

2018 Tax Update for Exempt Organizations

2017 Tax Act — Changes and Implications

Unrelated Business Income (UBI)

Understanding UBI

The underlying rationale is that business activities of exempt organizations should not have any unfair advantage over for-profit businesses.

- ▶ UBI is taxed using corporate tax law
- ▶ Proceeds from an activity are UBI if the activity involves trade or commercial activity, if it is regularly carried on and if it is not substantially related to the organization's exempt mission
- ▶ Activities specifically excluded:
 - Activities where substantially all (85%) work is performed by volunteers
 - Activities performed primarily for convenience of organization members, students, patients or employees
 - Sales of donated merchandise
 - Certain bingo games
- ▶ Allowable deductions on Form 990-T:
 - Must have a proximate and primary relationship to the business
 - Costs of facilities and personnel used for both exempt and non-exempt activities must be allocated on a "reasonable basis" (Note that IRS has been promising "safe harbor" calculation methods for years in its Priority Guidance Plan, but that guidance has not yet been published)
 - Net operating losses can be claimed consistently with corporate tax law

2017 Changes in UBI Rules

- ▶ New 21% tax rate (use blended rates for FY2018)
- ▶ Silo approach to claiming losses — each separate business must be calculated individually, and losses in one cannot offset income from another
 - How does IRS define a separate trade or business? What about partnerships?
 - How can expenses be allocated among separate businesses? The current standard is that they can be allocated on a "reasonable basis".
 - IRS has the allocation of dual-use facilities between exempt and UBI activities on its Priority Guidance Plan.

Interim Guidance Released August 21, 2018 — Notice 2018-67

Notice 2018-67 addresses UBI issues related to defining “trade or business,” determining when businesses are separate and deducting net operating losses (NOLs).

- ▶ **Defining “trade or business.”** Until proposed regulations are issued, exempt organizations may rely on a “reasonable, good-faith interpretation” of the statutes to determine whether it has one or more unrelated trades or businesses. Such interpretations may include grouping businesses based on 6-digit NAICS codes.
- ▶ **Partnership interests owned by exempt organizations.** The interim guidance offers some tests and guidelines for determining when partnership income must be treated as UBI.
 - De minimis test — Does the organization hold no more than 2% of profits and own no more than 2% of capital? Taxpayers can use the average of the beginning and ending ownership percentages on their Form K-1s to calculate these percentages
 - Control test — Does the organization hold 20% or less of the capital interest? Does it have control or influence over the partnership?
 - Transition rule — Exempt organizations can treat partnership interests acquired before August 21, 2018, as comprising a single trade or business
 - An exempt organization may aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as single trade or business
- ▶ **Net operating losses (NOL)**
 - NOL carryovers from tax years that began before January 1, 2018, are deducted from taxable income without regard to the silo rules
 - After January 1, 2018, there is no carryback period; however losses can be carried forward indefinitely
 - Notice 2018-67 on NOLs
 - Later losses (2018 and later) must be claimed before earlier losses
 - Some key questions remain involving carrying losses and the limitation of losses to 80% of taxable income
- ▶ **Fringe benefit rules**
 - For-profit businesses can no longer deduct costs related to mass transit passes or parking that are excluded from income by their employees.
 - For exempt organizations, **parking and transportation expenses (after 1/1/2018) will be treated as UBI**
 - There are many unanswered questions, such as how an organization calculates this UBI amount for
 - parking facilities owned by the exempt organization
 - free spaces provided under a building lease
 - parking that is free to employees but paid by visitors
 - These issues are not on the IRS Priority Guidance Plan, but IRS is working on providing guidance

- Alternatives:
 - Make estimated tax payments and file fiscal year returns based on your best estimate of the UBI value
 - Include that best estimate in the employee's W-2
- My recommendation:
 - Pay the tax as the organization, instead of passing it onto employees
 - If the valuation is wrong, you have to amend numerous W-2s
 - For employees paid less than the FICA limit, payroll tax alone is 15.3% (compared to 21% UBI rate)
 - Employees making more than the FICA limit are likely to have marginal tax rates greater than 21%

Excise tax on executive compensation

A 21% excise tax will be imposed on "covered employees" who meet **three conditions**:

- ▶ Current and former employees who are/were:
 - One of the five highest compensated employees in the tax year
 - A covered employee for any year beginning after December 31, 2016
- ▶ Employees of specific exempt categories:
 - 501(b) and 501(c) organizations
 - Government entities, *except* state governments or those with sovereign powers (taxing authority, police power or ability to claim eminent domain)
 - Farmers' cooperatives
 - 527(e)(1) political organizations
- ▶ Employees receiving either:
 - Compensation above \$1 million (not including payment for medical or veterinary services performed directly by the employee)
 - Parachute payments contingent on the employee's separation and three times the base compensation or more, *not* including:
 - Payments under a qualified employee benefit plan, SEP, or Simple plan
 - Annuity contracts under 403(b) or 457(b) plans
 - Payments for medical or veterinary services performed by the individual
 - Payments to someone who is not highly compensated

Excise tax for certain private colleges

Private colleges with 500 or more full-time paying students and endowment assets of \$500,000 per student will be charged an excise tax of 1.4% net investment income. Guidance on this change is not on the IRS Priority Guidance Plan.

However, on June 8, 2018, IRS published Notice 2018-55.

- ▶ No capital loss carryovers or carrybacks will be allowed
- ▶ Basis cannot be less than fair market value on December 31, 2017, plus or minus basis adjustments
- ▶ IRS currently expects that related entities can use a loss by one entity to offset a gain by the other, but is requesting comments

Substantiation Regulations

No longer sufficient substantiation:

- ▶ A blank pledge card for the donor to fill in
- ▶ A fully completed Form 8283

What might happen next?

Pending action from Congress

- ▶ Competing priorities may prevent Congress from enacting technical fixes before year-end
- ▶ House leaders are working on additional tax cuts, separate from any fixes to the 2017 bill

Proposed legislation affecting charitable giving

- ▶ Universal Charitable Giving Act: Allows deduction of up to 1/3 the standard deduction for taxpayers who don't itemize
- ▶ Charitable Giving Tax Deduction Act: Creates an above-the-line charitable deduction with no cap
- ▶ Legacy IRA Act: Extends the rollover law to include gifts of up to \$400,000 to charitable remainder trusts and charitable gift annuities. The \$400,000 must be reduced by any IRA funds donated to an operating charity of up to \$100,000.
- ▶ Partial repeal of Johnson Amendment: Bans IRS from rescinding tax-exempt status of politically active churches without approval of the IRS Commissioner