017 Tax Cuts and Jobs Act will directly impact nonprofits, and several will have an indirect impact. Changes to the calculation of UBTI include disallowing organizations to net profits and losses from more than one unrelated trade or business, as well as increasing UBTI by the amount of certain fringe expenses. Excise tax changes include imposing a 21% excise tax on compensation over \$1 million for the five highest paid employees and imposing a 1.4% excise tax on net investment income of certain educational institutions.

The far-reaching tax law changes also impact charitable contributions by repealing the special rule that provides a charitable deduction for the amount paid for the right to purchase tickets for athletic events; ensuring that donee organizations will not be allowed or required to report details of donations of \$250 or more; increasing the 50% limitation for cash contributions to public charities and certain private foundations to 60%; suspension of overall limitation on itemized deductions; and increasing the standard deduction.

Some of these changes will be easy for organizations to quantify but, for others, only time will tell. Exempt organizations should consult with their tax professional to determine exactly how their particular situation will be impacted and what actions they should take to mitigate their tax consequences. Organizations may also need to explore new ways to garner contributions from individual taxpayers. It's imperative that exempt organizations keep up to date on additional regulations that are likely to result from these tax law changes.

About the Author

Mary Kreider, CPA

989.793.9830 | markre@yeoandyeo.com



Mary is a manager at Yeo & Yeo CPAs. She provides business consulting, financial reporting and tax planning and preparation services with a focus on nonprofit organizations. She is a member of the firm's Nonprofit Services Group and has 12 years of public accounting experience. She is based in the firm's Saginaw office.

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